Proskauer

SEC Issues BDCs Temporary Exemptive Relief Regarding Issuance of Senior Securities and Negotiated Co-Investments

April 10, 2020

On April 8, 2020, the Securities and Exchange Commission (the "SEC") issued an exemptive order to business development companies ("BDCs") to provide temporary flexibility to issue and sell senior securities and participate in certain negotiated co-investment transactions (the "Order").[1] The exemptions are premised upon the challenges that BDCs may face in fulfilling their statutory mandate to provide capital to smaller domestic operating companies in light of the current and potential effects of COVID-19. The relief is available to a BDC through the earlier of December 31, 2020 and the date on which the BDC elects to cease relying on the exemption (the "Exemption Period").

Issuance and Sale of Senior Securities

During the Exemption Period, subject to certain conditions, a BDC may issue or sell senior securities (i.e., debt or preferred stock) on the basis of an adjusted portfolio value (a senior security issued in reliance on the Order, a "covered senior security"). At the time of issuance of a covered senior security, a BDC electing to rely on the Order will calculate its asset coverage ratio in accordance with Section 18(b) of the Investment Company Act of 1940, as amended (the "1940 Act"), except that with respect to portfolio company holdings (1) that were held as of December 31, 2019, (2) the BDC continues to hold at the time of the proposed issuance or sale and (3) for which the BDC is not recognizing a realized loss, the BDC may use values calculated as of December 31, 2019 to calculate portfolio value (the "Adjusted Portfolio Value") to meet an "Adjusted Asset Coverage Ratio."[2] To calculate the Adjusted Asset Coverage Ratio, a BDC must reduce its asset coverage ratio by an amount equal to 25% of the difference between the asset coverage ratio calculated using the Adjusted Portfolio Value and the asset coverage ratio calculated in accordance with Section 18(b) of the 1940 Act.[3]

In order to take advantage of this relief, the BDC must adhere to the following conditions:

- Prior to relying on the Order, the BDC must make an election by filing a Current Report on Form 8-K. The election must also be withdrawn through the subsequent filing of a Current Report on Form 8-K.
- For 90 days after making the election, a BDC relying on the Order may not make investments in new portfolio companies unless it complies with the relevant statutory asset coverage ratio applicable to it under Section 18 of the 1940 Act (as modified by Section 61 of the 1940 Act) (i.e., 150% or 200%).
- Prior to the election to rely on the relief, the BDC's board of directors, including a "required majority" as defined in Section 57(o) of the 1940 Act (the "Required Majority"), must determine that the issuance or sale of covered senior securities is permitted under the Order and is in the best interests of the BDC and its shareholders.
- Prior to a BDC issuing or selling covered senior securities, the BDC's board of directors, including the Required Majority, must determine that each such issuance is in the best interests of the BDC and its shareholders. In making its determination, the board of directors must obtain and consider certain certifications and information from the BDC's investment adviser and obtain advice from an independent evaluator.[4]
- The BDC's board of directors must receive and review monthly reports from the BDC's investment adviser regarding and assessing the efforts undertaken (and progress made) to achieve compliance with the applicable statutory asset coverage requirements prior to the end of the Exemption Period.
- Upon expiration of the Exemption Period, if the BDC is not in compliance with the applicable statutory asset coverage requirements, it must file a Current Report on Form 8-K detailing (1) its current asset coverage ratio, (2) why it was unable to comply with the applicable asset coverage requirements, (3) the timeframe within which it expects to come into compliance with the applicable asset coverage requirements and (4) the specific steps it will take to regain compliance with the applicable asset coverage requirements.
- The BDC must maintain for at least six years the minutes and reports prepared in connection with its reliance on the Order.
- Except for fees permitted by Section 57(k) of the 1940 Act and payments/distributions made to all holders of a class of the BDC's securities, no affiliated person of the BDC, nor any affiliated person of such a person, may receive any transaction fees or other remuneration from an issuer in which the BDC invests during the Exemption Period.

Importantly, the Order does not provide relief in connection with the declaration or payment of any dividend or any other distribution by a BDC.

