

BDCs 101: The Board Perspective

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October 13, 2021

Why are We Talking about BDCs?

- Attracting significant sponsor and investor interest over past few years
- Among the most innovative parts of the industry in terms of product development
- Significant differences from traditional 1940 Act funds, especially from a board member's perspective

Historical Background of BDCs

- Created in response to the credit crisis of the 1970s to facilitate the formation of capital for small businesses and at the behest of the venture capital industry
- The venture capital industry felt unduly limited by the Investment Company Act of 1940 Act (the “1940 Act”) in its ability to provide financing to small businesses
- In 1980, Congress amended the 1940 Act to permit a new category of closed-end investment company with operating company qualities, the BDC, which could invest in private companies by lessening certain restrictions imposed by the 1940 Act relating to, among others, leverage and incentive fees

What do BDCs do?

- BDCs facilitate capital raising by small, developing (i.e., “middle market” companies), and financially troubled companies that lack access to the public capital markets and other traditional financing
- BDCs facilitate such capital raising by **investing in or lending to** such private companies and/or **making managerial assistance** available to them with the goal of generating capital appreciation or current income

Value Proposition to Investors

- Provides access to the pre-IPO market of emerging-growth or expansion-stage privately-owned companies
- Trend of BDCs investing in PE-sponsored companies, offering a “double-underwriting” benefit
- Tax benefits (especially attractive to non-US investors)
- Access at various levels of capital structure
- Publicly available information

Types of BDCs

Exchange-Listed BDCs

- Shares are IPO'ed through traditional firm commitment underwritten offering, or direct listing, and trade on the NYSE or NASDAQ

Non-Traded BDCs

- Shares sold to retail investors through continuous public offerings. Conducts periodic repurchases (commonly quarterly) and typically 5-7 years before exchange listing or IPO

