Building a better working world

SEC actions and their impact to business development companies

By Eyal Seinfeld and Alyssa Erceg

The last year has been a particularly busy time for the Securities and Exchange Commission (SEC), as the SEC has proposed and finalized several rules and issued an exemptive order that impact business development companies (BDCs).

In the past, while certain rules were applicable to BDCs, they were not necessarily written with BDCs in mind or were written prior to the advent of BDCs. Application of the rules among BDCs was inconsistent. The recent proposed and adopted rules and the exemptive order deliberately address the unique issues that BDCs encounter in financial and regulatory reporting and should bring consistency in their application.

SEC rules finalized

Changes to the criteria to qualify as accelerated filers and large accelerated filers

On 12 March 2020, the SEC adopted a final rule that changes the criteria for entities that qualify as accelerated filers and large accelerated filers. Under the adopted rule, if a BDC has (1) public float of $75 million or more, but less than $700 million, and (2) has investment income of less than $100 million, the BDC is excluded from the definition of accelerated filer and large accelerated filer and becomes a non-accelerated filer. In determining public float, the measurement date is as of the last business day of the issuer's most recently completed second fiscal quarter (for calendar-year companies, 30 June). In determining investment income, the measurement is based on the preceding year's gross investment income, as defined in Rule 6-07.1 of Regulation S-X.

As a non-accelerated filer, certain requirements are applied differently, including extended deadlines for filings required on Forms 10-K (90 days) and 10-Q (45 days), as well as an exemption from the independent auditor attestation requirements for internal control over financial reporting under Section 404(b) of the Sarbanes-Oxley Act of 2002.

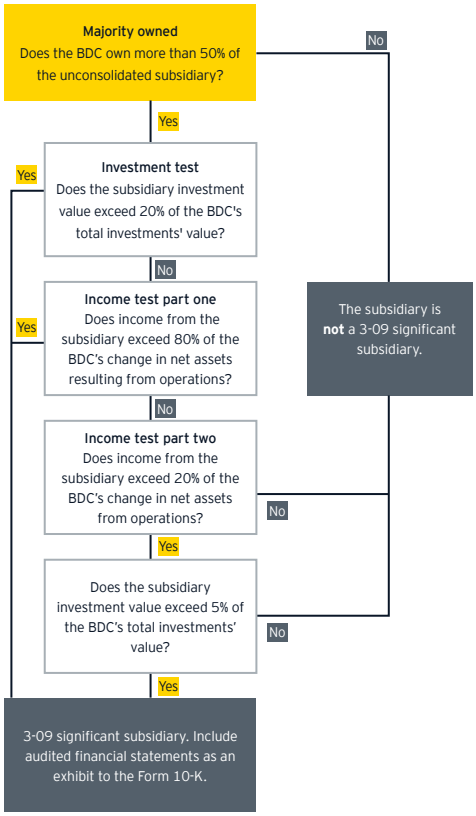
The final rule became effective on 27 April 2020 and applies to a Form 10-K filing due on or after the effective date.

Changes to the definition of significant subsidiary

On 20 May 2020, the SEC adopted a final rule, Amendments to Financial Disclosures about Acquired and Disposed Businesses, that changes the criteria for what is considered a significant subsidiary. Identifying significant subsidiaries of a BDC is primarily relevant in two circumstances, which are in connection with the acquisition of another fund and in connection with the reporting requirements under Regulation S-X Rules 3-09 and 4-08(g). The final rule's impact on the application of Rules 3-09 and 4-08(g) are potentially significant (and are discussed in more detail below) as, for the first time, the application of the rules is specifically tailored to BDCs and allows for a consistent definition of what is considered a significant subsidiary in a BDC context.

Under the final rule, BDCs apply two tests – an investment test and an income test – to evaluate whether a subsidiary is significant. The investment test compares the value of the individual investment to a BDC's total investments. The income test compares income from the subsidiary to a BDC's change in net assets resulting from operations. The income test has two parts, which are further discussed below. Income from a subsidiary is calculated as the sum of gross investment income, net realized gains and losses on investments, and net change in unrealized gains and losses on investments. Once these components are added, the absolute value must be used. The income test allows for five-year averaging of the denominator when the absolute value of a BDC's current year change in net assets resulting from operations is at least 20% lower than the absolute value of the five-year average for the Rule 3-09 test and is at least 10% lower than the absolute value of the five-year average for the Rule 4-08(g) test.

