

# SECURITIES AND EXCHANGE COMMISSION

## 17 CFR Part 270

[Release No. IC-27539; File No. S7-37-04]

RIN 3235-AJ31

### Definition of Eligible Portfolio Company under the Investment Company Act of 1940

**AGENCY:** Securities and Exchange Commission (the “Commission”).

**ACTION:** Reproposed rule.

**SUMMARY:** The Commission is reproposing for comment an additional definition of the term “eligible portfolio company” under the Investment Company Act of 1940 (“Investment Company Act” or “Act”). The reproposed rule is intended to more closely align the definition of eligible portfolio company, and the investment activities of business development companies (“BDCs”), with the purpose that Congress intended. The reproposed rule would expand the definition of eligible portfolio company to include certain companies that list their securities on a national securities exchange (“Exchange”).

**DATES:** Comments should be received on or before January 2, 2007.

**ADDRESSES:** Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission’s Internet comment form (<http://www.sec.gov/rules/proposed>); or

- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-37-04 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-37-04. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** Rochelle Kauffman Plesset, Senior Counsel, or Elizabeth G. Osterman, Assistant Chief Counsel, Office of Chief Counsel, (202) 551-6825, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5030.

**SUPPLEMENTARY INFORMATION:** The Commission today is reproposing Rule 2a-46(b) [17 CFR 270.2a-46] under the Investment Company Act [15 U.S.C. 80a et seq.].<sup>1</sup>

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<sup>1</sup> The Commission today issued a release adopting Rule 2a-46, which defines eligible portfolio company as a company whose securities are not listed on an Exchange, and Rule 55a-1, which conditionally permits BDCs to make additional (follow-on) investments in certain companies. Definition of Eligible Portfolio Company under the Investment Company Act of 1940, Investment Company Act Release No. 27538 (Oct. 25, 2006) (“Adopting Release”).

## I. BACKGROUND

BDCs are closed-end investment companies that Congress established for the purpose of making capital more readily available to certain types of companies.<sup>2</sup> To accomplish this purpose, the Investment Company Act prohibits a BDC from making any investment unless, at the time of the investment, at least 70 percent of its total assets (“70% basket”) are invested in securities of certain specific types of companies, including “eligible portfolio companies.”<sup>3</sup>

The Investment Company Act defines eligible portfolio company to include domestic operating companies that, among other things, do not have any class of securities that are marginable under rules promulgated by the Federal Reserve Board.<sup>4</sup> In 1998, for reasons unrelated to small business capital formation, the Federal Reserve Board amended its definition of margin security to increase the types of securities that would fall within that definition under its rules. This amendment had the result of reducing the number of companies that qualify as eligible portfolio companies.

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<sup>2</sup> Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94<sup>th</sup> Stat. 2274 (1980) (codified at scattered sections of the United States Code) (“SBIIA”). See also generally H.R. Rep. No. 1341, 96<sup>th</sup> Cong., 2d Sess. 21 (1980) (“House Report”).

<sup>3</sup> See Section 2(a)(46) of the Investment Company Act (statutory definition of eligible portfolio company) [15 U.S.C. 80a-2(a)(46)]. See also Section 55(a) of the Investment Company Act (regulating the activities of BDCs) [15 U.S.C. 80a-54(a)].

<sup>4</sup> Section 2(a)(46)(C)(i) of the Investment Company Act. See also Section 2(a)(46)(C)(ii) (defines eligible portfolio company to include companies that are controlled by the investing BDC or certain of its affiliates); Section 2(a)(46)(C)(iii) (defines eligible portfolio company to include certain very small companies).

In November 2004, the Commission proposed Rule 2a-46<sup>5</sup> and Rule 55a-1 to address the impact of the Federal Reserve Board's 1998 amendments on the definition of eligible portfolio company.<sup>6</sup> As proposed, Rule 2a-46(a) would have defined eligible portfolio company to include any domestic operating company<sup>7</sup> that does not have a class of securities listed on an Exchange,<sup>8</sup> and Rule 2a-46(b) would have defined eligible portfolio company to include any domestic operating company that has a class of securities listed on an Exchange, but is in danger of having its securities delisted because of financial difficulties. As proposed, Rule 55a-1 would have conditionally permitted a BDC to continue to invest in a company that had met the proposed definition of eligible

