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New BDC Opportunities: How the Passage of the Small Business Credit Availability Act Will Benefit Both New and Existing Business Development Companies

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After years of intense regulatory and legislative efforts, the business development company ("BDC") industry earned a potentially significant win in the form of the Small Business Credit Availability Act ("SBCAA"), which was included as part of the Consolidated Appropriations Act, 2018 ("Omnibus Spending Bill") passed by Congress on March 23, 2018. The SBCAA enacts a number of meaningful legislative reforms with respect to BDCs — closed-end investment companies regulated under the Investment Company Act of 1940 ("1940 Act"), that generally invest in the debt, and to a lesser extent equity, of primarily U.S.-based, nonpublic middle-market issuers.

Specifically, the SBCAA impacts BDCs in two fundamental ways. First, it significantly increases the ability of BDCs to utilize leverage to acquire investments by modifying the asset coverage requirements applicable to BDCs under the 1940 Act ("Leverage Reform Provisions"). Second, it directs the SEC to implement regulations enabling BDCs to follow the more lenient reporting requirements and communications restrictions under the Securities Act of 1933, as amended ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act") applicable to traditional public operating companies, including with respect to incorporation by reference and the use of free writing prospectuses (collectively, "Securities Offering Reform Provisions").

These changes will likely have a significant impact on BDCs going forward, though the impact may differ materially between existing publicly traded BDCs and newly formed non-traded BDC structures, including the increasingly popular "private" BDC structure, which mimics a traditional private credit fund capital call model but utilizes a 1940 Act-regulated BDC vehicle. In particular, as a result of certain conditions that must be met under the Leverage Reform Provisions, existing BDCs — particularly publicly traded ones — will likely face some headwinds in taking advantage of the looser leverage limits under the 1940 Act. However, newly formed BDCs, as well as private BDCs that may only have a relatively small number of stockholders, may more easily meet the requirements to permit a reduction in the required asset coverage ratio under the 1940 Act. In contrast, many of the most useful sections of the Securities Offering Reform Provisions, including with respect to incorporation by reference and automatic effectiveness of shelf registration statements, will only apply to publicly traded BDCs.

Overview of the Leverage Reform Provisions

Under the 1940 Act, BDCs must generally meet certain levels of asset coverage with respect to their outstanding "senior securities," which typically consist of outstanding borrowings under credit facilities and other debt instruments, including publicly and privately offered notes. "Asset coverage," as defined under the 1940 Act, generally refers to the ratio of a BDC's total assets compared to its aggregate amount of outstanding senior securities.[1] Prior to the passage of the SBCAA, the 1940 Act required that a BDC have asset coverage of at least 200 percent, representing approximately a 1-to-1 debt-to-equity ratio, at the time of any borrowings or other issuances of senior securities.[2] Under the Leverage Reform Provisions of the SBCAA, BDCs that meet certain specified conditions may elect to decrease their effective asset coverage requirement to 150 percent, representing approximately a 2-to-1 debt-to-equity ratio, which substantially increases their ability to deploy leverage to acquire investments.[3] A BDC may elect to be subject to the lower asset coverage requirement in two ways.

First, the BDC can seek the approval of its board of directors, including a majority of its directors who are not "interested persons" of such BDC, as such term is defined under the 1940 Act (i.e., the BDC's independent directors), in order to opt in to the lower asset coverage requirement; *provided* that:

- The lower asset coverage ratio will not take effect until one year following receipt of such board approval; and
- If the BDC does not list its shares on a national securities exchange, it must offer to repurchase all of its then-outstanding shares from the holders thereof as of such approval date, with a maximum of 25 percent of such outstanding shares subject to repurchase therefrom in each of the following four quarters.

Second, the BDC can seek the approval of a majority of the *votes cast* by its stockholders at an annual or special meeting thereof at which a quorum is present in order to opt in to the lower asset coverage requirement. Notably, if a BDC receives the requisite stockholder approval, the lower asset coverage ratio may take effect immediately following the date of such approval.

