PRACTICE NOTE

Business Development Companies

by Jennifer Daly, Jack Fitzpatrick, Joseph Opich, Michael Rosella, and Thomas Peeney, Paul Hastings LLP

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An overview of business development companies, including their lending requirements, investment advantages and the requirements relating to affiliate transactions, management, reporting and the Investment Company Act of 1940.

In the wake of the 2008 financial crisis, tighter lending requirements caused smaller companies to start looking for alternative financing sources. One of these sources was the business development company (BDC). In the years since, the growth of BDCs in the leveraged loan market has increased significantly. Today, BDCs provide an important source of funding in the private credit market.

As of year-end 2019, BDCs held approximately $109 billion in loan balances. That number ballooned to $244 billion as of the first quarter of 2023.

This Note provides an overview of BDCs. Specifically, it explains:

- What BDCs are and how they are regulated.
- BDC lending requirements.
- The main advantages of investing in BDCs.
- Restrictions relating to affiliate transactions.
- Key differences between externally managed and internally managed BDCs.
- BDC reporting and operational requirements.
- Issues involved with lending to BDCs.

BDCs Explained

BDCs are investment vehicles that provide capital primarily to small, developing, financially troubled and middle market companies (see Practice Note, Middle Market Lending: Overview: Middle Market Loan Providers). While the growth of BDCs is a relatively new phenomenon, BDCs have actually been around for many years.

BDCs were originally established by Congress pursuant to the Small Business Investment Incentive Act of 1980. BDCs are defined in the Investment Company Act of 1940, as amended (1940 Act), and the rules thereunder. BDCs, however, are exempt from many of the regulatory constraints imposed by the 1940 Act. Specifically, Section 2(a)(48) of the 1940 Act defines "business development company" to be a domestic closed-end company that both:

- Operates for the purpose of making investments in certain securities specified in Section 55(a) of the 1940 Act (15 U.S.C. § 80a-54(a)) and, with limited exceptions, makes available "significant managerial assistance" with respect to 70% of the issuers of these securities held by the BDC.
- Has elected BDC status pursuant to Section 54(a) of the 1940 Act to be subject to the provisions of Sections 55 through 65 of the 1940 Act.

(15 U.S.C. § 80a-2(a)(48).)

Interests in BDCs are also usually registered under the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act). The Securities Act regulates the registration and public sale of securities. The Exchange Act governs the periodic reporting obligations of public companies. For more information generally, see Practice Notes, US Securities Laws: Overview and Periodic Reporting and Disclosure Obligations: Overview.

The majority of BDCs are publicly traded companies, providing permanent capital to the BDC and liquidity to its investors. In addition to public stock, BDCs may issue debt, other equity securities, options, warrants and rights that may be converted into voting securities. Any debt or senior security a BDC issues must be approved by the board of directors of the BDC, and immediately after the debt or security is issued or sold, the BDC must have asset coverage of not less than 200% (150% if certain conditions are met (see Leverage Ratio)).

A BDC is not, however, required to be a public company. Non-traded BDCs may only be sold to accredited investors with financial standards that vary from state to state. In addition, non-traded BDCs are not liquid securities and often have a limited investment period that is similar to those of private equity funds.

Although not required, BDCs are typically set up as regulated investment companies (RICs) so that they qualify for pass-through treatment for US federal income tax purposes. To qualify as a RIC, a BDC must:

- Make an election to be treated as a RIC.
- Meet a source of income test (generally at least 90% of the RIC's gross income must consist of income from its business of investing in stocks and securities and gains from the same, and certain other limited types of passive income).
- Hold a broadly diversified pool of assets with limits on concentration in each issuer (10%) and percentage of the RIC (5%).
- Distribute at least 90% of its taxable income as dividends to its stockholders each year.

If the BDC qualifies for pass-through tax treatment, distributions to stockholders generally are taxable to the stockholders as either ordinary income or capital gains, depending on the type of income earned by the BDC. In addition, a BDC stockholder generally recognizes taxable gain or loss when it sells its shares. Income from RICs is subject to the 3.8% federal tax on net investment income.

