

# Memorandum

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## New Temporary Exemptive Relief Relating to Coronavirus Gives BDCs the Ability to Use Adjusted Asset Coverage Calculations and Provides Follow-On Flexibility

April 10, 2020

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On April 8, 2020, the U.S. Securities and Exchange Commission (the “Commission”) issued an [exemptive order](#) (IC Release No. 33837) to business development companies (“BDCs”) granting exemptions from specified provisions of the Investment Company Act of 1940 (the “1940 Act”) and certain rules thereunder (the “Order”). The Order grants BDCs (that elect to rely on it) greater flexibility until December 31, 2020 to (1) issue senior securities and (2) enter into follow-on co-investment transactions, all subject to conditions. In this memorandum, we discuss the key implications of the Order, then provide a more detailed summary of it.

### Follow-On Flexibility for Co-Investments

Of the two exemptions granted by the Commission, it is likely that the additional co-investment flexibility will provide BDCs with the greater benefit. Until December 31, 2020, a BDC relying on an existing “co-investment” exemptive order may participate in a so-called follow-on investment with affiliated private funds that do not currently hold an interest in the issuer. Under existing exemptive relief precedent, a BDC and an affiliated private fund can jointly negotiate a co-investment in an issuer if neither has an existing position in the issuer, but if a negotiated follow-on opportunity arises, other affiliated funds are not able to participate unless they were part of the initial co-investment. In essence, the temporary exemptive relief means that a BDC sponsor, when considering whether to refinance the existing debt and/or provide rescue financing to a BDC portfolio company, will have access to additional pools of capital to provide such financing. This emergency relief will be welcome to BDC sponsors who are fielding inquiries from portfolio companies who need financial flexibility to weather the current storm.

The follow-on investment relief is a temporary solution to a fundamental flaw in the Commission’s co-investment exemptive orders. While the Commission should be applauded for temporarily fixing the problem, even when it is a problem of its own making, we remain hopeful that this is just the first step in solving a broken co-investment system.<sup>1</sup> The Commission should use this opportunity to permanently fix and modernize the co-investment

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<sup>1</sup> See [The Evolution of Co-Investment Exemptive Orders and Why They Should Become Extinct](#) (Article from October 2018 Registered Funds Alert).

See [Novel Co-Investment Application Filed—A New Approach to Resolving an Old Problem](#) (Article from May 2019 Registered Funds Alert).

system to allow flexible uses of capital for the benefit of BDCs and registered funds without weakening investor protection.

### Adjusted Asset Coverage Ratio

The Order also provides BDCs with additional flexibility to issue senior securities by allowing BDCs to adjust their asset coverage ratio for purposes of compliance with the 1940 Act. The relief is subject to conditions, including limitations on the BDC's ability to make new investments and restrictions on remuneration that may be received by a BDC's affiliates from issuers in which the BDC invests. Importantly, the Order does not provide relief from the 1940 Act restrictions on declaring distributions or repurchasing stock when applicable asset coverage tests are not met.

BDCs relying on the Order may use portfolio company valuations as of December 31, 2019 instead of valuations for those same portfolio companies as of the most recent quarter, provided that the BDC has not realized a loss, including a permanent impairment, after December 31, 2019 on those same portfolio companies. Given the current market dislocation, the December 31, 2019 valuations will likely be higher than the most recent quarter's valuation, thereby increasing the BDC's adjusted asset coverage ratio. By allowing BDCs to use an adjusted asset coverage ratio, BDCs will be permitted to incur additional leverage or issue additional preferred shares to meet liquidity constraints caused by the coronavirus disease 2019 ("COVID-19") pandemic.

Although the Order does not explain the primary rationale for the relief, it appears that the Commission's intent was to allow a BDC to add leverage that exceeds statutory restrictions for the purpose of providing financial support to existing portfolio holdings (not for new investments or for dividends and other distributions) that are affected by COVID-19. An example in the Order illustrates this point. The Order also provides a temporary safe harbor for a BDC that might otherwise fail to meet the 1940 Act asset coverage requirements of sections 18(a)(1)(A) or 18(a)(2)(A) of the 1940 Act, as modified for BDCs by section 61 of the 1940 Act. We applaud the Commission for its responsiveness to market needs, but we question the practicality of many aspects of this relief.

Certain of the conditions a BDC must follow to avail itself to the asset coverage relief are onerous. In other words, a BDC and its Board will need to carefully consider the implications of those conditions before seeking to rely on the Order.

Limits on New Investments. As explained above, the Commission's purpose in issuing the relief appears to be to allow a BDC to exceed statutory asset coverage limits for the purpose of supporting existing portfolio holdings only. While we question why the Commission so narrowly crafted the relief, that purpose at least explains why the Commission has limited the relief to leverage for existing portfolio holdings. A BDC that elects to take advantage of the adjusted asset coverage ratio to issue senior securities are limited to only making follow-on investments in portfolio companies held by the BDC on the date of such election for a period of 90 days following the issuance, unless the BDC's standard asset coverage

ratio rises to its applicable 1940 Act requirement, 200% or 150%. This limitation on investments may pose a significant hindrance on the BDC's operations, which may affect returns to shareholders. For example, following an issuance, the BDC will generally not be able to recycle capital, including capital received from the maturity of a loan. Given the significant portion of syndicated debt held by many BDCs, this condition could impair the normal investment function of a BDC.

