ALERTS

Regulated Funds: SEC Issues Order Providing Flexibility to Business Development Companies to Issue and Sell Senior Securities and to Participate in Certain Joint Arrangements

April 13, 2020

On April 8, 2020, the U.S. Securities and Exchange Commission issued an order ("Order") providing temporary exemptions from certain requirements imposed on business development companies ("BDCs") by the Investment Company Act of 1940, as amended ("1940 Act").[1] The action was taken by the SEC in response to the "far-reaching and unanticipated effects" of the COVID-19 pandemic on financial markets, and particularly credit markets. The exemptions provided for in the Order enable BDCs to (i) issue and sell senior securities and (ii) engage in joint enterprises or joint arrangements that would otherwise be prohibited.[2]

Recognizing that BDCs are likely to face challenges during the COVID-19 pandemic in providing capital to the portfolio companies in which they invest, the SEC issued the Order in an effort to prevent (i) the inability of a BDC to satisfy 1940 Act asset coverage requirements due to temporary mark-downs in the value of loans made by a BDC to a portfolio company and (ii) certain BDC affiliates from being restricted from participating in additional investments in a BDC's portfolio companies due to restrictions in the BDC's current exemptive order permitting co-investments. The SEC appears to anticipate that the challenges faced by BDCs during the COVID-19 pandemic may continue into late 2020 and the exemptions provided for in the Order will remain in effect until at least Dec. 31, 2020 ("Exemptive Period"). Notably, however, certain conditions for reliance on

the Order, including public disclosure of a BDC's intent to do so, may limit the number of BDCs that elect to utilize the relief the Order provides.

Issuance and Sale of Senior Securities

The Order provides a BDC the ability during the Exemptive Period to modify how its asset coverage ratio is calculated, which could enable certain BDCs to more easily issue or sell senior securities. A BDC's asset coverage ratio refers to the ratio of a BDC's total assets compared to its aggregate amount of outstanding senior securities. Section 61(a)(1) of the 1940 Act imposes a 200% asset coverage requirement in respect of any senior security issued by a BDC.[3] Section 61(a)(2) of the 1940 Act allows BDCs meeting certain specified conditions to elect to decrease their effective asset coverage requirement to 150%, representing approximately a 2-to-1 debt-to-equity ratio.[4] While a BDC will remain subject to the asset coverage requirements of these sections of the 1940 Act, as well as to the requirements of Section 18(b) of the 1940 Act, during the Exemptive Period the Order permits the calculation of asset coverage ratio to be adjusted using asset values generated prior to the current COVID-19 crisis, subject to certain conditions, as described below:

1. *Adjusted Portfolio Value*. In connection with the issuance or sale of a covered senior security, the Order permits a BDC to modify the calculation of its asset coverage ratio with respect to portfolio company holdings (i) that the BDC held at Dec. 31, 2019; (ii) that the BDC continues to hold at the time of such issuance or sale; and (iii) for which the BDC is not recognizing a realized loss.[5] In connection with the adjusted calculation, the BDC may use values calculated as of Dec. 31, 2019 to calculate portfolio value ("Adjusted Portfolio Value") to meet an adjusted asset coverage ratio ("Adjusted Asset Coverage Ratio"). In order to calculate its Adjusted Asset Coverage Ratio, a BDC must reduce its asset coverage ratio using the Adjusted Portfolio Value by an amount equal to 25% of the difference between the asset coverage ratio calculated using the Adjusted Portfolio Value and the asset coverage ratio that would normally be calculated in accordance with section 18(b) of the 1940 Act.

2. *Election*. Before first engaging in the issuance or sale of a senior security in reliance on the Order, a BDC must publicly announce that it has made an election to do so on Form 8-K.

3. *Limitation on New Investments*. A BDC that has elected to rely on the Order cannot, for a period of 90 days from the date of its election, make an initial investment in a portfolio company in which the BDC was not already invested as of the date of the Order, provided that a BDC may make an initial investment in such a portfolio company if at the time of investment its asset coverage ratio complies with the asset coverage ratio applicable to it under Sections 18 and 61 of the 1940 Act, without taking into account the modifications provided for under the Order.

