
The ABCs of BDCs

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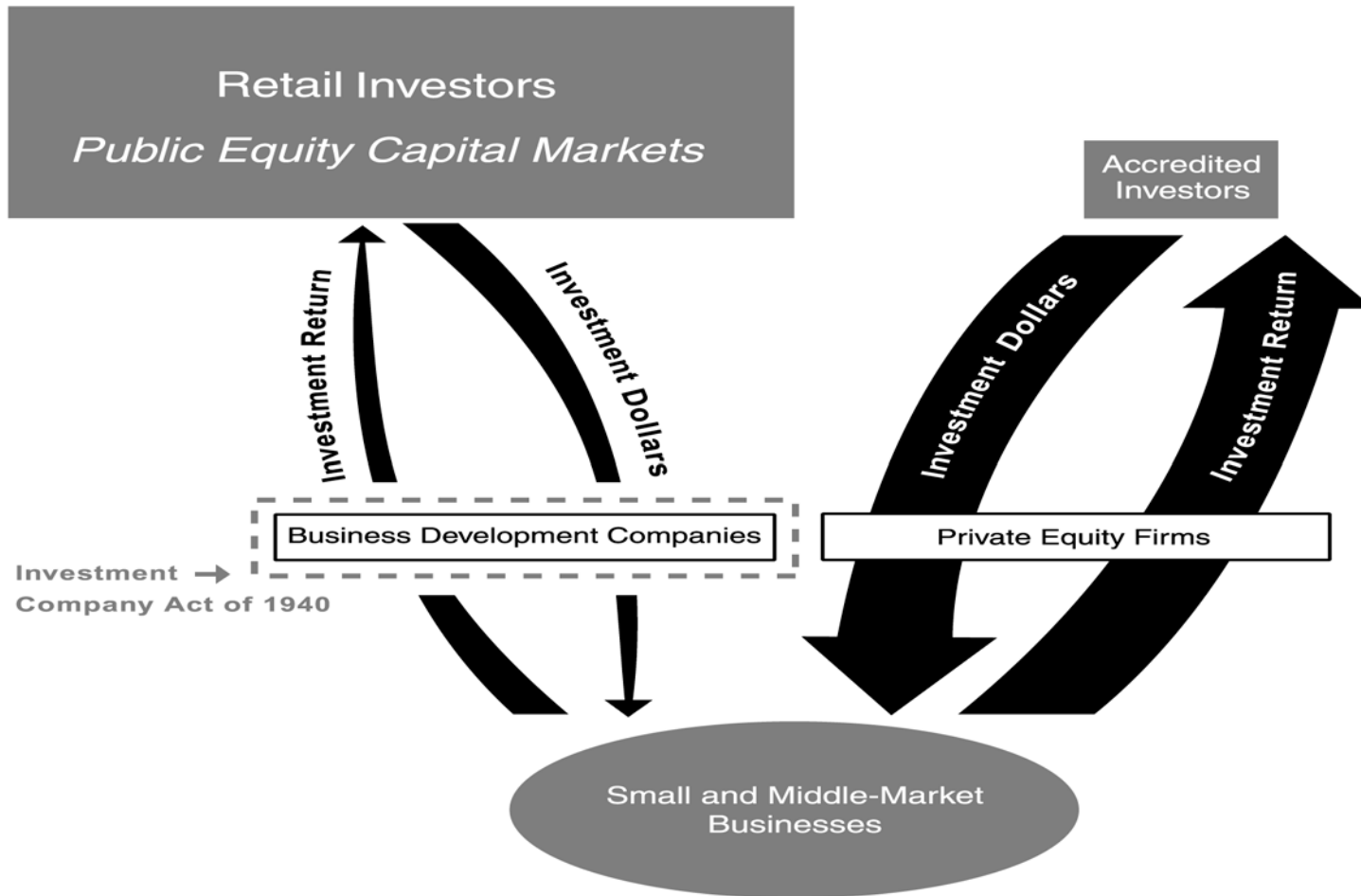
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What is a Business Development Company?

- Created by the Small Business Investment Incentive Act of 1980 (the “1980 Amendments”) as a result of a perceived crisis in the capital markets in the 1970s.
- Private equity and venture capital firms believed the “small private investment company” exemption (Section 3(c)(1) of 1940 Act) limited their capacity to provide financing to small, growing businesses.
- Provided Regulated Investment Company (RIC) status in 1990.
- Special type of closed-end fund that:
 - Provides small, growing companies access to capital.
 - Enables private equity funds to access the public capital markets.
 - Enables retail investors to participate in the upside of pre-IPO investing with complete liquidity.
- Hybrid between an operating company and an investment company.