In either case, a BDC must file a current report on Form 8-K within five business days of such approval indicating the receipt of such approval and the effective date of the applicability of the lower asset coverage ratio to the BDC. Thereafter, a notice must be included on such BDC's website, as well as in its periodic filings with the SEC, indicating:

- That it has elected to be subject to the reduced asset coverage requirements; and
- The aggregate value of senior securities issued by such BDC and the asset coverage ratio as of the date of such BDC's most recent financial statements.

To the extent a BDC lists its shares on a national securities exchange, it must also include disclosures in its future periodic filings reasonably designed to ensure that stockholders are informed of:

- The amount of indebtedness and asset coverage ratio of such BDC, determined as of the date of financial statements dated as of or most recently prior to such periodic filing; and
- The principal risk factors associated with such indebtedness.

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[1] *See* Section 18(h) under the 1940 Act.

[2] *See* Section 61(a) under the 1940 Act. Notably, the 200 percent asset coverage requirement already permits BDCs to utilize twice as much leverage as traditional registered closed-end funds. *See,* e.g., Section 18 under the 1940 Act.

[3] *See* Section 802 of the SBCAA, amending Section 61(a)(2) of the 1940 Act.

Overview of the Securities Offering Reform Provisions

Federal securities laws impose various filing and disclosure requirements on public operating companies in connection with public offerings, as well as restrictions on the timing and nature of communications with stockholders or prospective investors. Over the years, however, the SEC has relaxed those requirements and restrictions for certain public operating company issuers, most notably with respect to incorporation by reference in Securities Act filings, as well as with respect to the use of free writing prospectuses in connection with public offerings. Up until now, however, BDCs were unable to avail themselves of the relaxed requirements and restrictions applicable to public operating companies.

The Securities Offering Reform Provisions set forth in the SBCAA seek to change this by requiring that the SEC — within a year from the passage of the SBCAA — implement regulatory changes designed to provide BDCs with access to the same relaxed requirements and restrictions that are available to public operating companies currently under federal securities laws.[4] Among other things, the Securities Offering Reform Provisions seek to modify a number of existing Securities Act exemptions relating to both oral and written communications to either specifically include BDCs among eligible issuers or, alternately, remove them from the list of excluded issuers in such rules. As a result, BDCs will have essentially the same flexibility as public operating companies in communicating with prospective investors using free writing prospectuses and other means without violating the Securities Act. For example, BDCs will now have access to:

- Rules 168 and 169 under the Securities Act, which allow reporting and non-reporting operating company issuers, respectively, to disseminate certain factual information about the company and make certain forward-looking statements, subject to certain conditions;
- Rule 163A under the Securities Act, which permits public operating companies to make certain communications before filing a registration statement, as long as they are made more than 30 days prior to the filing of a registration statement and certain other conditions are met;
- Rule 163 under the Securities Act, which allows certain large public operating companies, known as well-known seasoned issuers ("WKSIs"), to make certain unrestricted offers prior to filing a formal registration statement, through the use of free writing prospectuses, as long as a certain conditions are met; and
- Rule 164 under the Securities Act, which provides a safe harbor for the use of free writing prospectuses.

More importantly for many publicly traded BDCs, the Securities Offering Reform Provisions require that the SEC implement changes to the registration process for BDCs under the Securities Act to permit BDCs to utilize a process similar to that utilized by exchange-listed public operating companies under Forms S-3 and F-3. Specifically, while publicly traded BDCs have historically been permitted to utilize a "shelf" registration process for follow-on equity offerings under existing SEC staff guidance, the Securities Offering Reform Provisions seek to codify that ability, while also enabling publicly traded BDCs with sufficient market capitalization to take full advantage of the "short form" registration process available to certain public operating companies that file shelf registration statements using Forms S-3 and F-3. In particular, BDCs that meet the Form S-3 eligibility requirements should have the ability, at a minimum,

[4] *See* Section 803 of the SBCAA.

