

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 270

[Release No. IC-27538; 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:** Final rule.

**SUMMARY:** The Commission is adopting two new rules under the Investment Company Act of 1940 ("Investment Company Act" or "Act"). The new rules 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 rules expand the definition of eligible portfolio company in a manner that promotes the flow of capital to certain small, developing and financially troubled companies.

**DATES:** *Effective Date:* November 30, 2006.

**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 adopting new Rule 2a-46 [17 CFR 270.2a-46] and new Rule 55a-1 [17 CFR 270.55a-1], both under the Investment Company Act [15 U.S.C. 80a *et seq.*].<sup>1</sup>

#### Table of Contents

- I. Background
- II. Discussion
  - A. Rule 2a-46
  - B. Rule 55a-1
- III. Cost-Benefit Analysis
  - A. Benefits
  - B. Costs
- IV. Consideration of Promotion of Efficiency, Competition and Capital Formation
- V. Paperwork Reduction Act
- VI. Final Regulatory Flexibility Analysis
  - A. Reasons and Objectives of the New Rules

<sup>1</sup> Rules 2a-46 and 55a-1 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"). The Commission today also issued a release reproposing Rule 2a-46(b). Definition of Eligible Portfolio Company under the Investment Company Act of 1940, Investment Company Act Release No. 27539 (Oct. 25, 2006).

- B. Significant Issues Raised by Public Comment
- C. Small Entities Subject to the Rule
- D. Reporting, Recordkeeping, and Other Compliance Requirements
- E. Commission Action To Minimize Adverse Impact on Small Entities
- VII. Statutory Authority

#### I. Background

In 1980, Congress enacted the Small Business Investment Incentive Act ("SBIIA"), which, among other things, established BDCs as 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.<sup>2</sup> Consistent with this purpose, Section 55(a) of the Investment Company Act generally prohibits a BDC from acquiring any assets unless, at the time of acquisition, at least 70 percent of its total assets are invested in securities of certain specified types of companies ("70 percent basket").<sup>3</sup> Among other things, the 70 percent basket may include securities of eligible portfolio companies purchased in transactions not involving any public offering,<sup>4</sup> securities of eligible portfolio companies already controlled by the BDC without regard to the nature of the offering,<sup>5</sup> and securities of certain

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

<sup>3</sup> Section 55(a) of the Investment Company Act [15 U.S.C. 80a-54(a)]. See House Report at 23 ("The restrictions are designed to assure that companies electing special treatment as [BDCs] are in fact those that [SBIIA] is intended to aid—companies providing capital and assistance to small, developing or financially troubled businesses that are seeking to expand, not passive investors in large, well-established businesses.").

Congress did not specifically regulate how a BDC should invest the remainder of its assets ("30% basket"). See *id.* at 31, 38-40. Congress clarified, however, that a BDC would be required to invest its 30% basket in a manner consistent with the overall purpose of SBIIA. *Id.* at 39-40 ("One such purpose would be to allow an investment \* \* \* in a publicly-held company whose success may be stimulated or revived by the infusion of new capital or managerial assistance. A second purpose might be to recognize the need for [BDCs] \* \* \* to have a source of cash flow to fund current operations or to meet contingencies which may arise.").

<sup>4</sup> See Section 55(a)(1) of the Investment Company Act. See also Section 2(a)(46) of the Investment Company Act [15 U.S.C. 80a-2(a)(46)] (statutory definition of eligible portfolio company).