No Relief for Issuance of Dividends or Distributions. The Order does not provide relief in connection with the declaration or payment of any dividend or any other distribution that is otherwise prohibited by sections 18(a)(1)(B) or 18(a)(2)(B) of the 1940 Act. Therefore, to the extent that a BDC has public debt or preferred shares outstanding, even if a BDC satisfies the adjusted asset coverage ratio test, it may be prohibited from declaring dividends or distributions to shareholders.<sup>2</sup> The vast majority of BDCs have elected to be treated for tax purposes as a regulated investment company (a "RIC") under Subchapter M of the Internal Revenue Code of 1986, as amended (the "Code"). As RICs, BDCs are generally required to distribute to their shareholders, for each taxable year, at least 90% of their "investment company taxable income," which is generally net ordinary income plus the excess, if any, of realized net short-term capital gains over realized net long-term capital losses. Had the relief applied to declarations or payments of dividends, it would have solved a significant concern for affected BDCs that fail to meet applicable 1940 Act asset coverage requirements – choosing between compliance with the 1940 Act or the Code.

Board Approval of Each Issuance of Senior Securities. Prior to a BDC issuing or selling senior securities, the Board, including a majority of independent directors, must determine that each such issuance is in the best interests of the BDC and its shareholders. The Board must also obtain certifications from the investment adviser as well as advice from an "independent evaluator" regarding whether the terms and conditions of the issuance are fair and reasonable. Obtaining certifications from the BDC's investment adviser should not pose a problem; however, the independent evaluator advice requirement will necessarily add to the cost of an issuance. As a reminder, these Board approval and certification requirements would apply to each issuance, including by implication each borrowing under a BDC's credit facility. Therefore, this requirement may prove to be burdensome without a concomitant benefit.

Prohibitions on Receipt of Transaction Fees or Other Remuneration. The Order also limits the ability of affiliates of the BDC, including affiliated BDCs or registered funds, to receive transaction fees or other remuneration from an issuer in which the BDC invests while it relies on the Order. By prohibiting such fees altogether for any first-tier or second-tier affiliated person of the BDC, as opposed to permitting pro rata sharing of such fees among a BDC and its affiliated funds, a BDC relying on the adjusted asset coverage relief may in effect not be able to rely on the follow-on relief described above, since the

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<sup>2</sup> The reference to public debt is because the 1940 Act does not prohibit the payment of distributions regardless of asset coverage when leverage is generated by private arranged debt. See section 18(g) of the 1940 Act. Of course, as a contractual matter the debt providers may require asset coverage ratios to be met prior to the declaration or payment of any distribution.

investment adviser's other clients could not receive their pro rata share of commitment fees in connection with the transaction.

Requirement to Meet Standard Asset Coverage Ratio at the End of the Exemption Period. The Board must receive and review, at least monthly, reports about the efforts that the investment adviser has undertaken, and progress that the BDC has made, towards achieving compliance with its standard asset coverage requirement by December 31, 2020. Any BDC not in compliance with the standard statutory asset coverage requirements at that time must immediately file a Form 8-K with the following information: (a) the BDC's current asset coverage ratio; (b) the reasons why the BDC was unable to comply with the asset coverage requirements; (c) the time frame within which the BDC expects to come into compliance with the asset coverage requirements; and (d) the specific steps that the BDC will be undertaking to bring itself into compliance with the asset coverage requirements.

Additionally, prior to electing to take advantage of the increased flexibility to issue senior securities, a BDC should review its current debt documents to ensure that it is not prohibited from increasing its leverage beyond the current statutory limits. BDCs may be required to obtain a waiver or amendment to take advantage of the relief granted by the Order.

The relief granted by the Commission is further outlined below.

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## Timing

From April 8, 2020 to the earlier of (a) December 31, 2020 (including such date) and (b) the date by which a BDC ceases to rely on the Order (the "Exemption Period").

## Relief

### FOLLOW-ON RELIEF

During the Exemption Period, if a BDC has a co-investment order from the Commission (an "existing co-investment order"), the BDC 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*:

- 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
- if such participant is an Affiliated Fund, it either (X) has previously participated in a Co-Investment Transaction with the BDC with respect to the issuer, or (Y) is not invested in the issuer;<sup>3</sup> *provided that*:

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<sup>3</sup> The terms Follow-On Investment, Regulated Fund, Affiliated Fund and Co-Investment Transaction shall 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. For purposes of the Order, the term Affiliated Fund does not include any open or closed-end investment company

- Any such transaction is otherwise effected in accordance with the terms and conditions of the existing co-investment order; and
- Board Oversight.
  - Non-Negotiated Follow-On Investments. Non-Negotiated Follow-On Investments do not require prior approval by the Board; however they are subject to the periodic reporting requirements set forth in the BDC's existing co-investment order.
  - Follow-On Investments other than Non-Negotiated Follow-On Investments. 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.<sup>4</sup>

