

## Is It Time for SBICs to Consider BDCs As a Source of Financing?

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The common perception is that investing in pooled investment funds that specialize in small or start-up companies is available only to wealthy investors through hedge funds or other private investment companies. The reality is, however, that a little-known but increasingly popular vehicle, the business development company (BDC), provides a portal for public investors to access the upside potential of start-ups in a diversified and, thus, reduced risk environment. The BDC model gives SBICs the ability to access the public markets as a possible source of funding.

Congress recognized the need for BDCs two decades ago when it enacted legislation in 1980 aimed at encouraging the flow of public dollars into small businesses in the United States. This legislation amended the Investment Company Act of 1940 to create a regulatory framework that would be flexible enough to accommodate venture financing by a public investment vehicle.

The 1940 Act, which regulates mutual funds, was amended to authorize closed-end investment companies to elect to be regulated as BDCs. The framework modified certain general requirements of the 1940 Act to permit companies electing to be BDCs to compete with private venture capital enterprises, as long as they were designed to invest primarily in small growing businesses.

### **Creation of the BDC Structure**

Historically, private equity investing has been, and to a significant extent continues to be, done with private dollars either through private funds or direct investments. Before 1980, however, there was simply no avenue for public investment in small and developing companies. The restrictions imposed by the 1940 Act as they existed prior to 1980, and under which a public equity fund would have been required to register, made impracticable the operation of a public entity devoted to investing in small and growing businesses.

A perceived crisis in the capital markets led Congress to enact the 1980 Amendments. This legislation attempted to eliminate provisions of the 1940 Act and the Investment Advisers Act of 1940, as amended, that created unnecessary disincentives to private equity investment. Congress intended for the legislation to help increase the flow of capital to smaller, growing and innovative businesses. The centerpiece of the 1980 Amendments was the creation of a new category of investment company that was subject to the 1940 Act but that was operated as a venture capital enterprise – the business

development company.

As a statutory framework, the 1980 Amendments were designed to put in place a workable approach to the regulation of private equity investing through a public investment vehicle. By focusing on those provisions of the 1940 Act that created unnecessary obstacles to the formation of a publicly held private equity fund, Congress believed that small businesses would benefit from capital sources previously unavailable. The 1980 Amendments forged a regulatory framework for BDCs from the core provisions of the 1940 Act.

The specific provisions of the 1940 Act regulating BDCs fall into two distinct categories. One category includes those provisions that directly or indirectly enable the company to invest successfully in developing businesses. Examples of these provisions include lower asset coverage requirements for borrowing, mandatory investment in small businesses (as a percentage of the company's total assets), and relaxed restrictions on affiliated transactions.

The second category includes those provisions designed to compensate employees of BDCs in a manner consistent with compensation practices in the venture capital industry. Examples of such provisions include permitting the company to issue certain types of equity-based compensation to employees and permitting the company to make loans to its employees to enable them to purchase the company's securities. Collectively, these provisions were designed to achieve Congress's goal of promoting capital investment in small businesses by encouraging venture capitalists previously unwilling to submit to 1940 Act regulations to establish public funds for private investment.

Doing so would permit those companies to do two things that traditional closed-end funds (and mutual funds) could not do: (1) give incentives to their management with options and other derivative securities, and (2) engage in more extensive leveraging than would otherwise be permitted under federal securities laws. These two carrots were believed to be the minimum necessary to encourage money managers to take the risks associated with investing in small companies. In return, BDCs were required to invest at least 70% of their assets in "eligible portfolio companies"—which the 1940 Act defines generally to mean any U.S. companies whose securities were not marginable—and to make managerial assistance available to such companies.

### **Environment for the BDC Model**

Although fewer than 60 companies have taken advantage of the BDC structure, there has been a renewed focus by the investment community and the marketplace. In late 1999 alone, five new BDC initial public offerings (IPOs) were in registration, most notably an offering by meVC Draper Fisher Jurvetson Fund I. In March 2000, meVC Draper Fisher closed on a \$330 million fund that began trading on the New York Stock Exchange in late June. In addition, Excelsior Venture Partners Investors III, LLC, has amended its registration statement to increase its proposed offering to \$800 million and intended to close on its offering before the end of 2000.

