

# CORONAVIRUS INFORMATION & UPDATES

April 14, 2020

## SEC Order Temporarily Exempts BDCs from Certain Asset-Coverage Requirements and Joint Transaction Prohibitions

On April 8, 2020, the SEC [issued an order](#) (the “Order”) that provides temporary flexibility for business development companies (“BDCs”) (i) to issue and sell senior securities and (ii) to participate in certain joint transactions that would otherwise be prohibited by Section 57(a)(4) of the 1940 Act and Rule 17d-1 thereunder. The Order provides exemptions to assist BDCs in providing capital to their portfolio companies<sup>1</sup> in specific limited situations and subject to certain conditions where:

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- A BDC would otherwise be unable to satisfy the asset coverage requirements under the 1940 Act due to temporary mark-downs in the value of its investments in its portfolio companies.
- A BDC’s affiliates would otherwise be prohibited from participating in additional investments in the BDC’s portfolio companies due to restrictions in the BDC’s exemptive order permitting co-investments.

The Order’s exemptive relief is effective immediately and ends upon the earlier of (i) December 31, 2020 or (ii) the date by which the BDC ceases to rely on the Order (the “Exemption Period”). A description of the Order’s provisions follows.

### A. ASSET COVERAGE EXEMPTION

Notwithstanding the senior security asset-coverage requirements of Section 18 of the 1940 Act (as modified by Section 61(a) for a BDC), during the Exemption Period, the Order permits a BDC to issue senior securities based on its “Adjusted Portfolio Value” (“APV,” as defined below), which is used to determine its “Adjusted Asset Coverage Ratio” (“AACR,” defined below).

- Section 18(a), as modified for BDCs by Section 61(a), specifies the asset coverage ratio normally required of a BDC immediately after it issues a senior security.
- Section 18(b) requires that the asset coverage ratio required immediately after the issuance of a senior security must be determined on the basis of values calculated within the forty-eight hours (excluding Sundays or holidays) preceding the issuance of the senior security.

As explained below, the Order provides that, at the time of any issuance of a senior security, the BDC shall calculate asset coverage ratios in accordance with Section 18(b), except that, in reliance on the Order, the BDC may use its APV to determine its AACR.

<sup>1</sup> The Order’s introductory paragraph states: “BDCs were created to provide capital to smaller domestic operating companies that otherwise may not be able to readily access the capital markets (we refer to such companies as ‘portfolio companies’).” It is unclear whether that term is limited to “eligible portfolio companies” as defined in Section 2(a)(46).

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To calculate its APV, with respect to portfolio company holdings (i) that the BDC held at December 31, 2019, (ii) that the BDC continues to hold at the time of such issuance (iii) for which the BDC is not recognizing a realized loss,<sup>2</sup> the BDC may use **values calculated as of December 31, 2019.**<sup>3</sup>

To calculate its AACR, a BDC reduces its current asset coverage ratio (“ACR”) calculated using its current APV by an amount equal to 25% of the difference between (i) the asset coverage ratio calculated using its APV and (ii) the current asset coverage ratio calculated in accordance with Section 18(b):

$$AACR = ACR_{\text{Current APV}} - \frac{1}{4} (ACR_{\text{Current APV}} - ACR_{\text{Current}})$$

The Order provides the following example.

A BDC has a 220% asset coverage ratio on December 31, 2019,<sup>4</sup> which has declined to 160% on March 31, 2020. Using its APV, the BDC’s asset coverage ratio is 200% on March 31, 2020.

On March 31, 2020, the BDC’s AACR is 190%, which is equal to its March 31, 2020 ACR using its APV (200%) minus 10% (25% of the difference between 200% and 160%).

$$190\% = 200\% - \frac{1}{4} (200\% - 160\%)$$

Thus, the BDC cannot issue senior securities on March 31, 2020 unless, immediately after the issuance, the BDC’s AACR meets the threshold specified by Section 18(a) as modified by Section 61(a).

***Additional conditions apply:***

1. Before a BDC can elect to rely on the Order’s asset coverage exemption, the BDC’s Board of directors or trustees (“Board”), including a required majority of the Board, as defined in Section 57(o) of the 1940 Act (a “Required Majority”), must determine that the issuance of senior securities is permitted by the Order and is in the best interests of the BDC and its shareholders.

<sup>2</sup> BDCs may not include a December 31, 2019 fair value measurement in their AACR if the portfolio company holding is permanently impaired. For purposes of the Order, a permanently impaired holding is a holding where a BDC recognized a realized loss subsequent to December 31, 2019, and the loss is not recoverable. This is similar to the process required of SBICs.

<sup>3</sup> For purposes of determining a BDC’s AACR, portfolio company holdings acquired after December 31, 2019 must be valued using values calculated within the forty-eight hours (excluding Sundays or holidays) preceding the issuance of the senior security.