Rule 3-09 significant subsidiary decision tree



For Rule 3-09 purposes in connection with a Form 10-K filing, a BDC analyzes all majority-owned unconsolidated subsidiaries to determine whether they are Rule 3-09 significant subsidiaries by performing the following evaluation:

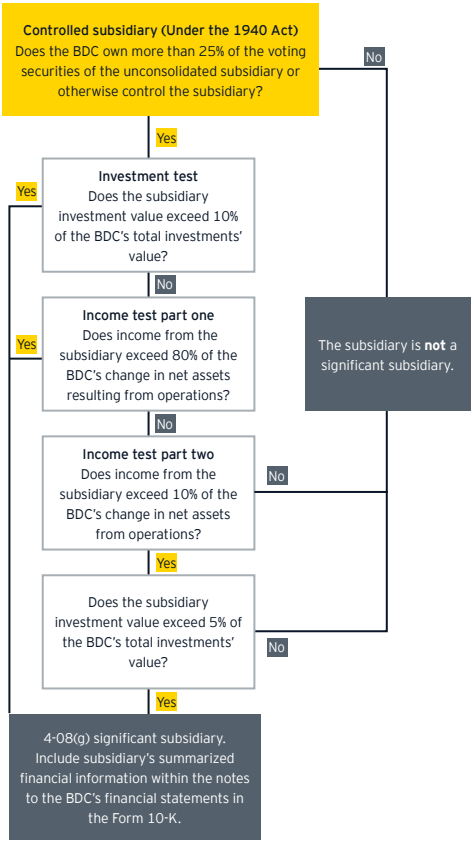
- Under the investment test, if the subsidiary investment value exceeds 20% of the BDC's total investments value, then it is a significant subsidiary.
- If the investment test doesn't exceed 20%, the BDC applies part one of the income test. If income from the subsidiary exceeds 80% of the BDC's change in net assets resulting from operations (numerator and denominator are both absolute values, and five-year averaging for the denominator may be considered), then it is a significant subsidiary.
- If the investment test doesn't exceed 20%, and the income test part one doesn't exceed 80%, the BDC applies the income test part two. If (1) income from the subsidiary exceeds 20% of the BDC's change in net assets resulting from operations (numerator and denominator are both absolute values, and five-year averaging for the denominator may be considered) and (2) the subsidiary investment value exceeds 5% of the BDC's total investments value, then it is a significant subsidiary.

For Rule 3-09 significant subsidiaries, BDCs must include the subsidiary's audited financial statements as an exhibit to the Form 10-K.

For Rule 4-08(g) purposes in connection with a Form 10-K filing, a BDC analyzes all unconsolidated controlled subsidiaries (based on the definition of control in the Investment Company Act of 1940 (1940 Act) — generally, more than 25% ownership of the subsidiary's voting securities) that were not considered Rule 3-09 significant subsidiaries to determine whether they are Rule 4-08(g) significant subsidiaries by performing the following evaluation:

- Under the investment test, if the subsidiary investment value exceeds 10% of the BDC's total investments value, then it is a significant subsidiary.
- If the investment test doesn't exceed 10%, the BDC applies part one of the income test. If income from the subsidiary exceeds 80% of the BDC's change in net assets resulting from operations (numerator and denominator are both absolute values, and five-year averaging for the denominator may be considered), then it is a significant subsidiary.
- If the investment test doesn't exceed 10%, and the income test part one doesn't exceed 80%, the BDC applies the income test part two. If (1) income from the subsidiary exceeds 10% of the BDC's change in net assets resulting from operations (numerator and denominator are both absolute values, and five-year averaging for the denominator may be considered) and (2) the subsidiary investment value exceeds 5% of the BDC's total investments value, then it is a significant subsidiary.

Rule 4-08(g) significant subsidiary decision tree



For Rule 4-08(g) significant subsidiaries, BDCs must include the subsidiary's summarized financial information within the notes to the BDC's audited financial statements.

For quarterly reporting purposes, if a BDC has a subsidiary that is a majority-owned subsidiary that fails any Rule 3-09 significant subsidiary test at quarter-end, the BDC must include summarized income statement information within the notes to the quarterly financial statements.

The amendments will be effective 1 January 2021 with voluntary early compliance permitted if all amendments are applied in their entirety.

SEC exemptive order

Temporary relief from asset coverage and joint transactions prohibitions

On 8 April 2020, the SEC issued an exemptive order under the 1940 Act (Exemptive Order) that provides relief to BDCs impacted by the COVID-19 outbreak to enable them to make additional investments in portfolio companies.

The Exemptive Order allows BDCs that breach asset coverage requirements prescribed by the 1940 Act to raise capital by issuing and selling senior securities (e.g., debt, preferred stock) if they meet certain conditions, including satisfying an alternative asset coverage requirement (adjusted asset coverage ratio). In the absence of the Exemptive Order, a BDC that does not meet the asset coverage requirements would not be able to issue or sell senior securities (even under existing credit facilities).