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<sup>5</sup> Under Section 2(a)(46)(C)(iv), the term eligible portfolio company includes any issuer that, in addition to meeting the requirements of Sections 2(a)(46)(A) and (B), "meets such other criteria as the Commission may, by rule, establish as consistent with the public interest, the protection of investors, and the purposes fairly intended by the policy and provisions of [the Act]." See House Report at 23 ("... the Commission is given rulemaking authority to expand the class of eligible portfolio companies, following certain specific standards."). The legislative history of the SBIIA also makes clear that the intent of this provision "is to enable the Commission through the administrative process to broaden, if appropriate, the category of eligible portfolio company." While stating that BDCs "already have substantial freedom of action to purchase securities of companies which are not eligible portfolio companies," referring to the investments permitted to be made outside of the 70% basket, Congress also noted its expectation that "the Commission would institute [rulemaking] proceedings to consider whether the definition of eligible portfolio company can be expanded, consistent with the purpose of the legislation, to increase the flow of capital to small, developing businesses or financially troubled businesses. In providing the Commission with rulemaking authority, Congress noted "[a]mong the objective factors which the Commission may consider in [rulemaking] proceedings are the size of such companies, the extent of their public ownership, and their operating history as going concerns and public companies." See House Report at 31.

<sup>6</sup> The rules were proposed in Definition of Eligible Portfolio Company under the Investment Company Act of 1940, Investment Company Act Release No. 26647 (Nov. 1, 2004) [69 FR 64815 (Nov. 8, 2004)] ("2004 Proposing Release").

<sup>7</sup> The proposed rule would have incorporated the provisions of Section 2(a)(46)(A) and (B). Section 2(a)(46)(A) of the Investment Company Act defines eligible portfolio company to include (among other things) companies organized under the laws of, and with their principal business in, one or more states of the United States. Section 2(a)(46)(B) of the Investment Company Act generally excludes from the definition of eligible portfolio company any company that meets the definition of investment company under Section 3 of the Investment Company Act, or that is excluded from the definition of investment company by Section 3(c) of that Act, but includes as an eligible portfolio company a small BDC that is licensed by the Small Business Administration and that is a wholly-owned subsidiary of a BDC.

<sup>8</sup> The rule as proposed also would have defined eligible portfolio company to include any domestic operating company that does not have any class of securities listed on an automated interdealer quotation system of a national securities association (i.e., The NASDAQ Stock Market LLC) ("Nasdaq"). On August

portfolio company at the time of the BDC's initial investment(s) in it, but did not subsequently meet that definition.

Today, the Commission adopted Rule 2a-46, initially proposed as Rule 2a-46(a), and Rule 55a-1.<sup>9</sup> The Commission did not adopt proposed Rule 2a-46(b) based on commenters' concerns that the proposed rule would be unworkable and too narrow.

## **II. DISCUSSION**

### **A. Comments Received on 2004 Proposing Release**

We received thirty-six comment letters that addressed the proposed rules.<sup>10</sup> Most commenters argued that proposed Rule 2a-46(b), which would have defined eligible portfolio company to include domestic operating companies whose securities were listed on an Exchange but were in danger of being delisted because of financial difficulties, would be unworkable.<sup>11</sup> Some commenters also argued that the proposed rule would be too narrow because it would not include some small companies that list their securities on an Exchange, but that nevertheless may have difficulties accessing conventional sources of capital and raising additional capital on the public capital markets. They argued that

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1, 2006, Nasdaq began operating as a national securities exchange registered under Section 6(a) of the Exchange Act. See [www.nasdaq.com/newsroom/news/pr2006/ne\\_section06\\_097.stm](http://www.nasdaq.com/newsroom/news/pr2006/ne_section06_097.stm).

<sup>9</sup> See *supra* note 1.

<sup>10</sup> Commenters included members of Congress, BDCs, law firms, trade associations and small businesses that had received financing from a BDC. The comment letters are available for inspection in the Commission's Public Reference Room at 100 F Street, NE, Washington, DC 20549 (File No. S7-37-04). They also may be viewed at <http://www.sec.gov/rules/proposed/ic-26647.htm>.

