KIRKLAND & ELLIS LLP Alert

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PUBLICLY OFFERED PRIVATE EQUITY FUNDS - RECENT BDC OFFERINGS

Overview and Current Market Environment

A number of private equity ("PE") firms have recently sponsored the formation of publicly offered business development companies ("BDCs"). Most of these recent public BDCs ("Mezz BDCs") focus on mezzanine or debt investing in private portfolio companies as their principal strategy, seeking to distribute high current income to investors with some potential for capital appreciation.

Adopting a public BDC structure provides the PE sponsor with a stable pool of evergreen capital in a flow-through tax vehicle, an attractive fee structure similar to a private PE fund or mezz fund, and the ability to employ some degree of leverage. However, raising public capital imposes a higher level of SEC regulation than for a private PE fund or mezz fund, including regulation of fees, fund management and governance, permitted investments, portfolio security valuation and other areas of a public BDC's ongoing investing and operations, as well as all of the regulatory and disclosure obligations associated with being a publicly-traded company with exchange listed securities.

A PE sponsor considering launching a BDC should weigh the benefits of a public BDC against the regulatory burdens. In addition, a PE sponsor with an existing private PE Fund must determine whether the terms of the existing PE Fund allow (1) investment opportunities to be shifted to the new BDC or (2) the new BDC to co-invest (e.g., supply mezz debt) in a transaction in which the existing PE Fund is investing.

Whether BDCs continue to be popular likely depends on the stock market performance of BDCs currently being marketed and the extent to which BDC shares trade at a discount from the BDC's net asset value (i.e., the fair value of the BDC's assets minus the BDC's liabilities). Other closed-end publicly traded funds are often plagued by such discounts to net asset value, resulting in public perception issues for the sponsor and, in some cases, investor unrest. The recent after-market performance of Apollo's Mezz BDC, which has traded below its IPO price, is creating market uncertainty for other pending BDC offerings.

This Alert describes current trends in BDC offerings and their regulatory and tax structure.

BDC Structure and Operations

General. A BDC (1) must be organized under U.S. state law, with its principal place of business in the U.S., (2) generally is organized as a corporation in a state with favorable corporate law for a publicly offered investment fund, such as Maryland, and (3) is a publicly offered closed-end investment company, registering its securities with the SEC on Form N-2, which describes:

- Offering terms, including size, price, underwriting arrangements and compensation,
- Risk factors,
- Proposed investment program and strategy and any investment policies or restrictions,

- BDC management, including directors, officers and investment adviser,
- Tax consequences,
- Regulation,
- Material contracts with the investment adviser and other service providers and fees and expenses payable by the BDC,
- Related party transactions and co-investment and other affiliated transaction policies,
- Portfolio pricing guidelines,
- Capital structure and anti-takeover provisions, and
- Dividend and distribution policies.

The BDC's shares are usually (1) sold in a firm commitment underwritten public offering of SEC registered securities, with the underwriter receiving compensation (approximately 6% to 7%) payable out of the offering proceeds (or occasionally by the sponsoring investment adviser), and (2) listed on a securities exchange to provide investor liquidity. The BDC invests the net offering proceeds in government securities, high quality short-term debt securities and cash equivalents pending investment in portfolio securities.

A BDC is subject to 1934 Act regulation as a public company (10-Qs, 10-Ks, proxy statements, etc.), constitutes a specialized investment company under the Investment Company Act of 1940 (the "1940 Act") and qualifies for flow-through taxation under Subchapter M of the Internal Revenue Code, thus avoiding corporate-level federal income tax (except on income and gains not distributed to the BDC's shareholders).

Most recently formed BDCs focus on mezz or debt investments in private companies with some equity kicker, such as warrants, and some reserve the right to invest a specified portion of total assets (e.g., 30%) in equity securities, such as common or preferred stock. The current market appeal of such Mezz BDCs stems from (1) an expected high yield relative to other debt-oriented investment products in today's low interest rate environment, together with an expected capital appreciation component, and (2) the public's ability to invest with established PE sponsors. Several such Mezz BDCs successfully launched underwritten initial public offerings ("IPOs") raising substantial funds in a relatively short time frame (e.g., $930 million Apollo 4/04 IPO and $150 million Technology Investment 11/03 IPO) and approximately 11 other Mezz BDC IPOs (aggregating $5.6 billion) are currently pending at the SEC.

BDC Management. As a corporation, the BDC has a board of directors, a majority of whom must be "disinterested" under the 1940 Act and stock exchange requirements. To qualify, a director must not have designated affiliations or material business relationships with the BDC's investment adviser, underwriter or their affiliates. The board of directors must meet at least quarterly to review the BDC's portfolio performance, approve portfolio security valuations and monitor and address ongoing compliance requirements under the 1940 Act and other applicable law. Beginning two years after the BDC's IPO, the board must annually review whether to renew the PE sponsor as the BDC's investment adviser. The board may fire the PE sponsor as investment adviser at any time on 60 days notice.

