SEC EXPANDS DEFINITION OF ELIGIBLE PORTFOLIO COMPANY FOR BDCs

Last Thursday, the Securities and Exchange Commission amended Rule 2a-46 under the Investment Company Act of 1940 to expand the ability of business development companies (BDCs) to invest in small cap companies that list a class of their securities on an exchange.[1] The SEC, in adopting the amendment, noted that the amendment's purpose was to increase the availability of capital to certain smaller companies that may not have ready access to the public capital markets or other forms of conventional financing.[2] The expansion of the definition of "eligible portfolio company" will add flexibility to BDCs' portfolio management by increasing investment opportunities for BDCs. The amendment to Rule 2a-46 will become effective on July 21, 2008.

Under the amendment, for the first time, a domestic operating company with securities listed on a national securities exchange may qualify as an "eligible portfolio company," so long as the company has a market capitalization of less than $250 million (not subject to future adjustment for inflation) computed as of any date in the 60-day period prior to the BDC's acquisition of the company's securities. A BDC's follow-on investment in such a company more than 60 days after the company's market capitalization was last below $250 million generally would be considered an investment in an eligible portfolio company only if the conditions of Rule 55a-1 are satisfied.[3]

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1 *Definition of Eligible Portfolio Company under the Investment Company Act of 1940*, Investment Company Act Release No. 28266 (May 15, 2008) (the "Adopting Release"). The Division of Investment Management has published a brief summary of the amended Rule: *Definition of Eligible Portfolio Company: Amendment to Rule 2a-46 under the Investment Company Act: A Small Entity Compliance Guide*, Division of Investment Management, SEC (May 19, 2008), http://sec.gov/info/smallbus/secg/rule2a-46-secg.htm.

2 *SEC Broadens Opportunities for Small Business Financing*, SEC (May 15, 2008) (press release), http://www.sec.gov/news/press/2008/2008-90.htm.

3 The Adopting Release does not discuss the interplay of amended Rule 2a-46 with Rule 55a-1, but does not expressly change the existing relationship between those two rules. The SEC has said that, pursuant to Rule 55a-1, a BDC may consider investments in eligible portfolio companies to include

> follow-on investments in a company that met the definition of eligible portfolio company under Rule 2a-46 at the time of the BDC's initial investment(s) in the company, but subsequently would not meet the definition of eligible portfolio company because the company no longer meets the requirements of that rule (*i.e.*, following the BDC's initial investment(s) in the company, the company listed its securities on an Exchange), subject to certain conditions. These conditions permit a BDC to make a follow-on investment only if the BDC, at the time of the follow-on investment: (1) owns at least 50 percent of (a) the greatest number of equity securities of such company, including securities convertible into or exchangeable for such securities, and (b) the greatest amount of certain debt securities of such company held by the BDC at any time during the period when such company was an eligible portfolio company; and (2) is one of the twenty largest holders of record of the company's outstanding voting securities.

Notably, the SEC chose the $250 million market capitalization standard rather than two alternative standards on which the SEC had sought comment - a $150 million market capitalization standard or a standard limiting the public float of the listed company to $75 million.[4]

Background

A BDC is prohibited from acquiring certain assets unless, at the time of acquisition, certain specified investments represent at least 70% of its total assets, sometimes referred to as the "70% basket." Among the types of investments included for purposes of the 70% basket are, under certain circumstances, securities issued by an eligible portfolio company. Originally, eligible portfolio companies did not include any company that had a class of securities that were marginable under the rules and regulations adopted by the Board of Governors of the Federal Reserve System. Over time, and with greatest effect in 1998, the Federal Reserve Board significantly expanded the categories of marginable securities. As a result, many issuers that were once eligible portfolio companies were no longer eligible.

In late 2006, in part to address that result, the SEC adopted Rule 2a-46 to expand the definition of eligible portfolio company to include all domestic operating companies that had no class of securities listed on a national securities exchange.[5] At that time, the SEC also requested public comment on appropriate market capitalization levels or public float levels that should apply to listed companies under a broadened definition of eligible portfolio company. Last week, in choosing the $250 million market capitalization standard rather than the $150 million standard, the SEC agreed with commenters who asserted that companies with market capitalizations of $250 million or less have limited access to the public equity and debt markets, are typically followed by few analysts, have lower trading volume than larger companies and have few or no institutional investors. The SEC, in declining to adopt the proposed $75 million public float standard, acknowledged that a public float requires information about an issuer and its affiliates that, unlike market capitalization information, is not readily available through third parties. Such

