AN ALERT FROM THE BDO FINANCIAL SERVICES PRACTICE

ASSET MANAGEMENT **INSIGHTS**

SHOULD BUSINESS DEVELOPMENT COMPANIES BANK ON REGULATORY REFORM?

By Nick Maroules and Dale Thompson

Since their inception in 1980, business development companies (BDCs) have filled a gap in traditional bank lending to provide financing to small and mid-sized businesses.

The growth of this alternative investment vehicle has accelerated in the last decade after gaining popularity during the 2007-2008 financial crisis and following the Volcker Rule's prohibitions on bank investments in traditional private equity funds.

BDCs are essentially publicly registered closed-end funds that have a congressional mandate to provide investment and management expertise to businesses throughout the U.S. to facilitate job creation and business growth.

Although BDCs are not registered under the 1940 Act, they elect to be subject to SEC regulation under many of the 1940 Act provisions. BDCs are also typically registered under the Securities Act of 1933 and the Securities Exchange Act of 1934 and are subject to all registration and reporting requirements under those two statutes.

While most BDCs sell their shares in public offering and are traded on national exchanges, some "unlisted BDCs" make use of broker-dealer networks to sell their shares. They are structured to provide investors with higher-than-average dividends (currently between 7 and 12 percent on average) by avoiding taxation at the corporate level, allowing them to pass along ordinary income and capital gains directly to their investors.

The appetite among asset managers to use the BDC structure as an investment vehicle remains strong as they offer several distinct advantages. They allow asset managers to operate like a traditional private equity fund and have access to permanent capital through the public markets. Unlike traditional private funds that are limited to raising money from "sophisticated investors" who have minimum income and net worth requirements, there are few restrictions on who can invest in BDCs.

Established asset managers continue to enter the industry with Carlyle most recently joining other heavyweights such as BlackRock, TPG, Apollo and Ares. And while the ranks

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of BDCs continue to increase, there is a growing anxiety among BDC managers about the current regulatory framework BDCs find themselves operating within. Voluminous regulation coupled with increasing costs to maintain compliance has challenged the industry and fueled a growing movement to modernize the regulatory framework so that BDCs can more easily carry out their policy mandate.

OUTLOOK FOR REGULATORY REFORM

In early October, the U.S. Treasury Department issued a report with recommendations about how to reform the U.S. regulatory system for the capital markets. The report proposes allowing BDCs to use the same securities offering and proxy rules available to traditional operating reporting companies by taking advantage of certain exemptions. This would provide better alignment with other reporting entities and eliminate certain reporting, disclosure and filing burdens specific to BDCs. Also fueling optimism within the BDC community, the Financial CHOICE Act passed in the US House of Representatives in June. The proposed reforms introduced several measures that would enable BDCs to more easily raise and deploy capital, streamline their compliance and reporting responsibilities, eliminate regulatory burdens and better align the BDC regulatory framework with those of other operating companies.

Among the Act's provisions, the most significant for BDCs include:

1. **Reducing the asset coverage ratio to 150 percent, taking on more leverage.**
   This would allow BDCs to increase their leverage up to a 2:1 debt-to-equity ratio, up from where it currently stands at 1:1. Allowing BDCs to take on more debt could expand lending opportunities for the funds. Banks and other types of financing vehicles are often leveraged at significantly higher levels.

2. **Allowing BDCs to purchase interests of registered investment advisors without the need for exemptive relief. Expanding the pool of securities that BDCs could acquire.**
   This would afford BDC managers greater flexibility in carrying out their investment strategies in some cases. Under current law, BDCs are generally prohibited from acquiring securities issued by an investment adviser although some have been granted exemptive relief while others have not.

3. **Expanding the definition of "qualified assets," granting BDCs more flexibility.**
   Under current law, at least 70 percent of a BDC's total assets are required to be invested generally in securities acquired from "eligible portfolio companies". The proposed reforms would expand the definition of what qualifies for the "70 percent bucket". It would also allow BDCs to hold some interests in investments companies which is currently prohibited.

