

The “Private BDC” Alternative

Prepared by:

Owen J. Pinkerton





Regulatory Overview



Regulatory Overview

Summary

- Created by the Small Business Investment Incentive Act of 1980 as a result of a perceived crisis in the capital markets in the 1970s.
- Special type of closed-end fund designed to provide small, growing companies access to capital, while also enabling private equity funds to access the public capital markets.
- Hybrid between an operating company and an investment company.
 - Regulated as an investment company, but to a lesser extent as provided by Sections 55-65 of 1940 Act
 - Required to file periodic reports under the Securities Exchange Act like operating companies (i.e., Forms 10-K, 10-Q and 8-K and proxy statements)
- BDCs generally elect to be taxed as a Regulated Investment Company (RIC)



Regulatory Overview

Brief Overview of Regulatory Requirements

- Must offer to provide managerial assistance to portfolio companies;
- Must have majority-independent board of directors;
- Must value assets at least quarterly;
- Must maintain 200% asset coverage ratio;
- Must appoint a chief compliance officer (who reports to the board) and maintain compliance procedures designed to prevent violations of federal securities laws;
- Must adopt of code of ethics that requires reporting requirements of investment personnel;
- Must maintain a fidelity bond to protect the BDC against larceny and embezzlement;
- All securities must be held by custodian that meets requirements under the 1940 Act; and
- All BDCs and their investment advisers subject to regulatory exams by the SEC.



Regulatory Overview

Regulations of BDCs vs. other investment companies

- *Character of Investments* – Must generally invest at least 70% of total assets in “qualifying assets” pursuant to Section 55(a) of the 1940 Act
 - Generally requires investments in “eligible portfolio companies” which are private U.S. companies or U.S. companies with a market cap not greater than \$250 million
 - Other categories of investment companies are not subject to these requirements
- *Leverage* – Must maintain 200% asset coverage ratio (1:1 assets to leverage) as opposed to 300% asset coverage ratio for other investment companies



Regulatory Overview

- *Affiliated Transactions* – BDCs, like other investment companies, are subject to restrictions on transaction with affiliates, but restrictions on BDCs are less onerous than restrictions on other investment companies
 - In order to co-invest with an affiliate, must obtain exemptive relief from the Division of Investment Management or invest in transactions where price is the only negotiated item (such as syndicated loans)
- *Adviser Compensation* – Investment advisers to BDCs are able to receive capital gains incentive fees in an amount not to exceed 20% of realized capital gains
 - Investment advisers to other investment companies generally prohibited from receiving capital gains incentive fees