<sup>4</sup> Sections 61(a)(1) and (2) of the 1940 Act modify the asset coverage requirements of Section 18(a) to be either 200% or 150%, but the Order does not indicate whether the BDC in question is complying with the 200% or 150% requirement. Consider the following additional example: Assume the BDC’s required asset coverage ratio is 150% (*i.e.*, it is relying on Section 61(a)(2)). On December 31, 2019, its ACR is 200%. However, on March 31, 2020, its ACR is only 100% because of decreases in portfolio values (assuming no permanent impairments and no acquisitions of securities after December 31, 2019). If the BDC were permitted to use its year-end ACR as its AACR, its March 31 AACR would be 200%. However, under the Order, its AACR is 175% (three-quarters of the difference between 100% and 200%). Thus, the BDC has some flexibility to borrow with respect to the applicable statutory ratio (150%), but not as much as it would have if it were permitted to rely on its December 31 ACR (200%).

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2. Before a BDC issues senior securities in reliance on the Order, the Board, including a Required Majority, must determine that each such issuance is in the best interests of the BDC and its shareholders. Prior to making such determination, the Board must obtain and consider (i) a certification from the BDC's investment adviser that the issuance of senior securities is in the best interests of the BDC and its shareholders. The certification must include the investment adviser's recommendation and the reasons underlying the recommendation, including whether the adviser has considered other reasonable alternatives that would not result in the issuance of a senior security; and (ii) advice from an Independent Evaluator<sup>5</sup> regarding whether the terms and conditions of the proposed issue of senior securities are fair and reasonable compared to similar issuances, if any, by unaffiliated third parties in light of current market conditions.
3. Before relying on the Order's asset coverage exemption, a BDC must file a Form 8-K disclosing its election to rely on the Order's exemption.
4. A BDC that elects to rely on the Order's asset coverage exemption may not, for 90 days from the date of the election, make an initial investment in any portfolio company in which the BDC was not already invested, provided that a BDC may make an initial investment in such a portfolio company if, at the time of investment, its asset coverage ratio complies with the applicable statutory asset coverage ratio.
5. The Board of any BDC that has elected to rely on the asset coverage exemption of the Order must receive and review, no less frequently than monthly, reports prepared by the BDC's investment adviser regarding and assessing the efforts that the investment adviser has undertaken, and progress that the BDC has made, towards achieving compliance with the statutory asset coverage requirements under the 1940 Act by the expiration of the Exemption Period. Upon expiration of the Exemption Period, any BDC not in compliance with the statutory requirements must make a filing on Form 8-K that includes the following information (i) the BDC's current asset coverage ratio, (ii) the reasons why the BDC was unable to comply with the statutory asset coverage requirements, (iii) the time frame within which the BDC expects to come into compliance with the statutory asset coverage requirements and (iv) the specific steps that the BDC will be undertaking to bring itself into compliance with the statutory asset coverage requirements.
6. Each BDC is required to make and preserve as required records the minutes describing (i) the Board's deliberations in connection with condition 2 above, including the factors considered by the Board in connection with such determinations, as well as all related documents and reports provided to the Board and (ii) the reports made to the Board pursuant to condition 5 above, including copies of all other information provided to or relied upon by the Board.
7. Except 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, shall 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.

<sup>5</sup> The Order defines Independent Evaluator as "a person who has expertise in the valuation of securities and other financial assets and who is not an interested person, as defined in section 2(a)(19) of the Investment Company Act, of the BDC, or any affiliate thereof."



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## B. EXPANSION OF RELIEF FOR BDCs WITH EXISTING CO-INVESTMENT ORDERS

During the Exemption Period, the Order separately provides additional flexibility for follow-on transactions to any BDC to which an SEC order permitting co-investment transactions in portfolio companies with certain affiliated persons is currently applicable (“existing co-investment order”).

Specifically, a BDC subject to an existing co-investment order may participate in a Follow-On Investment (which may include a Non-Negotiated 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, it either (a) has previously participated in a Co-Investment Transaction with the BDC with respect to the issuer or (b) is not invested in the issuer.

- The Order provides that the terms Follow-On Investment, Regulated Fund, Affiliated Fund and Co-Investment Transaction have the same meanings ascribed to them in the BDC’s existing co-investment order or, if the BDC’s existing co-investment order uses a substantially similar term, the substantially similar term.
- Under the Order, the term Affiliated Fund does not include any registered open-end or closed-end fund or a BDC.

*Additional conditions apply:*

1. Any transaction relying on the Order must otherwise be effected in accordance with the terms and conditions of the existing co-investment order.
2. Non-Negotiated Follow-On Investments do not require prior approval by the Board. However, the transactions are subject to the periodic reporting requirements set forth in the BDC’s existing co-investment order.
3. In connection with making the findings required by the BDC’s existing co-investment order with respect to Follow-On Investments that are not Non-Negotiated Follow-On Investments, the Board, and a Required Majority, must review the proposed Follow-On Investment both on a stand-alone basis and in relation to the total economic exposure of the BDC to the issuer.
4. For purposes of complying with condition 3 above, the Board, and a Required Majority, need not make the findings required with respect to Enhanced Review Follow-On Investments, as such term is defined in existing co-investment orders.

## OBSERVATIONS

In light of some of the conditions attached to the Order’s exemptive relief, the narrow scope of relief and potential contractual limitations otherwise applicable to BDCs (such as credit facilities and other debt instruments), it remains to be seen how helpful the Order will be to BDCs in practice.

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