There are several BDCs that include SBICs within their corporate structure, such as Allied Capital Corporation (which is currently the largest BDC), Medallion Financial Corporation, MACC Private Equities, and PMC Capital, Inc.

Even in the adverse market for IPOs during the second half of 2000, a new BDC, UTEK Corporation, was able to complete a small offering in October 2000. UTEK has a unique investment model called “U2B<sup>SM</sup>” which allows it to acquire, develop, and finance new university technology that is synergistic with a company’s core technology and consistent with its growth strategy. UTEK then enables these companies to acquire this technology in exchange for stock.

Although there are several different investment models that a BDC may pursue, the renewed interest has primarily been in the venture capital space. One example that has received a lot of attention is meVC Draper Fisher, which focuses on investing in early stage technology companies with the idea of taking them public as soon as possible. Its holdings include stakes in Foliofn, which customizes stock portfolios on-line, and eYak, which specializes in Web-based video conferencing. Some of the other smaller, lesser-known venture players include Winfield Capital and Harris & Harris Group, Inc., which have been operating as BDCs for several years.

### **How BDCs Operate**

A BDC is essentially a hybrid between an investment company and an operating company. BDCs provide either long-term debt or equity capital to small and middle market companies. A significant advantage of BDCs is the liquidity of investors’ shares in the company, unlike private funds that restrict redemptions. Like other closed-end funds, their shares are typically sold through underwritten offerings and traded on exchanges. Unlike closed-end funds, BDCs’ shares may trade at a premium to their net asset value, due to the unique nature of the business of investing in private companies.

As a vehicle for offering shares to the public, the BDC model allows much greater flexibility than the traditional closed-end investment fund model. BDCs permit venture capitalists to access the investment dollars of the increasing number of retail investors who want to participate in pre-IPO appreciation. But unlike their private equity fund counterparts, BDCs reduce the risk associated with investing in unseasoned businesses by maintaining a diversified investment portfolio.

However, BDCs, like mutual funds, are subject to certain substantive regulations under the 1940 Act, most of which are designed to protect shareholders from overreaching by persons affiliated with the BDC. In addition, a number of activities of a BDC require approval of a majority of its board of directors, including a majority of those directors who are not employees of the BDC. Also like registered mutual funds and closed-end funds, BDCs can elect to avoid taxation at the corporate level. BDCs also file quarterly and annual reports with the SEC (Forms 10-K and 10-Q) just like operating companies.

Like other investment companies, BDCs are generally required, as a price for not being taxed

themselves, to distribute most of their capital gains and net operating income to shareholders.

## **Modernizing BDC Regulations**

Even though there have been several successful BDCs, the BDC model has not enjoyed overwhelming acceptance. In late summer of 2000, a committee of BDCs, including the three largest BDCs, was formed to make it less cumbersome to operate a BDC and to encourage growth of the industry. The Committee for Modernization of BDC Regulation is working with the Securities and Exchange Commission (SEC) to modernize BDC regulations in three primary areas — operations, financing, and compensation.

First, the Committee is seeking to make the regulations governing BDC operations more flexible, including streamlining the regulatory process by asking the SEC to codify certain administrative actions that it has taken in connection with BDCs. Second, the Committee is seeking to increase flexibility in financing, including allowing BDCs to rely on existing disclosure materials to expedite the registration process, as seasoned operating companies are allowed to do, when making certain types of offerings. Third, the committee is seeking changes in compensation regulations to allow BDCs to better compete for venture capital talent.

The committee has met with the SEC staff regarding its agenda and is currently working with the staff to implement changes in the three areas noted above. The committee believes that modernizing the regulations would make the BDC structure a more viable business model and would promote the Congressional purpose for which BDCs were created – funding small businesses.

As a result of the advent of the New Economy and new acceptance in the marketplace of venture funds by retail investors, BDCs are likely to continue to emerge from their obscurity to provide a viable vehicle for public investors to participate in venture capital financing, including SBICs.

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## **Pull-Outs:**

**1**

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**2**

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