The BDC's investments are managed by its investment adviser, which is the PE sponsor or its affiliate.[1] A BDC's investment adviser must be registered under the Investment Advisers Act of 1940 (the "Advisers Act"), creating additional regulatory burdens for a PE sponsor which was not previously so registered.

BDC Investors. Investors in a § 3(c)(1) private PE fund must generally be "accredited investors" ($1

[1] While some established BDCs operate as internally managed companies, with officers and employees performing the investing and operating functions, the recent Mezz BDC offerings are externally managed with an investment adviser (the PE sponsor) supplying investment management services. This Alert focuses on such externally managed BDCs.

million net worth or $200,000 per year income for an individual or $5 million in assets for an entity) and for a § 3(c)(7) private PE fund must be "qualified purchasers" ($5 million investment assets for an individual or $25 million for an entity). And where the private PE fund's sponsor is a registered investment adviser, each investor in a § 3(c)(1) private PE fund must also be a "heavy hitter" with $1.5 million net worth or $750,000 under the PE sponsor's management.

One of the principal advantages of a BDC is that BDC investors are not so restricted, because the general investing public can purchase BDC securities in the registered offering or post IPO-trading.

BDC Management Fees. A BDC's fee structure is often similar to a private PE Fund. Most Mezz BDCs adopt the following fee structure:

- Base management fee usually in the range of 1.75% to 2.5% of the BDC's net asset value (plus any borrowings) or the BDC's gross assets, paid quarterly in arrears.

- Incentive fee based on net investment income usually 20% of the BDC's net investment income (e.g., interest income on debt securities, dividend income and most other portfolio income) in excess of a fixed or benchmark hurdle rate, often including a make-up once the hurdle rate is met, paid quarterly in arrears.

- Incentive fee based on net realized capital gains usually 20% of the BDC's net realized capital gain less realized capital loss and unrealized depreciation,[2] calculated and paid annually in cash. Because this is a fee and not a partnership allocation, it constitutes ordinary income to the investment adviser for federal income tax purposes (rather than flow-through capital gain as with a private PE fund).

Because the PE sponsor's advisory contract must be renewed periodically, there is the potential for the BDC's disinterested directors to renegotiate investment advisory fees (or even retain a different adviser). In addition, developments in the mutual fund industry could over time create pressure on the level of BDC advisory fees.

BDC Investment Advisory Agreement. The 1940 Act and the Advisers Act create termination and renegotiation risks not present in most private PE fund partnership agreements. The BDC's board of directors -- and the disinterested directors in particular -- have 1940 Act mandated fiduciary duties in reviewing, approving and renewing the advisory agreement with the PE sponsor, such as detailed review as to the scope and quality of the adviser's services, the adviser's revenue and profitability from the BDC and comparable fees at other funds. The advisory contract, including fees, must be approved initially by the BDC's board of directors and also by a majority of the BDC's disinterested directors at an in-person meeting and can have a term of no more than two years. After the initial two year term, the BDC board and disinterested directors must annually renew and decide whether to continue the contract at an in-person meeting.

The BDC advisory contract must from the outset allow the BDC board or shareholders to terminate the advisory contract on short notice (i.e., 60 days) without payment of any penalty, such as future management or incentive fees.

Finally, the advisory agreement must provide for automatic termination in the event of an "assignment" of the advisory contract without approval of the BDC's board, disinterested directors, and shareholders, which is triggered by a transfer of 50% or more of investment adviser's (i.e., the PE sponsor's) voting securities and under some circumstances may be triggered by a transfer of as little as 25%.

BDC Investments. At least 70% of a BDC's total assets must be "qualifying" assets i.e., fall within one of the categories described in (1) through (6) below:

[2] The Advisers Act caps the BDC's fee at 20% and allows only "realized" capital gain to be covered.

1. Securities acquired by the BDC in a private placement where the BDC meets the control or managerial-assistance test described below and the portfolio company meets the following criteria:

   (a) The portfolio company is organized under U.S. state law, with its principal place of business in the U.S., *and*

   (b) The portfolio company is an "Operating Company," i.e., its principal business is not investing, reinvesting or trading in securities,[3] *and*

   (c) The portfolio company meets at least one of three tests: (1) the company does not, prior to the BDC investment, have a class of margin securities under Reg T[4], *or* (2) the company is a small and solvent company with total assets not exceeding $4 million and paid in capital of at least $2 million, *or* (3) the company is controlled[5] by the BDC or by the BDC and others as a group (and, in either case, the BDC has an affiliated director of the company).

