Opportunity rises for business development companies

InFocus: Regulatory proposals impact the BDC market

Top takeaways

Three recent proposals from the US Securities and Exchange Commission (SEC) could change the private credit landscape. The proposals are designed to streamline and enhance the regulatory framework for business development companies (BDCs) and add definitions to existing investment company specific rules.

While the early 2010s' explosive growth in BDC numbers has not been replicated as of late, BDC numbers and assets have continued to rise.

With changes likely coming, firms that manage BDCs should assess their preparedness to capture the growing demand from investors.

Overview

Private capital has long been a leading conduit in middle-market lending. BDCs, a form of closed-end funds, play a crucial role in providing financing solutions for companies seeking loans typically between $10 million and $100 million. Recently, the US SEC proposed multiple rules to streamline and enhance the regulatory framework for BDCs, including fund-of-funds arrangements,[1] offering reform,[2] and rules affecting disclosures about investment company specific acquisitions.[3] While some of the new proposed rules will affect all registered funds—from mutual funds to unit investment trusts—alternative investment advisers that manage BDCs will be especially interested.

BDCs bridge middle-market financing gap

Private equity (PE) firms offer private BDCs to accredited and institutional investors as an additional diversification vehicle from public equity and debt markets. PE firms also manage public BDCs, which appeal to retail investors looking for additional yield opportunities. These investment companies are regulated under the 1940 Act and were created in 1980 to bridge the financing gap faced by small- and medium-sized businesses in securing funding from banks. The gap expanded after the financial crisis as banks de-levered their balance sheets.[4] PE firms and others stepped in by forming BDCs to extend critical credit to businesses.

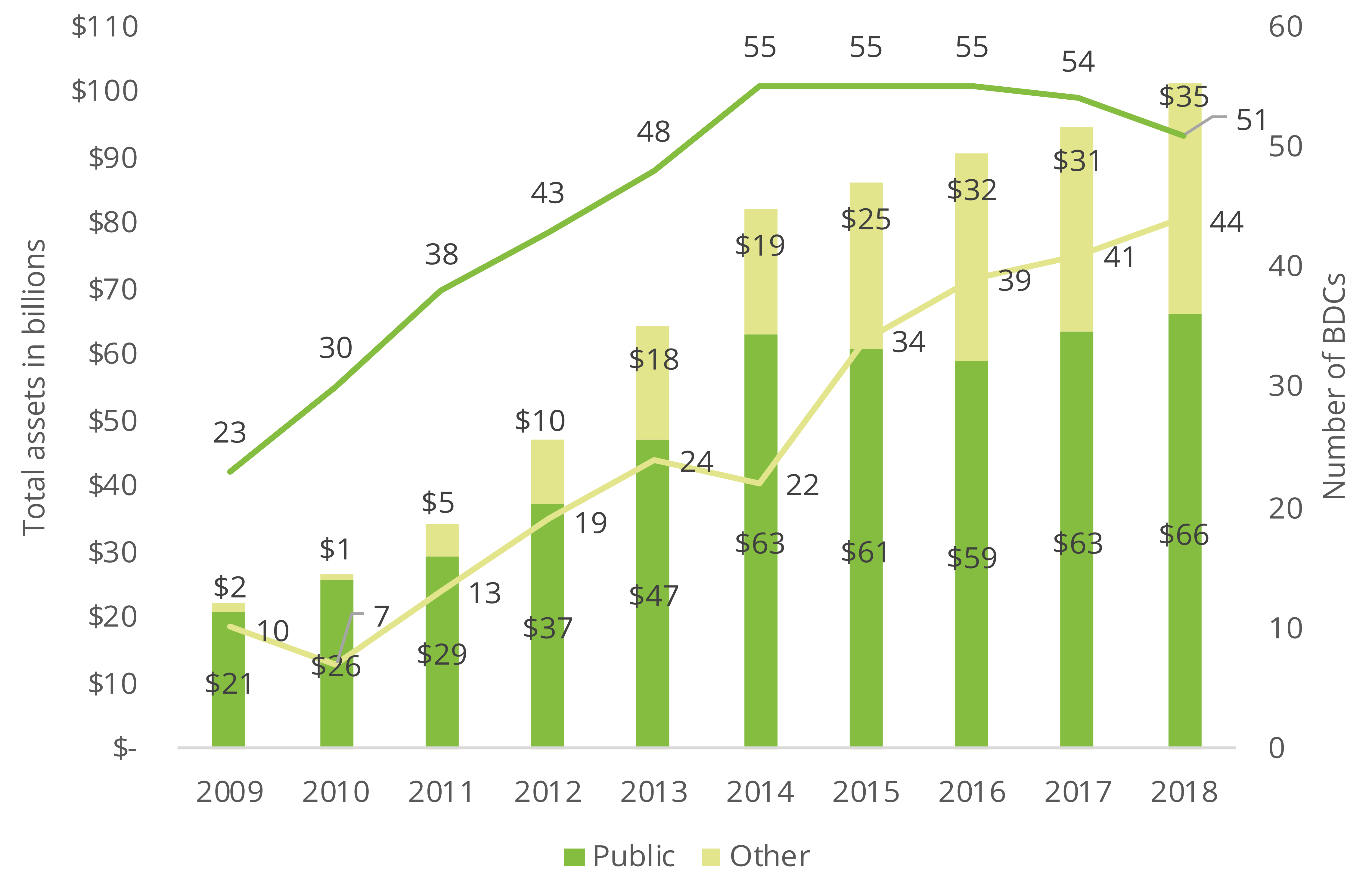
While the early 2010s' explosive growth in BDC numbers and assets has not been replicated as of late, new BDCs have been created even as others have withdrawn the designation. While assets have continued to rise, the 25% five-year compound annual growth rate (CAGR) of total assets from 2010 to 2014 slowed to 4% from 2014 to 2018.[5]