<sup>5</sup> See Section 55(a)(2) of the Investment Company Act, referring to companies with respect to which the BDC satisfies the requirements of Section 2(a)(46)(C)(ii) of the Act. Section 2(a)(46)(C)(ii) provides that a company that meets the initial requirements set forth in Sections 2(a)(46)(A) and (B) is an eligible portfolio company if "it is controlled by a [BDC], either alone, or as part of a group acting together, and such [BDC] in fact exercises a controlling influence over the management or policies of such eligible portfolio

financially distressed companies that do not meet the definition of eligible portfolio company and that are purchased in transactions not involving any public offering.<sup>6</sup>

The definition of eligible portfolio company is central to the restrictions of section 55(a) and the purpose of SBIIA. Section 2(a)(46) first generally defines eligible portfolio company to include only domestic companies that are not investment companies under the Investment Company Act ("domestic operating companies").<sup>7</sup> Section 2(a)(46)(C) further defines eligible portfolio company under three categories. Many BDCs invest in companies that historically met the criteria of section 2(a)(46)(C)(i).<sup>8</sup> Under section 2(a)(46)(C)(i), an eligible portfolio company includes any company that does not have any class of securities with respect to which a member of a national securities exchange, broker or dealer may extend or maintain margin credit pursuant to the rules or regulations adopted by the Federal Reserve Board under section 7 of the Securities Exchange Act of 1934 ("Exchange Act"). At the time that

company and, as a result of such control, has an affiliated person who is a director of such eligible portfolio company."

<sup>6</sup> See Section 55(a)(3) of the Investment Company Act (includes, among others, companies that have filed for bankruptcy). In addition, a BDC generally may purchase the securities of an eligible portfolio company from any person in a non-public offering if there is no ready market for the securities and, immediately before the purchase, the BDC owns at least 60% of the issuer's outstanding equity securities. Section 55(a)(4) of the Investment Company Act. BDCs may also invest in securities received in exchange for, or distributed on or with respect to, the securities described in paragraphs (1) through (4) of Section 55(a) or pursuant to the exercise of options, warrants or other rights relating to these securities and in cash and certain short-term securities. Sections 55(a)(5) and (6) of the Investment Company Act.

<sup>7</sup> See House Report at 29. Sections 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 the Act, but includes as an eligible portfolio company any small BDC that is licensed by the Small Business Administration and that is a wholly-owned subsidiary of a BDC.

<sup>8</sup> In addition to section 2(a)(46)(C)(i), discussed *infra*, section 2(a)(46)(C)(ii) includes in the definition of eligible portfolio company any issuer in which the BDC or certain affiliates own a controlling interest, see *supra* note 5, and section 2(a)(46)(C)(iii), enacted in 1996, includes in the definition any issuer that has total assets of not more than \$4 million, and capital and surplus (shareholder equity minus retained earnings) of not less than \$2 million.

section 2(a)(46) was adopted, Congress generally perceived the Federal Reserve Board's definition of "margin security" to be a "rational and objective test" that could be used to determine whether a company has ready access to the public capital markets or other sources of financing.<sup>9</sup> Nevertheless, Congress recognized that the definition's reliance on the Federal Reserve Board's margin rules might need to be adjusted in the future. Accordingly, Congress specifically gave the Commission rulemaking authority under section 2(a)(46)(C)(iv) of the Investment Company Act to expand the definition of eligible portfolio company.<sup>10</sup>

Since 1980, the Federal Reserve Board has periodically amended its definition of margin security to increase the types of securities that would fall within that definition under its rules. In 1998, for reasons unrelated to small business capital formation, the Federal Reserve Board adopted amendments to those 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.<sup>11</sup>

On November 1, 2004, we proposed for comment Rules 2a-46 and 55a-1 under the Investment Company Act.<sup>12</sup> The proposed rules were designed to address the impact of the Federal Reserve Board's 1998 amendments on

the definition of eligible portfolio company by realigning that definition, and the investment activities of BDCs, with the purpose of SBIA.

Generally, proposed Rule 2a-46 would have defined eligible portfolio company in one of two ways. Proposed Rule 2a-46(a) would have defined eligible portfolio company to include any domestic operating company<sup>13</sup> that does not have any class of securities listed on a national securities exchange ("Exchange").<sup>14</sup> Proposed 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 (1) has received notice that its securities will be delisted and (2) is not eligible to list its securities on any Exchange. Proposed Rule 55a-1 would have conditionally permitted a BDC to include in its 70 percent basket follow-on investments in any company that was an eligible portfolio company as defined by proposed Rule 2a-46 at the time of the BDC's initial investment(s) in it, but no longer met that definition.