We expect that BDCs will rely on this portion of the Order only where the portfolio is experiencing significant distress that is expected to be short-term in nature and there is a ready source of unsecured leverage available (such as a revolving credit facility from the BDC's investment adviser or an affiliated fund). Before relying on this relief, BDCs should determine the asset coverage requirements under their credit facilities, indentures and other relevant documentation. In many instances, the documentation may require asset coverage calculations to be completed in accordance with GAAP (which is not modified by the Order) or impose other calculations (such as a borrowing base calculation or an asset coverage requirement in excess of the statutory requirements applicable to the BDC) that are not altered as a result of the Order.

Negotiated Co-Investment Transactions

During the Exemption Period, BDCs with existing exemptive relief from the SEC permitting them to engage in negotiated co-investment transactions with certain affiliated persons notwithstanding Sections 17(d) and 57(a)(4) of the 1940 Act and Rule 17d-1 thereunder (an "existing co-investment order") may engage in a Follow-On Investment (including a Non-Negotiated Follow-On Investment) with one or more Regulated Funds and/or Affiliated Funds, provided that (1) if the participant is a Regulated Fund, it has previously participated in a Co-Investment Transaction with the BDC with respect to the issuer and (2) if such participant is an Affiliated Fund, it either (a) has previously participated in a Co-Investment Transaction with the BDC with respect to the issuer or (b) is not invested in the issuer.[5]

Non-Negotiated Follow-On Investments will not require prior approval of the BDC's board of directors, but they will be subject to the periodic reporting requirements set forth in the BDC's existing co-investment order. Follow-On Investments that are not Non-Negotiated Follow-On Investments require review by the BDC's board of directors, and a Required Majority, both on a stand-alone basis and in relation to the total economic exposure of the BDC to the issuer. Any such transaction must otherwise be completed in accordance with the terms and conditions of the BDC's existing co-investment order, provided, however, that such findings will not be required with respect to Enhanced Review Follow-On Investments for a BDC that has an existing co-investment order that permits such investments.

We expect that a number of BDCs, especially those that are part of larger asset management platforms, will rely on this element of the relief provided under the Order, particularly where an existing portfolio company requires additional capital (whether as part of a restructuring or otherwise) and the BDC and current affiliated co-investors either do not have incremental capital available or cannot increase economic exposure to the portfolio company (whether due to concentration limits, investment limitations or otherwise).

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Proskauer's cross-disciplinary, cross-jurisdictional Coronavirus Response Team is focused on supporting and addressing client concerns. We will continue to evaluate the CARES Act, related regulations and any subsequent legislation to provide our clients guidance in real time. Please visit our Coronavirus Resource Center for guidance on risk management measures, practical steps businesses can take and resources to help manage ongoing operations.

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[1] Investment Company Act Release No. 33837 (April 8, 2020) available at https://www.sec.gov/rules/exorders/2020/ic-33837.pdf.

[2] If a portfolio company holding is permanently impaired (i.e., the BDC recognized a realized loss subsequent to December 31, 2019 that is not recoverable), a BDC may not include that holding at its December 31, 2019 fair value measurement for purposes of its Adjusted Asset Coverage Ratio.

[3] Section 18(b) of the 1940 Act requires a BDC to determine its asset coverage with respect to a senior security on the basis of values calculated as of a time within 48 hours (not including Sundays or holidays) next preceding the time of such determination.

[4] An independent evaluator means a person who has expertise in the valuation of securities and other financial assets and who is not an interested person (within the meaning of Section 2(a)(19) of the 1940 Act of the BDC or any affiliate thereof. This is the same concept provided for in Rule 17a-8 under the 1940 Act (which addresses certain mergers of affiliated companies). We expect that most independent valuation firms engaged by BDCs in connection with their quarterly valuation process will satisfy these criteria.

[5] Capitalized terms have the same meanings ascribed to them (or a substantially similar term) in a BDC's existing co-investment order. Affiliated Fund does not include any BDC or investment company registered under the 1940 Act.