Also, the preferred type of BDC structure has shifted in recent years: The number of publicly traded BDCs has fallen from 55 in 2014 to 51 at the beginning of 2019 (figure 1) due to mergers and firms opting to operate as private BDCs.[6] This shift is further evidenced when looking at total assets held by BDCs. Public BDCs held more than 90 percent of assets in 2009, compared with only 65 percent in 2018 (figure 1).

The SEC may be seeking to address this shift by potentially simplifying the process for other fund types to invest into public BDCs. The goal of its proposal is to "create a consistent, rules-based framework for fund-of-funds arrangements while providing robust protections for investors."[7]

Figure 1

BDCs have continued to increase assets



Source: Capital IQ and Deloitte Center for Financial Services analysis

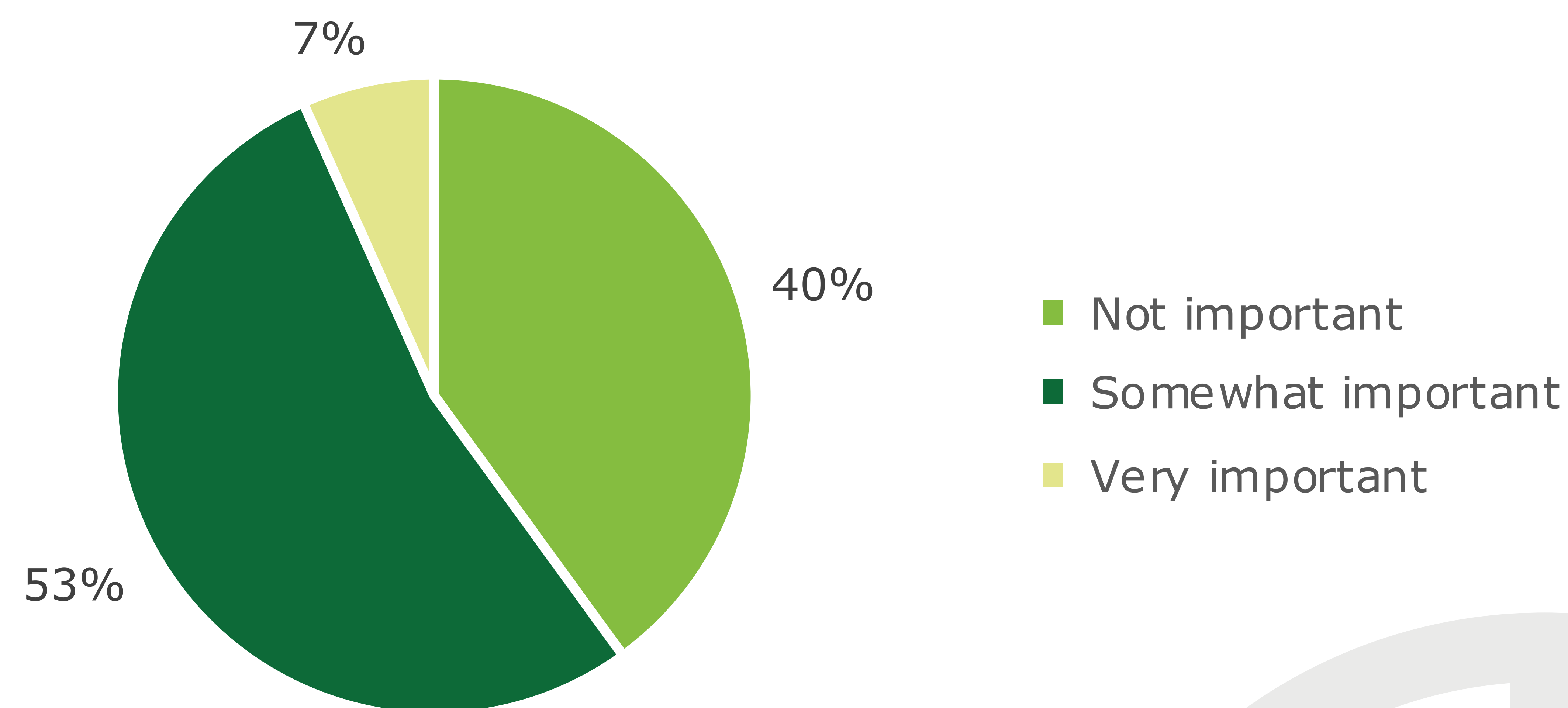
BDCs find lending dynamics intriguing

Does slowing asset growth suggest alternative investment advisers have less reason to watch the BDC market? Quite the contrary. A resurgence of interest may be on the horizon, especially considering that a reduced tolerance for risk led some banks to tighten their credit policies toward large-, middle-, and small-market firms over the past year (figure 2).[8,9]

BDCs, in contrast, gained additional flexibility thanks to federal legislation passed in spring 2018. BDCs now can maintain a debt-to-equity ratio of 2:1, an increase from 1:1.[10] While higher leverage may increase risk as well as rewards, it is still well below that generally afforded to banks. BDCs with successful strategies now have greater opportunity to differentiate themselves and attract capital from investors seeking additional risk.

Figure 2

Reduced tolerance for risk as a reason for tightening credit standards or loan terms



Source: Federal Reserve, "Senior Loan Officer Opinion Survey on Bank Lending Practices," January 2019