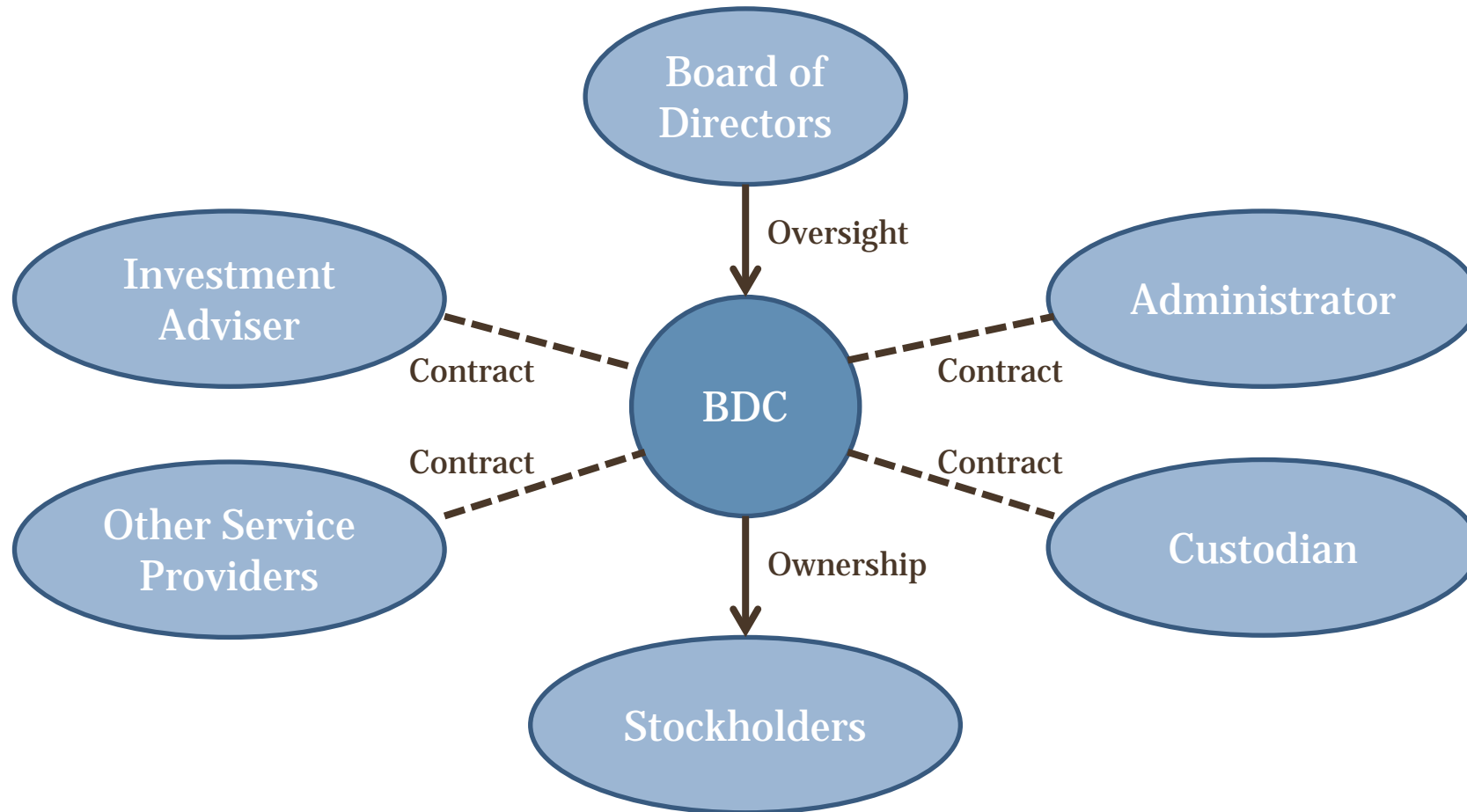
Private BDCs

- Shares are sold through private placements (limited to accredited investors) and historically funded via subscription/capital call mechanism
- Historically, targets a liquidity event (*e.g.*, liquidation or exchange-listing) within 5-7 years
- PPM and subscription document offering

Types of BDCs (cont'd)

	Exchange-Listed BDC	Non-Traded BDC	Private BDC
Registered with the SEC under the Securities Exchange Act of 1934	✓	✓	✓
Registered with the SEC under the Securities Act of 1933	✓	✓	No – Rule 506(b) or (c)
Publicly traded on an exchange (e.g., NYSE or NASDAQ)	✓		
Regulated under the Investment Company Act of 1940 restrictions (e.g., leverage and affiliated transactions)	✓	✓	✓
Available only to accredited investors			✓
Available to retail investors	✓	✓	
Continuous offering		✓	✓
Flow-through tax treatment	✓	✓	✓
Periodic tender offers		✓	Not common, but permitted
State registration and regulation		✓	

Structure of a BDC



Notes:

- A BDC can be internally managed (i.e., does not have an external investment adviser)
- Administrator is often an affiliate of the adviser and is reimbursed for costs of providing administrative services to the BDC

Laws Applicable to a Private BDC

Investment Company Act of 1940

- Designed to mitigate conflicts of interest with key service providers
- Requires a board to oversee functions
- Includes substantive prohibitions
- Establishes a fiduciary duty with respect to receipt of compensation, coupled with a private right of action
- Requires ongoing disclosure to stockholders
- SEC may adopt rules or grant exemptions under the statute

Securities Exchange Act of 1934

- Disclosure statutes (10-Ks, 10-Qs, 8-Ks)
- Impose liability for false and misleading disclosure

Regulation M of IRS Code of 1986

- Pass-through taxation if diversification, good income and distribution requirements met (i.e., taxed as a regulated investment company (RIC))
- 1099 tax reporting

Differences From Other Investment Companies

- Must affirmatively elect to be a BDC
- Similar to a closed-end fund, but several key differences
 - Exempt from many 1940 Act restrictions and Advisers Act of 1940 restrictions (*e.g.*, allowed to charge performance fees and ability to engage in certain affiliated transactions with board approval)
 - Must maintain at least 70% of its assets in “qualifying investments” (typically private U.S. companies)
 - Must offer to provide significant managerial assistance to companies that fall in the 70% basket
 - Board must be at least majority independent, slightly higher than for registered investment companies
- Leverage restrictions
 - Asset coverage requirement of 150% for all senior securities (equivalent to 2:1 debt-to-equity) with appropriate board/stockholder approval
 - Unfunded commitments to portfolio companies do not count toward the asset coverage requirement if BDC has a reasonable belief that it will have sufficient cash and cash equivalents to cover its obligations when due

Differences From Other Investment Companies (cont'd)

