

MEMO# 18254

November 24, 2004

SEC PROPOSES TO EXPAND ELIGIBLE INVESTMENTS BY BUSINESS DEVELOPMENT COMPANIES; COMMENTS REQUESTED BY DECEMBER 10TH

[18254] November 24, 2004 TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 44-04 SEC RULES COMMITTEE No. 93-04 SMALL FUNDS COMMITTEE No. 50-04 RE: SEC PROPOSES TO EXPAND ELIGIBLE INVESTMENTS BY BUSINESS DEVELOPMENT COMPANIES; COMMENTS REQUESTED BY DECEMBER 10TH The Securities and Exchange Commission has proposed for comment two new rules under the Investment Company Act of 1940 that would expand the categories of investments in which business development companies ("BDCs") may invest the majority of their assets.¹ The Release states that the proposal is intended to promote the flow of capital to small, developing and financially troubled companies. The proposal is briefly summarized below. Comments on the SEC proposal must be filed by Friday, January 7, 2005. If you have suggested comments for possible inclusion in the Institute's comment letter, please provide them to Rachel Graham by phone (202-326-5819), fax (202-326-5827) or e-mail (rgraham@ici.org) no later than Friday, December 10th.

I. Proposed Rule 2a-46 under the Investment Company Act A. Issuers with No Securities Listed on an Exchange or on NASDAQ Under current law, a BDC generally may not make any investment unless at least 70% of its assets are invested in certain types of securities ("70% basket"), including those issued by "eligible portfolio companies" in transactions not involving a public offering. Section 2(a)(46) of the Investment Company Act defines eligible portfolio company to include, among other things, an issuer that does not have a class of securities with respect to which a member of a national securities exchange, broker, or dealer may extend margin credit pursuant to rules adopted by the Federal Reserve Board. This provision was intended to serve as a "rational and objective test for determining whether an issuer has ready access to the securities markets."²

¹ See Definition of Eligible Portfolio Company Under the Investment Company Act of 1940, SEC Release No. IC-26647 (Nov. 1, 2004), 69 Fed. Reg. 64816 (Nov. 8, 2004) ("Release"), available on the SEC's website at <http://www.sec.gov/rules/proposed/ic-26647.htm>. ² See Release at 64817 (citing a Congressional report on the Small Business Incentive Act of 1980, which established BDCs). ² According to the Release, in 1998, the Federal Reserve Board revised the definition of margin security for reasons unrelated to small business development, and those revisions have had the unintended effect of reducing the number of businesses eligible for BDC investment. The Release states that the SEC proposal would realign the definition of eligible portfolio company with the purpose for which BDCs were established, i.e., to make capital more readily available to small, developing and financially

troubled businesses.³ Specifically, the proposal would expand the definition of eligible portfolio company to include any issuer that does not have any class of securities listed on a national securities exchange or on NASDAQ. The Release explains that, in the view of the Commission, most issuers that are able to list their securities have access to the public capital markets. The Release states that the Commission considered linking the definition of eligible portfolio company to an issuer's level of market capitalization. The Release lists several apparent shortcomings of such an approach, including: (1) the difficulty in determining what level to set as a measure of small, developing or financially troubled businesses; (2) the fact that an issuer might be able to adjust its market capitalization to fall below the specified level; and (3) the fact that market capitalization can change frequently over time due to market and economic conditions. The Release also states that a market capitalization approach "could result in some registered investment companies electing BDC status to take advantage of the less restrictive provisions of the Investment Company Act generally applicable to BDCs."⁴ The Commission requests comment on, among other things: (1) whether the proposal would adequately describe issuers that are small, developing or financially troubled businesses without ready access to the public capital markets; (2) whether there are alternative approaches that would be more objective and workable than the proposal; and (3) the likelihood that registered investment companies would elect BDC status if the definition of eligible portfolio company was linked to an issuer's market capitalization.

B. Financially Troubled Issuers Under current law, BDCs are generally permitted to invest in certain financially troubled issuers, such as those in bankruptcy proceedings or subject to reorganization under court supervision, and have these investments count toward the 70% basket. The Commission's proposal would expand the definition of eligible portfolio company to include certain issuers that exhibit financial trouble while their securities are listed on a national securities exchange or on NASDAQ. Specifically, the proposal would require that such an issuer: (1) has received a notice from the exchange or NASDAQ that it does not meet the quantitative standards for continued listing of its securities; and (2) does not meet the initial quantitative listing standards for any class of its securities on any other exchange or NASDAQ. The Release states that the proposal is designed to permit BDCs to provide capital to issuers at risk of losing their listing status. ³ See Release at 64818. ⁴ See Release at 64819. The Commission stated that it would not necessarily object to such a result but would need to engage in further study to determine if such "regulatory arbitrage" would be appropriate. *Id.* ³ The Commission requests comment on, among other things: (1) whether the proposal captures those financially troubled issuers that could benefit from BDC financing; (2) whether the proposal should limit the period during which such an issuer would be considered an eligible portfolio company (e.g., 12 months following receipt of the notice); and (3) whether another objective factor would serve as a clearer indicator that an issuer with securities listed on an exchange or NASDAQ is beginning to experience financial trouble.

II. Proposed Rule 55a-1 Under the Investment Company Act Under current law, a BDC may include in its 70% basket certain follow-on investments in issuers that were eligible portfolio companies when the BDC made its initial investment(s), but that are no longer eligible portfolio companies as a result of having issued marginable securities. The proposal would similarly permit a BDC to include in its 70% basket certain follow-on investments in issuers that were eligible portfolio companies when the BDC made its initial investment(s), but that are no longer eligible portfolio companies as a result of having listed a class of securities on an exchange or on NASDAQ. The Commission requests comment on the proposal, including whether it should include a time restriction on such follow-on investments. Rachel H. Graham Assistant Counsel

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