What is a Business Development Company? (con't)



What are the Benefits of the BDC as an Investment Vehicle?

- Access to public capital markets
- Shares are traded on national exchanges
- Flow-through tax treatment as a RIC
- Reduced burden under 1940 Act, as compared to closed-end funds
 - Restrictions on leverage
 - Restrictions on affiliated transactions
- External model permits management fee and “carried interest” incentive fee structure
- Publicly available financial information through quarterly reporting
- Portfolio is typically diversified
 - Reduces risk typically associated with private equity investments

How Did the BDC Industry Develop?

- Prior to 2003, the largest BDCs were primarily internally managed.
 - Choice reflected the success of the internally managed, income producing BDC model.
- In 2004, Apollo Investment Corporation raised \$930 million in less than three months which ignited the growth in the BDC industry.
- There has been a steady stream of BDC IPOs since that period
- IPO markets have opened up again for BDCs - comparable to 2004.
- The top 25 actively traded BDCs have approximately \$25 billion in assets under management.
- In the first six months of 2011, BDCs have raised over \$565 million in follow on equity transactions and \$1.6 billion in convertible debt offerings in the 144A market

How Does a Company Become a BDC?

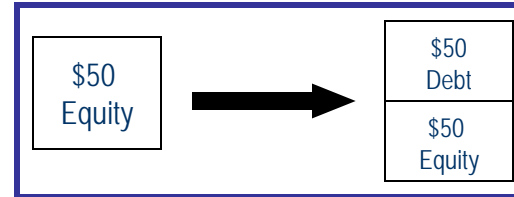
- Organize the entity - typically as a Delaware or a Maryland corporation
- Register a class of securities on Form N-2 under the 1940 Act
- Register a class of securities under the 1934 Act
- Apply to list securities on the NYSE, Nasdaq, or the NYSE AMEX (unless the BDC intends to be a non-traded BDC)
- Make an election to be a BDC by filing a Form N-54A
- Have registration statement be declared effective by the SEC
- Comply with regulatory requirements of the 1940 Act
- Comply with reporting requirements including the 1934 Act, Sarbanes-Oxley Act, and Dodd-Frank Act

What Must a BDC Invest In?

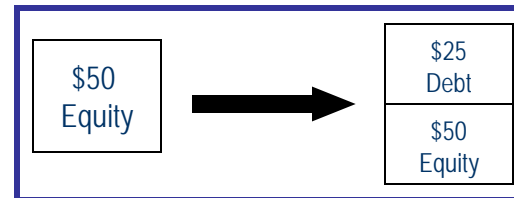
- A BDC must invest 70% of its assets in “good” BDC assets.
- 70% basket includes securities issued by an eligible portfolio company, as defined in Section 2(a)(46), which includes:
 - U.S. issuers that are neither an investment company as defined in section 3 (other than a wholly-owned SBIC) nor a company which would be an investment company except for the exclusion from the definition of investment company in section 3(c) and
 - (i) do not have any class of securities listed on a national securities exchange; or
 - (ii) have a class of securities listed on a national securities exchange, but have an aggregate market value of outstanding voting and non-voting common equity of less than \$ 250 million.
- A BDC can generally invest with flexibility in “bad” assets that do not fall within the “70% basket”.
 - The SEC Staff has never been called upon to consider whether utilizing a specific strategy for the entire “30% basket,” e.g., investing solely in foreign companies, might run afoul of the intent of Section 55(a)

What are the Borrowing Limitations?

- BDCs must have 200% asset coverage (Total Assets/Total Debt)
 - For example, a BDC with \$50 in equity can borrow up to \$50
 - A BDC would be able to invest \$100 in growing businesses



- Other investment companies are restricted to a 300% asset coverage requirement with respect to issuing debt



- BDCs may exclude leverage at the SBIC level if the SEC grants exemptive relief, which many have received.

Can a BDC Engage in Transactions with Affiliates?

- Section 57 addresses the ability of BDCs to engage in certain types of transactions with affiliates:
 - Section 57 is less onerous than its counterpart for registered investment companies (Section 17)
- Depending on the nature of the affiliation with the BDC, transactions involving a BDC and one or more of its affiliates require either:
 - Authorization by the required majority of the board of directors, which consists of a majority of the board, including a majority of disinterested board members; or
 - An order of the Commission.

