

**BUSINESS DEVELOPMENT COMPANIES WITH WHOLLY-OWNED SBIC SUBSIDIARIES—ASSET COVERAGE REQUIREMENTS**

The Commission has, from time to time, issued exemptive orders to business development companies (“BDCs”)<sup>1</sup> granting limited relief from the asset coverage requirements of sections 18(a) and 61(a) of the 1940 Act.<sup>2</sup> Subject to representations and a condition described in the exemptive applications, this relief permits a BDC to treat certain indebtedness issued by its wholly owned subsidiary operating as a small business investment company (“SBIC Subsidiary”) as indebtedness not represented by senior securities for purposes of determining the BDC’s consolidated asset coverage.<sup>3</sup>

Recently, the staff has become aware that certain BDCs have sought to rely on this limited relief in connection with SBICs that have not issued indebtedness that is held or guaranteed by the Small Business Administration (“SBA”). As discussed further below, the staff does not believe that reliance on the relief for this purpose is consistent with the representations historically included in the exemptive applications. In addition, to make explicit this existing requirement under the orders, the staff requests that all new applications include a modified condition, as described below.

***Background***

Section 18(a)(1) of the 1940 Act prohibits a registered closed-end company from issuing any class of senior security representing indebtedness unless the company complies with the asset coverage requirements set forth in that section.<sup>4</sup> Section 61(a) of the 1940 Act makes section 18(a) applicable to BDCs, with certain modifications.

A BDC may be deemed an indirect issuer of any class of senior security issued by its direct or indirect wholly owned SBIC Subsidiary. As a result, absent exemptive relief, the BDC would also be required to comply with the asset coverage requirements on a consolidated basis, meaning that it would treat as its own the assets and liabilities of its SBIC Subsidiary for purposes of calculating the BDC’s asset coverage.<sup>5</sup>



The Commission has issued a number of exemptive orders to BDCs granting limited relief from the asset coverage requirements. This relief allows the BDCs to treat certain indebtedness issued by their wholly owned SBIC Subsidiaries as indebtedness not represented by senior securities for purposes of determining the BDC's consolidated asset coverage. For purposes of the asset coverage calculation, this indebtedness is deducted from the BDC's total assets and is also excluded from the amount of senior securities representing indebtedness.

In support of the request for relief, applicants represent that companies operating under the SBIA, such as the SBIC Subsidiaries, are subject to the SBA's separate regulation of permissible leverage in their capital structure. Applicants also point to section 18(k) of the 1940 Act, which exempts investment companies operating as SBICs from the asset coverage requirements contained in sections 18(a)(1)(A) and (B) for senior securities representing indebtedness. Applicants contend that because an SBIC Subsidiary would be entitled to rely on section 18(k) if it were a BDC, there is no policy reason to deny the benefit of that exemption to the BDC parent.

#### ***Existing Orders***

Existing orders are subject to several representations and a condition described in the exemptive applications. Although in most cases the representations and condition have not explicitly required that the SBIC Subsidiary have issued indebtedness held or guaranteed by the SBA, we believe this requirement is implicit in the rationale for the relief. Specifically, the relief is premised on the SBA's separate oversight of the SBIC Subsidiary's indebtedness rendering application of the 1940 Act's asset coverage requirements unnecessary. However, if the SBIC Subsidiary has not issued indebtedness such that the SBIC Subsidiary is fully subject to that oversight, the application of the 1940 Act's requirements is not duplicative. Accordingly, where an SBIC Subsidiary has not issued indebtedness that is held or guaranteed by the SBA, the staff does not believe that reliance on the order would be consistent with the representations made in the existing exemptive applications.

#### ***Potential Applicants for Orders***

To make explicit this existing requirement under the orders, the staff requests that all new applications include a modified condition. Specifically, the condition should provide that any senior securities representing indebtedness of an SBIC Subsidiary will not be considered senior securities and, for purposes of the definition of "asset coverage" in section 18(h), will be treated as indebtedness not represented by senior securities but only if that SBIC Subsidiary has issued indebtedness that is held or guaranteed by the SBA.<sup>6</sup>

## Endnotes

- 1 Section 2(a)(48) of the 1940 Act defines a BDC to be any closed-end investment company that, among other things, is operated for the purpose of making investments in securities described in sections 55(a)(1) through 55(a)(3) of the 1940 Act and makes available significant managerial assistance with respect to the issuers of such securities.
- 2 For examples of this type of relief, see *In the Matter of Medley Capital Corporation, et al.*, Investment Company Act Release Nos. (30234) (Oct. 16, 2012) (notice) and (30262) (Nov. 14, 2012) (order) and *In the Matter of Saratoga Investment Corporation, et al.*, Investment Company Act Release Nos. (30145) (July 23, 2012) (notice) and (30171) (Aug. 20, 2012) (order).
- 3 A “small business investment company” or “SBIC” is a company that is licensed by the Small Business Administration (“SBA”) to operate as such under the Small Business Investment Act of 1958 (“SBIA”).
- 4 Section 18(g) of the 1940 Act provides, in relevant part, that “‘Senior security’ means any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends; and ‘senior security representing indebtedness’ means any senior security other than stock.”
- 5 Section 18(h) of the 1940 Act provides, in relevant part, that, “‘Asset coverage’ of a class of senior security representing an indebtedness of an issuer means the ratio which the value of the total assets of such issuer, less all liabilities and indebtedness not represented by senior securities, bears to the aggregate amount of senior securities representing indebtedness of such issuer.”
- 6 See *In the Matter of OFS Capital Corporation, et al.*, Investment Company Act Release Nos. (30771) (Oct. 30, 2013) (notice) and (30812) (Nov. 26, 2013) (order).

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