

Publicly Traded Private Equity Review provides a periodic update of issues in the publicly traded private equity space.

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In This Issue

[BDC Roundtable Update:
Shelf Offerings Below NAV](#)

[Regulatory Initiatives:
Temporary Modification of
Asset Coverage Requirements
for BDCs](#)

[Guidance Regarding BDC
Distributions Under IRS
Revenue Procedure 2009-15](#)

[Shareholder Approval of Sales
of Shares Below NAV](#)

[The Proposed Elimination of
Discretionary Broker Voting for
the Election of BDC Directors](#)

BDC Roundtable Update: Shelf Offerings Below NAV

At the September BDC Roundtable we discussed the progress of our discussions with the staff of the Division of Investment Management of the U.S. Securities and Exchange Commission (the Staff) regarding the ability of a business development company (BDC) to offer shares of common stock off of a shelf registration statement at a price below its current net asset value (NAV). At that time, the Staff's position was that in order for a BDC to offer shares of its common stock at a price below NAV off of a shelf registration statement, a BDC would have to file a post-effective amendment prior to each takedown offering.

Since the BDC Roundtable, we have continued our discussions with the Staff on this issue and, as a result of our efforts, the Staff has reconsidered their position and cleared a procedure that will allow a BDC to conduct offerings of shares of its common stock at a price below NAV off of an existing or new shelf registration statement. Pursuant to the new procedure, a BDC can file a single post-effective amendment (or a new shelf registration statement), which must include certain required disclosure as set forth below. A BDC

can rely on this new process in order to complete offerings of its common stock at a price below NAV off of its shelf registration statement provided that the BDC has not exceeded a specific level of dilution. Because this process does not require any additional action or approval from the Staff with respect to the contemplated offering of securities, the process provides BDCs with much-needed flexibility in their capital-raising activities.

- The Staff has imposed a limit on the cumulative dilution to a BDC's NAV per share that a BDC may incur while using a shelf registration statement to sell shares of its common stock at a price below NAV. A BDC can complete multiple offerings off of an effective registration statement only to the extent that the cumulative dilution to the BDC's NAV per share does not exceed 15%. Once the cumulative dilution to the BDC's NAV per share from multiple offerings off of a particular registration statement exceeds 15%, the BDC must file a new post-effective amendment or registration statement, which must again be declared effective by the Staff.
 - For example, if a BDC's most recently determined NAV at the time of its first offering off of its shelf registration statement is \$15.00 and it has 30 million shares outstanding, the sale of 6 million shares at net proceeds to the BDC of \$7.50 per share (a 50% discount) would produce dilution of 8.33%. If the BDC subsequently determined that its NAV per share increased to \$15.75 on the then 36 million shares outstanding and the BDC then made an additional offering, it could, for example, sell approximately 7.2 million additional shares at net proceeds to the BDC of \$9.45

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- per share, which would produce dilution of 6.66%, before the BDC would reach the aggregate 15% limit. If the BDC were to file a new post-effective amendment, the threshold would reset.
- The amount of dilution incurred will be measured separately for each offering pursuant to a post-effective amendment by calculating the percentage dilution or accretion to aggregate NAV from that offering and then summing the percentage from each offering. A BDC must include these limitations in its post-effective amendment or registration statement and in each prospectus supplement.
 - A BDC must include specific dilution tables demonstrating the various dilutive or accretive effects the offering will have on different types of investors, including:
 - The level of dilution that existing stockholders who do not participate in the offering would experience based on the offering size and discount to NAV;
 - The level of dilution and accretion that existing stockholders who participate in the offering would experience based on their level of participation in the offering; and
 - The level of dilution or accretion that new investors would experience based on the offering size and the discount to NAV.
 - The prospectus supplement pursuant to which any offering of shares of common stock at a price below NAV is made should include a chart based on the number of shares offered and the discount to the most recently determined NAV. These new requirements are in addition to the standard Investment Company Act of 1940 (the 1940 Act) requirements regarding stockholder and disinterested director approval prior to conducting any offering below NAV.
 - The Staff has requested that a form of prospectus supplement be filed along with the registration statement.
 - A BDC must include an additional undertaking (either in its post-effective amendment or shelf registration statement) stating that it will file a new post-effective amendment in the event its common stock is trading below NAV and it either: (i) receives, or is advised by its independent registered accounting firm that it will receive, an audit report reflecting substantial doubt regarding its ability to continue as a going concern; or (ii) concludes that a material adverse change has occurred in its financial position or results of operations that has caused the financial statements and other disclosures on the basis of which the offering would be made to be materially misleading.