to incorporate by reference previously filed Exchange Act reports in lieu of including duplicative disclosure in their shelf registration statements filed on Form N-2. In addition, while the applicable provision of the SBCAA fails to specifically call for the ability to forward-incorporate by reference future Exchange Act filings as permitted under Forms S-3 and F-3, the intent of the language in the SBCAA appears to clearly contemplate applying forward-incorporation by reference to BDCs as well.[5] As a result, once implemented by the SEC, publicly traded BDCs should hopefully enjoy the same ability to incorporate disclosure from both prior — and future — periodic reports in satisfaction of their Securities Act disclosure obligations in connection with public offerings, significantly streamlining the process for conducting follow-on public debt and equity offerings. The Securities Offering Reform Provisions also provide for BDCs that meet the WKSI requirements to file registration statements that become effective automatically — without SEC staff review.

In addition, Congress has specifically instructed the SEC to grant BDCs other rights permitted to those public operating companies filing registration statements on Form S-3, namely:

- Restricting the SEC from asking such companies for certain broad reports about their business, under Rule 418;
- Granting BDCs, which would otherwise be allowed to file on Form S-3, the same latitude as public operating companies in connection with certain proxy statement filings;
- Mitigating certain of the adverse effects of not complying with Regulation FD, which requires public companies to disclose information when such information is released selectively; and
- Precluding BDCs from making "undertakings" on Form N-2 that are more restrictive than those which filers on Form S-3 are required to make.

Potential Impact of the BDC Leverage and Securities Offering Reforms

The passage of the SBCAA will undoubtedly have lasting impacts on both existing and future BDCs, though the nature, timing and extent of the actual impact on any particular BDC will vary widely depending on a number of factors, including:

- Whether the BDC has been formed and currently has third-party investors;
- Whether the BDC is publicly traded, non-traded or operates in a "private" BDC structure; and
- The nature and specific wording of any leverage restrictions or covenants included in the BDC's outstanding leverage facilities and debt instruments, if any.

For example, depending on these factors, certain BDCs that trade publicly or have more restrictive existing leverage covenants may need significant time and effort to avail themselves of the benefits of increased leverage available under the Leverage Reform Provisions of the SBCAA. For example, in addition to seeking approval to opt in to the new more flexible leverage requirements, existing BDCs may need to have detailed discussions with existing lenders, as well as with rating agencies for those BDCs with rated debt.

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[5] *See* Section 803(b)(1) of the SBCAA.

Newly formed BDCs, however, will likely opt in to the lower asset coverage ratio requirement and negotiate corresponding leverage covenants from day one, absent market pressure not to do so. In short, the more immediate impact of the Leverage Reform Provisions may be seen in newly formed BDCs, including new "private" BDCs, which will likely seek to take full advantage of the additional leverage afforded to them. The availability of increased leverage may also lead to further growth in BDCs — including private BDCs — with a focus on lower-yielding liquid credit instruments, as opposed to directly originated credit instruments that BDCs have historically targeted. Existing BDCs may also adopt liquid credit strategies as part of their overall investment portfolio, given the ability to apply higher leverage on their portfolio as a whole.

In addition, publicly traded BDCs will have full access to the benefits set forth in the Securities Offering Reform Provisions once implemented by the SEC, as opposed to non-traded or "private" BDCs, which will continue to lack the public market capitalization necessary to satisfy Form S-3 eligibility requirements. Notably, the ability to file automatically effective shelf registration statements for BDCs that qualify as WKSIs, coupled with the availability of incorporation by reference from Exchange Act reports, will likely significantly reduce the burden associated with the shelf registration process for the larger publicly traded BDCs. While those continued restrictions will likely do little to stop the growth of private BDCs — which are offered privately rather than through public offerings — they may continue to highlight the trend away from publicly offered "non-traded" BDCs towards more flexible 1940 Act offering structures, such as interval funds.

What Should BDCs Do Now?