Proposals enhance BDC regulatory framework

Over the past six months, the SEC has issued a series of proposals designed to streamline and enhance the regulatory framework for BDCs and to add definitions to the existing rules tailored specifically for investment companies. These actions are designed to reduce ambiguity around transaction reporting requirements and thereby improve the financial information that investors receive.[11]

1. **On December 19, 2018, the SEC requested comments concerning new rules on fund-of-funds arrangements that would alter several regulations on BDCs.** One proposed change concerns the Acquired Fund Fees and Expense Disclosure (AFFE) rule adopted in 2006. This rule stipulates that the acquiring fund (e.g., an exchange traded fund (ETF) or mutual fund) must combine the fees and expenses of the acquired fund (e.g., a BDC) with their own expense ratio. The new SEC proposal is "designed to prevent duplicative and excessive fees in fund-of-funds arrangements by requiring an evaluation of aggregate fees."[13] Furthermore, if, as it proposes, the SEC excludes BDCs from having to provide the AFFE disclosure similar to the exclusion for collateralized loan obligations (CLOs) and real estate investment trusts (REITs), BDCs may once again be included in primary stock indices. As part of an index from which many portfolio managers benchmark, more institutional money could flow into BDCs, thus strengthening corporate governance as shareholder engagement increases from this investor class.[14]

   The SEC also proposed the removal of the "3-5-10 percent" rule in section 12d-1-A that restricts the amounts registered investment companies (mutual funds, unit investment trusts, listed and unlisted closed-end funds, and ETFs) and BDCs can invest in other registered investment companies or BDCs. These adjustments may likely expand the options for investments and could generate more interest in both traded and non-traded BDCs.

