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January 7, 2005

Via Email

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: *Comments on Proposed Rule: Definition of Eligible Portfolio Company under Investment Company Act of 1940*
Release No. IC-26647; File No. S7-37-04

Dear Mr. Katz,

We are pleased to submit this letter to the Securities and Exchange Commission in response to the Commission's request, contained in Release No. IC-26647, for comments on the Commission's proposed rules on the definition of eligible portfolio company under the Investment Company Act of 1940 (the "1940 Act"). We serve as counsel to business development companies and are intimately aware of the issues that gave rise to the Commission's proposal.

Introduction

We applaud the Commission's initiative in exercising its rulemaking authority to realign the definition of eligible portfolio company under the 1940 Act and the investment activities of business development companies with the purposes of the Small Business Investment Incentive Act of 1980 ("SBIIA"). Based on Section 2(a)(46)(C)(iv) of the 1940 Act and our review of the legislative history of the SBIIA, we agree that the Commission has the authority under the Section to adopt rules to expand the definition of an eligible portfolio company, subject to certain

specified standards.[1] The legislative history of the SBIIA suggests that this delegation of authority was intended to keep contemporary the definition of eligible portfolio company while at the same time protecting the interests of investors and maintaining the purpose of the SBIIA.[2]

We note that part of Congress' intent behind the creation of business development companies and the definition of eligible portfolio company in the drafting of the SBIIA was to create a source of financing for US companies that "are unable to borrow through conventional sources or which do not have ready access to the public capital markets."[3] These companies were of three types - small, developing, or financially troubled. We respectfully submit that any expansion of the definition of eligible portfolio company to realign the definition, as well as the activities of business development companies, with the purpose of the SBIIA should attempt to balance the financing needs of all three of these types of companies. To that end, we encourage the Commission to include public market capitalization as an alternative measure of small, developing or financially troubled businesses.[4] The use of such a measure as an alternative would help to align the definition of eligible portfolio company with the purpose of the SBIIA by including the types of issuers that Congress intended to make eligible for business development company financing and that may otherwise be excluded by the Commission's recently proposed measures – *i.e.*, as discussed below, whether a company is listed or has received notice of delisting and is ineligible to be listed elsewhere. We believe that alternative eligibility based on public market capitalization, which might include an increased threshold under certain circumstances, would replicate to a great extent the eligibility standards embodied in the SBIIA in 1980. We note that a currently pending legislative initiative - H.R. 3170 - as referred to the Senate Committee on Banking, Housing and Urban Affairs, envisions, as part of the definition of eligible portfolio company, any company which has not more than $250 million in aggregate value of its publicly traded equity securities. H.R. 3170 also would allow a business development company to invest in an issuer that has more than $250 million but less than $500 million in aggregate value of its outstanding publicly traded equity securities, so long as such investment represents not more than 10% of the business development company's investments in

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[1] *See* H. Rep. No. 1341, 96th Cong., 2d Sess. (1980) at 23: "The Commission is given rulemaking authority to expand the class of eligible portfolio securities, following certain specified standards." *See also* H. Rep. No. 1341, 96th Cong., 2d Sess. (1980) at 31: "The third category [of eligible portfolio company] includes companies which meet other criteria as the Commission may establish by rule as consistent with the public interest, the protection of investors and the purpose fairly intended by the policy and provisions of this Act…. [T]he Committee expects the Commission would institute 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 companies. Among the objective factors which the Commission may consider in such proceedings are the size of such companies, the extent of their public ownership, and their operating history as going concerns and public companies."

[2] *See* H. Rep. No. 1341, 96th Cong., 2d Sess. (1980) at 31.

[3] *Id.* at 30-31.

[4] When Congress adopted the definition of eligible portfolio company in 1980, the term included all privately owned companies that did not have public debt securities outstanding as well as approximately two-thirds of the then public companies. *See* S. Rep. No. 958, 96th Cong., 2d Sess. (1980).

qualifying assets at the time of purchase. We encourage the Commission to include in its rule an alternative test for eligibility based on public market capitalization using the aggregate values set out in H.R 3170, and to consider the possibility of increasing these values over time.