#### SENIOR SECURITIES/ADJUSTED ASSET COVERAGE RATIO

- A BDC may issue or sell a senior security that represents an indebtedness or that is a stock (together, the “covered senior securities”), *provided that*:
  - Adjusted Portfolio Value. At the time of any issuance or sale of a covered senior security, the BDC must calculate asset coverage ratios in accordance with section 18(b) of the 1940 Act, except that, in reliance on the Order, 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 or sale; and (iii) for which the BDC is not recognizing a realized loss,<sup>5</sup> the BDC may use values calculated as of December 31, 2019, to calculate portfolio value (the “Adjusted Portfolio Value”) to meet an Adjusted Asset Coverage Ratio.
    - To calculate the Adjusted Asset Coverage Ratio, a BDC must reduce its asset coverage ratio using the Adjusted Portfolio Value by an amount equal to 25% of the difference between the asset coverage ratio calculated using the Adjusted Portfolio Value and the asset coverage ratio calculated in accordance with section 18(b) of the 1940 Act.
    - For example a BDC has a 220% asset coverage ratio on December 31, 2019. Its asset coverage ratio declines to 160% on March 31, 2020, not using the Adjusted Portfolio Value, and 200% if it calculated the ratio (without the 25% decrease) using the Adjusted Portfolio Value. This BDC would

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registered under the 1940 Act or a BDC. The term “Non-Negotiated Follow-On Investment” shall be given the meaning ascribed to it in existing co-investment orders. For purposes of the Order, a BDC may participate in a Non-Negotiated Follow-On Investment in reliance on the Order whether or not such term is used in its existing co-investment order.

<sup>4</sup> For purposes of complying with this condition of the Order, 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.

<sup>5</sup> BDCs may not include a December 31, 2019, fair value measurement in their Adjusted Asset Coverage Ratio 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.

have an Adjusted Asset Coverage Ratio of 190% (200% minus 10% (25% of the difference between 200% and 160%)).

- Limitation on New Investments. A BDC that has elected to rely on the Order can only, for 90 days from the date of such election, make follow-on investments in any portfolio company in which the BDC holds as of the date of the Order, April 8, 2020, *provided that* a BDC may make an initial investment in a portfolio company if at the time of investment the BDC's asset coverage ratio complies with the asset coverage ratio applicable to it under section 18 of the 1940 Act, as modified by section 61.
- Board Approval of Reliance on the Order. Prior to a BDC's election to rely on the Order, the BDC's board of directors or trustees (the "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 or sale of covered senior securities is permitted by the Order and is in the best interests of the BDC and its shareholders.
- Form 8-K Announcement. Prior to relying on the Order for purposes of issuing or selling covered senior securities, a BDC must make an election by filing on Form 8-K. Similarly, a BDC may withdraw its election through filing on Form 8-K.
- Board Approval of Each Issuance of Senior Securities. Prior to a BDC issuing or selling covered senior securities, 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:
    - a certification from the BDC's investment adviser that the issuance of covered senior securities is in the best interests of the BDC and its shareholders; such certification shall include not only the investment adviser's recommendation, but also the reasons therefore, including whether the adviser has considered other reasonable alternatives that would not result in the issuance or sale of a covered senior security; and
    - advice from an Independent Evaluator<sup>6</sup> regarding whether the terms and conditions of the proposed issuance or sale of a covered senior security are fair and reasonable compared to similar issuances, if any, by unaffiliated third parties in light of current market conditions.
- No Sunset Period. The Board of any BDC that has elected to rely on 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 asset coverage requirements under section 18 of the 1940 Act, as modified by section 61, by the expiration of the Exemption Period. Upon expiration of the Exemption Period, any BDC not in compliance with the asset coverage requirements applicable to such BDC at that

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<sup>6</sup> The term "Independent Evaluator" shall mean 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 1940 Act, of the BDC, or any affiliate thereof.

time as described in sections 18(a)(1)(A) and 18(a)(2)(A), as modified by sections 61(a)(1) and 61(a)(2), must immediately make a filing on Form 8-K that includes the following information:

- the BDC's current asset coverage ratio;
  - the reasons why the BDC was unable to comply with the asset coverage requirements;
  - the time frame within which the BDC expects to come into compliance with the asset coverage requirements; and
  - the specific steps that the BDC will be undertaking to bring itself into compliance with the asset coverage requirements.
- Recordkeeping. Each BDC must make and preserve, for a period of not less than six years, the first two years in an easily accessible place, minutes describing the Board's deliberations in connection with each issuance of covered senior securities, including the factors considered by the board in connection with such determinations, as well as all information, documents and reports provided to the Board in connection therewith; and the reports made to the Board by the investment adviser, including copies of all other information provided to or relied upon by the Board.
- No Compensation or Remuneration of Any Kind. Except (i) to the extent permitted by section 57(k) of the 1940 Act (certain brokerage or underwriting compensation); or (ii) 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, can 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. For the avoidance of doubt, this condition does not apply to the receipt of investment advisory fees by an investment adviser to the BDC under an investment management agreement entered into in accordance with section 15 of the 1940 Act.

For further information regarding this memorandum, please contact one of the following:

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