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Definition of Eligible Portfolio Company under the Investment Company Act of 1940, Investment Company Act Release No. 27538 (Oct. 25, 2006) (adopting Rule 55a-1 and original Rule 2a-46). Last week's amendment of Rule 2a-46 may make obsolete the parenthetical in the above paragraph, "(*i.e.*, following the BDC's initial investment(s) in the company, the company listed its securities on an Exchange)." Under amended Rule 2a-46, that parenthetical now more appropriately might say, "(*i.e.*, following the BDC's initial investment(s) in the company, a class of the company's securities was listed on an Exchange and the company's aggregate market value was never less than $250 million on any day during the 60-day period prior to the subsequent investment)."

4 *Definition of Eligible Portfolio Company under the Investment Company Act of 1940*, Investment Company Act Release No. 27539 (Oct. 25, 2006) (the "Reproposing Release").

5 *Definition of Eligible Portfolio Company under the Investment Company Act of 1940*, Investment Company Act Release No. 26647 (Nov. 1, 2004) (the "Proposing Release").

a process would have imposed a burden not present in other SEC rules that use a public float standard.

Additional Items of Note

Valuation Methodology

Under amended Rule 2a-46, the market capitalization of a company as of a particular day must be computed using the price at which the company's common equity is last sold, or the average of the bid and asked prices of the company's common equity, in the principal market for the common equity, on that day. This calculation, however, is solely for purposes of determining whether a company meets the definition of eligible portfolio company, and may not be used by a BDC to value its portfolio companies for purposes of its net asset value calculation.[6]

No Adjustment for Inflation

Certain commenters had suggested that the standard adopted by the SEC should be adjusted periodically in the future to take account of the effect of inflation, the growth of equity markets, or changes in the capital structure of small companies. The Rule as amended, however, did not provide for any future adjustment of the $250 million figure. In the Adopting Release, the SEC indicated, without further explanation, that its reason for not providing for any future adjustment for inflation was because the proposed Rule amendment had not provided for such an adjustment.[7]

Federal Legislators and the Comment Process

The proposal to amend the definition of "eligible portfolio company" received an unusual level of interest from members of Congress. The comment process included input from members of both the U.S. House of Representatives[8] and the U.S. Senate,[9] urging the SEC to adopt Rule 2a-46 and, more recently, urging the SEC to amend Rule 2a-46 to provide for the $250 million

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6 A BDC must value its interests in portfolio companies for purposes of calculating its net asset value consistent with Section 2(a)(41) of the 1940 Act. *See* Adopting Release at n.37.

7 *See* Adopting Release at n.26.

8 Letter from Rep. Michael G. Oxley, then-Chairman, Committee on Financial Services, Rep. Richard H. Baker, then-Chairman, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, and Rep. Sue W. Kelly, then-Chairwoman, Subcommittee on Oversight and Investigations, to Christopher Cox, Chairman, SEC (Nov. 15, 2005), http://www.sec.gov/rules/proposed/s73704/s73704-18.pdf.

9 Letter from Sens. Charles E. Schumer and Robert Menendez to Christopher Cox, Chairman, SEC (Apr. 24, 2006), http://www.sec.gov/rules/proposed/s73704/s73704-44.pdf.

market capitalization standard.[10] The SEC's Division of Investment Management also recently publicly recommended to the Commission that it amend Rule 2a-46.[11]

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If you have any questions concerning the foregoing or would like additional information, please contact Rose F. DiMartino (212-728-8215, rdimartino@willkie.com), Maria Gattuso (212-728-8294, mgattuso@willkie.com), James G. Silk (202-303-1275, jsilk@willkie.com), Jesse P. Kanach (202-303-1276, jkanach@willkie.com), Matthew E. Newell (202-303-1284, mnewell@willkie.com), or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, NW, Washington, DC 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, DC telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at www.willkie.com.

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[10] Letter from Rep. Paul E. Kanjorski, Chairman, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, to Christopher Cox, Chairman, SEC (Apr. 15, 2008) (not yet available with the other comments on the Proposing Release and the Reproposing Release, which can be found at http://www.sec.gov/rules/proposed/s73704.shtml#27539).

[11] *SEC Staff Recommends Commission Action to Facilitate Investment in Small Business*, Division of Investment Management, SEC (May 7, 2008) (press release), http://www.sec.gov/news/press/2008/2008-81.htm.