BDC Lending Requirements

BDCs have lending requirements that differ from other traditional and non-traditional lenders. As a general matter, a BDC must:

- Maintain at least 70% of its investments in eligible assets before investing in non-eligible assets (see Eligible Assets).
- Have significant asset diversification (see Diversification).
- Make available significant managerial assistance with respect to 70% of the issuers of the securities in which it invests (see Significant Managerial Assistance).
- Maintain a certain leverage ratio (see Leverage Ratio).
- Distribute earnings on a regular basis (see Distributions).

Eligible Assets

Section 55(a) of the 1940 Act sets forth the list of eligible assets in which a BDC may make unlimited investments including in "eligible portfolio companies" as defined in Section 2(a)(46) of the 1940 Act.

Under the 1940 Act, an "eligible portfolio company" is one that:

- Is organized under the laws of, and has its principal place of business in, any state of the US.
- Is not:
  - an investment company as defined in Section 3 of the 1940 Act (other than a small business investment company wholly owned by the BDC); or
  - a company that would be an investment company except for the exclusions permitted in Section 3(c) of the 1940 Act.
- Satisfies one of the following:
  - it does not have any class of securities that is a "margin security" under Federal Reserve Board Regulation T;
  - it is controlled by a BDC that has an affiliated person who is a director of the eligible portfolio company;
  - it has total assets of not more than $4,000,000, and capital and surplus (shareholders' equity less retained earnings) of not less than $2,000,000 or
  - either does not have a class of securities listed on a national securities exchange or has a class of securities listed on a national securities exchange, but has an aggregate market value of outstanding voting and non-voting common equity of less than $250 million (Rule 2a-46, 1940 Act).

The following seven types of investments are "eligible assets" under Section 55(a) of the 1940 Act:

- Securities purchased in a private offering, either from an issuer that is an eligible portfolio company (or is an affiliate or had been an affiliate of an eligible portfolio company in the past 13 months) or from an issuer that meets the first two criteria of being an "eligible portfolio company" (a domestic issuer and not an investment company nor excluded from the definition of an investment company under Section 3(c) of the 1940 Act) but has issued a class of securities that are "margin securities" under Federal Reserve Board Regulation T if:

  - at the time of the purchase, the BDC owns at least 50% of (x) the greatest number of equity securities of the issuer and securities convertible into or exchangeable for the securities and (y) the greatest amount of debt securities of such issuer, and these securities were held by the BDC at any point in time during the period when the issuer was an eligible portfolio company (except that options, warrants and debt that have expired, been converted or been repaid are not considered to have been held); and
  - the BDC is one of the 20 largest holders of record of the issuer's outstanding voting securities;

- Securities of any eligible portfolio company controlled by the BDC.
- Securities purchased in a private offering from an issuer that is a domestic issuer and not an investment company nor excluded from the definition of an investment company under Section 3(c) of the 1940 Act, or from a person who is, or who in the past 13 months has been, an affiliate of the issuer, if the securities were:
  - issued by an issuer that is in bankruptcy proceedings, subject to a court supervised reorganization, or subject to a plan or an arrangement resulting from the bankruptcy proceedings or reorganization;
  - issued by an issuer pursuant to or in consummation of the plan or arrangement; or
  - issued by an issuer that, immediately prior to the purchase of the issuer's securities by the BDC, was not in bankruptcy proceedings but was unable to meet its obligations as they came due without material assistance other than conventional lending or financing arrangements.
- Securities of eligible portfolio companies purchased in a private offering if there is no ready market for the securities and if immediately before the purchase the BDC owns at least 60% of the outstanding equity securities of the issuer (giving effect to all securities presently convertible into or exchangeable for equity securities of the issuer as if the securities were so converted or exchanged).
- Securities received in exchange for or distributed on securities described in the previous four categories, or through the exercise of options, warrants or rights relating to the securities.
- Cash, cash items, US government securities or high quality debt securities maturing in one year or less.
- Office furniture and equipment, interests in real estate and leasehold improvements and facilities maintained to conduct the business operations of the BDC, deferred organization and operating expenses, and other noninvestment assets needed for its operations as a BDC.

(15 U.S.C. § 80a-54(a).)