First, all existing BDCs should evaluate their current public disclosure, including in any existing registration statements on Form N-2 and their most recent Exchange Act filings, for any required changes reflecting the impact — or potential impact — of the implementation of the SBCAA. Such areas may include any discussion of regulatory requirements under the 1940 Act, the BDC's use of leverage or risk factors relating to either. In particular, BDCs contemplating seeking approval to utilize the higher level of leverage afforded under the Leverage Reform Provisions should consider updates to applicable risk factor disclosure to note the potential impact of such additional leverage in their next Securities Act filing or Exchange Act periodic report.

Second, existing BDCs contemplating adopting the reduced asset coverage requirement under the Leverage Reform Provisions should carefully evaluate the language of any leverage covenants contained in their existing credit agreements or debt instruments to determine how opting in to that lower asset coverage ratio may impact those covenants. Specifically, in certain cases, the language of such leverage covenants may cross-reference to the asset coverage requirements set forth in the 1940 Act, or otherwise operate in a manner that would permit a BDC to lever up to the maximum permitted under the 1940 Act without violating the applicable covenant. In many other cases, though, BDC credit agreements will instead mirror the existing 200 percent asset coverage requirement without taking into account subsequent changes in applicable 1940 Act leverage restrictions.

Third, any manager contemplating a new BDC — whether a private BDC or one that intends to publicly trade — should take steps to ensure that the new BDC vehicle has properly "opted in" to the relaxed leverage restrictions available under the Leverage Reform Provisions of the SBCAA. Specifically, even if a manager is unsure whether its newly formed BDC will actually utilize the increased leverage, failing to opt in upfront will subject that BDC to significant time and expense to seek the appropriate approval for the lower asset coverage ratio in the future. In addition, a BDC can continue to use disclosure to signal to investors whether or not it currently intends to use the additional leverage available to it under the Leverage Reform Provisions, even after "opting in" to the lower asset coverage requirement.

Fourth, any BDC negotiating a new credit agreement or debt instrument should carefully consider whether to include language contemplating the usage of the additional leverage available under the Leverage Reform Provisions. For example, many BDCs already include language in their credit agreements regarding the exclusion of leverage incurred by any small business investment company subsidiaries for which they have received corresponding exemptive relief from the SEC. Similarly, BDCs may wish to explore including a similar carve-out for additional leverage they may incur after opting in to the lower asset coverage requirement under the Leverage Reform Provisions.

Finally, once the SEC adopts the reforms mandated by the Securities Offering Reform Provisions of the SBCAA, publicly traded BDCs may wish to consider filing either a new shelf registration statement on Form N-2 or, alternatively, a post-effective amendment to an existing shelf registration statement, to take advantage of the inclusion of the ability to incorporate by reference from prior (and, hopefully, future) Exchange Act filings. Specifically, the ability for larger BDCs to incorporate by reference Exchange Act filings, while taking advantage of the automatic shelf registration process available to WKSIs, will likely significantly reduce the time, effort and expense associated with conducting public follow-on debt and equity offerings. In particular, the prospectuses prepared for those public offerings will likely shrink dramatically, along with the time and expense associated with their preparation.

Conclusion

The Leverage Reform Provisions and the Securities Offering Reform Provisions set forth in the SBCAA and adopted as part of the passage of the Omnibus Spending Bill will likely have both long-lasting and significant impacts on the BDC industry as a whole. In particular, the lowering of the asset coverage requirement will allow BDCs to potentially utilize greater leverage, which may encourage new and existing BDCs to invest in more liquid — but lower yielding — debt investments and similar instruments. In addition, the availability of a true shelf registration and offering process for publicly traded BDCs, including the use of incorporation by reference from Exchange Act filings and the ability to file automatically effective registration statements under the Securities Act, should meaningfully streamline the public debt and equity offering process going forward, once the SEC has fully implemented the mandated changes. Both existing and prospective BDCs should, however, be mindful of the impact of these reforms on their existing and contemplated operations and related public disclosure moving forward.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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