

COVID-19 NEWS OF INTEREST

# SEC Provides Relief to BDCs Relating to Co-Investment Transactions and the Issuance of Senior Securities

April 16, 2020

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On April 8, 2020, the Securities and Exchange Commission issued exemptive relief from certain requirements of the Investment Company Act of 1940 to business development companies (“BDCs”) that provides BDCs with additional flexibility to engage in certain co-investment transactions with affiliates and to issue and sell senior securities.<sup>1</sup> The SEC’s exemptive order (the “Order”) was issued in response to the adverse impact on credit markets caused by the outbreak of COVID-19 and is designed to help BDCs fulfill their statutory mandate to provide capital to small- and medium-sized businesses in the U.S. that may lack ready access to the capital markets. A BDC may rely on the Order until December 31, 2020, or such date by which the BDC elects to no longer rely on the Order, if earlier (the “Exemption Period”). The Order applies to BDCs only and not to registered closed-end funds.

## Co-Investment Relief

Many BDCs have previously received exemptive orders from the SEC that allow them to participate in the same investment opportunities with affiliated regulated funds (“Regulated Funds”)<sup>2</sup> and affiliated private funds (“Affiliated Funds”) as part of a co-investment program, where such participation would otherwise be prohibited by Section 57(a)(4) of the Investment Company Act and Rule 17d-1 thereunder (“co-investment relief”). Such co-investment relief is subject to a number of conditions, including with respect to follow-on investments in a portfolio company. The Order seeks to ease the

<sup>1</sup> See Investment Company Act Release No. 33837 (Apr. 8, 2020).

<sup>2</sup> A Regulated Fund includes both a BDC and a registered closed-end fund.

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impact of restrictions in the existing co-investment relief that prohibit certain of a BDC's affiliates from participating in additional investments in the BDC's portfolio companies.

Generally speaking, a BDC that has made an investment in an issuer in reliance on its co-investment relief may make additional investments in the same issuer (each, a "Follow-On Investment"), provided generally that any Regulated Funds and/or Affiliated Funds that participate in the Follow-On Investment originally invested in the issuer alongside the BDC in a transaction covered by the BDC's co-investment relief.<sup>3</sup> A BDC may not make a Follow-On Investment in reliance on its co-investment relief if one or more Regulated Funds and/or Affiliated Funds that do not hold an investment in the issuer also seek to participate in the Follow-On Investment.

Pursuant to the Order, a BDC with existing co-investment relief is permitted to participate in a Follow-On Investment with one or more Regulated Funds and/or Affiliated Funds, provided that: (i) if such participant is a Regulated Fund, it has previously participated in a co-investment transaction with the BDC with respect to the issuer, and (ii) if such participant is an Affiliated Fund,<sup>4</sup> it either (x) has previously participated in a co-investment transaction with the BDC with respect to the issuer, or (y) is not invested in the issuer. The Order includes "Non-Negotiated Follow-On Investments" in the scope of the relief.<sup>5</sup>

Follow-On Investments made in reliance on the Order must otherwise be effected in accordance with the terms and conditions of the BDC's existing co-investment relief. In addition, the board of directors of the BDC (the "Board"), including a required majority of the Board as defined in Section 57(o) of the Investment Company Act (a "Required Majority"), must review a proposed Follow-On Investment made in reliance on the Order both on a stand-alone basis and

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<sup>3</sup> Some BDCs have received co-investment relief that permits Follow-On Investments with respect to an issuer where the BDC and any participating Regulated Funds and/or Affiliated Funds obtained the initial investment in a "pre-boarding investment" not made in reliance on the co-investment relief. A "pre-boarding investment" is an investment in an issuer held by a BDC as well as one or more Affiliated Funds and/or one or more other Regulated Funds, that was acquired prior to participating in any transaction in reliance on the co-investment relief, either (i) in a transaction in which the only term negotiated by or on behalf of such funds was price in reliance on certain SEC staff no-action relief in respect of joint transactions (a "JT No-Action Letter"); or (ii) in transactions occurring at least 90 days apart and without coordination between the BDC and any Affiliated Fund or other Regulated Fund.

<sup>4</sup> For purposes of the Order, the term "Affiliated Fund" does not include a registered open-end or closed-end fund or another BDC.

<sup>5</sup> A "Non-Negotiated Follow-On Investment" is generally defined as a Follow-On Investment in which a BDC participates together with one or more Affiliated Funds and/or one or more other Regulated Funds (i) in which the only term negotiated by or on behalf of the funds is price, and (ii) with respect to which, if the transaction were considered on its own, the funds would be entitled to rely on one of the JT No-Action Letters.

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in relation to the total economic exposure of the BDC to the issuer in connection with making the findings required under the BDC's existing co-investment relief.<sup>6</sup>

### Relief for the Issuance and Sale of Senior Securities

Pursuant to the Order, a BDC may issue and sell a senior security that represents indebtedness or that is stock (each, a "covered senior security") notwithstanding the specific asset coverage requirements of Section 18 of the Investment Company Act, as modified by Section 61 with respect to the BDC,<sup>7</sup> and the requirement to determine asset coverage based on values calculated as of a time within 48 hours (excluding Sundays and holidays) next preceding the time of such determination, subject to certain conditions.

