Considerations when forming a business development company

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Building a better working world

Over the last decade, competition in the asset management industry has accelerated at a relentless pace. Investors continue to seek higher yields, more favorable tax structures, and more transparency. Similarly, asset managers continue to expand fundraising efforts and broaden their investor base, as well as forming partnerships to construct larger and more flexible investment origination platforms and innovating the investment vehicle offerings to meet evolving investor needs. The result? An increasing popularity in business development companies (BDCs).

BDCs have been in existence since their creation by Congress in 1980, but the number and size of BDCs has grown exponentially in recent years. Specifically, debt-focused BDCs have provided an opportunity for managers to lend to small and mid-size companies not addressed by traditional financing sources and earn the corresponding income-based performance fee standard for BDCs. The prospect of launching a BDC, and therefore, capturing capital from retail investors while accessing a more permanent capital base, has multiplied in popularity with traditional private fund managers.

Given the increased burden associated with managing a BDC compared with traditional private funds, asset managers considering entering the space should understand the various BDC structures, the ever-increasing regulatory and tax requirements, and the initial and ongoing operational demands that follow.

BDC structures

Publicly traded

Publicly traded BDCs are similar to other listed companies as their shares are typically bought and sold on national securities exchanges at market prices. They have an indefinite lifespan and are open to all investors, including retail investors who can transact in a BDC's shares on an exchange through their broker of choice. Publicly traded BDCs acquire their initial portfolio using proceeds from an initial public offering (IPO) to originate new investments or to acquire an existing portfolio (i.e., a warehoused portfolio). A listing transaction can often be a liquidity event for many non-traded and private BDCs, as discussed below.

Private

Private BDCs are offered through a private placement whereby accredited investors commit to contribute capital in a drawdown structure, meaning the BDC will call capital from investors as investment opportunities arise.

Similarly, liquidity is typically available to investors of a private BDC at the same time, with distributions of income and return of capital being provided to all investors similar to the distribution cycle of a private fund. Private BDCs may also have other liquidity events such as an IPO or other capital market transactions, which are available to all investors simultaneously, but until such liquidity event takes place, investors are committed and do not have the ability to redeem their shares.

Non-traded

Non-traded BDCs have historically been formed with the intent to have a liquidity event in the future, such as an IPO or merger. They may offer securities continuously up to a predetermined maximum amount. Like publicly traded BDCs, non-traded BDCs are available to accredited and retail investors alike. Investors of non-traded BDCs must purchase shares through distribution channels, similar to mutual funds.

Recent developments

Currently, the number of non-traded BDCs is exploding, beginning in 2020, when the U.S. Securities and Exchange Commission (SEC) granted an exemptive order to permit a non-traded BDC to offer multiple investor classes of shares. Additionally, there has been a rise of private and non-traded BDCs structured as "perpetual life" vehicles of indefinite duration, whose shares are intended to be offered monthly at a price generally equal to the BDC's monthly net asset value (NAV) per share.

A non-traded BDC also typically allows for investor liquidity through a share repurchase program, which is available to investors on a quarterly basis, for up to a certain portion of the BDC's NAV, usually up to 5%. As investors may join the BDC at different times, many non-traded BDCs have terms that provide equitable economics among investors while still adhering to regulatory requirements, as well as reporting requirements such as US GAAP.