Immediately prior to a potential issuance or sale of senior securities, for portfolio companies held by a BDC that were also held as of 31 December, 2019, and for which the BDC has not recognized a realized loss, the Exemptive Order permits the BDC to use the 31 December, 2019, values of its portfolio company holdings to calculate an adjusted portfolio value to determine its adjusted asset coverage ratio. The BDC would calculate its adjusted asset coverage ratio using the adjusted portfolio value reduced by 25% of the difference between the asset coverage ratio calculated using the adjusted portfolio value and the asset coverage ratio calculated in accordance with the 1940 Act.

If a BDC meets the asset coverage requirements utilizing the adjusted asset coverage ratio and the BDC meets all the conditions outlined in the Exemptive Order, the BDC is permitted to issue or sell senior securities on the calculation date. These conditions include the following: (1) the BDC must obtain various board of director approvals and file a Form 8-K, (2) the BDC may not fund initial investments in portfolio companies for 90 days after electing to use the relief (unless a BDC comes into compliance with the 1940 Act prescribed asset coverage ratio), (3) no affiliated person of the BDC can receive transaction fees or other remuneration from an issuer in which the BDC invests (excluding investment advisory fees or certain other payments made by an issuer to all security holders) and (4) the BDC's advisor must report to the board of directors at least monthly regarding the efforts undertaken and progress made toward achieving compliance with the 1940 Act prescribed asset coverage requirements.

The Exemptive Order also permits BDCs with existing co-investment orders to make follow-on investments in portfolio companies together with affiliated private funds that would otherwise represent joint transactions that are prohibited by the 1940 Act, subject to the BDC satisfying certain conditions.

Utilization of the Exemptive Order is optional and is permissible until 31 December 2020.

SEC rules proposed

Use of derivatives and unfunded commitments

On 25 November 2019, the SEC proposed new rule 18f-4, which is designed to provide a comprehensive approach to the regulation of derivatives, reverse repurchase agreements or similar financing transactions, and unfunded commitment agreements entered into by investment funds, including BDCs.

Of particular relevance to BDCs is the treatment of unfunded commitments under the proposed rule. Unfunded commitment agreements could be excluded from a BDC's asset coverage ratio if the BDC reasonably believes, at the time it enters into such an agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements, in each case as they come due. The determination of whether sufficient cash and cash equivalents will be available is subject to certain considerations, including that a BDC (1) must take into account reasonable expectations with respect to other obligations (e.g., any obligation with respect to senior securities, redemptions), (2) may not take into account cash that may become available from selling investments at prices that significantly deviate from their market values and (3) may not include cash from potential equity issuances. Management must document the basis for its determination at the time of entering into each unfunded commitment agreement.

We expect that many BDCs will meet the definition of limited derivatives users, but for those with more extensive derivative transactions, the proposed rule requires BDCs to satisfy certain conditions to exclude derivatives transactions from their asset coverage ratios, including:

- Adopting and implementing a written derivatives risk management program that includes the following elements: (1) risk identification and assessment, (2) risk guidelines, (3) stress testing, (4) backtesting, (5) internal reporting and escalation of material risks, and (6) periodic review of the program
- Complying with a limit on total leverage (where the value at risk (VaR) of a BDC's portfolio cannot exceed either (1) 150% of the VaR of the BDC's designated reference index or (2) 15% of the value of the BDC's net assets, if the derivatives risk manager is unable to identify an appropriate designated reference index)
- Designating a derivatives risk manager that reports to the BDC's board of directors

To meet the definition of a limited derivatives user and be exempt from the requirements described above, a BDC must:

- Either (1) limit its derivatives exposure to 10% of its net assets or (2) use currency derivatives solely to hedge currency risks associated with foreign currency-denominated investments, provided the notional amounts of the currency derivatives don't exceed the value of the foreign currency-denominated equity investments (or par value of fixed-income investments) by more than a negligible amount
- Adopt and implement policies and procedures reasonably designed to manage its derivatives risks

The proposed rule also includes requirements related to board of director oversight, regular board of director reporting and recordkeeping.

Comments on the proposal were due on 24 March 2020.

Proposal to modernize valuation practices

On 21 April 2020, the SEC proposed a new rule under the 1940 Act that would modernize BDC valuation practices and clarify how boards of directors can satisfy their obligation to determine fair value in good faith for portfolio holdings without readily available market quotations. In issuing the proposal, the SEC is responding to the evolution of markets and investment practices since 1970, when it last issued comprehensive valuation guidance.

