# New Legislation Will Benefit Business Development Companies While Closed-End Funds Remain in Limbo

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On March 23, 2018, President Donald Trump signed the Consolidated Appropriations Act of 2018 into law. This legislation includes the Small Business Credit Availability Act (SBCA), which contains numerous changes to regulations under the federal securities laws that impact business development companies (BDCs). Section 802 of the SBCA allows BDCs to increase their debt-to-equity leverage from 1:1 to 2:1, and Section 803 allows BDCs to rely on liberalized offering, proxy and communications rules previously available only to operating companies. Combined, these provisions are expected to provide much needed flexibility for BDCs to raise and invest capital in an efficient and cost-effective manner.

Two pending pieces of legislation could have a similarly significant impact on registered closed-end funds (CEFs). On June 8, 2017, the United States House of Representatives passed the Financial CHOICE Act of 2017 (the CHOICE Act), a bill that would allow certain CEFs to rely on the same liberalized offering, proxy and communications rules as BDCs under Section 803 of the SBCA. On January 17, 2018, the House of Representatives also passed the Expanding Investment Opportunities Act (EIOA), which is an amended version of the CEF-relevant portions of the CHOICE Act. It is unclear at this time what action the U.S. Senate will take with regard to either of these CEF bills in their current forms.

## Expanding Access to Capital for BDCs: Section 802 of the SBCA

Historically, Sections 18(a) and 61(a) of the Investment Company Act of 1940 (1940 Act) have required a BDC to have an asset coverage of 200 percent for debt or preferred stock that it issues or incurs. This has in effect required a 1:1 debt-to-equity leverage ratio. Section 802 of the SBCA lowers these 200 percent asset coverage requirements to 150 percent (a 2:1 debt-to-equity leverage ratio) for BDCs that meet certain criteria. A BDC wishing to lower its asset coverage requirement for debt and preferred stock to 150 percent must either (1) obtain shareholder approval by a majority of votes cast at a special or annual meeting where a quorum is present or (2) obtain the approval of a majority of the BDC's independent directors. Approval by shareholders would be effective on the first day after the date of approval, and approval by independent directors would be effective one year after the date of approval. With respect to either method of approval, if the BDC's common shares are not listed on a national securities exchange it must offer to repurchase from each shareholder as of the date of approval all of such shareholder's shares held on the date of approval. For shareholders accepting such an offer, the BDC would be required to repurchase 25 percent of such shareholders' eligible shares in each of the four calendar quarters following the calendar quarter in which the approval occurs.

Within five business days of the approval of the lower asset coverage requirements, a BDC must disclose such approval and its effective date in a filing under the Securities Exchange Act of 1934 (Exchange Act) (generally, on a Form 8-K) and on its website. Then, on an ongoing basis, a BDC's periodic Exchange Act filings on Form 10-K and 10-Q must disclose (1) the aggregate outstanding principal amount of debt or liquidation preference of preferred stock issued by the BDC, and the asset coverage percentage as of the date of the BDC's most recent financial statements included in that filing, (2) that the BDC has approved lower asset coverage requirements pursuant to Section 61(a) of the 1940 Act, (3) the effective date of such approval and (4) the risk factors associated with such leverage (including such risks as applicable to common shareholders).

These revisions allow BDCs to incur more leverage, and thus provide additional capital to small and midsize U.S. businesses, and potentially invest in more liquid, but lower-yielding, investments. We expect that a BDC's particular circumstances, including whether it is newly formed or currently existing, its need or desire for additional capital, the time horizon of that need or desire, covenants in existing financing documents, and the BDC's common shareholder base, will ultimately determine which approval method any particular BDC may find more advantageous, if any. In particular, existing unlisted BDCs should carefully consider whether the benefits of these lower leverage limits outweigh the risks of opening the BDC up to what in effect would be a mandatory self-tender for all of its common shares. Of note, however, is that the law, as enacted, does not specify any required price in connection with the repurchase offer that approval of these lower leverage limits would trigger. Also of note is that this flexibility may be more easily implemented for a newly formed BDC, which presumably will be able to "opt in" to these lower leverage limits as part of its initial organizational approvals, much in the same way an advisory contract approved as part of a BDC's initial organizational approvals does not require subsequent shareholder approval immediately following an initial public offering.