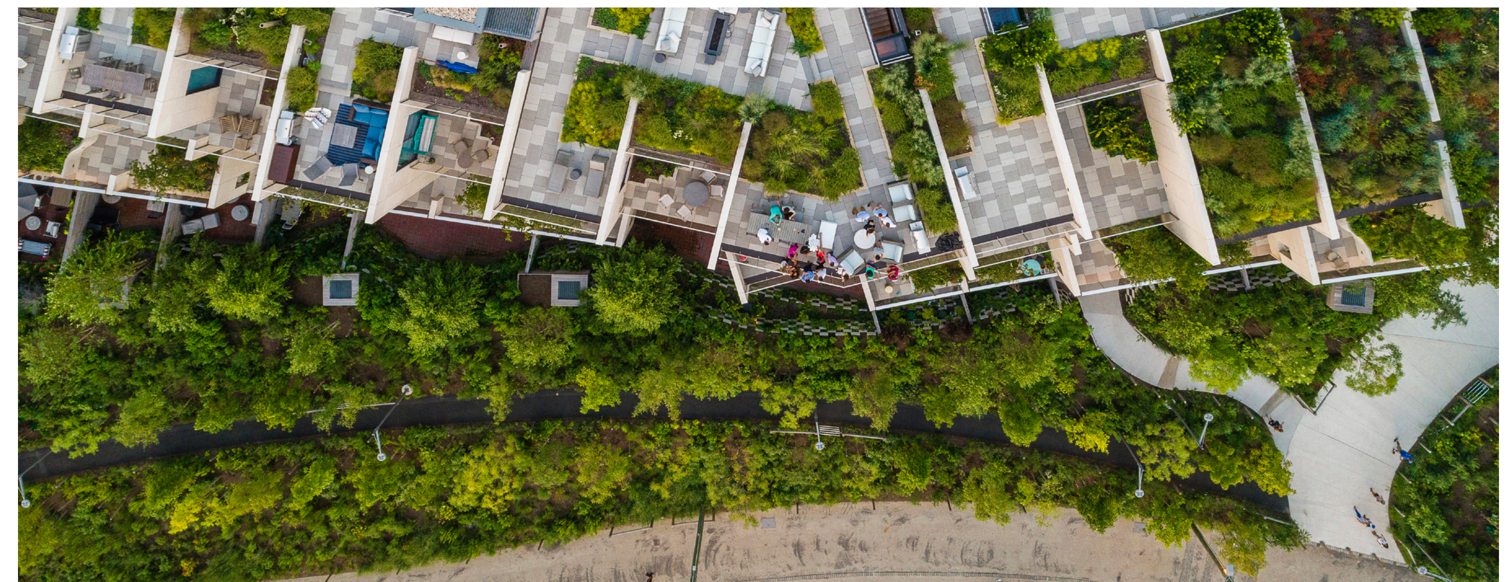
Other structuring considerations

BDCs are often formed as Delaware or Maryland corporations but may also be formed as trusts or limited liability companies (LLCs). In addition, BDCs are often externally managed, whereby the operations and investment management services are outsourced to an asset management firm that acts as the investment adviser. BDCs may also be structured as internally managed entities where the operations and investment management functions exist within the BDC. In an externally managed BDC, the terms of management fees and incentive fees paid to the investment adviser are disclosed to investors and recorded as such on the BDCs income statement. In an internally managed BDC, management is paid based on a compensation plan that is disclosed to investors, and such costs are recorded as operating expenses on the BDC's income statement.

Regulatory and tax requirements of BDCs

Forming a BDC

When forming a BDC, an asset manager must first submit an initial filing of its registration statement on Form N-2 under the Securities Act of 1933 (1933 Act) or on Form 10 under the Securities Exchange Act of 1934 (the 1934 Act). There are key differences among both forms and BDCs should work with legal counsel to determine which form is most appropriate based on the type of BDC. Generally, Form N-2 is a prospectus document used by closed-end investment companies to file an initial registration statement under the Investment Company Act of 1940 (the 1940 Act), a registration statement to offer



securities on a delayed or continuous basis under the Securities Act of 1933, or any combination of the two. Form 10 is used as a general form for registration of securities for potential trading on US exchanges. Form 10 is generally accompanied by, but does not include, a closed-end BDC's private placement memorandum.

The registration statement typically includes audited seed capital financial statements, which must include a balance sheet and footnotes that disclose the BDC's accounting policies and valuation policy, capital structure, fee structure and methods of financing investment originations. The seed capital financial statements may require the inclusion of a statement of operations if the BDC bears its own expenses or is expected to repay the adviser for expenses incurred to date. Given the different terms of expense arrangements between BDCs and their advisers, BDCs should work with their accounting advisers and independent public accountants, or auditors, to understand and comply with the requirements based on the specific circumstances of their agreements.