4. *Board Approval of Reliance on this Order*. Prior to a BDC's election to rely on the Order, its board of directors ("Board"), including a required majority of the Board, as defined in section 57(o) of the 1940 Act ("Required Majority"), must determine that the issuance or sale of senior securities is permitted by the Order and is in the best interests of the BDC and its shareholders.

5. *Board Approval of Each Issuance of Senior Securities*. Prior to each time a BDC issues or sells senior securities in reliance on the Order, the Board, including a Required Majority, must determine that such issuance is in the best interests of the BDC and its shareholders. Before making that determination, the Board must obtain and consider (i) a certification from the BDC's investment adviser that the issuance of such senior securities is in the best interests of the BDC and its shareholders;[6] and (ii) advice from an "Independent Evaluator"[7] regarding whether the terms and conditions of the proposed issuance or sale of a senior security are fair and reasonable compared to similar issuances, if any, by unaffiliated third parties in light of current market conditions.

6. *No Sunset Period*. The Board of a BDC that has elected to rely on the Order is required to receive and review, no less frequently than monthly, reports prepared by the BDC's investment adviser regarding and assessing the efforts that the investment adviser has undertaken, and progress that the BDC has made, towards achieving compliance with the normal asset coverage requirements under Section 18 and Section 61 of the 1940 Act (without regard to the relief provided by the Order), by the expiration of the Exemptive Period. Upon expiration of the Exemptive Period, a BDC that is non-compliant with the normal asset coverage requirements under the 1940 Act will be required to immediately file a Form 8-K that includes (i) the BDC's current asset coverage ratio; (ii) the reasons the BDC was unable to comply with the

asset coverage requirements; (iii) the time frame within which the BDC expects to come into compliance with the asset coverage requirements; and (iv) the specific steps that the BDC will be undertaking to bring itself into compliance with the asset coverage requirements.

7. *Recordkeeping*. A BDC is required to make and preserve, for a period of not less than six years, minutes describing (i) a Board's deliberations in connection with its approval of an issuance of senior securities, including the factors considered by the Board in connection with such determinations, as well as all information, documents and reports provided to the Board in connection with its determination; and (ii) any presentations made to the Board related to the requirements noted above, including copies of all other information provided to or relied upon by the Board.

8. *No Compensation or Remuneration of Any Kind*. Except (i) to the extent permitted by Section 57(k) of the 1940 Act; or (ii) for payments or distributions made by an issuer to all holders of a security in accordance with the security's terms, no affiliated person of a BDC, nor any affiliated person of such a person, may receive any transaction fees (including break-up, structuring, monitoring or commitment fees) or other remuneration from an issuer in which a BDC invests during the Exemptive Period. However, this limitation does not apply to the receipt of investment advisory fees by an investment adviser to a BDC.

Further, the Order provides relief only for the issuance or sale of senior securities representing indebtedness or the issuance of stock by a BDC, but does not provide relief for declarations or payments by a BDC of any dividend or any other distribution that may pose a violation under Sections 18 or 61 under the 1940 Act.

Given the narrow scope of the relief granted under the Order with respect to the asset coverage test under the 1940 Act, and the public disclosure requirement applicable to BDCs that opt to rely on such relief, many existing BDCs may wish to refrain from opting into the asset coverage ratio relief provided for under the Order unless they face a significant risk of violating the normal asset coverage ratio requirement under the 1940 Act as a result of widespread market-related decreases in the fair value of their portfolio assets. In particular, those BDCs that opt in to the relief may face negative market perceptions to the extent most BDCs elect not to do so. It may be prudent, though, for BDCs to carefully review the wording

of the leverage requirements included in any credit facilities or debt instruments they have outstanding to determine what, if any, impact the Order may have on such third-party leverage requirements to the extent a BDC does decide to opt in to the asset coverage ratio relief under the Order.