BDC Structures

Non-Traded, Traded and Private



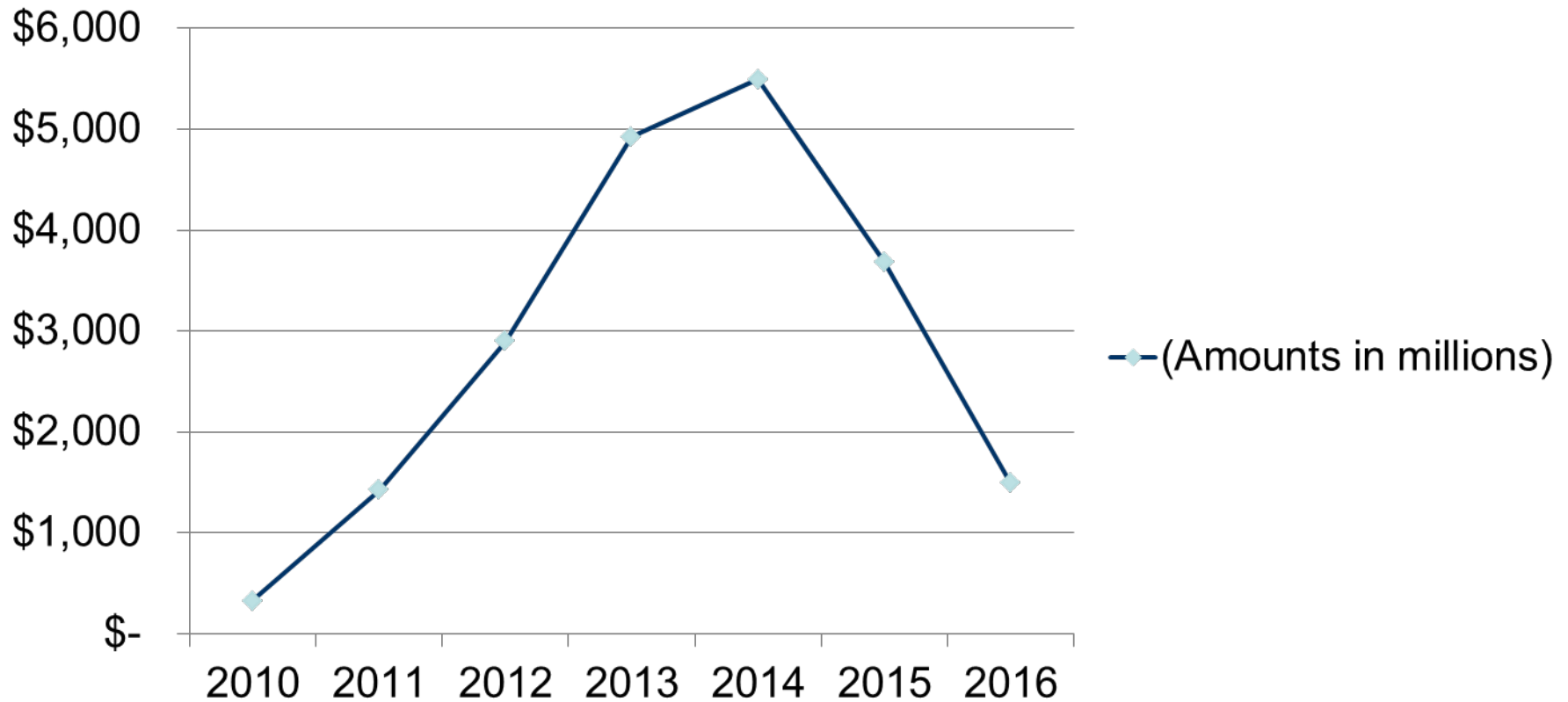
Non-Traded BDCs

- Since 2011, there has been a significant focus on publicly-offered, non-traded BDCs.
- FS Investment Corporation launched the first non-traded BDC in January 2009.
- From 2010 – 2014, fundraising for non-traded BDCs saw tremendous increases, but 2015 and 2016 have seen sharp declines, consistent with declines experienced by non-traded REITs and similar products.
- See the chart on the following page that shows capital raised by non-traded BDCs from 2010 to 2016 (annualized).



Non-Traded BDCs

Fundraising by Non-Traded BDCs (2010-2016)





Non-Traded BDCs

- Reasons for decline in fundraising include:
 - FINRA rules which require that net asset value (which reflects high up-front sales load) appears on customer account statements;
 - To date, SEC has not permitted BDCs to offer multiple share classes;
 - Department of Labor fiduciary standard and the effect it may have on sales of shares to retirement accounts; and
 - External negative events in the non-traded REIT/BDC industry.
- Result is that no new sponsors have launched a non-traded BDC offering in 2016 and only three new sponsors entered the market in 2015.



Listed BDCs

- Currently, there are approximately 50 BDCs whose shares are listed on a national securities exchange (“listed BDCs”). Of this amount, approximately 17 have total assets in excess of \$1 billion.
- In 2014, there were 6 firm commitment underwritten IPOs, and in 2013, there were 4 firm commitment underwritten IPOs.
- By way of contrast, in 2016 and 2015, there were no firm commitment underwritten initial public offerings conducted by BDCs. Combine this with the paucity of new sponsors entering the non-traded BDC space and sponsors have sought out alternative avenues to raise capital.
- In recent years, there has been an increase in the formation of so-called “private BDCs”.



BDC Structures

- From 2013 through November 2016, a total of 41 N-54As¹ were filed by entities electing to be regulated as BDCs. The breakout is below:

Type	Number
Private BDCs (Form 10 filings)	15
Non-Traded BDCs	14
Listed IPOs	9
Mergers	3
	41

¹ A Form N-54A is filed in order to formally elect to be regulated as a BDC. Number reflects the total number of entities that operated as BDCs following such election.



Private BDCs – What are They?