After filing its registration statement on either Form N-2 or Form 10, the BDC will file Form N-54A to notify the SEC of their election to be regulated under Sections 55-65 of the 1940 Act.[1]

Reporting requirements

Like other companies registered with the SEC, BDCs must file quarterly Form 10-Qs and annual Form 10-Ks. The financial statements must follow investment company regulations under Article 6 of Regulation S-X, which, among other requirements, mandates fair valuation of investments.

The 1934 Act establishes different classes of filers: non-accelerated filer, accelerated filer and large accelerated filer. The deadlines for filing of a company's Form 10-K and Form 10-Q are determined by its filing status. The summary below outlines (1) all the conditions that must be met under SEC Rule 12b-2 to be defined as each class of filer, and (2) the related filing deadlines for each class of filer:

	Large-accelerated	Accelerated	Non-accelerated
BDC structure	Publicly traded	Publicly traded	Private and non-traded
Conditions (1)			
Has been a public company for at least 12 months subject to the reporting requirements of Section 13(a) or 15(d) of the 1934 Act	✓	✓	
Has previously filed at least one annual report	✓	✓	
Has public float (2) of	$700 million or more	$75 million or more but less than $700 million	Less than $75 million
Has annual investment income of (3)	N/A	$100 million or more	Less than $100 million
Filing deadlines			
Annual reports (10-K)	60 days	75 days	90 days
Interim reports (10-Q)	40 days	45 days	45 days

(1) Since an investment company is not eligible to report as a smaller reporting company, the Rule 12b-2 condition related to this status is not applicable to a BDC and not included in the above summary table.

(2) In determining public float, the measurement date is as of the last business day of the issuer's most recently completed second fiscal quarter (for calendar-year companies, 30 June).

(3) On 12 March 2020, the SEC adopted a final rule to add annual revenue as a new condition for accelerated and non-accelerated filers. For BDCs, the measurement of revenue is based on the preceding year's gross investment income, as defined in Rule 6-07.1 of Regulation S-X.

The Jumpstart Our Business Startups Act of 2012 (JOBS Act) introduced emerging growth companies (EGCs) as an additional filing status for newly formed companies in their first five years. EGCs must meet the criteria below:

- Have annual revenue of less than $1.235 billion during its most recently completed fiscal year.
- Issue less than $1 billion in non-convertible debt securities over a rolling 36-month period, including securities issued in registered or unregistered offerings.
- Do not become a large accelerated filer.

Status as an EGC allows rapidly growing businesses to grow into the reporting requirements over five years rather than triggering such requirements solely based on the criteria in SEC Rule 12b-2. During the formation phase, EGCs may make confidential submissions to the SEC of a preliminary prospectus prior to public filings with the SEC. Thereafter, EGCs are permitted to have less extensive narrative disclosures than required of other reporting entities, particularly in how executive compensation is described. EGCs are also exempt from the 404(b) requirements of the Sarbanes-Oxley Act of 2002 (SOX).

BDCs are also subject to other reporting requirements, including reporting significant events to shareholders by filing Form 8-K, generally within four days of such events. Additionally, a publicly traded BDC must also make annual proxy filings and comply with other SEC requirements, such as reporting of beneficial ownership by directors, executive officers and significant shareholders (over 5% under Section 13 and over 10% under Section 16). Lastly, Form N-17f-2 is required if there is no external custodian. In the absence of an external custodian, a BDC's independent auditor will need to perform a security count of the securities and issue a certification report. Accordingly, many BDCs engage an external custodian.

Sarbanes-Oxley requirements

All BDCs must comply with the applicable rules established by SOX regarding management's certification with respect to financial statement presentation (Section 906) and certification and assessment of the design and effectiveness of internal controls over financial reporting (ICFR) (Sections 302 and 404(a)). As part of complying with 404(a), BDCs must include a report on their assessment of the effectiveness (also referred to as "management's assessment on ICFR") in all Form 10-K and 10-Q reports after their initial annual report on Form 10-K.

