SEC Amends Definition of "Eligible Portfolio Company" under the Investment Company Act of 1940

On July 21, 2008 the Securities and Exchange Commission ("SEC") expanded the definition of the term "eligible portfolio company" under the Investment Company Act of 1940, as amended (the "Investment Company Act" or the "Act"), to include any domestic operating company with securities listed on a national securities exchange ("Exchange") if the company has a market capitalization of less than $250 million.[1] This expansion of the rule will help companies known as "business development companies" or "BDCs" under the Investment Company Act broaden their participation in small business financing.

I. Background

In 1980, Congress created a category of entity defined as a "business development company" to be regulated under the Investment Company Act.[2] Congress intended that BDCs would make capital more readily available to certain types of companies, including small companies that may have difficulties accessing conventional sources of capital and raising additional capital on public markets.

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, including eligible portfolio companies as defined in Section 2(a)(46) of the Act and Rule 2a-46 thereunder.[3] One of the criterion which satisfied the eligible portfolio company definition was that a company does not have "any class of security" with respect to which a member of an Exchange, broker or dealer may have extended margin credit under the rules of the Federal Reserve Board adopted pursuant to the Securities Exchange Act of 1934, as amended (the "Exchange Act").[4]

In 1998, the Federal Reserve Board adopted amendments to the margin rules that "for reasons unrelated to small business capital formation, amended its definition of margin security to include all equity securities that trade on an Exchange or are listed on the NASDAQ Stock Market, and most debt securities."[5] As a consequence, the amendment to the margin rules significantly reduced the number of companies that qualified as eligible portfolio companies under the Investment Company Act.

However, in 2006, the SEC adopted Rule 2a-46 to address the impact of the Federal Reserve Board's 1998 amendment by expanding the definition of "eligible portfolio company" to include all private domestic operating companies and those public domestic operating companies whose securities are not listed on an Exchange. Public domestic operating companies whose securities were quoted on the over-the-counter bulletin board and through Pink Sheets LLC are not considered to be listed on an Exchange, and therefore were eligible portfolio companies under this provision.

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1 *Definition of Eligible Portfolio Company under the Investment Company Act of 1940, Investment Company Act* Release No. IC-28266 (May 15, 2008) amending Investment Company Act Rule 2a-46 (the "Adopting Release"), *available at* http://www.sec.gov/rules/final/2008/ic-28266.pdf

2 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).

3 Investment Company Act Section 55(a).

4 Investment Company Act Section 2(a)(46)(C)(i).

5 See Adopting Release, supra note 1.

II. Amendment to rule 2a-46

When Rule 2a-46 as described above was adopted, the SEC also proposed to expand the definition of eligible portfolio company to include certain public domestic operating companies that list their securities on an Exchange.[6] In May 2008, the SEC finally acted on this proposal by amending Rule 2a-46 to include a new paragraph (b) that further expands the definition of eligible portfolio company to include "any domestic operating company that has a class of securities listed on an Exchange and that has a market capitalization of less than $250 million (calculated using the price at which the company's common equity is 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."[7]

Note that, for purposes of this rule, a company's market capitalization is the aggregate market value of the company's outstanding voting and non-voting common equities. The SEC decided to use the market capitalization standard, as opposed to the public float standard, because it would be burdensome for a BDC to determine a company's public float. The SEC accepted comments submitted by BDCs to the effect that in order for a BDC to calculate a company's public float, it would have to determine the number of shares owned by the company's affiliates, which is information not readily available on a current basis through third-party sources.

In addition, the rule sets forth that the term "common equity" has the same meaning as in the Securities Act of 1933, which means "any class of common stock or an equivalent interest, including but not limited to a unit of beneficial interest in a trust or a limited partnership interest."[8]

The dollar level standard chosen by the SEC was based upon data presented by the SEC's Office of Economic Analysis ("OEA") that as of January 2008 "there were a total of 1,649 domestic operating companies whose securities were listed on NASDAQ, the NYSE and the Amex that have a market capitalization of less than $250 million. OEA further estimated that approximately 6,062 companies qualify as eligible portfolio companies under Rule 2a-46, as initially adopted (now Rule 2a-46(a)). Accordingly, OEA calculated that 7,711 companies, representing 78% percent of public domestic operating companies, qualify as eligible portfolio companies under amended Rule 2a-46."[9] In expanding Rule 2a-46 in this fashion, the SEC was persuaded by comments it received from BDC's that companies with market capitalization of less than $250 million often have limited access to the public equity and debt markets, "spotty analyst coverage at best, . . . few or none institutional investors, and . . . thin trading volumes."[10]

The SEC believes that the amendment to Rule 2a-46 will improve opportunities for investors and small business alike.

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6 Id.

7 Id.

8 Securities Act Rule 405.

9 See Adopting Release, supra note 1.

10 Id.

If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Maria Brito at 212.701.3668 or mbrito@cahill.com.