- Subject to Section 12 of the Exchange Act of 1934's reporting requirements (e.g., periodic reports on Forms 10-K, 10-Q and 8-K)
- Ability to engage in certain affiliated transactions with board approval
 - Many BDCs have obtained exemptive relief from the SEC permitting co-investments with affiliates of a BDC's external manager
- May be “internally managed”
- Different fee structures
 - Externally managed BDCs generally pay a base management fee plus a two-part incentive fee on net investment income and capital gains
 - Internally managed BDCs may compensate employees/managers based on performance and through an equity-based or profit-sharing plan
- Multi-class structure for non-traded BDCs only
- Independent counsel of the Board may not be engaged at launch
- Valuation is significantly different from mutual funds
- NASDAQ-listed BDCs will be subject to new board diversity rule

Notable BDC Board Responsibilities

Valuation

- 1940 Act makes directors responsible of portfolio holding valuations in the absence of readily available market values
- BDC must report its NAV quarterly. Board meetings are generally held in conjunction with the filings of each 10-Q and 10-K to obtain proper board approval re the valuations

Joint Transactions

- BDCs are permitted to engage in joint transactions with a broader range of affiliates than registered investment companies, with certain types of transactions requiring approval by the independent directors

Co-Investments

- Independent directors are primarily responsible for approving the fairness of allocations, not whether a co-investment is a “good” investment

Notable BDC Board Responsibilities (cont'd)

Payments In-Kind Monitoring

- Portfolio companies pay interest “in-kind” (*i.e.*, with shares of stock rather than cash)

Alternative Asset Classes

- BDC investments are increasingly complex, requiring directors who understand uni-tranche structures and other alternative investment classes
 - 70% of assets must be “qualifying investments”
 - The primary way a BDC can satisfy the 70% eligible investments test by investing in “eligible portfolio companies”
 - U.S. issuers that are private companies or are listed and have a market capitalization of less than \$250 million
 - Cannot be a registered or unregistered investment company

Different 1940 Act Affiliated Transaction Restrictions

Transactions between BDCs and an affiliate (or an affiliate of an affiliate) are restricted, and generally fall into two categories

1. Transactions with “close” affiliates are prohibited without SEC approval

- Directors, officers or employees of the BDC
- Entities controlled by a director, officer or employee of the BDC
- The BDC’s adviser, promoter, principal underwriter or any person who controls or is under common control with such entities (or any director, officer or employee of such entities)
 - Note: control is presumed with ownership of more than 25% of voting securities

2. Transactions with “remote” affiliates are prohibited unless approved by a majority of the independent directors of the BDC who have no financial interest in the transaction

- 5% stockholders or any person who controls or is under common control with a 5% stockholder (or any director, officer or employee of a 5% stockholder)
- Affiliated persons of a director, officer, employee, adviser, principal underwriter of the BDC
- Any person controlling or under common control with the BDC other than through an advisory or underwriter relationship

Co-Investment Relief: Sharing Opportunities

What investment opportunities need to be shown to the BDC under the terms of a co-investment exemptive order?

- Investments that fall within the BDC's stated investment objectives and strategies and "Board-Established Criteria" (see next slide)

What opportunities are not subject to a co-investment exemptive order?

- Transactions where only price is negotiated (i.e., BDC and affiliates are "term-takers")
- Opportunities where the BDC will not be transacting "jointly" with another affiliated fund
- There are other exemptive rules for transactions between the BDC and its controlled subsidiaries, or subsidiaries controlled by the BDC
- Certain other exemptions may also apply in restructuring contexts

Co-Investment Relief: Possible Board-Established Criteria

Requirements for Board-Established Criteria

- Must be approved by a BDC's board
- Must be consistent with a BDC's investment objectives and strategies
- Must be objective and testable (*i.e.*, based on observable information without exercising discretion)
 - Examples include:
 - ❑ Industry/sector
 - ❑ Minimum EBITDA
 - ❑ Asset class
 - ❑ Required commitment size

Co-Investment Relief: Oversight

What is the role of the Board?