<sup>11</sup> See, e.g., comments of Shearman & Sterling LLP (Jan. 7, 2005) ("... we believe that the requirement for a delisting notice would frustrate one of the purposes of proposed Rule 2a-46(b), which as expressed in the proposing release, seeks to address the need of, and provide access to capital readily to, financially troubled issuers that have not reached the dire financial straits contemplated by Section 55(a)(3) of the 1940 Act. In our experience, the delisting process often lags the 'facts on the ground,' and properly so, as Exchanges are reluctant to impose a premature death sentence on listed companies. Thus, we submit that a company that receives a delisting notice would likely be in severe financial distress."); comments of American Capital Strategies Ltd. (Jan. 7, 2005) (generally arguing that the minimum initial listing standards of an Exchange would exclude many of the companies Congress intended to benefit from BDC financing, and noting that

these companies should qualify as eligible portfolio companies under the rule.<sup>12</sup> Many commenters urged us to adopt a size-based standard and suggested a specific numeric threshold.<sup>13</sup>

### **B. Reproposed Rule 2a-46(b)**

After considering the comments received, the Commission believes that it is appropriate to seek further input on including additional companies in the definition of eligible portfolio company. Accordingly, the Commission is revising and reproposing Rule 2a-46(b) to provide an additional definition of eligible portfolio company.<sup>14</sup> We have included two alternatives of reproposed Rule 2a-46(b) for comment. Each alternative would include certain domestic, operating companies that list their securities on an Exchange.<sup>15</sup> The first alternative would include companies whose public float is less than \$75 million (“Alternative One”).<sup>16</sup> The second alternative (two versions) would

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the requirement for a delisting notice “could result in substantially the same situation as was caused by the Federal Reserve Board changes to the margin securities regulations”).

<sup>12</sup> See, e.g., comments of Allied Capital (Jan. 7, 2005); comments of UTEK (Jan. 7, 2005). But see comments of the Committee on Federal Regulation of Securities of the Business Law Section of the American Bar Association (Jan. 5, 2005) (supporting proposal in full); comments of the Investment Company Institute (Jan. 6, 2005) (supporting proposal in full).

<sup>13</sup> See, e.g., comments of Capital Southwest Corporation (Dec. 28, 2004); comments of Representative Sue Kelly and Representative Nydia Velázquez (Jan. 5, 2005); comments of Shearman & Sterling LLP (Jan. 7, 2005); comments of UTEK (Jan. 7, 2005); comments of Allied Capital (Jan. 7, 2005); comments of Williams & Jensen (Feb. 17, 2006).

<sup>14</sup> We are also proposing to renumber Rule 2a-46 as Rule 2a-46(a). We are not proposing any other changes to that rule.

<sup>15</sup> Like Section 2(a)(46) and proposed Rule 2a-46, reproposed Rule 2a-46(b) would define eligible portfolio company to include only domestic operating companies. See supra note 7.

<sup>16</sup> Public float is the aggregate market value of a company’s outstanding voting and non-voting common equity (i.e., a company’s market capitalization) minus the aggregate market value of common equity held by the company’s affiliates. See, e.g., Simplification of Registration Procedures for Primary Securities Offerings, Securities Act Release No. 6964 (Oct. 22, 1992) [57 Fed. Reg. 48970 (Oct. 29, 1992)]. Rule 2a-46(b)(2) would define the term “affiliate” for purposes of Alternative One by reference to the definition of the same term in Rule 405 under the Securities Act of 1933 (“Securities Act”) [17 CFR 230.405].

include companies whose market capitalization is less than either \$150 million or \$250 million (“Alternative Two”).

Under both alternatives, a company’s size would be calculated using the price at which the company’s common equity was last sold, or the average of the bid and asked prices of the company’s common equity, in the principal market for such common equity on any day in the 60-day period immediately before the BDC’s acquisition of its securities.<sup>17</sup> This provision is similar to the methodology used in current Commission rules that differentiate among companies based on their size,<sup>18</sup> and is intended to reduce regulatory complexity.

We discuss the use of a size-based standard and each of the alternatives below.

### **1. Size-Based Standard**

In the 2004 Proposing Release, we questioned whether a size-based standard could: (1) result in a company’s eligible portfolio company status fluctuating frequently as a result of market and economic conditions; (2) allow a company to manipulate its capital structure to fall below a specified level; and (3) introduce regulatory arbitrage by encouraging registered closed-end funds to elect BDC status so that they could have the benefit of the lighter regulatory burdens applicable to BDCs under the Investment Company Act. We also noted that it was unclear what level of market capitalization would be appropriate to define an eligible portfolio company.<sup>19</sup>

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<sup>17</sup> Reproposed Rule 2a-46(b)(1). Reproposed Rule 2a-46(b)(2) would define the term “common equity” for purposes of Rule 2a-46(b) by reference to the definition of the same term in Rule 405 under the Securities Act.

<sup>18</sup> See Form S-3 [17 CFR 239.13]; Securities Offering Reform, Securities Act Release No. 8591 (July 19, 2005) [67 FR 44722 (Aug. 3, 2005)] (“Securities Offering Reform”).