What are the Reporting Requirements?

- Form 10-K (Annual Report)
- Form 10-Q (Quarterly Report)
- Form 8-K (Current Report)
- Proxy Statements
- Sections 13 and 16 Filings
 - Forms 3, 4 or 5 for reporting beneficial ownership by insiders
 - Schedules 13D and 13G for reporting beneficial ownership by others
- Regulation G and Regulation FD
- Comply with the Sarbanes-Oxley Act of 2002
- Disclosure Controls and Procedures
- Internal Control over Financial Reporting/Attestation

What are the NYSE/Nasdaq/NYSE AMEX Reporting Requirements?

- BDCs that have their securities listed or traded on an exchange or association must comply with the corporate governance listing standards of the relevant exchange or association. For example:
 - A listed BDC must have an audit committee composed solely of “independent directors” (as defined by the applicable exchange or association)
 - Director nominees of a listed BDC must be selected or recommended for the Board’s selection by a nominating committee or the vote of a majority of the BDC’s independent directors (depending on the exchange)
 - The non-management, or “independent directors”, of the BDC must hold regularly scheduled executive sessions
 - The BDC must adopt a code of business conduct and ethics, various committee charters and, in the case of NYSE-listed BDCs, corporate governance guidelines
 - All such documents must be posted on the company’s website
 - BDC must comply with the corporate governance provisions of Dodd-Frank Act, to the extent applicable to BDCs

How do BDCs Value Their Assets?

- Investments are reported at fair value
- FASB ASC 820 – *Fair Value Measurements and Disclosures*
- Fair value – Price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at measurement date
- Regulated investment companies also governed by definition of “value” in Investment Company Act of 1940 further interpreted in SEC Codification of *Financial Reporting Policies* section 404.03 – “fair value as determined in good faith by the board of directors”

Principles of Valuation

- Investments classified into three levels:
 - *Level 1:* Inputs are unadjusted, quoted prices in active markets for identical financial instruments at the measurement date.
 - *Level 2:* Inputs include quoted prices for similar financial instruments in active markets and inputs that are observable for the financial instruments, either directly or indirectly, for substantially the full term of the financial instrument.
 - *Level 3:* Inputs include significant unobservable inputs for the financial instruments and include situations where there is little, if any, market activity for the investment. The inputs into the determination of fair value are based upon the best information available and may require significant management judgment or estimation.
- Majority of BDCs classify debt and equity investments as Level 3 instruments
- Debt investments with broker quotes may be considered a Level 2 instrument (broadly syndicated loans)

Positive and Negative Factors that Impact Valuation

- **General Economic Factors**
 - Changes in interest rates and credit spreads and return on equity
 - Changes in aggregate demand level
 - Changes in economic outlook
- **Industry Factors**
 - Change in supply or demand for product
 - Change in competition
 - Barriers to entry
- **Company Specific Factors**
 - Current and expected life cycle of company – Achievement of milestones, company performance relative to projections
 - Experience and competence of the top management team and board of directors
 - Existence of intellectual capital and intangible assets
 - Proprietary technology, products, or services
 - Quality of work force
 - Strategic relationships with major suppliers or customers
 - Cost structure and financial condition

What is Required to Set Up a BDC Valuation Process?

- Written internal valuation policy
- Need quarterly valuations – 10Q/10K
- Valuation write-ups and supporting data retained (SEC Codification of Financial Reporting Policies Rule 404.03-04)
- Use of third-party valuation firms
- PCAOB consents by valuation firms
- Involvement of board of directors or its designee

What are the Key Controls in the Valuation Process?

- Documented approval of trades
- Controls over inputs in valuation write-ups
- Segregation between preparation and review of valuations
- Identified and monitored problem loans
- High level analytical reviews
- Completeness of disclosures
- All controls evidence Sarbanes-Oxley 404 readiness

What is the Audit Process for Valuation?

- PCAOB policy – Generally 100% of investments valued annually
- Audit request – Listing of investments, level classification, valuation write-ups, portfolio company financial statements, purchases and sale log, etc.
- Interim valuation – Roll forward
- Review by audit firm's valuation specialists
- Communication between audit firm and valuation group (internal/external)
- Audit firm can't ignore external valuation results, however can't rely on the results either

What are the Required Financial Statement Disclosures Regarding Valuation?