4. **Diversifying the types of securities that BDCs can offer investors.**
   The CHOICE Act proposes limiting the rights granted to qualified institutional buyers (QIB) that purchase preferred stock. If enacted, BDCs would also be able to issue warrants, options or voting rights to subscribe or convert non-voting securities.

These proposed reforms have long been long-championed by BDCs and their advocates, most notably the Small Business Investor Alliance which serves as the trade association for the BDC industry. With a Senate vote still ahead, the CHOICE Act's immediate future is uncertain, but support for the reforms is unlikely to dissipate. BDCs are also keeping an eye on how the newly appointed SEC Chairman Jay Clayton and SEC Director of the Division of Investment Management, Dalia Blass, could shape regulatory developments moving forward.

PERFORMANCE CHECK

2017 has been a mixed bag for BDC performance to date. Several funds are paying out double digit dividends, but the S&P BDC Index's returns have lagged the broader index to date—registering -5.63 percent YTD returns as of early September versus the S&P 500's 11.13 percent haul. *Business Insider* also reported that "sliding loan pricing and increased repayments are continuing to curb the profitability and growth" of BDCs, with the sector trading at an average 7 percent discount to net asset value in mid-August.

Increased competition in middle market lending could also pose challenging for BDCs and could be a factor weighing down returns. BDCs comprise less than 5 percent of the $35 billion raised for middle market lending through August, with direct lending funds accounting for the largest slice of the pie.

Should the Federal Reserve continue to increase interest rates, BDCs are poised to do relatively well compared to other yield-generating investment options like REITs. The funds typically borrow at fixed rates, but offer loans at floating rates. Despite this expected net positive for BDCs, many funds are seeing compressed yields from their assets, leading to declining spreads that outweigh the bump from higher rates on loans issued.

STATUS QUO: A LOOK AT CURRENT BDC REGULATIONS

Investor appetite for exposure to alternative investments appears to be growing. Private equity firms are sitting on record levels of dry powder—totaling $963 billion in July—and 2017 is positioned to be another strong year for fundraising.

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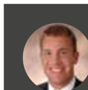
For private equity firms monitoring this space and considering whether they should pursue launching a new BDC, here are a few additional regulatory and tax considerations to keep in mind:

- BDCs can benefit from "pass-through" tax treatment by electing to be a regulated investment company (RIC) under Subchapter M of the Internal Revenue Code. In order to qualify as a RIC, they must satisfy certain asset diversification and qualifying income requirements and distribute substantially all (90 percent) of their taxable income to investors annually.
- BDCs are required to provide significant managerial assistance to their portfolio companies.
- Current regulations restrict BDC portfolio allocations into higher-risk sectors (such as financial services) to 30 percent.
- They are required to file quarterly and annual reports as well as proxy statements with the SEC and comply with investment company financial statement and reporting requirements in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification Topic 946, as well as Articles 6 and 12 of Regulation S-X.
- Financial statement audits of BDCs are subject to PCAOB auditing standards. Most listed BDCs must comply with the internal controls requirements set forth in the Sarbanes-Oxley Act.
- Under the Jumpstart Our Business Startups Act (JOBS Act), new BDCs may qualify as "emerging growth companies" (EGCs), subject to certain restrictions. EGCs are temporarily exempt (no more than five years) from certain reporting burden requirements.

CONCLUSION

The calls to provide regulatory relief to BDCs have become louder in recent years, stemming from strong advocacy initiatives championed by the industry. While their popularity continues to remain strong and their structure offers distinct advantages to asset managers, it remains clear that the current regulatory environment imposes several operational challenges for BDCs. We have yet to see how far the new presidential administration and Congress will go to modernize the rules and regulations for business development companies.

For more information, to register for upcoming events and to learn more about how BDO can support your BDC fund structure contact:



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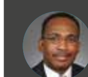

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