A BDC seeking to rely on the Order must calculate its asset coverage ratio at the time of issuance or sale of any covered senior security, but, for certain qualifying portfolio company holdings, may use values calculated as of December 31, 2019 (the "Adjusted Portfolio Value"), rather than values that would otherwise be required under Section 18(b) of the Investment Company Act, in order to meet an adjusted asset coverage ratio. The ability to use values calculated as of December 31, 2019 applies only to portfolio company holdings that (i) the BDC held as of that date, (ii) the BDC continues to hold at the time of issuance or sale of the covered senior security, and (iii) for which the BDC has not recognized a realized loss.<sup>8</sup> To calculate the adjusted asset coverage ratio, a BDC must reduce its asset coverage ratio using the Adjusted Portfolio Value 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 Investment Company Act.

The Order provides the following example: A BDC has a 220% asset coverage ratio on December 31, 2019. Its asset coverage ratio declines to 160% on March 31, 2020, not using the Adjusted Portfolio Value, and 200% if it calculated the ratio (without the 25% decrease) using the Adjusted Portfolio Value. This BDC would have an adjusted asset coverage ratio of 190% (200% minus 10% (25% of the difference between 200% and 160%)).

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<sup>6</sup> This condition does not apply to Non-Negotiated Follow-On Investments, but such investments are subject to certain periodic reporting requirements under a BDC's co-investment relief. Compliance with the condition does not require that the Board make the findings required with respect to Enhanced Review Follow-On Investments, as such term is defined in existing co-investment relief.

<sup>7</sup> A BDC is generally required under Section 18 of the Investment Company Act (as modified by Section 61 thereof with respect to BDCs) to maintain an asset coverage ratio of at least 200% after giving effect to the issuance of any covered senior security. As a result of the enactment of the Small Business Credit Availability Act in 2018, a BDC may elect to reduce its required asset coverage ratio to 150%, subject to certain conditions.

<sup>8</sup> A BDC may not include a December 31, 2019, fair value measurement in its adjusted asset coverage ratio if the portfolio company holding is permanently impaired (*i.e.*, if the BDC has recognized a realized loss subsequent to December 31, 2019, and the loss is not recoverable). The adjustment also does not apply to portfolio company holdings acquired after December 31, 2019. For purposes of the Order, all assets acquired and all senior securities issued after December 31, 2019, that are held or outstanding at the date of the calculation of the adjusted asset coverage ratio are required to be included in the calculation without adjustment.

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A BDC seeking to rely on the Order to issue or sell a covered senior security must make an election by filing on Form 8-K and satisfy the following additional conditions:

- For 90 days from the date of its election to rely on the Order, the BDC may not make an investment in a portfolio company in which the BDC was not already invested as of April 8, 2020, unless, at the time of investment, the BDC's asset coverage ratio complies with the asset coverage ratio applicable to it under Section 18 of the Investment Company Act, as modified by Section 61;
- Prior to making an election to rely on the relief, the BDC's Board, including a Required Majority, must determine that the issuance or sale of covered senior securities is permitted by the Order and is in the best interests of the BDC and its shareholders;
- Prior to the BDC issuing or selling covered senior securities, the Board, including a Required Majority, must determine that each issuance is in the best interests of the BDC and its shareholders. The Board must receive and consider:
  - a certification from the BDC's investment adviser that the issuance of covered senior securities is in the best interests of the BDC and its shareholders, and
  - the advice of an Independent Evaluator regarding whether the terms and conditions of the proposed issuance or sale of a covered senior security are fair and reasonable;<sup>9</sup>
- The BDC's investment adviser must deliver a report to the Board at least monthly regarding and assessing the efforts that the investment adviser has undertaken, and progress that the BDC has made, towards achieving compliance with the asset coverage requirements applicable to the BDC under Section 18 of the Investment Company Act, as modified by Section 61, by the date on which the relief expires;
- Upon expiration of the Exemption Period, a BDC not in compliance with the asset coverage requirements applicable to it at that time must immediately make a filing on Form 8-K that includes its then-current asset coverage ratio, the reasons why it was unable to comply with the asset coverage requirements, the time frame within which it expects to come into compliance and the specific steps to be undertaken to bring itself into compliance;
- The BDC must maintain certain records relating to its reliance on the Order for the time period required; and

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<sup>9</sup> The term "Independent Evaluator" is defined in the Order as a person who has expertise in the valuation of securities and other financial assets and who is not an interested person, as defined under the Investment Company Act, of the BDC, or any affiliate thereof.

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- Except (i) to the extent permitted by Section 57(k) of the Investment Company Act, or (ii) for payments or distributions made by an issuer to all holders of a security in accordance with the security's terms, no affiliated person of the BDC nor any affiliated person of such a person, may receive any transaction fees (including break-up, structuring, monitoring or commitment fees) or other remuneration from an issuer in which the BDC invests during the Exemption Period. This condition does not apply to the receipt of investment advisory fees by an investment adviser to the BDC under an investment management agreement entered into in accordance with Section 15 of the Investment Company Act.

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If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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