Regulatory Initiatives: Temporary Modification of Asset Coverage Requirements for BDCs

As previously reported, we, along with other members of the BDC industry, have been working on several regulatory and legislative initiatives with the Commission and with members of Congress. The initiatives that we have discussed include that:

- The Commission should use its authority under the 1940 Act, as it has done in other circumstances, to authorize the use of amortized cost accounting for assets held by BDCs that are intended to be held to maturity;
- The Commission should temporarily modify the asset coverage requirements for BDCs, which it has done in other circumstances; and

- The Commission should temporarily treat preferred stock as equity for purposes of the asset coverage test, consistent with the treatment of preferred stock issued by our lenders to the Treasury under the Troubled Asset Relief Program, known as TARP.

With respect to the temporary modification of the asset coverage test, we are in the process of submitting a draft rule to the Commission for consideration providing for temporary relief. The proposed rulemaking requests that the Commission adopt, for a two-year period, a rule modifying the existing asset coverage requirements for BDCs set forth in § 61 of the 1940 Act. Specifically, it would permit a BDC to issue senior securities for a two-year period, if, immediately after such issuance, the BDC has an asset coverage, as defined in § 18 of the 1940 Act, of at least 150%. The temporary rule is intended to provide relief to BDCs during the current economic crisis to permit them to continue their Congressionally mandated purpose of financing small- and middle-market U.S. private companies.

Guidance Regarding BDC Distributions Under IRS Revenue Procedure 2009-15

The Staff of the U.S. Securities and Exchange Commission's Division of Investment Management has informed us that they have taken a no-action position permitting BDCs to make distributions to shareholders consistent with the position taken recently by the Internal Revenue Service in Revenue Procedure 2009-15 (Rev. Proc. 2009-15) notwithstanding that such distribution might not otherwise be permissible under § 18(a) of the 1940 Act. Rev. Proc. 2009-15, which was issued on January 7, temporarily allows closed-end investment companies, including BDCs, when paying distributions subject to a shareholder election of cash or stock, to limit the total amount of cash to be distributed to 10% of the total distribution. The prior permissible limit was 20%.

The Staff informed us that the letter will be issued in the near future.

Shareholder Approval of Sales of Shares Below NAV

On March 12, the Securities and Exchange Commission's Office of Chief Counsel, Division of Investment Management, released a no-action letter to Kohlberg Capital Corporation (Kohlberg) saying it would not recommend enforcement action where a BDC was to sell its common stock at a price below its current NAV within one year after obtaining shareholder approval of such sale at a special meeting, rather than at an annual meeting of shareholders.¹

The Staff agreed with the assertions of Kohlberg that, although the language of § 63(2)(A) of the 1940 Act provides for shareholder approval at an annual meeting of shareholders, Congress did not intend to distinguish between approval obtained at an annual meeting or a special meeting, so long as approval was obtained within one year immediately prior to the transaction.

This position reinforces similar relief granted to a BDC in 1983.²

¹ Kohlberg Capital Corporation (pub. avail. Mar. 12, 2009).

² See Greater Washington Investors, Inc. (pub. avail. Oct. 21, 1983).

The Proposed Elimination of Discretionary Broker Voting for the Election of BDC Directors

The U.S. Securities and Exchange Commission (the Commission) recently published for comment a proposed rulemaking soliciting comments on the proposed changes to New York Stock Exchange (the NYSE) Rule 452 that would eliminate discretionary broker voting for the election of directors.³ In response to the Commission's request for comments on the proposed rulemaking, Sutherland submitted a comment letter on March 31, 2009, requesting that the NYSE and the Commission make a technical amendment to the proposed rulemaking to except *all* investment companies, including BDCs, from the proposed rulemaking so that BDCs may continue to permit discretionary broker voting for the election of directors.

The proposed rulemaking excepts registered investment companies so that they may continue to permit brokers to vote for the election of directors regardless of whether or not they have received instructions from the beneficial owners of the securities. The exception for registered investment companies came about as a result of the efforts of the Investment Company Institute (ICI), which assisted the NYSE Proxy Working Group and the NYSE staff in considering the disproportionate impact of the proposed changes to Rule 452 on investment companies. Specifically, the ICI emphasized that the proposed changes to Rule 452 would create significant difficulties for investment companies in achieving quorums and electing fund directors as a result of their large retail shareholder base.

Unfortunately, BDCs are not excepted from the proposed changes to Rule 452 because BDCs are not technically "registered" under the 1940 Act pursuant to § 8 but rather "elect to be regulated as a BDC" by filing a notification as required by § 54 of the 1940 Act. As a result of the reference in the proposed rulemaking to "*registered* investment companies" rather than just "investment companies," BDCs must comply with the proposed rulemaking despite the fact that registered investment companies and BDCs share the same characteristics that gave rise to the exception provided to registered investment companies—namely, regulatory structure and a large retail shareholder base.

A copy of this letter has been posted to our Web site and is available [here](#).

If you have any questions regarding these developments, please contact the Sutherland attorney with whom you regularly work. The attorneys in Sutherland's BDC Team are listed below.

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³ See Securities Exchange Act Release No. 59464 (Feb. 26, 2009), 74 C.F.R. 9864 (Mar. 6, 2009).

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