2. Securities of a U.S. based Operating Company controlled[6] by the BDC or by the BDC and others as a group (and in either case the BDC has an affiliated director of the portfolio company) where the BDC meets the control or managerial-assistance test described below, regardless of whether the BDC acquires the securities in a private placement.

3. Securities of a U.S. based Operating Company purchased in a private placement from the portfolio company or the company's officers, directors, or 5% or greater shareholders, where such company is insolvent or the securities are purchased in connection with a bankruptcy or reorganization and where the BDC meets the control or managerial-assistance test described below.

4. Securities of a U.S. based Operating Company purchased from anyone in a private placement if there is no ready market for the securities and the BDC already owns 60% or more of the portfolio company's fully diluted equity securities.

5. Securities received as a distribution on, in exchange for, or upon exercise of warrants, options or rights to acquire securities described in (1) through (4) above.

6. Cash, cash equivalents, U.S. government securities or high quality short-term debt securities.

Securities described in (1) through (3) above constitute "qualifying" assets only if the BDC either (1) controls[7] the portfolio company or (2) provides or offers to provide, significant managerial assistance to the company, i.e., significant guidance and counsel concerning the company's management, operations or business objectives and

[3] However, the BDC can own 95% or more of a small business investment company (an SBIC) without violating that rule.

[4] Under Reg T, margin securities include (1) securities listed on a national securities exchange or Nasdaq, (2) any debt security convertible into a security described in (1), (3) any non-convertible debt security (possibly including outstanding mezz debt), and (4) any foreign margin security. U.S. equity securities not listed on an exchange or Nasdaq (e.g., common stock, convertible or non-convertible preferred stock, warrants, etc.) are not Reg T margin securities.

H.R. 3170 recently passed by the House on 4/28/04 would expand the qualifying assets test in (1)(c)(1) to substitute for the Reg T margin securities test a test focusing on whether the company has (1) equity securities listed on an exchange or Nasdaq or (2) more than $250 million of public equity securities (more than $500 million where BDC acquires securities from portfolio company and such securities constitute not more than 10% of BDC's qualifying assets).

[5] Control means the power to exercise a controlling influence over management or policies of a company and is presumed if the BDC owns 25% or more of the company's voting securities, so long as there is no owner with a larger position.

[6] See footnote 5 for control definition.

[7] See footnote 5 for control definition.

policies (except that this requirement does not apply to a small and solvent company described in (1)(c)(2) above). A BDC purchasing portfolio company securities together with other persons acting as a group generally qualifies if the group controls the portfolio company or any member of the group provides or offers to provide managerial assistance.

The 70% qualifying asset test is applied each time the BDC purchases a portfolio security, based on the BDC's most recently determined asset fair values.

Affiliated Transactions and Co-Investing. A BDC is subject to extensive 1940 Act restrictions on affiliated transactions, i.e., most transactions between or involving the BDC (or a BDC controlled portfolio company) and the BDC's affiliates, including its officers, directors, 5% or greater shareholders, investment adviser, or any entity controlled by any of these BDC affiliates. The affiliated transaction restrictions would, for example, prohibit co-investments by a BDC and a private PE fund (both controlled/managed by the same PE sponsor) in the same portfolio company, absent SEC relief. The SEC has broad exemptive authority to permit affiliated transactions subject to an extensive and time consuming application process.[8]

Some existing BDCs have obtained SEC exemptive orders permitting co-investment in portfolio companies along with private PE funds managed by the same PE sponsor. In order to obtain this relief, the PE Fund must demonstrate to the SEC that procedures in place ensure the terms of each co-investment transaction will be fair and reasonable for the BDC and consistent with the BDC's stated investment policies and will receive disinterested director approval. Most recent Mezz BDC offerings and proposed offerings indicate that the BDC will not co-invest with affiliated private PE funds, although several have indicated a future intention to seek (or reserved the right to seek) SEC exemptive relief for co-investments.

Public Company Reporting and Regulation. A BDC must register its common stock under the 1934 Act and file periodic reports like any other public company (e.g., quarterly 10-Qs, annual 10-Ks, event-related 8-Ks and proxy statements). Directors, officers and greater than 10% stockholders of a public BDC must file beneficial ownership reports on Forms 3, 4 and 5 under 1934 Act §16 and are subject to §16(b) disgorgement for "short swing" profits. Greater than 5% BDC stockholders must file beneficial ownership reports on Schedule 13D or 13G.

As a public company with listed securities, a BDC is subject to all of the NASDAQ/NYSE corporate governance requirements for listed companies, including audit, nominating and compensation committee independence and other requirements, committee charter requirements, corporate governance guidelines, director and officer ethics codes, and annual exchange certifications. A BDC is also subject to Sarbanes-Oxley public company requirements, including:

- CEO and CFO certification requirements for annual and quarterly reports,
- Attorney up-the-ladder reporting obligations, and
- § 402 director and officer loan prohibitions.