Diversification

To the extent that a BDC intends to qualify annually as a RIC, a BDC must satisfy asset diversification requirements on a quarterly basis. At the close of each quarter of the taxable year, a BDC must have at least 50% of the value of its total assets invested in cash, cash items (including receivables), government securities, securities of other RICs, and other securities, with such other securities limited, in respect of one issuer, to an amount not greater than 5% of the value of the total assets of the BDC and 10% of the outstanding voting securities of any single issuer. In addition, a BDC generally does not qualify as a RIC unless, at the close of each quarter of the taxable year, no more than 25% of the value of the total assets of the BDC are invested in one issuer (other than government securities or the securities of other RICs); the securities (other than the securities of other RICs) of two or more issuers controlled by the BDC (by owning at least 20% of such issuer's outstanding voting securities) who are engaged in the same or similar businesses; or the securities of one or more "qualified publicly traded partnerships."

Significant Managerial Assistance

In connection with the goal of providing capital to smaller companies, BDCs may not be passive investors. A BDC must make available significant managerial assistance with respect to 70% of the companies that qualify as "eligible assets" under the 1940 Act in which it invests capital, however, there is no obligation of any company to accept such assistance.

There are no set criteria to satisfy the significant managerial assistance test, and BDCs use different tools to provide this assistance. Some examples include:

- Observation rights and interaction with the board of directors of the company.
- Providing contacts to other companies the BDC invests in that may provide operational synergies.
- Industry-specific advice.
- General advice to the officers and directors of the company in which the BDC invests.

It may also involve exercising a significant controlling influence over the management or policies of the portfolio company. If a BDC intends to operate under the Small Business Investment Act of 1958, making loans to a portfolio company would satisfy the significant managerial assistance requirement. (15 U.S.C. § 80a-2(a)(47).)

Leverage Ratio

In addition to asset diversification (see Diversification), a BDC also reduces its overall risk profile through a leverage ratio. A BDC must maintain a maximum total leverage ratio (total debt to total equity) of 1:1. However, due to the enactment of the Small Business Credit Availability Act in 2018, BDCs that take certain steps, including approval by either (a) the majority of shareholders of the BDC or (b) a majority of the independent directors of the BDC, are able to increase their leverage ratio to 2:1 (15 U.S.C. § 80a-60).

Distributions

A BDC that is treated as a RIC for US federal income tax purposes is required to distribute at least 90% of its taxable income as dividends to its stockholders each year. However, BDCs that are treated as RICs generally pay out more than 90% of their annual taxable income. This is because RICs are subject to an entity level 4% US federal excise tax unless the RIC annually distributes to its stockholders an amount equal to the sum of:

- 98% of its ordinary income.
- 98.2% of its capital gains.

(26 U.S.C. § 4982(b).)

BDCs as Investments

With the various lending requirements (see BDC Lending Requirements), it may appear that a BDC would be limited in its investment choices and not necessarily be an attractive option for investment. However, BDCs have a number of highly valuable aspects that are not available in other financing investments, including:

- **Fewer regulations.** BDCs are regulated under the 1940 Act, the Securities Act and the Exchange Act, but they are not subject to the ever-increasing regulations attributable to traditional banks.
- **Greater flexibility in types of investments.** BDCs do not have a target investment return that is as stringent as a mezzanine fund or hedge fund. As a result, BDCs have flexibility in terms of the types of investments they may choose to make and the types of investment return they can achieve. BDCs have been known to invest in senior term loans, unitranche loans, second lien term loans, mezzanine loans, preferred stock and common stock. By contrast, a traditional bank is usually limited to senior revolving loans and first lien term loans, and a mezzanine fund is typically limited to subordinated loans and preferred stock.
- **Larger groups of potential investors.** Unlike private equity funds and mezzanine funds, investors in BDCs do not need to meet customary accredited investor criteria. As a result, BDCs have greater access to income from a larger group of potential investors.
- **More liquidity for investors.** Once an investment is made in a BDC that is registered under the Exchange Act, the investor has the same ability to buy and sell that investment as it does for other publicly traded investments. Most BDCs are publicly traded so investors are not tying up their capital for long periods of time as they would in a private equity or mezzanine fund. This desire for liquidity has caused many BDC managers to merge private BDCs into public ones.
- **Greater flexibility for BDC managers.** Most private equity funds have investment timelines. As a result, a private equity manager may be required to return capital to investors before the desired hold time of the investment. By contrast, a BDC has capital that is not subject to redemption by investors at a date certain, providing the BDC manager with

more flexibility in its investment choices. This flexibility offers numerous benefits to the BDC. For example, a BDC can make a loan to a company with a maturity date that is seven or eight years out, which may provide less amortization and more liquidity for the borrower and a higher overall return for the BDC. In addition, the BDC can take a long-term approach with the company in terms of additional debt or equity investments because it is not required to return capital to its investors in a short period of time.