An Objective Definition of Eligible Portfolio Company is Necessary for BDCs to Operate

The regulatory framework of the 1940 Act under which business development companies operate necessitates the use of an objective and workable test for determining whether a company falls within the definition of eligible portfolio company. Under Section 55(a) of the 1940 Act, a business development company may acquire "non-qualifying" assets only if, at the time the acquisition is made, at least 70% of its total assets constitute "qualifying" assets (the "70% test"). In addition, under Section 2(a)(48) of the 1940 Act, a business development company must, among other things, be operated for the purpose of investing in certain qualifying assets (the "purpose test"). These qualifying assets include securities of eligible portfolio companies as defined in Section 2(a)(46) of the 1940 Act. Thus, when making investments, business development companies must have a high degree of certainty whether their investees are eligible portfolio companies in order to remain in compliance with both the 70% test and the purpose test.

The proposed rule, which would link the definition of eligible portfolio company to whether an issuer has a class of securities listed on a national securities exchange or on an automated interdealer quotation system of a national securities association (an "Exchange") provides a clear test that would allow business development companies to have a high degree of certainty of complying with the 70% test and the purpose test. We concur with the Commission that this test is a "rational, objective and workable test for determining whether an issuer is an eligible portfolio company, consistent with Congress's intent when it enacted the SBIIA."[5] In addition, we agree with the Commission's approach under proposed Rule 2a-46 that, if a company does not have a class of equity securities listed on an Exchange, it should fall within the definition of eligible portfolio company, regardless of whether such company has outstanding public debt securities. Furthermore, as discussed above, we encourage the Commission to adopt an alternative market capitalization standard that would capture the range of companies that were eligible portfolio companies in 1980 when the SBIIA was enacted.

In contrast, linking the definition of eligible portfolio company to whether a company is *eligible* to be listed on an Exchange is not a test that is objective or workable in practice. Business development companies should not be required to determine or verify that a company is eligible to list on an Exchange, as this determination is best suited for the Exchanges themselves. In addition, such a test would force business development companies to rely on and assess information received from third parties – notably the issuers seeking financing – in meeting their regulatory requirements under the 1940 Act. Such reliance would place on the business development company the risk of improperly designating a portfolio company as an eligible

[5] *See* Investment Company Act Release No. 26647 (Nov. 1, 2004) at page 6.

portfolio company due to the receipt of misinformation from that company, potentially resulting in a violation of the 70% test and the purpose test.

Furthermore, we believe that a company that would otherwise be eligible to list on an Exchange, but is not listed, should not be precluded from the definition of eligible portfolio company. Such a company would not have ready access to public capital[6] or may still be "developing," or its unlisted status may be an indication of financial "trouble" or other impediments to listing or quotation (particularly qualitative issues not easily evaluated by third party assessments). The existence of any of these circumstances would render such company eligible for investment by business development companies under the SBIIA as originally conceived. Thus, we believe that a standard of listed or not listed on an exchange is a more workable, objective test than eligibility for listing to determine status as an eligible portfolio company.[7]

Financially Troubled Listed Companies As Eligible Portfolio Companies

Rule 2a-46(b) has been proposed by the Commission to address the needs of financially troubled listed issuers that require ready access to capital by including in the definition of eligible portfolio company certain issuers that are in danger of losing their listing status.[8] We agree with the Commission that certain issuers that exhibit financial distress while their securities are listed on an Exchange should be included within the definition of eligible portfolio company. We respectfully submit, however, that including only those listed companies that have received a delisting notice from the Exchange on which their securities are listed and that do not satisfy the initial quantitative requirements for listing any class of securities on any Exchange, would involve the same uncertainties discussed above with respect to the determination of listing eligibility.

In addition, 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.[9] In our

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[6] *See* Investment Company Act Release No. 26647 (Nov. 1, 2004) at footnote 30: "Listing on an Exchange or on NASDAQ generally provides an issuer with visibility, marketability, third party established valuations and liquidity, all of which aid in capital formation."

[7] As noted elsewhere, we endorse the use of market capitalization as alternative criteria for eligible portfolio company status.

[8] *See* Investment Company Act Release No. 26647 (Nov. 1, 2004) at page 7.

[9] Section 55(a)(3) includes as a qualifying asset: "securities purchased in transactions not involving any public offering from an issuer described in sections 2(a)(46)(A) and (B) or from a person who is, or who within the preceding thirteen months has been an affiliated person of such issuer, or from any person in transactions incident thereto, if such services were

(A) issued by an issuer that is, or was immediately prior to the purchase of its securities by the business development company, in bankruptcy proceedings, subject to reorganization under the supervision of a

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. We note that this financial distress could be exacerbated by the receipt of the delisting notice, which typically would constitute a breach of the listed company's financial covenants in material contracts, and is almost always an indication of impending bankruptcy or insolvency. This prospective "domino effect" would effectively prevent an injection of much needed financing until it is too late to prevent irredeemable financial harm. It is also our experience that, by the time a company receives a delisting notice, it is likely already financially troubled, and would unlikely be eligible to list on another Exchange.