<sup>19</sup> See 2004 Proposing Release, supra note 6 at nn. 34-36 and accompanying text.

After careful review, we have reconsidered our initial concerns about using a size-based standard and believe that these concerns may be addressed. First, we have addressed our concern that a company's eligible portfolio company status may fluctuate based on market conditions by proposing, in both Alternative One and Alternative Two of Rule 2a-46(b), that the size would be computed using the price at which the company's common equity was last sold, or the average of the bid and asked prices of the company's common equity, in the principal market for such common equity, determined as of a single date within 60 days immediately prior to a BDC's acquisition of the company's securities. Second, permitting a company to meet the size-based standard on a single date within the 60-day period immediately prior to a BDC's acquisition of the company's securities also lessens our concern that a company might manipulate its capital structure to meet that standard. Third, with respect to our regulatory arbitrage concern, based upon further evaluation of the differences between registered closed-end funds and BDCs, we believe that most closed-end funds probably would not elect BDC status merely because of the different regulatory framework. Unlike BDCs, most closed-end funds are not structured so as to be able to offer managerial assistance to their portfolio companies. In addition, we believe that most closed-end funds probably would not choose a regulatory framework that would cause them to forego some investment flexibility by requiring them to invest a large percentage of their assets in privately negotiated transactions. One commenter also noted that a closed-end fund would be unlikely to elect BDC status "unless it was committed to the BDC mission to finance small and developing companies" because of certain regulatory requirements to which BDCs, but not closed-end funds, currently are subject.<sup>20</sup> Finally, based on our review of the comments, we

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<sup>20</sup> Comments of Allied Capital (Jan. 7, 2005). See also comments of UTEK (Jan. 7, 2005). These

believe that a size-based standard would provide a bright-line test that is easy to administer.

## **2. Alternative Proposals**

As one commenter pointed out, there is no single standard that precisely defines the types of companies that could benefit from BDC financing.<sup>21</sup> After carefully considering the comments on the original proposal and with this in mind, we are proposing the following two alternatives of Rule 2a-46(b) that we believe are consistent with the purpose Congress intended. In addition, as noted above, we have addressed the concerns we originally had regarding the use of a size-based standard.

### **(a) \$75 Million Public Float (Alternative One)**

Alternative One would define eligible portfolio company to include companies whose securities are listed on an Exchange and have a public float of less than \$75 million.<sup>22</sup> Alternative One incorporates the size-based standard used in Form S-3 and Rule 12b-2 under the Exchange Act.<sup>23</sup> We have used this standard to delineate between small, unseasoned companies, and larger, seasoned companies whose securities are listed on an Exchange.<sup>24</sup> For example, to register a primary securities offering for cash on

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commenters noted compliance costs related to the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002), and reporting obligations under the Exchange Act, as some of the regulatory burdens that might act to deter a closed-end fund that has no reason to elect BDC status, other than an interest in a different regulatory framework, from seeking to elect that status.

<sup>21</sup> Comments of Allied Capital (Jan. 7, 2005).

<sup>22</sup> Reproposed Rule 2a-46(b).

<sup>23</sup> Alternative One, while based on the requirements of Form S-3 and Rule 12b-2, does not incorporate any of the reporting requirements found in those rules out of concern that doing so could capture some companies that may not qualify to use Form S-3 or be considered an accelerated filer only because they were not in compliance with the reporting requirements. We are soliciting comments on this concern.

<sup>24</sup> Under recently adopted rules, an “unseasoned issuer” is defined as a company that is required to file reports under Section 13 or Section 15(d) of the Exchange Act [15 U.S.C. 78m or 78o(d)], but does not satisfy the requirements of Form S-3 for a primary offering of its securities; a “seasoned issuer” is defined as a company that is eligible to use Form S-3 for a primary offering of securities; and a “well-known

Form S-3, a company must have public float of at least \$75 million.<sup>25</sup> Companies that meet the eligibility requirements of Form S-3 are mature enough to be able to take advantage of short-form registration, including the resultant benefits of incorporation by reference and quick access to the capital markets through “shelf registration.” Similarly, under Rule 12b-2 under the Exchange Act, a company with \$75 million public float or more would be an “accelerated filer,” and thus be required to meet accelerated deadlines in filing certain Exchange Act reports.<sup>26</sup>

We believe that Alternative One would capture companies that Congress intended to benefit from BDC financing. In this regard, the Commission’s Office of Economic Analysis (“OEA”) estimates that, based on June 2006 data, Alternative One would increase the percentage of public domestic operating companies that would meet the definition of eligible portfolio company by 9.1 percent (a total of 896 companies). OEA’s calculations relating to public float are based, for the most part, on a public float definition that is similar to the definition of public float used for purposes of Form S-3

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seasoned issuer” is defined to include a company that, among other things, has at least \$700 million public float. Securities Offering Reform, supra note 18.