- **Potential for quicker return on capital.** BDCs can charge management fees in connection with their investments. This may result in a quicker return on capital for its investors.
- **Relatively safe debt and equity investment.** A BDC may issue debt and equity securities (including options, warrants and other rights that may be convertible into equity securities). However, any debt or equity issued by a BDC and any dividends paid by a BDC are subject to an asset coverage test of 200% (150% if certain conditions are met (see Leverage Ratio)). As a result, investing in a BDC is generally a relatively safe investment compared to many other types of debt and equity investments.
- **More affiliate transactions may be permitted.** BDCs have greater latitude in participating in affiliate transactions (see Affiliate Transactions).
- **Access to long-term debt.** BDCs can create wholly-owned subsidiaries, which are licensed by the US Small Business Administration (SBA) to operate as Small Business Investment Companies (SBICs). The SBIC subsidiary may issue SBA-guaranteed debentures that carry long-term fixed rates that are generally lower than rates of comparable bank and other debt. The SBIC subsidiary can issue SBA-guaranteed debentures in an amount of up to twice the SBIC's regulatory capital (which usually equates to the amount of its equity capital).
- **Investors have better access to financial information.** The majority of BDCs are public companies and are therefore required to file periodic financial statements. As a result, investors have better access to financial information on a quarterly basis and can take comfort in the fact that the financials of the BDC are subject to oversight by the Securities and Exchange Commission (SEC) (see BDC Reporting).

Affiliate Transactions

BDCs are subject to Section 56 of the 1940 Act, which prohibits a BDC from effecting or participating in transactions involving conflicts of interest unless certain procedures are satisfied (15 U.S.C. § 80a-56).

Restricted Transactions

Subsection 56(a) and Subsection 56(d) each describe four types of restricted transactions that affiliates, acting as principal, may not enter into with BDCs without prior approval. An affiliate may not knowingly:

- Sell any securities or other property to a BDC, or a company controlled by it, unless the sale involves solely securities issued by the BDC or securities issued by the affiliate that are part of a general offering to the holders of a class of its securities.
- Purchase from a BDC, or a company controlled by it, any security or other property (except securities issued by the BDC).
- Borrow money or other property from a BDC, or a company controlled by it (except under certain limited exceptions).
- Effect any transaction in which the BDC, or a company controlled by it, is a joint or a joint and several participant in contravention of SEC rules.

Subsection 56(b) and Subsection 56(e) each describe the following three types of affiliates:

- "First tier affiliates" (see First Tier Affiliates).
- "Second tier affiliates" (see Second Tier Affiliates).
- "Controlled affiliates" (see Controlled Affiliates).

The category of affiliate determines the type of approval, if any, required before engaging in a restricted transaction.

First Tier Affiliates

First tier affiliates are set forth in Section 56(b)(1-2) and include the following:

- Any director, officer, employee, or member of an advisory board of a BDC or any person (other than the BDC itself) who is, or any person directly or indirectly controlling, controlled by, or under common control with, such other person.

- Any investment adviser or promoter of, general partner in, principal underwriter for, or any person directly or indirectly either controlling, controlled by, or under common control with, a BDC (except the BDC itself and any person who, if it were not directly or indirectly controlled by the BDC, would not be directly or indirectly under the control of a person who controls the BDC), or any person who is, within the meaning of Section 2(a)(3) (C) or (D), an affiliated person of any such person specified in this bullet.

Second Tier Affiliates

Second tier affiliates are set forth in Section 56(e)(1-2) and include:

- Any person directly or indirectly owning, controlling, or holding with power to vote, 5% or more of the outstanding voting securities of such other person who is:
  - an executive officer (defined in this Section of the 1940 Act as the president, secretary, treasurer, any vice president in charge of a principal business function, and any other person who performs similar policymaking functions) or a director of, or general partner in, any such affiliated person; or
  - who directly or indirectly either controls, is controlled by, or is under common control with, such affiliated person.
- Any person who is an affiliated person of a director, officer, employee, investment adviser, member of an advisory board or promoter of, principal underwriter for, general partner in, or an affiliated person of any person directly or indirectly either controlling or under common control with a BDC (except the BDC itself and any person who, if it were not directly or indirectly controlled by the BDC, would not be directly or indirectly under the control of a person who controls the BDC).