- Valuation policy
- Control investments, investments in affiliates vs. investment in non-affiliates
- Schedule of investments
 - Disclose non-income producing investments
 - Lower threshold: 1% of net asset value
 - Disclose assets held in securitized vehicles
- Concentration – Geography and industry sectors
- Fair value and Level 3 reconciliation tables

What are the Valuation Hot Topics in 2011?

- Increasing scrutiny of the SEC and PCAOB for valuation analyses
 - Including the documentation of valuation analyses
- Increasing requirement to fair value debt and accounting
 - Debt valuation should account for both credit risk and interest rate risk.
- How many valuation methods should be used to value a financial instrument: one or several?
- Application of the option pricing method vs. current value method when valuing companies with convertible debt and preferred stock, warrants and common stock
- Application of valuation discounts and premiums – for lack of control, marketability and control premium
- Reconciling pricing differences from pricing services (i.e., S&P vs. Moody's vs. Fitch).

Accounting Standards Update (ASU) 2011-04

- Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS
 - Issued in May 2011 by FASB
 - 300+ pages
 - 160 pages of amendments to the Codification
 - 30 pages of background information and basis for conclusions
 - 85 pages of amendments to Topic 820 (Fair Value)
- Must be applied prospectively
- Effective for interim and annual periods beginning after December 15, 2011 (i.e., majority of the calendar year 2012 entities)

ASU 2011-04 (con't)

- Three disclosures required for public entities (SEC registrants)
 - Information about transfers between Level 1 and 2
 - Information about sensitivity of a Level 3 fair value measurement to changes in the unobservable inputs and any interrelationships between those unobservable inputs
 - Categorization by level of the fair value hierarchy for items not measured at fair value in the statement of financial position, but for which fair value of such items is required to be disclosed (not applicable to BDCs)

ASU 2011-04 (con't)

- Improves consistency in applications across jurisdictions (i.e., U.S. GAAP vs. IFRS) and minor, but important, changes in wording (i.e., “should” is replaced with “shall”)
- Need to measure the fair value of an instrument classified in the Company’s shareholders’ equity
 - The Company should measure the fair value of its own equity instrument from the perspective of a market participant that holds that instrument as an asset.
- Increased disclosures about fair value measurements
 - The Company should disclose quantitative information about unobservable inputs.

ASU 2011-04 (con't)

Example of Quantitative Information About Level 3 Fair Value Measurements

	Fair Value at 12/31/X9	Valuation Techniques	Unobservable Inputs	Range
Commercial mortgage-backed securities	\$50,000,000	Discounted cash flow	Constant prepayment rate	3.0% – 5.0% (4.1%)
			Probability of default	2% – 25% (5%)
			Loss severity	10% – 50% (20%)
Collateralized debt obligations	\$35,000,000	Consensus pricing	Offered quotes	20 – 45
			Comparability adjustments (%)	-10% – +15% (+5%)

ASU 2011-04 (con't)

- Permits an exception to the requirements of Topic 820 for measuring fair value when a Company manages its financial instruments on the basis of its net exposure vs. gross exposure
 - Allows the Company to measure the fair value of such financial assets and liabilities at that price it would be received to sell a net asset position or transfer a net liability position.
- Allows for application of premium and discounts in the fair value measurement.
 - In the absence of a Level 1 input, the Company should apply premiums and discounts when market participants price the asset or liability.
 - “Blockage” discounts are still not allowed.
- Additional disclosures about Level 3 fair value measurements are required.
 - Valuation process used by Company.
 - Sensitivity of the fair value measurement to changes in unobservable inputs.

How Can a BDC Compensate its Adviser?

- The investment adviser must be registered under the Investment Advisers Act of 1940
- The Advisers Act contains no prohibition against an adviser taking an incentive fee on ordinary income, although the market has effectively capped these fees at 20%, usually subject to a hurdle.
- This contrasts with incentive fees on capital gains, which are expressly prohibited unless assessed pursuant to an exception like that provided in Section 205(b)(3) of the Advisers Act.
- Some provide for payment of incentive fees in stock

How is the Adviser's Incentive Fee Calculated?

- SEC Staff has taken no formal position on the calculation of the fee but requires BDCs to contain extensive disclosure in registration statements regarding the manner in which the fee will be calculated in varying scenarios.
- Section 205(b)(3) of the Advisers Act permits external investment advisers to BDCs to receive incentive fees, provided that the BDCs do not have outstanding any equity-based compensation arrangement or profit-sharing plan.
 - Section 205(b)(3) provides an exception from the general prohibition on an investment adviser charging an incentive fee based on a share of capital gains.
 - May assess an incentive performance fee of up to 20% on a BDC's realized capital gains net of all realized capital losses and unrealized capital depreciation over a specified period.
- Section 205(b)(3) of the Advisers Act makes no reference to whether the unrealized capital depreciation by which the fee must be reduced includes:
 - only depreciation below the original cost of the security in question, or
 - whether it includes a decrease in value in a security above the original cost but below the point of a previous unrealized capital appreciation.