Additional considerations for BDCs in connection with approving increased leverage include the reaction of ratings agencies that rate debt and preferred equity leverage issued by BDCs. For example, in the wake of the passage of the SBCA, Standard & Poor's (S&P) temporarily downgraded the outlook for BDCs and warned BDCs to take a cautious approach to adopting higher leverage. S&P has indicated that this downgrade is temporary and that it will be revising its outlook in the coming months as each BDC's leverage and strategic plans become clearer.

BDCs not electing to approve lower leverage limits in accordance with the foregoing procedures would remain subject to the existing 200 percent asset coverage requirements (1:1 debt-to-equity leverage ratio) for debt and preferred stock.

## Parity for BDCs Regarding Offering and Proxy Rules: Section 803 of the SBCA

Section 803 of the SBCA requires the Securities and Exchange Commission (SEC), not later than one year after the date of enactment, to revise Form N-2, the registration form used by BDCs, as well as numerous rules under the Securities Act of 1933 (Securities Act), Exchange Act and Regulation FD. These revisions will provide several benefits to BDCs. Most notably, they will permit certain BDCs to qualify as well-known seasoned issuers (WKSIs) and file automatically effective shelf registration statements. Further, certain qualifying BDCs will be permitted (1) to forward-incorporate future Exchange Act filings by reference, thereby eliminating the need to amend any shelf registration statements each time they file new financial statements, and (2) to use definitive offering documents to update substantive disclosures. Finally, BDCs will benefit from the ability to rely on numerous safe harbor rules related to communications with the public before, during and after an offering. Overall, the purpose of Section 803 is to extend the rules created to streamline the registration and offering process for larger publicly traded operating companies to large BDCs.

### Shelf Registration Statements and Prospectus Delivery

Section 803 of the SBCA extends WKSI status to certain BDCs. The law removes the exclusion of BDCs from the definition of WKSI[1] and adds registration statements filed by BDCs on Form N-2 to the definition of "Automatic Shelf Registration Statement."

When an issuer qualifies as a WKSI, it can register a securities offering under the Securities Act on a shelf registration statement that becomes effective automatically upon filing. This streamlined process provides flexibility for WKSIs to time securities sales to meet market conditions without waiting for the SEC staff to review and comment on a registration statement and declare it effective. Granting the ability to qualify for WKSI status to BDCs will significantly reduce the costs associated with establishing and maintaining shelf offering programs for qualifying BDCs.

Section 803 of the SBCA requires the SEC to include securities registered on Form N-2 by a BDC that would otherwise meet the eligibility requirements of Form S-3[2] as securities permitted to be offered and sold on an immediate, continuous or delayed basis pursuant to Rule 415(a)(1)(x) of the Securities Act.[3] Further, BDCs will be permitted to file a shelf registration statement

[1] A WKSI is an issuer — other than an ineligible issuer — that is required to file reports with the SEC under Section 13(a) or 15(d) of the Exchange Act, meets the registrant requirements of Form S-3 or Form F-3, and either: (1) "as of a date within 60 days of determination date, has a worldwide market value of its outstanding voting and non-voting common equity held by non-affiliates of $700 million or more"; or (2) "as of a date within 60 days of the determination date, has issued in the last three years at least $1 billion aggregate principal amount of non-convertible securities, other than common equity, in primary offerings for cash, not exchange, registered under the Securities Act."

[2] For example, be an Exchange Act reporting company for 12 months and have a $75 million common share public float.

[3] This codifies historical positions of the SEC staff that generally have permitted BDCs to use a "shelf" registration process under Rule 415.

under Rule 415 of the Securities Act, but will not be required to file post-effective amendments to effectuate prospectus disclosure updates (such as for the inclusion of their most recent audited financial statements). The shelf registration statement, however, will continue to have a maximum lifespan of three years from the date of effectiveness.

These changes, together with other corresponding changes discussed below regarding the use of definitive offering documents and incorporation by reference, are likely to result in significant efficiencies by creating a streamlined process for many BDC shelf filings.

The SBCA also requires the SEC to revise Rule 497 of the Securities Act in order to allow a BDC to file a form of prospectus that contains substantive changes from or additions to a previously filed and effective base prospectus. This structure allows a BDC that has an effective base prospectus to sell securities registered on a shelf registration statement without filing a post-effective amendment and having to wait for the SEC staff to review and declare it effective. Instead, the BDC is permitted to file a prospectus supplement and access capital markets immediately. This can be extremely important for BDCs that trade at a discount and cannot offer shares at a price below net asset value per share without shareholder approval, or where obtaining favorable rates on preferred or debt financing can significantly impact returns to common shareholders. Furthermore, if the BDC is a WKSI, it would have the ability to file an automatically effective registration statement, immediately followed by a prospectus supplement, thereby accessing capital markets in a single day without the delay caused by SEC review.