2. **On March 20, 2019, the SEC issued a proposed rule that would streamline the registration and offering practices for BDCs and registered closed-end funds (CEFs).**[16] The proposal would permit these funds to use some of the same, and more advantageous, offering and proxy rules available to operating companies. The SEC intends for these changes to improve access to capital and facilitate investor communications by BDCs and CEFs.[17] In addition, there are proposed changes to the disclosure and regulatory framework to harmonize requirements around structured data requirements and the use of in-line XBRL, annual report disclosure requirements, and updates and requirements for CEFs and BDCs to file reports on Form 8-K to provide current information on important events.[18]

3. **On May 3, 2019, the SEC issued a proposal that would amend the financial statement requirements for investment company acquisitions and dispositions of businesses and related pro forma financial information.**[19] These changes are intended to improve communications related to acquisitions and divestitures, reduce complexity and costs of preparing the required disclosures, and facilitate timely access to capital. Under current regulations, investment companies follow the same general requirements of Rule 3-05 and Article 11 concerning audited and pro forma financial statements as do other registrants. However, because of the unique characteristics of investment companies and BDCs, it is often unclear how to apply the rules for an investment company's acquisition of another investment company or other types of funds.[20] New investment company-specific definitions created by Rules 6-11 and 1-02(w)(2) aim to bring more clarity to the general provisions found in SEC Regulation S-X.

What’s next?

Considering the potential strategic implications of the SEC proposals, PE firms offering BDCs should ask themselves:

- What do the proposed changes to the rules mean to our funds?
- Do we need to involve external legal or audit assistance in interpreting the rules and proposed changes?
- Should we comment on any of the proposals to convey our points of view or impact to our funds?
- How do the proposed changes affect the structure of our funds or planned business activities (e.g., mergers, acquisitions)?
- What actions should we take now to prepare?

These new rules may reshape the broader lending landscape by driving a change in the number of future BDC registrations. If credit availability expands as more firms enter the space, more small- and medium-sized businesses could seek additional financing through BDCs. The future looks bright for BDCs as potentially less burdensome regulations create opportunities to grow in the alternative financing market.

Endnotes

1. "SEC Proposes Rule Changes for Fund of Funds Arrangements," SEC, December 19, 2018, https://www.sec.gov/news/press-release/2018-295.
2. "SEC Proposes Offering Reforms for Business Development Companies and Registered Closed-End Funds," SEC, March 20, 2019, https://www.sec.gov/news/press-release/2019-39.
3. "SEC Proposes to Improve Disclosures Relating to Acquisitions and Dispositions of Businesses," SEC, May 3, 2019, https://www.sec.gov/news/press-release/2019-65.
4. Tracy Alloway and Arash Massoudi, "Non-bank lending steps out of the shadows," *Financial Times*, February 25, 2014, https://www.ft.com/content/7455f590-9d7d-11e3-a599-00144feab7de.
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14. SEC, The Coalition for Business Development, et al., "Application for an order pursuant to Section 6(c) of the Investment Company Act of 1940, to exempt certain business development companies from the meaning of the term 'Acquired Fund' for purposes of Form N-1A, Form N-2, Form N-3, Form N-4 and Form N-6 under the 1940 Act," SEC, September 4, 2018, https://www.sec.gov/Archives/edgar/data/1449853/000147361218000002/a26449579_12xcsbgexemptive.htm.
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20. Ibid.

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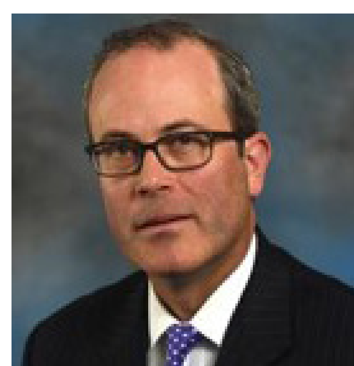

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