Because the process of evaluating ICFR will vary from company to company, SEC rules do not specify the methods or procedures to be performed in an evaluation. In adopting its Section 404 reporting rules in 2003, the SEC stated:[2]

"The assessment of a company's internal control over financial reporting must be based on procedures sufficient both to evaluate its design and to test its operating effectiveness. Controls subject to such assessment include, but are not limited to:

- Controls over initiating, recording, processing and reconciling account balances, classes of transactions and disclosure and related assertions included in the financial statements;
- Controls related to the initiation and processing of non-routine and non-systematic transactions;
- Controls related to the selection and application of appropriate accounting policies;
- Controls related to the prevention, identification and detection of fraud."

In addition to controls stated above, the following controls are also important in management's assessment:

- Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries
- Controls related to management override in financial reporting
- Controls over the identification and assessment of related party relationships and related party transactions
- Controls related to significant management estimates and the use of information produced by the entity (IPE)

In addition to management's assessment and certification under 404(a), all large accelerated and accelerated filers (excluding EGCs) are required to comply with Section 404(b) to include an independent auditor's report on ICFR. This report is in addition to the audit of the financial statements. Compliance with Section 404(b) can add incremental costs to the operations of the BDC, such as costs for management to document and evaluate its ICFR and costs to engage the independent auditor to perform an audit of ICFR in conjunction with the audit of the financial statements (an integrated audit). Non-accelerated filers and emerging growth companies are exempted from the requirements of Section 404(b).

[1]Additionally, Section 59 of the 1940 Act further indicates that BDCs shall apply Sections 1 – 6, 9, 10(f), 15(a), (c), and (f), 16(b), 17(f) through (j), 19(a), 20(b), 32(a) and (c), 33 – 47 and 49 – 53 of the 1940 Act.

[2]Final Rule: Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports; [Release Nos. 33-8238; 34-47986; IC-26068; File Nos. S7-40-02; S7-06-03].

Other requirements under the 1940 Act

Governance/board of directors: A BDC must have independent directors to serve as chairpersons of the BDC's Audit, Compensation and Ethics/Nominating/Governance Committee. These individuals sometimes serve for a long period of time, so it is vital that they understand the product, strategy and underlying investments; the concept of fair value; and their roles and responsibilities as directors. A board must be composed of a majority of independent directors, which means they must have no affiliation with the BDC's advisers, managers or independent auditors. During the selection process, all candidates should be questioned as to their independence from the BDC's auditors, and the BDC's auditors should have the opportunity to perform independence procedures in a timely manner. Generally, a BDC's board of directors will have a minimum of three independent directors (one to serve as a chair of each committee) and one or two interested directors.

Qualifying assets: BDCs must invest 70% of their total assets in qualifying assets, as defined in Section 55(a) of the 1940 Act. A BDC that does not meet this 70% qualifying asset threshold cannot acquire new assets, and as such, monitoring compliance with qualifying asset thresholds is critical to continuing to conduct business as a BDC.

Asset coverage:

The 1940 Act requires BDCs to maintain an asset coverage ratio (calculated as assets/senior securities) of at least 200%. In 2018, the passage of the Small Business Credit Availability Act allowed a BDC to elect to decrease its asset coverage ratio from 200% to 150% if certain conditions were met. To do so, existing BDCs were required to either a) obtain board approval to decrease the ratio and wait one year to do so or b) obtain approval through a shareholder vote, allowing for an immediate decrease. Further, non-traded and private BDCs were required to offer tenders in conjunction with the transition.

Co-Investment Exemptive Relief: The 1940 Act prohibits co-investment between a regulated investment company (RIC) and any affiliated RIC or private fund, unless the entity has filed an application with the SEC and been granted relief to do so.[3] It is common for BDCs to seek such relief to participate in investments alongside other funds managed by the same adviser.