## II. Discussion

We received thirty-six comment letters that addressed the proposed rules.<sup>15</sup> Commenters generally agreed that Commission rulemaking is appropriate at this time. Virtually all commenters supported proposed Rule 55a-1, and most commenters agreed with the definition of eligible portfolio company set forth in proposed Rule 2a-46(a). Some commenters, however, were concerned that proposed Rule 2a-46(b) would not include many of the small public companies whose securities are listed on an Exchange that historically would have met the definition of eligible portfolio company before the margin rule amendments. In addition, some commenters argued that some small companies that list their securities on an Exchange may not fall within the definition set forth in proposed Rule 2a-46(b), but nevertheless may have

difficulties accessing conventional sources of capital and raising capital on the public capital markets. These commenters argued that these companies should qualify as eligible portfolio companies under the rule.<sup>16</sup> Commenters also generally stated that proposed Rule 2a-46(b) was unworkable.<sup>17</sup>

After considering the comments received, the Commission today is adopting Rule 2a-46, initially proposed as Rule 2a-46(a), to define "eligible portfolio company" to include all private companies and all public companies whose securities are not listed on an Exchange. We estimate that, based on June 2006 data, 61.4 percent (6,041/9,845) of all public domestic operating companies qualify as eligible portfolio companies under Rule 2a-46.

We are not, however, adopting proposed paragraph (b). We are sensitive to some commenters' concerns that the proposed rule was too narrow. Accordingly, we are seeking comment on repropose Rule 2a-46(b) in a separate release.<sup>18</sup>

We also are adopting Rule 55a-1 today.<sup>19</sup> That rule conditionally allows BDCs to make follow-on investments in companies that met the definition of eligible portfolio company under Rule 2a-46 at the time of a BDC's initial investment(s) in them, but that do not meet that definition at the time of the BDC's follow-on investment.

We discuss the rules that we are adopting today in greater detail below.

### A. Rule 2a-46

Rule 2a-46 defines eligible portfolio company to include all private domestic operating companies<sup>20</sup> and those public domestic operating companies whose securities are not listed on an

<sup>9</sup> See House Report at 30-31.

<sup>10</sup> House Report at 31. 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 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 30% 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. 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." See House Report at 31.

<sup>11</sup> See 2004 Proposing Release, *supra* note 1 at nn. 19-23 and accompanying text.

<sup>12</sup> Id.

<sup>13</sup> The proposed rule incorporated the provisions of section 2(a)(46)(A) and (B). See *supra* note 7.

<sup>14</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 1, 2006, Nasdaq began operating as a national securities exchange registered under section 6(a) of the Exchange Act.

<sup>15</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>16</sup> See, *e.g.*, comments of UTEK (Jan. 7, 2005); comments of Gladstone Capital (Jan. 6, 2005); comments of Thompson & Knight (Jan. 4, 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). A few commenters also argued that the proposed rule may harm BDC shareholders because it would increase the risk profile of a BDC. See, *e.g.*, comments of Allied Capital (Jan. 7, 2005). We discuss this comment below. See *infra* notes 24-25 and accompanying text.

<sup>17</sup> See, *e.g.*, comments of Sherman & Sterling LLP (Jan. 7, 2005).

<sup>18</sup> See *supra* note 1.

<sup>19</sup> Rule 55a-1 as adopted has been modified from the proposed rule merely to refer to Rule 2a-46 as adopted, rather than reciting the definition of eligible portfolio company set forth in Rule 2a-46.

<sup>20</sup> Like Section 2(a)(46) and the proposed rule, Rule 2a-46 defines eligible portfolio company to include only domestic operating companies. See *supra* notes 7 and 13 and accompanying text.

Exchange.<sup>21</sup> 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.