Additionally, BDCs generally are required to deliver a final prospectus to each purchaser by printing and mailing hard copies to investors. Pursuant to revisions called for in the SBCA, BDCs will be able to rely on certain rules under the Securities Act that will significantly reduce the cost and burden associated with prospectus delivery. Under these rules, a BDC will not need to print and mail hard copies of the final prospectus to investors if the issuer timely files the final prospectus with the SEC, commonly referred to as "access equals delivery." BDCs also will be permitted to provide a notice of registration in lieu of sending the final prospectus.

### Incorporation by Reference Into Registration Statements and Proxies

The SBCA grants BDCs the ability to incorporate by reference into their shelf N-2s current and future Exchange Act filings. This will eliminate the need for certain BDCs to amend their offering documents in order to include new financial statements or new material information filed on a current report on Form 8-K and, along with the changes discussed above, may significantly reduce the costs associated with keeping current a shelf offering document and quickly producing a prospectus supplement for an offering.

The SBCA also calls for revisions to Schedule 14A under the Exchange Act to permit BDCs that meet the eligibility requirements of Form S-3 (meaning, the BDC has been an Exchange Act reporting company for 12 months and has a $75 million common share public float) to incorporate by reference previously filed documents into their proxy statements. Specifically, these BDCs will be permitted to incorporate by reference certain financial information, including financial statements and information required by Regulation S-X and Regulation S-K.

### General Summary of Anticipated Effect of Streamlined Shelf Offering Provisions

These benefits for BDCs are likely to have the effect of significantly reducing the high cost and frequent delays involved in BDC shelf filings. As noted, BDCs qualifying as WKSIs will be able to file automatically effective shelf registration statements and conduct immediate takedowns to access the securities markets. BDCs not qualifying as WKSIs, but that would otherwise qualify to register securities on Form N-2 to be offered and sold on an immediate, continuous or delayed basis pursuant to Rule 415(a)(1)(x) (in accordance with standards currently set forth in Form S-3), will only be required to file a registration statement that must be declared effective, and thus subject to SEC staff review and comment, once every three years. If these changes are appropriately implemented, all qualifying BDCs will otherwise be able to keep their shelf offering documents current through a combination of forward-incorporation by reference and filing prospectus supplements for particular offerings.
And — to further streamline the offering process — BDCs will be able to rely on the "access equals delivery" model for final prospectuses, rather than the current requirement of needing to print and deliver final prospectuses (whether that delivery is a physical hard copy or an electronic copy by email). The "access equals delivery" model will similarly apply to initial public offerings of BDCs and significantly reduce the costs and burdens of prospectus delivery in such transactions.

### Safe Harbors for Communications During the Pre-Filing Period and During the Waiting Period

Section 803 of the SBCA also relaxes restrictions on BDC communications with the public prior to filing a registration statement and allows BDCs to disseminate certain information about themselves and the offering, including, but not limited to, general business or financial information, earnings releases, financial projections, statements about future operations, products or services, and statements about future economic performance, as well as assumptions underlying any of these topics.

BDCs are prohibited from offering to sell securities through the use of a prospectus or otherwise unless a registration statement has been filed with the SEC. Given the Securities Act's broad definition of "offer" and "prospectus," this prohibition captures numerous communication methods and mediums. While rules-based safe harbors and exceptions exist, they were previously unavailable to BDCs. This has required BDCs to rely on historical positions of the SEC and its staff regarding ordinary business communications while "in registration" that formed the basis for certain of these rules-based safe harbors and exceptions. Although these historical positions have been available to issuers, including BDCs, the SBCA provides BDCs with the additional comfort, flexibility and certainty that other issuers enjoy with respect to ordinary business communications and advertising an offering while "in registration," mandates opening the availability of these rules-based safe harbors and exceptions to BDCs, and expands BDCs' flexibility in the case of certain rules that do not have a historical analog in prior SEC and SEC staff positions, such as the use of free writing prospectuses.