Controlled Affiliates

Restricted transactions with a controlled affiliate are prohibited unless a majority of the directors or general partners who are not interested persons of the BDC, and who have no financial interest in the transaction, approve the transaction. Under Section 2(a)(9) of the 1940 Act, “control” includes any person who owns beneficially, either directly or through one or more controlled companies, more than 25% of the voting securities of a company.

Approval of Affiliate Transactions

A BDC has two avenues to obtain approval of an affiliate transaction. For a transaction with a first tier affiliate, the BDC may file an application with the SEC requesting an exemption. The application to the SEC should include:

- The terms of the proposed transaction (including the compensation to be paid or received).
- Whether the proposed transaction is consistent with the policies of the BDC that are filed with the SEC.
- Whether the proposed transaction is consistent with the general purposes of the 1940 Act.

For a transaction with a second tier affiliate or a controlled affiliate, the BDC must obtain the approval of the majority of the disinterested directors or general partners of the BDC. Further, certain types of affiliate transactions are permitted by directors, officers, employees and general partners of a BDC, including the acquisition of warrants, options and voting securities of the BDC and borrowing money from the BDC in connection with customary executive compensation plans.

One of the issues often faced by BDCs is the determination of whether an affiliate is a first tier affiliate or a second tier affiliate in order to obtain the proper consent. In December 2014, the SEC released Guidance Update No. 2014-12, which provides guidance on how to treat an affiliated limited partner of a fund (a limited partner that owns at least 5% but less than 25% of the fund) that is under common control with a BDC. A strict reading of Section 56 of the 1940 Act would indicate that the limited partner is a first tier affiliate under Section 56(b)(2). However, the SEC notes that if the fund were organized as a corporation rather than a partnership, the same limited partner would be considered a second tier affiliate under Section 56(e)(1). The SEC found that in this scenario the limited partner should be treated as a second tier affiliate. The complexity of the overlapping law and exemptions has been criticized; however, other than the temporary relief granted for 2020, below, little progress has been made.

Affiliate Transaction Monitoring

Section 56(h) of the 1940 Act requires the directors or general partners of any BDC to adopt, and periodically review and update as appropriate, procedures reasonably designed to ensure that reasonable inquiry is made prior to the consummation of any affiliate transaction (15 U.S.C. § 80a-56(h)).

BDC Lender Liability Risks

Due to the nature of the BDC business model, BDCs and their affiliates often find themselves in various levels of a portfolio company's and borrower's capital structure. This feature of BDCs creates heightened levels of risk in the event a borrower struggles financially or files for bankruptcy.

Specifically, the 1940 Act contemplates that BDCs may be obligated to offer significant managerial assistance to their portfolio companies and borrowers. In the event a borrower requests such support and the BDC chooses to provide such assistance and become more involved in the borrower's day-to-day management, the BDC may face increased risk for "lender liability" claims. These claims generally arise because a lender is alleged to have violated a duty (whether implied or contractual) of good faith and fair dealing owed to a borrower or exercised a degree of control over a borrower giving rise to a duty to the borrower.

Lender liability claims typically allege misconduct where a lender:

- dominates or controls a borrower to the detriment of the borrower's other creditors;
- engages in other inequitable conduct to the detriment of the borrower's other creditors;
- causes, or intentionally acts to exacerbate, a borrower's insolvency or undercapitalization to the detriment of the borrower's other creditors; or
- engages in fraud with respect to, or makes misrepresentations to, the borrower's other creditors.

Similarly, BDCs may face claims for equitable subordination in a borrower's bankruptcy case. In such circumstances, another creditor seeks to subordinate the BDC's claim(s) against the borrower to the claims of other creditors of the borrower because the BDC is alleged to have engaged in unfair, inequitable or fraudulent conduct.

Thus, the nature of BDCs and their investment structure could strengthen lender liability claims against them in the event of a portfolio company's or borrower's financial difficulties or upon its filing for bankruptcy.