How are BDCs Taxed?

- A BDC may elect to be taxed as a regulated investment company (“RIC”) under the Internal Revenue Code
- Taxation as a RIC
 - Allows “pass through” tax treatment for income and capital gains that are distributed to shareholders
 - A BDC must distribute at least 90% of its investment income to shareholders annually
 - The BDC may retain, distribute or “deem distribute” capital gains
 - BDC must meet minimum source of income requirements annually and meet requirements on a quarterly basis with respect to the portfolio diversification
- Conversion to RIC status
 - Formation considerations – Built-in gains

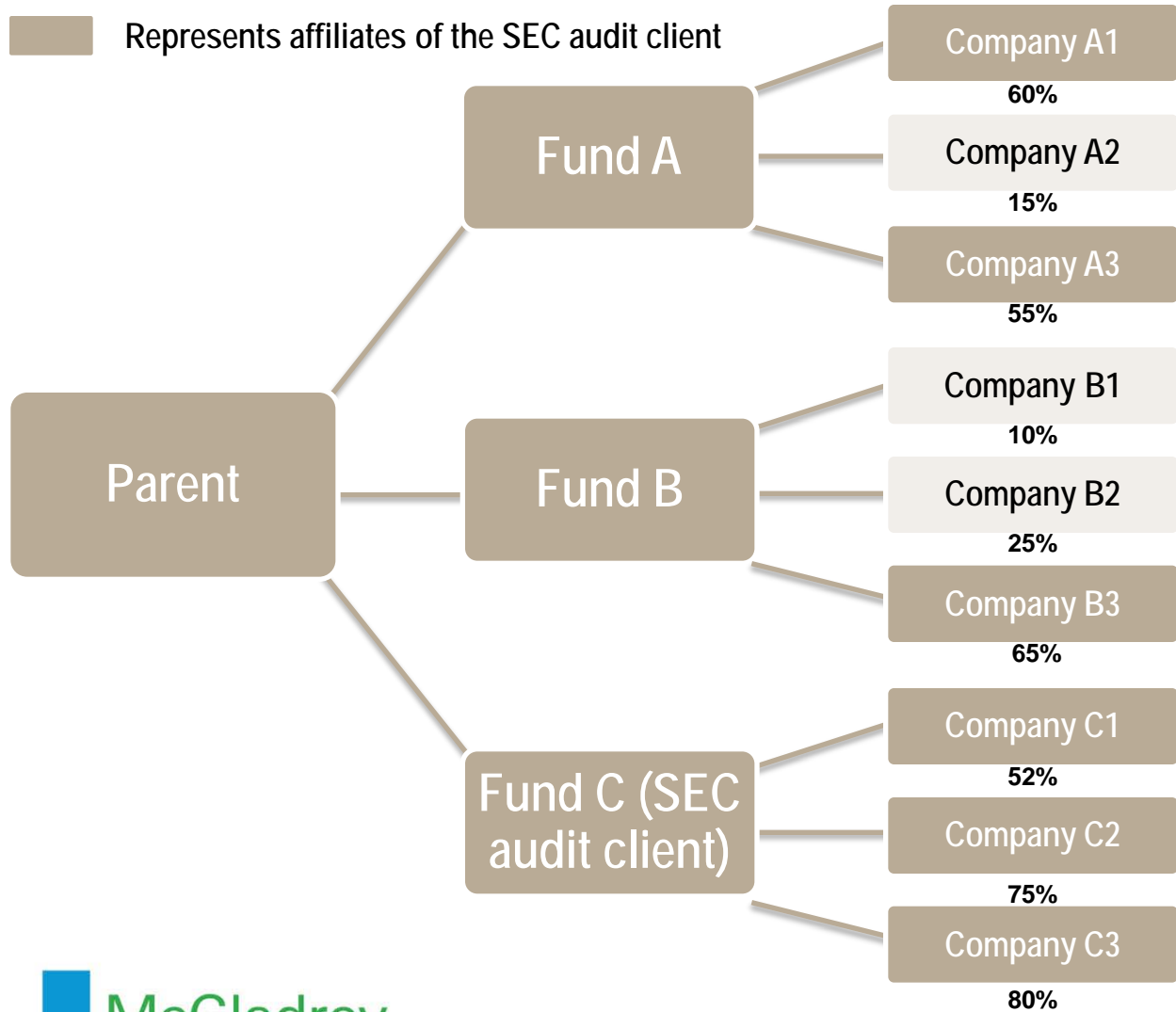
What are the Independence Requirements?