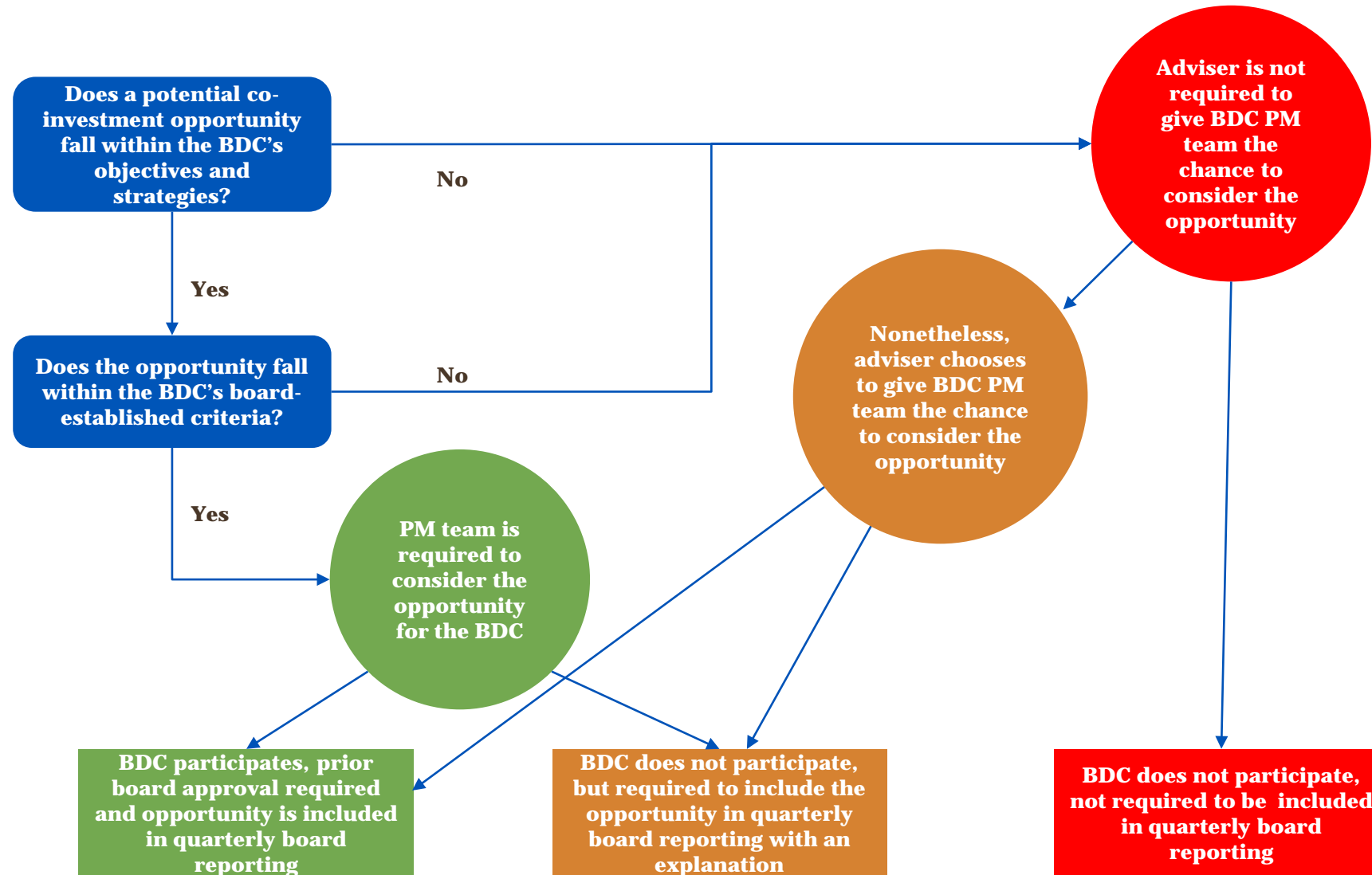
- The Board must approve participation in the co-investment program as being in the best interests of the BDC (but not individual co-investment opportunities)
- Under the relief, the Board's role is to oversee the administration of the co-investment program and ensure that the adviser is complying with the terms and conditions of an exemptive order
- The terms of the exemptive order are meant to ensure that the BDC will have an opportunity to participate in relevant investment opportunities and receive fair allocations of those opportunities
 - For initial co-investments and certain follow-on investments or dispositions related to co-investments made in reliance on the exemptive order, the Board will be provided with detailed information regarding the transaction and asked to make certain findings before the BDC can participate in the transaction
 - The findings that the Board will be asked to make relate to conflicts of interest (e.g, over-reaching) and do not relate to the merits of whether a proposed investment is a “good” investment

Co-Investment Relief: Board Reporting

What reporting must be given to the Board?