Management of a BDC

A BDC may be managed by an external investment adviser or by an internal manager. There are many factors that determine whether a BDC will elect to be managed externally or internally, including management compensation and internal regulatory structure. Roughly 90% of BDCs operating today (and almost all new BDCs) are externally managed.

Externally Managed BDCs

When a BDC elects to be externally managed, the BDC will enter into a management agreement with the entity providing the management services. The management agreement is subject to the requirements of the 1940 Act, which include approval by the board of directors and stockholders of the BDC.

One of the biggest advantages of the external manager model is that an external investment adviser presumably already has the infrastructure, staff and expertise to satisfy the regulatory requirements applicable to BDCs, including requirements relating to custody of assets. However, there are certain disadvantages to having an external manager, including:

- **Higher compensation.** Compensation for an external manager tends to be higher than for internally managed BDCs. Traditionally, the management agreement will include a three-tiered fee structure, which includes:
  - a base management fee tied to gross assets that is typically in the 1.5% to 2% range;
  - an interest income fee of 20% above a threshold negotiated between the BDC and the manager; and
  - a 20% incentive fee on realized gains (net of realized and unrealized losses).
- **Conflicts of interest.** Conflicts of interest may arise relating to the allocation of investment opportunities by the external manager between the BDC and the external manager's other clients.
- **Registration requirements.** Investment advisers to externally managed BDCs also must be registered with the SEC. Once registered with the SEC, the manager must comply with traditional regulatory requirements, including adoption of a compliance program.

Internally Managed BDCs

When a BDC is internally managed, the BDC's stockholders compensate the executives of the BDC directly through the supervision of the board of directors or other governing body. Because the fees of an internal manager are set by the board, the manager's compensation is locked in rather than tied to the assets, which provides the BDC with potential cost savings. However, entities with established origination platforms may have trouble starting an internally managed BDC.

Like externally managed BDCs, internally managed BDCs have potential conflicts of interest and insider knowledge issues that need to be addressed. As a result, not only would the employees of the BDC need to be separated from the larger firm, but the BDC would most likely need to, among other things, have separate operating systems, legal counsel and compliance departments. Therefore, the BDC would lose much of the origination, research or other expertise of the larger company.

BDC Reporting

Initial Reporting

A BDC that registers under the Securities Act must file all of the following:

- Form N-6F, which is an intent to file a notification of election.
- Form N-54A, which is an election to be registered as a BDC.
- Form N-2, which is a registration statement that must describe, among other things:
  - the intended use of the proceeds;
  - investment objectives and policies, including any investment restrictions;
  - the terms of the offering, including the amount of shares being offered, price, underwriting arrangements and compensation;
  - risk factors (including the unique risks associated with investing in a portfolio of small and developing or financially troubled businesses); and
  - the management of the BDC, including directors, officers and the investment adviser.

Ongoing Reporting

BDCs are required to register a class of equity securities under Section 12 of the Exchange Act (15 U.S.C. § 78*l*). Once the BDC is subject to the Exchange Act, it must file customary periodic reports required under the Exchange Act, including Form 10-K, 10-Q and 8-K reports and comply with the proxy solicitation rules. The BDC's directors and officers and some stockholders of the BDC also become subject to reporting obligations relating to their ownership of the company's stock. For more information see Practice Note, Periodic Reporting and Disclosure Obligations: Overview.

Operational Requirements

A BDC is subject to ongoing compliance with the 1940 Act. Certain of those requirements relate to:

- The BDC's board of directors (see Board of Directors).
- The code of ethics of the BDC (see Code of Ethics).
- Compliance by the BDC (see Compliance).
- Recordkeeping by the BDC (see Recordkeeping).

Board of Directors

To ensure that its board of directors is unbiased when policing conflicts, Section 56(a) of the 1940 Act requires a majority of the directors of a BDC to be persons who are not "interested persons" of the BDC. Under Section 2(a)(19) of the 1940 Act, an "interested person" is defined to include any:

- Affiliate of the BDC.
- Member of the immediate family of any natural person who is an affiliate of the BDC.
- Interested person of any investment adviser of, or principal underwriter for, the BDC.
- Person or partner or employee of any person who has acted as legal counsel to the BDC in the prior two fiscal years.
- Person or any affiliate of a person that has executed a portfolio transaction for the BDC in the six-month period before the date of determination.
- Person or any affiliate of a person that has loaned money or property to the BDC in the six-month period before the date of determination.