<sup>25</sup> In addition to having public float of at least \$75 million, a company is eligible to use Form S-3 to register a primary offering of its securities for cash if it: (1) is organized under the laws of the United States or any state and has its principal business operations in the United States; (2) has a class of securities registered under Section 12(b) or a class of equity securities registered under Section 12(g) of the Exchange Act [15 U.S.C. 78j(b) or (g)], or is required to file periodic reports under Section 15(d) of the Exchange Act [15 U.S.C. 78o(d)]; (3) has been subject to the requirements of Section 12 or Section 15(d) of the Exchange Act and has filed in a timely manner all of the material required to be filed under Sections 13, 14 or 15(d) of the Exchange Act for at least one year [15 U.S.C. 78m, 78n or 78o(d)]; and (4) has not failed to pay a dividend or sinking fund installment on preferred stock or defaulted on certain specified obligations since the end of the last fiscal year.

<sup>26</sup> Accelerated filers, in addition to having a public float of \$75 million or more, are companies that meet the following conditions as of the end of their fiscal year: (1) they have been subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act for a period of at least 12 calendar months; (2) they previously have filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act; and (3) they are not eligible to use Forms 10-KSB and 10-QSB [17 CFR 249.310(b) and 17 CFR 249.308(b)]. See Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, Securities Act Release No. 8128 (Sept. 5, 2002) [67 FR 58480 (Sept. 16, 2002)].

and is included in Alternative One.<sup>27</sup> New Rule 2a-46, based on June 2006 data, includes approximately 61.4 percent of public domestic operating companies (a total of 6,041 companies).<sup>28</sup> Thus, approximately 70.5 percent (6,937/9,845) of existing domestic public operating companies could qualify as eligible portfolio companies under new Rule 2a-46 and Alternative One of repropoed Rule 2a-46(b).<sup>29</sup>

We note that Alternative One is similar to a suggestion made by one commenter, a BDC.<sup>30</sup> This commenter suggested that we define eligible portfolio company to include public companies that have market capitalization of less than \$100 million to ensure that BDCs continue to invest most of their assets in smaller companies.<sup>31</sup>

Finally, we note that Congress intended that we consider a number of factors in engaging in any rulemaking to define eligible portfolio company, including the extent of

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<sup>27</sup> OEA relied on the estimate of public float provided by Bloomberg LLP in calculating the estimates used in this Release. Bloomberg defines public float as the number of shares outstanding less shares held by insiders and those deemed to be “stagnant shareholders.” “Stagnant shareholders” include ESOPs, ESOTs, QUESTs, employee benefit trusts, corporations not actively engaged in managing money, venture capital companies and shares held by governments. Bloomberg provides estimates of public float for 3,471 out of 3,804 (91%) of the domestic operating companies identified. For the 333 companies for which OEA was unable to obtain an estimate of public float, OEA used each company’s market capitalization. Since small public companies often have a high percentage of insider investors, using market capitalization most likely results in a number that underestimates the number of companies that have a public float of less than \$75 million.

<sup>28</sup> See Adopting Release, *supra* note 1 at text following n.17.

<sup>29</sup> We note that our estimates reflect only those companies with less than \$75 million public float whose securities are listed on Nasdaq, the New York Stock Exchange (“NYSE”) and the American Stock Exchange (“Amex”). The estimates do not reflect those companies whose securities are exclusively listed on a regional exchange (*i.e.*, those companies whose securities are not dually listed on the NYSE, the Amex or Nasdaq) because such information is not available on our primary data source. While there are only a limited number of these companies, we believe that most of them have a public float of less than \$75 million and thus would also be eligible portfolio companies under either of the proposed alternatives of Rule 2a-46(b).

<sup>30</sup> Comments of Capital Southwest Corporation (Dec. 28, 2004).

<sup>31</sup> We estimate that there is little difference between the number of companies that would be included under the standard proposed under Alternative One and a standard using \$100 million market capitalization. OEA estimates that approximately 918 public domestic operating companies would be included under a \$100 million market capitalization standard, compared to 896 public domestic operating companies that would be included under a \$75 million public float standard (a difference of 22 companies).



















