Tax compliance

For US tax purposes, a BDC will generally elect to be treated as a RIC, which introduces several other regulatory advantages and challenges. A BDC can provide a number of tax benefits if it elects to be, and qualifies annually as, a RIC under the Internal Revenue Code. As a RIC, a BDC enjoys the benefit of simplified investor tax reporting (simple Forms 1099, no complicated Schedules K-1); serve as suitable investments for tax-exempt and foreign investors by "blocking" income that would otherwise be unrelated business taxable income (UBTI) for tax-exempt investors or income that is effectively connected with a US trade or business (ECI) for foreign investors; serve as effective vehicles for funds using leverage; and do not pay entity-level income taxes provided they meet certain RIC qualification and distribution requirements described below. For asset managers accustomed to partnership taxation, RIC tax requirements and considerations may be unfamiliar.

To qualify as a RIC annually, a BDC must meet three primary requirements under Subchapter M of the Internal Revenue Code:

- Qualifying income: Generally, at least 90% of the BDC's annual gross income must be derived from dividends, interest, gains from the sale or exchange of securities and other qualifying income associated with the business of investing in securities. BDCs may generate other types of income, and in the context of RIC requirements, it can be questionable whether that income is considered qualifying income. Categories of income that come into question may include but are not limited to upfront commitment fees, underwriting fees and facilities fees.
- Consider in year 1: A BDC typically generates more non-qualifying income in its first year of operations. During this time, it may not be generating much coupon income, original issue discount income or other income that would qualify, so the non-qualifying income component could be substantial and should be closely monitored. As a leading practice, a BDC should use its legal counsel and tax advisers to examine the terms of every deal because the tax liability at the BDC level could be significant if the components of income do not meet the requirements of the gross income test.
- Quarterly asset diversification: At the end of each fiscal quarter, at least 50% of a BDC's assets must be invested in "good" assets such as cash items, securities of other RICs, government securities or investments in other securities, provided its investment in any one security represents 5% or less of the BDC's gross assets, and 10% or less voting rights of a single issuer. Lastly, a BDC cannot invest more than 25% of its gross assets in (1) a single issuer, (2) any two or more issuers controlled by the BDC and engaged in the same or similar businesses, or (3) one or more "qualified publicly traded partnerships."
- Consider in year 1: The quarterly asset diversification is especially important to monitor in the first quarter of operations, when a BDC may only hold a few investments and could encounter problems meeting these requirements. Failure to meet the requirement in the first quarter of operations is generally not curable and thus could mean an inability to qualify as a RIC for that year.
- Distributions: To qualify as a RIC, for each fiscal year, a BDC must distribute to its shareholders on a timely basis at least 90% of its investment company taxable income, which is generally defined as net ordinary income plus net short-term capital gains. The BDC's remaining 10% of investment company taxable income and its long-term capital gains are not required to be distributed to maintain its RIC qualification, but the BDC is taxed at the corporate income rate on any investment company taxable income or long-term capital gains that are not distributed to shareholders. In practice, most BDCs make the necessary distributions to avoid incurring any corporate-level income tax.

Additionally, BDCs must be aware of a separate RIC tax regime in the Internal Revenue Code called the "excise tax rules." These rules require RICs to distribute substantially all of their net income and gains to shareholders on a calendar-year basis, regardless of when their fiscal years ends. Failure to do so will result in a 4% non-deductible federal excise tax on undistributed amounts. From time to time, a BDC may determine to pay some excise tax for a calendar year (e.g., where the benefits of remaining fully invested in its portfolio outweigh the amount of the tax and costs of having to sell a portion of its portfolio to raise cash for the distribution).

- Consideration in year 1: Cash management and planning are important to consider while adhering to the distribution requirements. In particular, a BDC should monitor its non-cash income such as income from original issue discounts or payments in kind. This income must be included for distribution purposes, but unless the entity plans ahead, it may not have the cash on hand to make the required distributions. During the formation, BDCs should consider establishing a dividend reinvestment plan to keep the cash within the BDC.

