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**SEC Amends Definition of “Eligible Portfolio Company” under the
Investment Company Act of 1940**

On October 25, 2006, the Securities and Exchange Commission (“SEC”) adopted rules¹ which amend the definition of “eligible portfolio company” under the Investment Company Act of 1940, as amended (the “Investment Company Act”)². The new rules make a long-desired change in a definition which has significance for investment vehicles which are regulated as business development companies (“BDCs”) under the Investment Company Act.

I. Background

In 1980, Congress created a category of entity defined as a “business development company” to be regulated under the Investment Company Act.³ BDCs were to provide a means of “making capital more readily available to small, developing and financially troubled companies that do not have ready access to the public capital markets or other forms of conventional financing.”⁴

As part of the regulatory scheme adopted by Congress, a BDC, which is in substance a special form of investment company, is required to invest at least 70 percent of its total assets in securities of certain types of companies.⁵ Among the categories of investments which may be included in the 70 percent basket are securities of “eligible portfolio companies” purchased in transactions not involving a public offering.⁶ The Investment Company Act uses a number of criteria to define “eligible portfolio

¹ Definition of Eligible Portfolio Company under the Investment Company Act of 1940, Investment Company Act Release No. IC 27538 (Oct. 25, 2006) adopting Investment Company Act Rules 2a-46 and 55a-1, available at <http://www.sec.gov/rules/final/2006/ic-27538.pdf> (the “Adopting Release”).

² Investment Company Act Section 2(a)(46).

³ BDCs were created under the Small Business Investment Incentive Act, Pub. L. No. 96-477, 94 Stat. 2274 (1980) (codified at scattered sections of the United States Code).

⁴ Adopting Release at 2.

⁵ Investment Company Act Section 55(a).

⁶ Investment Company Act Section 55(a)(1).

companies,” one of which is that such a company not have “any class of security” with respect to which a member of a national securities exchange, broker or dealer may extend margin credit under the rules of the Federal Reserve Board adopted pursuant to the Securities Exchange Act of 1934, as amended (the “Exchange Act”). This test was thought to be a “rational and objective test” at the time Section 2(a)(46) was adopted.⁷ However, Congress gave the SEC flexibility to establish other criteria by regulation if the SEC deemed it “consistent with the public interest, the protection of investors, and the purposes fairly intended by the policy and provisions of” the Investment Company Act.⁸

In 1998, the Federal Reserve Board adopted amendments to the margin rules “that had the unintended consequence of reducing the number of companies that meet the definition of eligible portfolio company by expanding the definition of margin security to include all publicly traded equity securities and most debt securities.”⁹ The SEC proposed Rules 2a-46 and 55a-1 in November 2004 to address the impact of the Federal Reserve Board’s 1998 amendments on the definition of eligible portfolio company.¹⁰

II. New Rules 2a-46 and 55a-1

A. Rule 2a-46

Rule 2a-46 defines eligible portfolio company to include all private domestic operating companies and those public domestic operating companies whose securities are not listed on a national securities exchange registered under the Exchange Act, such as the New York Stock Exchange, the American Stock Exchange, and Nasdaq. Public domestic operating companies whose securities are quoted on the over-the-counter bulletin board (“OTCBB”) and through Pink Sheets LLC (“Pink Sheets”) are not listed on an Exchange, and therefore are eligible portfolio companies under this provision.¹¹ The new Rule negates the effect of the 1998 Federal Reserve Board amendments to the margin rules which had unintentionally caused issuers with marginable debt securities to be excluded from the eligible portfolio company definition.

B. Rule 55a-1

Rule 55a-1 permits a BDC to include in its 70 percent basket follow-on investments in a company that met the definition of eligible portfolio company under Rule 2a-46 at the time of the BDC’s initial investment in the company, but subsequently would not meet the definition of eligible portfolio company because the company no longer meets the requirements of that rule (i.e., following the BDC’s initial investment in the company, the company listed its securities on an Exchange), subject to certain

⁷ Adopting Release at 4.

⁸ Investment Company Act Section 2(a)(46)(C)(iv).

⁹ Adopting Release at 5, emphasis added.

¹⁰ Definition of Eligible Portfolio Company under the Investment Company Act of 1940, Investment Company Act Release No. IC-26647 (Nov. 1, 2004).

¹¹ Note, Rule 2a-46 does not require BDCs to focus their investment activities in financially troubled companies whose securities are traded on the OTCBB or through Pink Sheets.

conditions. These conditions permit a BDC to make a follow-on investment only if the BDC, at the time of the follow-on investment: (1) owns at least 50 percent of (a) the greatest number of equity securities of such company, including securities convertible into or exchangeable for such securities, and (b) the greatest amount of certain debt securities¹² of such company, in each case held by the BDC at any time during the period when such company was an eligible portfolio company; and (2) is one of the twenty largest holders of record of the company's outstanding voting securities.

The SEC stated that it believes that the new rules "more closely align" the definition of eligible portfolio company with the original purpose for which BDCs were intended.¹³

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¹² Debt securities which have been converted, or repaid or prepaid in the ordinary course of business or incident to a public offering of securities of such company are not considered to be held by the BDC for purposes of this requirement. Investment Company Act Section 55(a)(1)(B)(i)(II).

¹³ Adopting Release at 10.