In particular, the SBCA permits BDCs qualifying as WKSIs to rely on Rule 433 under the Securities Act, which permits free writing prospectuses, and also will allow BDCs qualifying as WKSIs to rely on Rule 163 under the Securities Act, which permits WKSIs to engage in unrestricted oral and written offers before a registration statement is filed, subject to certain conditions. Additionally, Section 803 of the SBCA specifically provides that nothing in Section 803, or in the rule and form amendments to be made pursuant to the requirements of Section 803, may be construed to prevent a BDC from distributing sales material under Rule 482 of the Securities Act, which governs the requirements for advertisements and other sales materials with respect to the securities of BDCs.

Further, under the SBCA, brokers or dealers are expressly permitted to distribute certain communications to the public about BDCs without such communications constituting offerings. Under these rules, a broker's or dealer's publication of research reports about an issuer's securities will not constitute an offer to sell a security regardless of whether the issuer proposes to file, has filed or has an effective registration statement, and even if the broker or dealer will be participating in the offering. Additionally, brokers or dealers will be permitted to publish or distribute, subject to certain conditions, issuer-specific reports or industry reports without such reports constituting an offering. This equalizes the treatment of BDCs with other issuers under these rules.

### Effectiveness of SBCA Provisions

Section 803 of the SBCA provides that if the SEC does not act to revise its rules and forms as directed within the one-year timeframe provided by the SBCA, BDCs will be entitled to treat such revisions as having been completed in accordance with the actions required to be taken by the SEC until such time as such revisions are completed by the SEC.

## Provisions of the CHOICE Act Relevant to CEFs

Section 499A of the CHOICE Act would extend essentially the same changes applicable to BDCs under Section 803 of the SBCA to CEFs. In addition to the benefits discussed above, the CHOICE Act also would eliminate the need for costly and time-consuming individual no-action relief to file automatically effective registration statement updates for certain CEFs, since such updates would no longer be required in a post-effective amendment. Of note is that, while CEFs have been successful in obtaining such no-action relief (although costly and time-consuming), the SEC staff had not extended such relief to BDCs.

It is notable, however, that CEF registration statements in particular do not necessarily have required content that perfectly overlaps with the required content of CEF Exchange Act filings. If the CHOICE Act were to ultimately become law, subsequent SEC rulemakings would need to address the overall disclosure and reporting regime for CEFs in order for CEFs to take full advantage of the streamlined offering process that would be available to them as a result of these changes. In the absence of the SEC taking the lead on this topic, CEF industry participants would need to evaluate how to modify the usual scope of information contained in Exchange Act filings so as to, if desired, take full advantage of the streamlined offering process that would be available. This observation also is true, to an extent, for BDCs; however, BDCs already file the same Exchange Act reports as other issuers and the transition to using a streamlined offering process is likely to be simpler for BDCs than for CEFs.

## Provisions of the EIOA

The EIOA is intended to effect the same changes that Section 499A of the CHOICE Act contemplates for CEFs and Section 803 of the SBCA effects for BDCs. One significant difference between the EIOA and the CHOICE Act is that the EIOA would

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only apply to certain CEFs; CEFs that are not listed on a national securities exchange or do not make periodic repurchase offers pursuant to Rule 23c-3 under the Investment Company Act of 1940 (1940 Act) would not benefit from the EIOA.

The EIOA contains provisions that would require the SEC to propose rules within 180 days of enactment and to finalize rules within one year of enactment to allow any CEF that is registered as an investment company under the 1940 Act and is listed on a national securities exchange or makes periodic repurchase offers pursuant to Rule 23c-3 under the 1940 Act (commonly referred to as "interval funds") to use the securities offering and proxy rules that are available to traditional operating companies, subject to appropriate conditions. The EIOA also provides that if the SEC fails to adopt revisions to the securities offering and proxy rules within the specified time frames, then such CEFs would be deemed to be an eligible issuer under the final rule of the SEC titled "Securities Offering Reform" (70 Fed. Reg. 44722; published August 3, 2005).

## Status of the CHOICE Act and the EIOA

Both the CHOICE Act and the EIOA are currently awaiting a vote from the Senate, with the EIOA having been referred to the Senate Committee on Banking House and Urban Affairs on January 18, 2018. Taken together, both bills, if enacted, would significantly reduce costs for many CEFs and allow many CEFs to access the capital markets on a more streamlined basis.