Therefore, as RICs, BDCs must distribute substantially all of their investment income and gains annually to avoid paying entity-level corporate income or excise taxes. Distributions of a RIC's annual net investment income and gains are generally taxable in the hands of its investors as ordinary income or capital gain. RICs, however, are able to pass through the tax character of certain investment income and gain to investors by annually reporting the amount of their distributions with this character. This includes distributions qualifying for the reduced

[3] Investment Company Act Release No. 33837 (Apr. 8, 2020).

long-term capital gain rate as either qualified dividend income or long-term capital gain. Foreign investors can also benefit from US withholding tax exemptions for the portion of a RIC's distributions designated as attributable to interest-related or long- or short-term capital gain dividends.

In consideration of the above requirements and the tax benefits of a BDC structure, there are also other considerations that asset managers should consider in developing their tax regime, such as employing the use of blocker entities for RIC qualifying income purposes, RIC compliance and other tax considerations around seeding a BDC and restructuring certain debt or equity investments, and book/tax differences that arise due to differences between tax treatment and accounting under US GAAP. Management should consult its tax advisers experienced in these areas.

Key operational considerations

CEO, principal financial officer, and CCO

Because BDCs are registered entities, they must have a chief executive officer (CEO), a principal financial officer and a chief compliance officer (CCO). The CEO and principal financial officer are responsible for asserting to the information contained in the required SEC filings. The CCO reports to the board and works to ensure that the BDC adopts and implements appropriate compliance policies and procedures. As most BDCs are externally managed (meaning, they do not have their own employees), these roles are generally filled by employees of the investment adviser.

Third-party outsourcing

BDCs may engage third-party service providers, including external administrators, valuation specialists and/or custodians. Managers often find that having external administrators helps facilitate compliance with the SOX internal control reporting requirements as external administrators typically produce a service organization controls (SOC) report that is audited by an independent service organization auditor. It is important for a BDC to be cognizant that all third-party providers are ultimately subject to the oversight of the BDC's management. When selecting service providers, management should choose those who are familiar with the regulations and requirements that apply to BDCs, as well as those who can meet the reporting timeline and technological demands of the BDCs.

Valuation

A BDC must value its investment portfolio on a quarterly basis in connection with preparing its quarterly report on Form 10-Q. Valuations must follow ASC 820, Fair Value Measurement (ASC 820). The fair values of investments may differ based on the types of investments held and may range from the use of closing prices on listed exchanges or readily available market quotes for identical or similar assets, to valuation models developed using unobservable inputs. Typically, investments whose fair value is determined using unobservable inputs will be modeled internally by the BDC's investment adviser. These valuations may sometimes be corroborated by or outsourced (subject to the approval of the BDC's investment adviser) to a third-party valuation firm. In turn, the third-party valuation firm will typically provide a report that indicates a range of reasonable fair values or a fair value point estimate. Further, a BDC's investment adviser should maintain oversight over the third-party valuation firm's work and establish an effective control framework for determining the criteria by which investments are corroborated by or outsourced to a third-party valuation firm, and controls over monitoring the work of the third-party valuation firm and reviewing their valuation reports.

In September 2022, the SEC's Rule 2a-5 under 1940 Act became effective, updating its last valuation guidance from 1970 to be responsive to changes in the industry. The new rule allows for a BDC's board of directors to assign a valuation designee within the adviser, who is responsible for the determination of investment fair value. Should the board of directors assign such a designee, the designee is responsible for overseeing the adviser's determination of fair value, rather than being directly responsible for the determination of fair value as before the new rule. Such oversight should include:

- Periodically assessing and managing material valuation risks, including material conflicts of interest
- Establishing and applying fair value methodologies
- Testing those methodologies
- Overseeing and evaluating pricing services used by the BDC
- Adopting and implementing written policies and procedures addressing the determination of fair value

When a board of directors assigns the fair value determination to the fund's adviser, the adviser would be required to provide to the board of directors, at least quarterly, a written assessment of the adequacy and effectiveness of the adviser's process for determining fair value.