We believe that there are alternative ways to determine whether a company that is listed on an Exchange is financially troubled before its problems reach the point that they may have become fatal to the company's continued financial viability, and we encourage the Commission to adopt one or more of such alternatives. These alternatives may include, for example, evidence of credit impairment such as missed principal or interest payments on financings. The Commission might consider using such alternatives for the definition of an eligible portfolio company as a supplement to proposed Rule 2a-46(b).

Follow-on Investments Reward Business Development Companies

We note that proposed Rule 55a-1 has no time limit for follow-on investments in issuers that were eligible portfolio companies at the time of the initial investment and no longer fall within the definition of eligible portfolio company. We agree with this approach. Imposing a time limit on follow-on investments may unduly hinder a business development company's ability to continue to nurture and provide financing to a portfolio company that continues to be in need of, and to benefit from, additional business development company capital. Imposing a time limit on follow-on investments may also limit a business development company, and thus its shareholders, from reaping the financial benefits from a portfolio company that has grown or developed or that was rescued from financial trouble. The proposed rule should not unnecessarily penalize or prevent business development companies from experiencing the rewards of investments in, or continuing to provide needed financing to, small, developing, or financially troubled companies, which, as Congress noted, are "a diverse and dynamic component of our national economy."[10] As Congress also noted, the intent of the SBIIA was to

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court of competent jurisdiction, or subject to a plan or arrangement resulting from such bankruptcy proceedings or reorganization;

(B) issued by an issuer pursuant to or in consummation of such a plan or arrangement; or

(C) issued by an issuer that, immediately prior to the purchase of such issuer's securities by the business development company, was not in bankruptcy proceedings but was unable to meet its obligations as they came due without material assistance other than conventional lending or financing arrangements."

[10] *See* S. Rep. No. 958, 96th Cong., 2d Sess. (1980).at 4.

"remove burdens on venture capital activities that create unnecessary disincentives to the legitimate provision of capital to small businesses and other companies which, by reason of their size, seasoning or financial condition, are appropriate investments for business development companies."[11] We would encourage the Commission to promulgate Rule 55a-1 to allow business development companies to complete follow-on investments in companies that they had a role in capitalizing.

We believe that the Commission should also study the possibility of expanding proposed Rule 55a-1 to allow business development companies to make follow-on investments in companies even when they no longer meet the objective criteria established in Section 55(a)(1)(B) of the 1940 Act and echoed in proposed Rule 55a-1. Under these criteria, a follow-on transaction in an issuer that is no longer an eligible portfolio company will be a qualifying investment only if the business development company is one of the 20 largest holders of record of such issuer's outstanding voting securities. Certain business development companies focus on debt investments and may rarely find themselves as one of the 20 largest holders of record of voting securities of these portfolio companies. These business development companies are therefore effectively foreclosed from making follow-on investments under Section 55(a)(1)(B) or proposed Rule 55a-1. We believe the Commission should consider changing the conditions in Rule 55a-1 to accommodate the needs of business development companies that are not typically equity investors. There are equally compelling reasons to permit these business development companies to make follow-on investments in portfolio companies when the original investment took the form of debt as when the business development company invested in equity. As a result, we encourage the Commission to consider the need to expand Rule 55a-1 to accommodate the different types of investment programs pursued by business development companies.

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In sum, it is our view that the definition of eligible portfolio company should be a clear, objective and easily identifiable standard. In addition, we believe that allowing follow-on investments in companies that were eligible portfolio companies at the time of the original investment, but no longer fall within the definition of eligible portfolio company is consistent with the expressed purpose of the SBIIA.

[11] *Id.* at page 5.

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We appreciate this opportunity to comment on the Commission's proposing release, and would be pleased to discuss any questions the Commission or its Staff may have with respect to this letter. Any such questions may be directed to Margery K. Neale at 212-848-4868 or Thomas J. Friedmann at 202-508-8030.

Very truly yours,

/s/ Shearman & Sterling LLP

Shearman & Sterling LLP

cc: Hon. William H. Donaldson, Chairman.
Hon. Paul S. Atkins, Commissioner
Hon. Roel C. Campos, Commissioner
Hon. Cynthia A. Glassman, Commissioner
Hon. Harvey J. Goldschmid, Commissioner

Paul F. Roye, Director, Division of Investment Management
Giovanni P. Prezioso, General Counsel