The proposed rule would codify the common practice of assigning the determination of fair value to a BDC's advisor, but would require a board of directors to take specific steps to oversee the advisor's determination of fair value, including:

- Periodically assessing and managing material valuation risks, including material conflicts of interest
- Establishing and applying fair value methodologies

- Testing those methodologies
- Overseeing and evaluating pricing services used by the BDC
- Adopting and implementing written policies and procedures addressing the determination of fair value

When a board of directors assigns the fair value determination to the fund's advisor, the advisor would be required to provide to the board of directors, at least quarterly, a written assessment of the adequacy and effectiveness of the advisor's process for determining fair value.

While the 1940 Act requires BDC boards of directors to fair value positions for which market quotations are not readily available, the SEC had never previously defined when market quotations are readily available. The proposed rule states that a market quotation would be readily available only when it is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date. That means a quote would be unreliable and, therefore, not readily available if US GAAP would require an adjustment or the consideration of additional inputs to value the security.

This proposed definition of when market quotations are readily available would clarify that a BDC board of directors' responsibilities extend to investments that are categorized as Level 2 under the hierarchy established in Financial Accounting Standards Board's Accounting Standards Codification (ASC) 820, *Fair Value Measurement*, even if these investments are valued using third-party pricing services or broker quotes. In practice, many BDCs had interpreted the 1940 Act's requirement to only include investment valuations categorized in Level 3 of the valuation hierarchy in ASC 820.

The SEC also said "indications of interest" or "accommodation quotes" would not be readily available market quotations and reaffirmed its previous statement that evaluated prices are not by themselves readily available market quotations.

The SEC also attempts to reduce redundancies with standards set by other governing bodies. The proposal affirms that a methodology used to determine fair value would need to be consistent with ASC 820. The proposal also would rescind the guidance on the recognition, measurement, disclosure and auditing of investment securities, which is included in Accounting Series Release (ASR) Nos. 113 and 118 that were issued in 1969 and 1970, respectively. The SEC believes this guidance is no longer necessary because ASC 820 modernized the approach to the accounting topics addressed in these ASRs, and the Public Company Accounting Oversight Board was created by the Sarbanes-Oxley Act of 2002 to establish guidance for auditors.

Comments on the proposal are due by 21 July 2020.

Final thoughts and summary

The SEC's finalized and proposed rules and the exemptive order directly address BDCs. In its release, the SEC has acknowledged the industry's unique issues and practices. BDCs could now benefit from reduced financial reporting requirements as a result of the changes to the definitions of accelerated filer and large accelerated filer and the changes to the criteria for significant subsidiary tests. On the other hand, the proposed derivatives and fair value rules could place additional demand on management's analysis and documentation related to unfunded commitments and Level 2 investments, and enhance board oversight requirements. It is critical that management monitors these proposed rules as they are finalized, and to ensure compliance, management continues to engage in discussions with its internal stakeholders, external auditors and advisors.

EY | Assurance | Tax | Strategy and Transactions | Consulting

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for ourpeople, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

EY is a leader in serving the global financial services marketplace
Nearly 51,000 EY financial services professionals around the world provide integrated assurance, tax, transaction and advisory services to our asset management, banking, capital markets and insurance clients. In the Americas, EY is the only public accounting organization with a separate business unit dedicated to the financial services marketplace. Created in 2000, the Americas Financial Services Organization today includes more than 11,000 professionals at member firms in over 50 locations throughout the US, the Caribbean and Latin America.

EY professionals in our financial services practices worldwide align with key global industry groups, including EY's Global Wealth & Asset Management Center, Global Banking & Capital Markets Center, Global Insurance Center and Global Private Equity Center, which act as hubs for sharing industry-focused knowledge on current and emerging trends and regulations in order to help our clients address key issues. Our practitioners span many disciplines and provide a well-rounded understanding of business issues and challenges, as well as integrated services to our clients.

With a global presence and industry-focused advice, EY's financial services professionals provide high-quality assurance, tax, transaction and advisory services, including operations, process improvement, risk and technology, to financial services companies worldwide.

SCORE No. 09883-201US
2006-3522901 BDFSO
ED None

ey.com

Contact the authors

Eyal Seinfeld
Partner, BDC Markets
Leader, Financial Services Organization
Ernst & Young LLP
eyal.seinfeld@ey.com
+1 212 773 1450

Alyssa Erceg
Senior Manager
Financial Services Organization
Ernst & Young LLP
alyssa.erceg@ey.com
+1 212 773 3383