Expansion of Relief for BDCs with Existing Co-Investment Orders

During the Exemptive Period, a BDC that has previously been issued a co-investment order by the SEC ("Existing Co-Investment Order"), may engage in certain joint enterprises or joint arrangements that may be prohibited by Section 57(a)(4) of the 1940 Act and Rule 17d-1 thereunder. Subject to the Order, a BDC with an Existing Co-Investment Order may participate in a Follow-On Investment[8] (which may include a Non-Negotiated Follow-On Investment) with one or more Regulated Funds and/or Affiliated Funds, provided that (i) if such participant is a Regulated Fund, it has previously participated in a Co-Investment Transaction with the BDC with respect to the issuer; and (ii) if such participant is an Affiliated Fund, it either (X) has previously participated in a Co-Investment Transaction with the BDC with respect to the issuer or (Y) is not invested in the issuer.

The Order also establishes the following Board oversight requirements for BDCs that are engaged in co-investment transactions with affiliates in reliance on the exemptions provided for in the Order.

1. *Non-Negotiated Follow-On Investments*. Non-Negotiated Follow-On Investments do not require prior approval by the Board. However, a Board remains subject to the periodic reporting requirements established in an Existing Co-Investment Order.

2. *Follow-On Investments Other than Non-Negotiated Follow-On Investments*. In connection with all findings required by an Existing Co-Investment Order with respect to Follow-On Investments that are not Non-Negotiated Follow-On Investments, the Board, and a Required Majority, are required to review the proposed Follow-On Investment, both on a stand-alone basis and in relation to the total economic exposure of the BDC to the issuer.

Notably, the temporary co-investment relief provided for under the Order may provide slightly greater latitude for a BDC facing capital constraints

to permit certain affiliates to help fund necessary follow-on investments in potentially struggling portfolio companies.

The Order is one in a series of actions taken by the SEC aimed at mitigating the impact of COVID-19 on financial market participants. In issuing this temporary, emergency order, the SEC has taken a significant step in granting flexibility to BDCs to offer capital and liquidity to portfolio companies that may be impacted significantly by the COVID-19 pandemic. If you have any questions about the content of this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

Authored by Karen Spiegel and Noah B. Aschen.

---

[1] Investment Company Act Release No. 33837 (April 8, 2020), available here.

[2] Section 57(a)(4) of the 1940 Act and Rule 17d-1 prohibit a BDC from engaging in a "joint enterprise or other joint arrangement or profit-sharing plan" with affiliates of the BDC unless an exemptive order has been received by the BDC pursuant to Section 57(c).

[3] 15 U.S.C. § 80a–60

[4] *See* "New BDC Opportunities: How the Passage of the Small Business Credit Availability Act Will Benefit Both New and Existing Business Development Companies," April 4, 2018, available here.

[5] A Dec. 31, 2019 value cannot be used for a portfolio company that has become "permanently impaired," as defined in the Order.

[6] Such certification must include the reasons for the investment adviser's recommendation, including whether the adviser has considered other reasonable alternatives that would not result in the issuance or sale of a covered senior security.

[7] The term "Independent Evaluator" is defined as a person with expertise in the valuation of securities and other financial assets and who is not an "interested person," as such term is defined in section 2(a)(19) of the 1940, of the BDC, or any affiliate thereof.

[8] Pursuant to the Order, the terms "Follow-On Investments," "Regulated Funds," "Affiliated Funds" and "Co-Investment Transaction" have the

meanings ascribed to them in the relevant Existing Co-Investment Order. For purposes of the Order, the term Affiliated Fund does not include any open or closed-end investment company registered under the 1940 Act or a BDC. “Non-Negotiated Follow-On Investments” also has the meaning ascribed to it in the relevant Existing Co-Investment Order, notwithstanding that a BDC may participate in a Non-Negotiated Follow-On Investment in reliance on the Order whether or not such term is used in its Existing Co-Investment Order.

This is a fast-moving topic and the information contained in this Alert is current as of the date it was published.

Practices

INVESTMENT MANAGEMENT

Attachments

Download Alert