- SEC Regulation S-X requires the auditor of a registrant's financial statements to be independent of the audit client, and sets forth restrictions on financial, employment, business relationships and restrictions on non-audit services
- Both the company and audit firm have a responsibility to ensure auditor independence
- Four overarching principles – The relationship should not:
 - Create a mutual or conflicting interest
 - Permit auditor to audit his own work
 - Permit auditor to act as management or an employee
 - Put auditor in a position of being an advocate for the client

How is an Audit Client Defined?

- The SEC defines “audit client” as the entity whose financial statements are being audited, reviewed, or attested and any affiliates of the audit client.
- Affiliate is any entity:
 - That has control over the audit client
 - Over which the audit client has control (including controlled portfolio companies)
 - That is under common control with the audit client
 - Over which the audit client has significant influence, unless the entity is not material to the audit client
 - That has significant influence over the audit client unless the audit client is not material to the entity
 - Is part of the audit client’s investment company complex

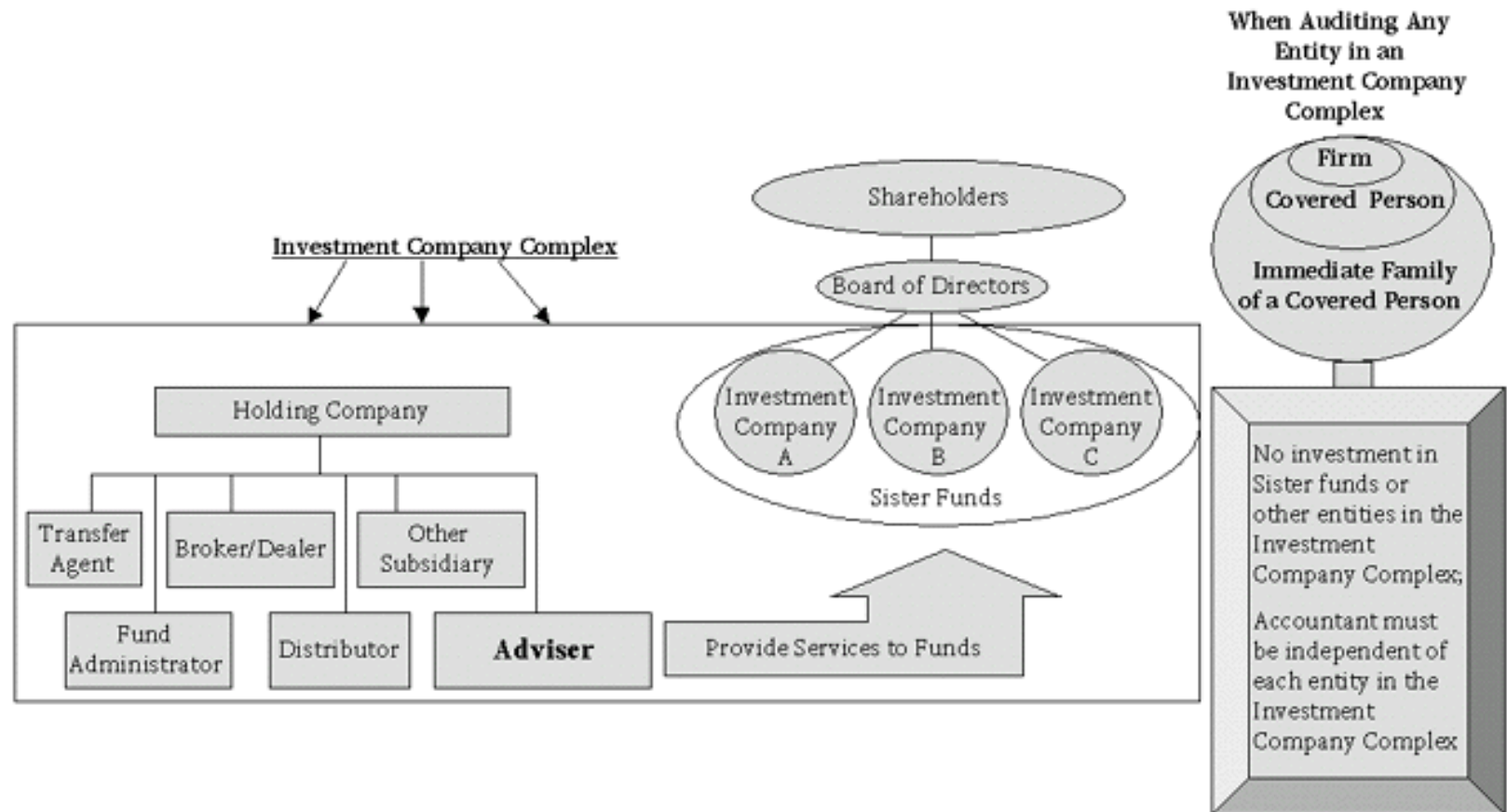
Affiliate Rules Applied



- The SEC rules are applied to the auditor's relationships with all entities determined to be affiliates.
- The extent to which the non-audit service rules apply depends upon the relationship between the audit client and its affiliate.

Investment Company Complex

- Auditor must be independent of all entities in complex



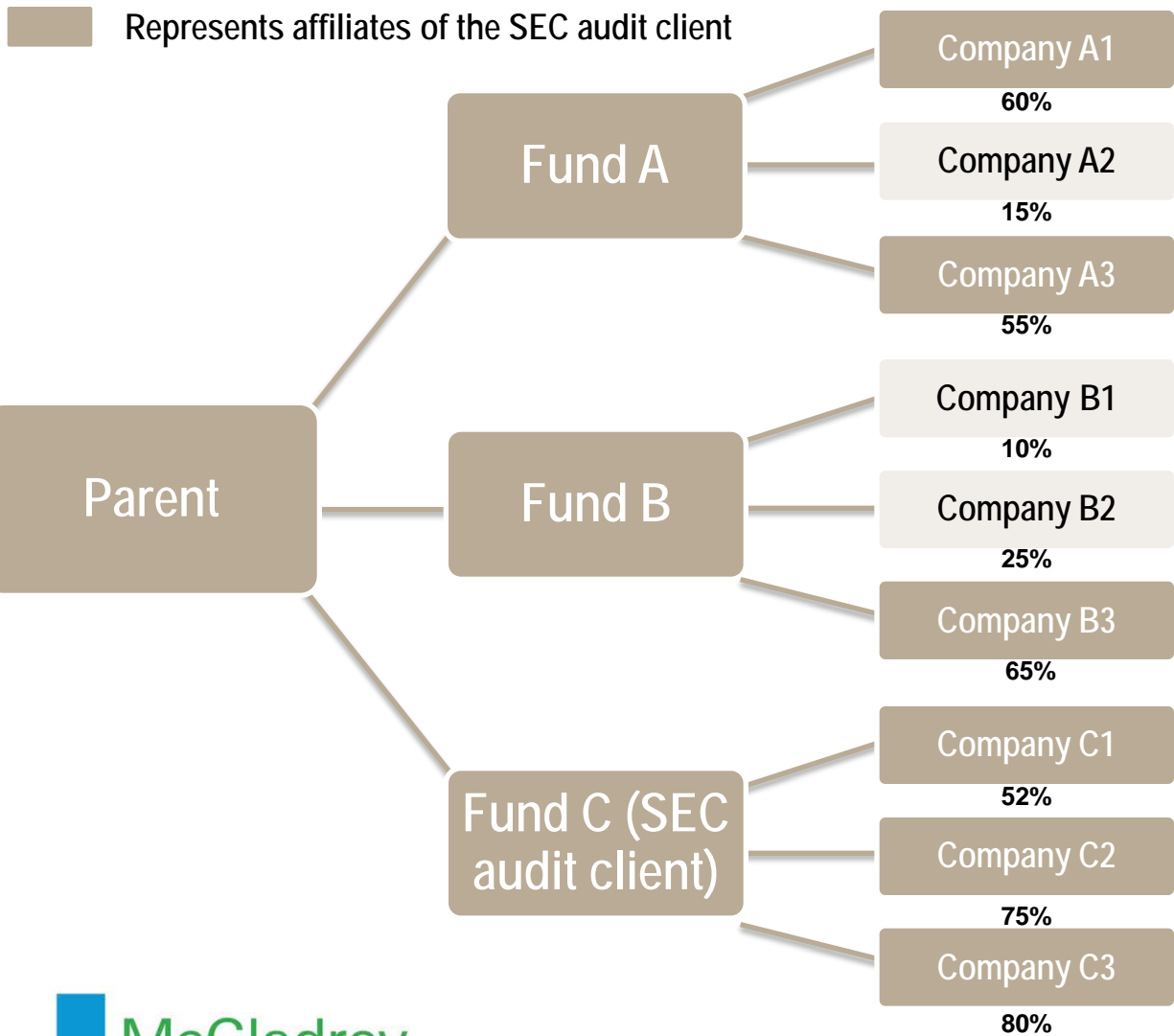
Which Non-Audit Services are Allowed to be Performed?