Operating as a public company requires remarkable transparency, which may be surprising to certain PE sponsors accustomed to operating private PE funds, such as quarterly financial statements identifying the current fair value of each portfolio company investment.

Finally, operating as a public company subjects the fund to greater shareholder litigation risks for securities law violations, together with higher premiums associated with public company D&O insurance.

Taxation/Subchapter M. BDCs rely on Subchapter M of the Internal Revenue Code (the "Code") to

[8] Under certain circumstances, a BDC's disinterested directors with no financial interest in the transaction may approve a limited class of such transactions (e.g., a transaction with 5% or greater BDC shareholder) if the BDC's directors find the transaction reasonable and fair and not involving overreaching by non-BDC parties.

avoid corporate-level federal income tax. To qualify for Subchapter M treatment, the BDC must:

- derive at least 90% of its gross income from dividends, interest, gains from the sale of securities and other investment related income,
- distribute to its shareholders annually at least 90% of (1) its ordinary income (e.g., interest and dividend income) plus (2) the excess of its realized short-term capital gain over its net realized long-term capital loss,[9] and
- maintain a minimally diversified portfolio as of each quarter end.

A Mezz BDC may recognize phantom taxable income -- i.e., interest or OID not paid in actual cash -- requiring the BDC to use cash reserves or borrow funds (subject to 1940 Act restrictions) to meet Subchapter M's shareholder distribution requirements.

Leverage. Under the 1940 Act, a BDC may use a limited amount of leverage, i.e., debt securities and preferred stock, so long as its assets are at least 200% of the amount of debt and preferred stock, and in addition may also borrow an amount up to 5% of its assets for temporary or emergency purposes.

Portfolio Securities Valuation. A BDC must follow strict 1940 Act rules in establishing quarterly values for its portfolio securities -- market quotations where available, otherwise fair value, i.e., the amount the BDC could reasonably expect to receive upon a current sale as determined in good faith by the BDC's board of directors, a standard which may differ from the manner by which PE sponsors value private PE funds. A BDC's portfolio securities valuation often receives significant scrutiny from the SEC and the BDC's investors.

Other 1940 Act Requirements. Other unique 1940 Act requirements applicable to a BDC include:

- Required use of a qualified custodian for BDC assets,
- Prohibition on issuing additional BDC common stock at a price below net asset value without shareholder approval,
- Code of ethics for directors, officers and investment adviser personnel relating to personal investing activities, and requiring reporting of personal transactions,
- Written proxy voting policies,
- Fidelity bond requirements, and
- Effective October 2004, detailed compliance procedures administered by a chief compliance officer reporting directly to the BDC board whose compensation is approved by the board.

SEC Oversight. A BDC and its investment adviser (the PE sponsor) are subject to ongoing SEC compliance examinations, i.e., periodic detailed SEC reviews of the BDC's books, records and transactions.

<u>Advisers Act Regulation of BDC Sponsor</u>

To serve as the BDC's investment adviser, the PE sponsor must be an SEC registered investment adviser.[10] If the PE sponsor is not previously so registered, a new registration in connection with the BDC's creation may well require registration of the PE sponsor's other management companies under SEC alter ego theories, in which case the PE sponsor generally cannot receive carried interest

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[9] If the BDC meets this 90% distribution test but distributes less than 100% of its ordinary income and capital gain, corporate-level tax applies to the undistributed portion. A BDC that distributes income to shareholders after the calendar year in which the income is earned may also be subject to a 4% excise tax on the delayed distribution.

[10] See Levin and Moehrke, Investment Adviser Regulation of Private Equity Fund General Partner, published in the Summer 2002 issue of Venture Capital Review and available at www.kirkland.com, for a detailed description of SEC registration and ongoing obligations for SEC registered investment advisers.

from its private PE funds unless (1) each investor in the PE sponsor's private PE funds has $1.5 million net worth or $750,000 invested with the PE sponsor, or (2) the private PE Fund qualifies as a QP Fund under 1940 Act §3(c)(7).

Conclusion

The recent public BDC trend is still in its early stages, with a number of very sizable offerings that are yet to come to market. Because Apollo's recent $930 million Mezz BDC IPO is trading below its $15 IPO price, there is currently uncertainty in the market for other pending BDC offerings. If the public market ultimately recognizes the traditional "J" curve performance of most PE funds, PE sponsors may find BDCs an attractive investment vehicle, but should be aware of applicable ongoing regulatory burdens, public profile, reporting and disclosure obligations and restrictions arising out of existing private PE Funds managed by the PE sponsor as discussed above.

Should you have any questions about this Alert, please contact any of the following K&E attorneys or the K&E partner or associate with whom you maintain a client relationship:

Jack S. Levin, P.C.	Scott A. Moehrke	James S. Rowe
(312) 861-2004	(312) 861-2199	(312) 861-2191

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