Dividend reinvestment plans

BDCs must manage their cash carefully to cover distribution requirements in a timely manner. For example, entities will commonly generate noncash income through original issue discounts, market discounts or payments in kind. This income must be included for distribution calculation purposes, but unless the BDC plans ahead, it may not have the cash on hand to make the required distributions. One strategy for meeting the distribution requirements and maintaining liquidity within the BDC is to establish a dividend reinvestment plan (DRIP). If adopted by the BDC's board, such plans allow for dividends to be automatically used to purchase additional shares of the company rather than to be paid out in cash. A DRIP may be established as an "opt-in" or an "opt-out" plan. When forming a new BDC, the use of a DRIP should be contemplated, along with other plans or agreements that provide for cash management and options to investors alike.

Expense limitation and reimbursement plans

To manage expenses and required distributions in the initial years after a BDC's launch, a BDC may establish an expense limitation and reimbursement agreement with its adviser. Under such agreement, the adviser agrees to pay BDC expenses above a certain limitation threshold. Thereafter, the adviser may recoup the payments from the BDC. The adviser's recoupment is subject to certain conditions, specifically that the recoupment is limited by the expense ratio of the BDC, and the BDC must be able to maintain a distribution level that is at least equal to the distribution rate at the time of the waiver, after giving effect to the adviser recoupment. Additionally, the recoupment payment must be paid within short time frame, typically three years after the expense payment. BDCs should have a clearly documented and well-followed policy developed with their compliance officer and counsel. BDCs should include transparent and consistent disclosure of expense arrangements in their prospectus or equivalent offering document, and in their financial statements.

Joint ventures

As a mechanism for deploying additional capital and enhancing yield, many BDCs have formed joint ventures (JVs) between the BDC and an unrelated third party. Traditionally, the BDC owns 87.5% and a third party owns 12.5% of the economic interests of the joint venture, although recently there have been varying terms and structures developed to meet the evolving needs of BDCs and counterparties alike. The control of the JV, or voting rights, are split 50/50 to avoid consolidation by either party. These JVs invest in lower yielding assets (such as first lien loans) but benefit from higher leverage than permitted within the BDC directly (as limited by the asset coverage requirements). JVs are nonqualifying assets under the 1940 Act and therefore the capital deployed through these entities cannot exceed 30% of the BDC's total assets. When the BDC determines the fair value of its JV investment, it can do so by applying fair value techniques, such as a discounted cash flow analysis, or it may measure its investment using net asset value (NAV) as a practical expedient if it meets the conditions to do so under ASC 820. Once an election to use NAV as a practical expedient is made, it must be applied consistently, unless the BDC has the ability to sell the JV investment and intends to sell it in the near-term at a price that differs from NAV.

Formational transactions

BDCs whose formation or growth is conducted through the transfer of assets from an existing portfolio must be mindful of the associated regulatory, tax and reporting requirements. This includes potential disclosure requirements and/or audited schedules of investments in the initial registration statement. Upon the transfer of assets, financial reporting considerations include those as outlined in ASC 860, Transfers and Servicing and reporting requirements under ASC 850, Related Party Disclosures.

Final thoughts

The increasing popularity of BDCs reflects the advantages to investors and asset managers alike. Managers should be cognizant of the regulatory requirements and costs of compliance of operating a BDC and may not be used to such burdens if they have historically managed private, non-regulated funds. Integrating a registered product into a broader business model can be difficult if the manager is not properly prepared. That being said, the requirements of operating a BDC are not unique when considering other registered investment companies or SEC-registered companies, and therefore, working with their legal counsel, auditors, tax advisers and others with knowledge of BDC compliance can ensure managers are able to successfully benefit from launching a BDC.

Other operational consideration, such as the need for investment in technology and data management; the importance of effective service provider relationships and oversight; and accounting hot topics, such as revenue recognition, consolidation and valuation, will be explored in future articles.

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