Always Allowed	Sometimes Allowed	Always Prohibited
Due diligence services including: financial, transaction tax, commercial, human resources, IT systems, working capital services, transaction integration	Bookkeeping	Management/employee functions (e.g., loaned staff, operating as a project management office, etc.)
Sell-side/divestiture services	Financial information system design and implementation	Human resources (e.g., searching for candidate, negotiating position, salary)
Advice on accounting and tax structuring	Appraisal or valuation services, fairness opinions, or contribution-in-kind reports	Broker-dealer, investment advisor, or investment banking services
Tax compliance services (e.g., tax return preparation, tax research and advice)	Actuarial services	Legal services (e.g., utilizing the accounting firm's correspondent legal firm for legal advice in a foreign country on a transaction)
Analyze and advise on financial models	Internal audit outsourcing	Expert services (providing an expert opinion or service for an audit client or audit client's legal representative)

Non-Audit Services: Sometimes Allowed

- The “sometimes allowed” services (noted on previous table) are allowed for audit clients and/or their affiliates if it is reasonable to conclude that:
 - The results of the services will NOT be subject to the audit procedures of the auditor during its audit of the audit client’s financial statements.
- Not subject to audit exception – This exception is not available to entities that are downstream from an audit client under SEC rules.

Example: Sometimes Allowed Services



- The auditor could provide financial information implementation services to the Private Equity Fund, Funds A and B and their respective portfolio companies without impairing independence.
- The auditor could not provide these services to Fund C or its respective portfolio companies without impairing independence.

What are the 1940 Act Operational Requirements?

- BDC must have a majority of independent directors - persons who are not “interested persons” as defined in Section 2(a)(19) of the 1940 Act.
- Custodian Agreement
 - A BDC generally must place and maintain its securities and similar investments in the custody of a bank qualified under Section 26(a)(1) of the 1940 Act or a broker dealer, or be subject to additional audit and operational procedures related to securities held in safekeeping
- Fidelity Bond
 - A BDC must maintain a bond issued by a reputable fidelity insurance company, in an amount prescribed by the 1940 Act, to protect the BDC against larceny and embezzlement. The bond must cover each officer and employee with access to securities and funds of the BDC
- Requirement to maintain and enforce a Code of Ethics for officers of the BDC
 - Includes reporting of all securities holdings and transactions

What are the 1940 Act Operational Requirements? (con't)

- Restrictions on investing in other investment companies. May not invest:
 - in more than 3% of the outstanding voting stock of an investment company
 - more than 5% of the value of its total assets in an investment company
 - more than an aggregate of 10% of its total assets in investment companies
- Restrictions on investment funds investing in a BDC
 - Neither a public (i.e. registered) or private investment fund may own more than 3% of the outstanding voting stock of a BDC
- Limitations on indemnification
 - A BDC is prohibited from protecting any director or officer against any liability to the company, or its security holders, arising from willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of such person's office.
- Bookkeeping and records requirements
 - A BDC must maintain and make available for inspection prescribed books and records
- BDCs must make available significant managerial assistance to their portfolio companies

What are the 1940 Act Operational Requirements? (con't)

- Must appoint a chief compliance officer
- Must maintain a compliance program compliant with Rule 38a-1 of the 1940 Act, which requires:
 - adoption and implementation of policies and procedures designed to prevent violation of the federal securities laws
 - review of these policies and procedures annually for their adequacy and the effectiveness of their implementation
- Compliance polices and procedures for the registered investment adviser under Rule 206(4)-7 of the Investment Advisers Act of 1940
 - requires an investment adviser of a BDC to adopt and implement policies and procedures.
 - Requires maintenance and enforcement of a code of ethics for advisor's employees
- Subject to regular examinations by the SEC

Questions and More Information

Thank you for attending today's webinar. For more information about BDCs, please feel free to contact any of the presenters.

You may also visit www.publiclytradedprivateequity.com.

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