

MEMO# 20534

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SEC Adopts New Rules for Business Development Companies and Reproposes Additional Rule Defining Eligible Portfolio Companies

©2006 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [20534] November 1, 2006 TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 32-06 SEC RULES COMMITTEE No. 48-06 SMALL FUNDS COMMITTEE No. 29-06 RE: SEC ADOPTS NEW RULES FOR BUSINESS DEVELOPMENT COMPANIES AND REPROPOSES ADDITIONAL RULE DEFINING ELIGIBLE PORTFOLIO COMPANIES The SEC has adopted two new rules under the Investment Company Act of 1940 that expand the definition of “eligible portfolio companies” in which business development companies (“BDCs”) may invest the majority of their assets,¹ and has repropose a third rule further defining the permissible investment activities of BDCs.² Comments on the proposed rule must be filed with the SEC by Tuesday, January 2, 2007. If you have suggested comments for possible inclusion in the Institute’s comment letter, please provide them to Mara Shreck by phone (202/326-5923) or email (mshreck@ici.org) no later than Friday, November 17th. I. Background Under current law, a BDC generally may not make any investment unless at least 70 percent 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. Eligible portfolio companies are defined to include issuers that do not have a class of securities with respect to which a member of a 1 See Definition of Eligible Portfolio Company Under the Investment Company Act of 1940, SEC Release No. IC-27538 (Oct. 25, 2006) (“Adopting Release”). The final rules can be found on the SEC’s website at <http://www.sec.gov/rules/final/2006/ic-27538.pdf>. The Institute did not object to the rules as proposed. The Institute’s comment letter can be found at <http://www.sec.gov/rules/proposed/s73704/ici010605.pdf>. 2 See Definition of Eligible Portfolio Company Under the Investment Company Act of 1940, SEC Release No. IC-27539 (Oct. 25, 2006) (“Proposing Release”). The proposed rule can be found on the SEC’s website at <http://www.sec.gov/rules/proposed/2006/ic-27539.pdf>. 2 national securities exchange, broker, or dealer may extend margin credit pursuant to rules adopted by the Federal Reserve Board. However, in 1998 the Federal Reserve Board revised the definition of margin security for reasons unrelated to small business development, and those revisions had the unintended effect of substantially reducing the number of businesses eligible for BDC investment. To realign the definition of eligible portfolio company with the purpose for which BDCs were established, in 2004 the SEC proposed three rules that would expand the categories of companies in which BDCs may invest the

majority of their assets.³ Two of the proposed rules were adopted essentially as proposed, and the third was revised and reissued for comment. The adopted and repropounded rules are summarized below.

II. Adopted Rules

A. Rule 2a-46 Rule 2a-46 defines eligible portfolio company to include all private domestic operating companies and those public domestic operating companies whose securities are not listed on a national securities exchange ("Exchange"). The Adopting Release explains that public companies whose securities are quoted on the over-the-counter bulletin board or through Pink Sheets LLC are not listed on an Exchange, and therefore are eligible portfolio companies.

B. Rule 55a-1 Rule 55a-1 permits a BDC to include in its 70 percent basket, under certain conditions, follow-on investments in a company that was an eligible portfolio company under Rule 2a-46 at the time of the BDC's initial investment(s), but that is no longer an eligible portfolio company (i.e., following the initial investment the company listed its securities on an Exchange). Such a follow-on investment is permitted only if, at the time of the follow-on investment, the BDC (1) owns at least 50 percent of both (a) the greatest number of equities securities of the portfolio company, and (b) the greatest amount of certain debt securities of the portfolio company held by the BDC at any time during the period when the company was an eligible portfolio company; and (2) is one of the 20 largest holders of record of the company's outstanding voting securities.

III. Repropounded Rule

Reproposed Rule 2a-46(b) would further expand the definition of eligible portfolio company to include certain companies that list their securities on an Exchange. The SEC has requested comment on two alternative rules for determining which listed securities would be eligible, both of which

³ 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). For a summary of the proposed rules, see Institute Memorandum to Closed-End Investment Company Committee No. 44-04, SEC Rules Committee No. 93-04, Small Funds Committee No. 50-04 [18254], dated November 24, 2004.

⁴ establish a size-based standard. Under the first alternative, the definition of eligible portfolio company would include companies whose securities are listed on an Exchange and have a public float of less than \$75 million. Under the second alternative, the definition of eligible portfolio company would include companies that have securities listed on an Exchange based on their market capitalizations. The SEC has proposed two possible limits for market capitalization – \$150 million or \$250 million.

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⁴ Public float is the company's market capitalization less the aggregate market value of common equity held by the company's affiliates. See Proposing Release at n. 16.