- Natural person who the SEC determines to have had a material business or professional relationship with the BDC or the principal executive officer of the BDC during the past two completed fiscal years.

(15 U.S.C. § 80a-2(a)(19).)

The board of directors must meet at least quarterly to review the BDC's portfolio performance and approve portfolio security valuations, as well as to address ongoing compliance requirements.

Code of Ethics

Section 17(j) of the 1940 Act states that a BDC must have rules and regulations that include requirements for the adoption of codes of ethics by registered investment companies and investment advisers of such standards as are reasonably necessary to prevent fraudulent, deceptive or manipulative acts.

Rule 17j-1 of the 1940 Act provides more clarity on the types of items that should be included in a BDC's code of ethics (17 CFR § 270.17j-1). Under Rule 17j-1, a BDC is required to adopt a written code of ethics to prevent "access persons" from engaging in actions that are fraudulent, deceptive or manipulative and that code of ethics needs to be approved by the disinterested board of the BDC or investment adviser (17 CFR §270.17j-1(c)).

An access person is defined as a director, officer, general partner or employee or any other person in a control relationship to the BDC or investment advisor that has information with respect to the transactions in securities or debt obligations (other than government obligations, money market funds and similar investments in which fraud or manipulation is unlikely to occur) (Covered Security) contemplated by the BDC (17 CFR § 270.17j-1(a)(1)(i)-(ii)). Once the access persons are identified, the BDC must provide a report to the board no less than annually describing any issues arising under the code of ethics and certify that the BDC has adopted procedures to prevent access persons from violating the code of ethics (17 CFR § 270.17j-1(c)(2)).

In addition, the following reports are required to be delivered by each access person to the BDC (17 CFR § 270.17j-1(d)):

- No later than ten days after a person becomes an access person and within 45 days of each calendar year thereafter:
  - the title, name of shares and principal amount of each Covered Security in which the access person had any direct or indirect beneficial ownership;
  - the name of any broker, dealer or bank with whom the access person maintained an account in which any securities were held for the direct or indirect benefit of the access person; and
  - the date that the report is submitted by the access person.
- No later than 30 days following the end of each calendar quarter with respect to any transaction during such quarter in a Covered Security in which the access person had an ownership interest:
  - the date of the transaction, the title, the interest rate and maturity date, the number of shares and the principal amount of the Covered Security involved;
  - the nature of the transaction;
  - the price of the Covered Security in the transaction;
  - the name of the broker, dealer or bank involved in the transaction; and
  - the date that the report is submitted by the access person.
- No later than 30 days following the end of each calendar quarter with respect to any accounts established by the access person:
  - the name of the broker, dealer or bank where the account was established;
  - the date the account was established; and
  - the date the report is submitted by the access person.

Finally, the BDC must have procedures whereby compliance personnel review the access person reports and must keep detailed recordkeeping with respect to copies of the code of ethics, records of violations and actions taken to rectify violations, all access person reports and all access persons for a period of at least five years (17 CFR § 270.17j-1(f)).

Compliance Procedures

Rule 38a-1 under the 1940 Act requires a BDC to adopt and implement policies and procedures reasonably designed to prevent the BDC from violating the federal securities laws. This compliance program must be approved by the board, including a majority of its independent directors. The BDC must appoint a chief compliance officer to oversee the compliance program.

The BDC's compliance procedures should address, at a minimum, the following areas:

- Portfolio management processes.
- Trading practices.
- Accuracy of disclosures made to investors, clients and regulators, including account statements and advertisements.
- Safeguards on client assets from conversion or inappropriate use by advisory personnel.
- Accurate creation of required records and their maintenance in a manner that secures them from unauthorized altercation or use.
- Valuations of portfolio holdings.
- Identification of affiliated persons.
- Safeguards for the protection of non-public information.
- Compliance with various governance requirements.

The BDC must review its compliance program annually.

(SEC Release Nos. IA-2204; IC-26299 (Feb. 5, 2004).)

Recordkeeping

Section 31 of the 1940 Act, as incorporated by Section 64 of the 1940 Act, requires a BDC to maintain and keep current the accounts, books and other documents relating to its business (15 U.S.C. § 80a-30). These records will form the basis for financial statements required to be filed pursuant to Section 30 of the 1940 Act (15 U.S.C. § 80a-29) and of the related auditor's certificates.