- On a quarterly basis, a report of the following:
 - Co-investment opportunities that were required to be shown to the BDC but were not (with an explanation of why such opportunities were not shown);
 - Co-investment opportunities that were shown to the BDC that another fund participated in, but the BDC did not choose to participate (which needs to include an explanation of why such opportunities were not taken);
 - All follow-on investments and dispositions by another affiliated fund in any issuer held by the BDC during the prior quarter;
 - All “Pro Rata Dispositions”; and
 - All information needed by the Board to determine whether all potential co-investments and completed co-investments made during the preceding quarter complied with the relief
- The CCO of the BDC will prepare an annual report for the Board each year that evaluates and documents the BDC’s compliance with the terms and conditions of the relief and the procedures established to achieve such compliance
- The independent directors must consider on an annual basis whether continued participation in co-investments is in the BDC’s best interests

Illustration of Co-Investment Process



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Based in the Firm’s Washington, D.C. office, Christopher Healey is Counsel in the Registered Funds Practice. With what clients describe as “unparalleled knowledge” (*The Legal 500 United States*), he frequently counsels clients on the development of innovative retail products, complex asset management M&A transactions, novel applications for SEC exemptive relief and investment company status issues under the Investment Company Act of 1940.

Christopher’s practice focuses on advising registered funds, business development companies (BDCs), investment advisers and fund boards. He has advised preeminent sponsors and investment managers such as BC Partners, Blackstone, Carlyle and First Eagle, among others.

Christopher was named a “Rising Star” at *Fund Intelligence’s* 2020 Mutual Funds Industry and ETF Awards. He has served as co-chair of the DC Bar’s Investment Management and Broker-Dealer Regulation Subcommittee since 2017.

- BC Partners, including with respect to the launch of its public and private BDC platform, the acquisition of multiple BDCs
- Blackstone with respect to its BDCs, credit-focused listed closed-end funds and interval fund
- Carlyle, in connection as adviser to its credit-focused interval fund and certain BDC-related matters
- First Eagle, with respect to its BDC and the launch of its credit-focused interval fund
- Co-investment exemptive relief clients include Apollo, BC Partners, Blackstone, Carlyle, First Eagle and others
- Asset management M&A transactions, including advising: JPMorgan in its capacity as financial advisor in several BDC mergers; Blackstone in its acquisitions of DCI and Harvest Fund Advisors, as well as its acquisitions of minority stakes in GI Partners, Kohlberg & Co., L.P., Leonard Green, Marlin Equity Partners and PAG; Blackstone and Corsair Capital in their majority investment in First Eagle Investment Management; KKR in its transaction to become sole adviser to Corporate Capital Trust; Lightyear in its acquisition and subsequent sale of Advisor Group; MassMutual in its sale of OppenheimerFunds to Invesco; Oaktree in its acquisition of the Fifth Street BDC relationship; and USAA in the sale of its mutual fund business to Victory Capital

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Jasmin M. Ali is an associate in the Firm's Registered Funds Practice, where she represents registered investment companies, their independent directors/trustees and investment advisers in regulatory, transactional and compliance matters. She regularly works on a variety of matters regarding the establishment, registration, reorganization, and operation of retail and institutional investment products. She also works with clients to respond to new SEC rules affecting the investment management industry.

Prior to law school, Jasmin worked for two major asset managers in a sales capacity distributing mutual funds and variable annuities and, prior to that, in an operations capacity within a transfer agent. During law school, Jasmin interned with a major financial institution where she assisted in implementing Dodd-Frank compliant policies and procedures and served as an editor of the *Uniform Commercial Code Reporter-Digest*.

- Blackstone Credit. with respect to its BDCs
- Blackstone Real Estate. with respect to BREIT, BREIT Operating Partnership L.P. and its open-end real estate funds, BREIF
- First Eagle, with respect to its BDC
- AQR open-end funds
- New Mountain, with respect to its private BDC

Experience prior to Simpson Thacher includes representing:

- DoubleLine open- and closed-end funds, including closed-end fund initial public offerings
- Western Asset Management and Franklin Templeton (formerly, Legg Mason) open- and closed-end funds, including tender offers
- Cohen & Steers Capital Management open- and closed-end funds, including closed-end fund initial public offerings
- Stone Harbor Investment Partners open- and closed-end funds