- What is the difference between a private BDC and a non-traded or listed BDC?
 - Private BDCs offer their shares privately to accredited investors pursuant to Regulation D under the Securities Act of 1933.
 - Many private BDCs conduct their private offerings through a commitment and draw-down structure, whereby the BDC calls committed capital from investors as needed to make investments.
 - One of the requirements for an entity to elect to be regulated as a BDC is to have a class of equity securities registered under Section 12 of the Securities Exchange Act of 1934 (the “Exchange Act”). Since a private BDC does not conduct a public offering, it files a Registration Statement on Form 10 with the SEC to register its shares.
 - Therefore, like listed BDCs and non-traded BDCs, private BDCs are subject to the provisions of the 1940 Act applicable to BDCs and are also subject to the reporting requirements under the Exchange Act.
 - Private BDCs generally do not offer liquidity until a listing on a national securities exchange or some other “liquidity event” such as a merger or a liquidation.



Private BDCs – Who May Benefit

Who may benefit from private BDC structure

- This structure may be appealing to a private equity firm or other asset manager that has ready access to an existing base of accredited investors with whom the firm has a pre-existing relationship.
- This structure may also be appealing to a start-up asset manager that is looking to create a public track record without having to bear the costs associated with a non-traded public offering or is unable to enlist the services of an investment bank to do an IPO.
 - Further, entities that are BDCs or intend to elect to be regulated as BDCs are not eligible to conduct a “mini IPO” under Regulation A+.



Private BDCs - Advantages

- Other potential advantages over alternative structures:
 - No SEC, FINRA or state registration fees. To put this into context, a \$1 billion public offering would result in approximately \$425,000 in SEC, FINRA and state registration fees.
 - Timing of effectiveness is more certain. Form 10s go effective by lapse of time 60 days after filing with the SEC. If comments are not resolved within that 60-day timeframe, the SEC will ask the registrant to withdraw and re-file with responses to comments.
 - Limited liability. Since private BDCs conduct private offerings, the offering memorandum is not subject to the liability provisions of the Securities Act of 1933, and the offering is not subject to FINRA Rule 2310.
 - Regulated entity. Private BDCs are subject to regulation under the 1940 Act, must have a chief compliance officer and must be advised by a federally-registered adviser. This may be an attractive feature for potential investors.



Private BDCs – Disadvantages

- Potential disadvantages to this structure include:
 - Cannot sell to the retail public. All purchasers must be accredited investors.
 - Restrictions on general solicitation. General solicitation not permitted unless relying on Rule 506(c) which requires that all purchasers be verified as accredited investors.
 - Compliance costs. Private BDCs are still subject to the provisions of the 1940 Act, which require a chief compliance officer, robust compliance policies and procedures, subject the BDC to periodic inspections and examinations from the SEC and generally require that the BDC be advised by a federally-registered adviser. BDC is also subject to limitations on affiliated transactions and must have a majority-independent board of directors.
 - Reporting costs. BDCs, including private BDCs, also must comply with Exchange Act reporting requirements, which are more costly than for other private vehicles (including private funds). Reports include annual reports, quarterly reports and current reports (i.e., 10-Ks, 10-Qs, etc.).



Private BDCs – Examples

Name	Filing Date of N-54A	Commitments / Draw-down?	Total Assets as of 9/30	Anticipated Term
Carlyle GMS Finance	5/2/2013	Yes	\$1.45 billion	IPO
Golub Capital Invest. Corp.	12/31/2014	Yes	\$930 million	Liquidity Event
TCW Direct Lending	12/30/2014	Yes	\$1.53 billion	Exchange for listed shares
Audax Credit BDC	6/18/2015	Yes	\$151 million	Limited tender offers
Crescent Capital BDC	6/5/2015	Yes	\$216 million	IPO
Parkview Capital Credit	2/12/2016	No	\$42 million	Not noted
Owl Rock Capital Corp.	3/3/2016	Yes	\$859 million	Listing
Goldman Sachs Private Middle Market	7/13/2016	Yes	\$305 million	7-Year Term
Hancock Park Corporate Income	7/15/2016	No	\$1 million	Listing
AB Private Credit Investors Corp.	10/6/2016	Yes	--	IPO
Bain Capital Specialty Finance	10/6/2016	Yes	\$317,909	IPO
Prospect Credit Corp.	10/13/2016	Yes	--	Not noted



Need more information?

For more information, please contact me at:

Owen J. Pinkerton

Partner

Morris, Manning & Martin LLP

1401 Eye Street, NW, Suite 600

Washington, DC 20005

(202) 216-4812

opinkerton@mmmlaw.com