The rules require, among other items, that the BDC maintain and keep journals (or other records of original entry) containing an itemized daily record detailing all:

- Purchases and sales of securities (including sales and redemptions of its own securities).
- Receipts and deliveries of securities (including certificate numbers if that detail is not recorded by a custodian or transfer agent).
- Receipts and disbursements of cash and all other debits and credits.

In addition, the BDC must maintain separate ledger accounts (or other records) reflecting the following:

- Securities in transfer.
- Securities in physical possession.
- Securities borrowed and securities loaned.
- Monies borrowed and monies loaned (together with a record of the collateral and substitutions in that collateral).
- Dividends and interest received.
- Dividends receivable and interest accrued.

Revised Rules 31a-2 and 204-2 under the 1940 Act provide that BDCs may maintain records electronically if they establish and maintain procedures to:

- Safeguard the records from loss, alteration or destruction.
- Limit access to the records to authorized personnel, the SEC and (in the case of funds) fund directors.
- Ensure that electronic copies of non-electronic originals are complete, true and legible.

(17 C.F.R. §§ 270.31a-2 and 275.204-2.)

Lending to a BDC

Because BDCs maintain low leverage ratios (see Leverage Ratio), they are generally considered to have good credit quality and are attractive as borrowers to traditional banks (see BDCs as Investments). Many BDCs use leverage as a way to maximize the capital provided to the BDC. For example, if a BDC has $100 million of equity plus a $10 million credit line, that BDC really has $110 million available for investment.

In addition, because of the generally good credit quality of a BDC, banks usually lend the BDC money at much lower interest rates than the BDC lends money to its investments. As a result, by using leverage the BDC will be able to use more dollars to make investments and it will be able to skim interest off of the additional capital dollars provided to the BDC by traditional banks.

When lending to a BDC a bank takes a number of criteria into account including the BDC's:

- Management team.
- Investment strategy.
- Track record.
- Profitability.
- Deal sourcing.
- Investment differentiation.

Many loans to a BDC are structured as revolving loans with a borrowing base. The borrowing base tends to be much more structured to account for the specific BDC than a traditional asset-based loan. The borrowing base can include numerous factors, such as:

- Concentrations in industries.
- Concentrations for particular types of loans.
- The credit quality of the underlying borrower.
- The credit quality of equity investments held by the BDC.
- The currency of the loans made by the BDC.
- The use of proceeds of underlying loans.
- The underlying maturity of the loans.
- Whether or not the underlying loans are secured or unsecured.

A borrowing base for a BDC with a well-established management team that invests primarily in senior loans will look very different from the borrowing base for a newer BDC that invests primarily in mezzanine loans. Similarly, the interest rate charged to a BDC for revolving loans will depend on the criteria above, as well as the investment types of the BDC (see Diversification and Eligible Assets). Additionally, the Small Business Credit Availability Act, by loosening leverage limits, has allowed BDCs to generate higher returns across all lending categories, increasing the popularity of senior debt.

However, lending to BDCs is not without risk for both the lender and the BDC. If a portion of the borrowing base is tied to equity investments of the BDC and those investments lose value, a mandatory prepayment will be required. The BDC will then have to either use available cash, which may impact its leverage ratio, or sell an asset earlier than anticipated.

Similarly, if the borrowers of the BDC are not repaying the loans provided by the BDC, the BDC may have trouble meeting its interest payments owed to its lender. In both cases, the BDC may be required to sell investments at lower than anticipated returns solely because the BDC has a lender.

In addition, if the BDC were to default on its loan, the lender can foreclose on BDC assets, which will further reduce returns and make the BDC less attractive to outside investors. As a result, it is essential that the lenders to a BDC have utmost confidence that the BDC and its internal or external managers have adequate experience and the relevant expertise to execute its investment strategy.

Finally, new rules altered the counting of debt for leverage ratio purposes, which affects the lending calculus. On October 28, 2020, the SEC adopted Rule 18f-4, which allows BDCs to use derivatives to manage risk, provided that certain conditions are met (SEC Release No. 34084). Rule 18f-4 went into effect on February 19, 2021, with a compliance date of August 19, 2022. This rule provides a more economically effective method of lending to BDCs.