Rule 2a-46 in our view provides a workable and appropriate test for determining whether a company is an eligible portfolio company. The rule more closely aligns the definition of eligible portfolio company with the purpose of SBIIA by including many of the types of companies that Congress originally intended to benefit from BDC financing that may have lost their eligible portfolio company status because of the change in the margin rules. Rule 2a-46 is consistent with the public interest, the protection of investors and the purposes fairly intended by the policy and provisions of the Investment Company Act.<sup>22</sup>

Most commenters supported proposed Rule 2a-46(a), and agreed that this approach would establish a clear, workable standard that correlates to whether a company has access to publicly raised capital.<sup>23</sup> A few commenters, however, raised a concern that this provision, when coupled with the definition set forth in proposed paragraph (b), would cause BDCs to focus their investment activities on companies that are in financial distress because of their view that most public companies that are quoted on the OTCBB or through Pink Sheets are financially troubled.<sup>24</sup>

<sup>21</sup> Under this provision, an issuer would be an eligible portfolio company if it does not have a class of securities listed on a national securities exchange registered under Section 6(a) of the Exchange Act, [15 U.S.C. 78f(a)] such as the New York Stock Exchange ("NYSE"), the American Stock Exchange ("Amex"), and Nasdaq. See *supra* note 14.

<sup>22</sup> See *supra* note 10.

<sup>23</sup> See, e.g., comments of American Capital Strategies Ltd. (Jan. 7, 2004); comments of Sherman & Sterling LLP (Jan. 7, 2005). We note that the House of Representatives has passed legislation that in part defines eligible portfolio company in a manner similar to the definition that we are adopting today. See H.R. 436, 109th Cong., 1st Sess. (2005) (an eligible portfolio company includes any company that "does not have any class of equity securities listed for trading on a national securities exchange or traded through the facilities of a national securities association as described in Section 15A of the Securities Exchange Act of 1934"). S. 1396, which is identical to H.R. 436, was introduced in the Senate on July 14, 2005. S. 1396, 109th Cong., 1st Sess. (2005). Both H.R. 436 and S. 1396 are currently pending before the Senate Committee on Banking, Housing and Urban Affairs.

<sup>24</sup> Comments of UTEK (Jan. 7, 2005); comments of Allied Capital (Jan. 7, 2005). Some commenters also raised the concern that the proposed rule would harm BDC shareholders by raising BDCs' risk profiles. Rule 2a-46, however, is intended to address the inadvertent reduction in the number of companies that qualify under Section 2(a)(46) by

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. Although some companies have their shares traded on the OTCBB or through Pink Sheets because of financial circumstances, this is not true for all companies whose securities are traded on these quotation mediums. Rather, OTCBB and Pink Sheets companies also include small public companies that do not meet the minimum listing standards of one of the Exchanges, and companies that wish to become more developed before applying to list their securities on an Exchange even though they may already be eligible to do so.<sup>25</sup> In other words, although companies whose securities are traded on the OTCBB and through Pink Sheets include financially troubled companies, they also include small, developing, financially stable public companies. Thus, we believe that including companies that are traded on the OTCBB or through Pink Sheets as eligible portfolio companies under Rule 2a-46 will not require BDCs to change their investment strategies to focus on financially troubled companies. Instead, the rule is designed to more closely align the definition with the purpose of SBIIA.

We note that OTCBB and Pink Sheets companies also include a few large companies that do not list their securities on an Exchange even though they may meet applicable listing requirements. With this in mind, we had asked in the Proposing Release whether we should exclude from the definition of eligible portfolio company any company that would meet the lowest initial quantitative listing standard of any Exchange, regardless of whether the company enters into a

the amendment to the margin rules. The rule does not alter the statutory mandate or requires a BDC to invest in any particular company. Further, Congress addressed investor protection concerns with respect to BDC shareholders in 1980. See House Report at 22 (explaining that SBIIA "is intended to preserve to the fullest possible extent \* \* \* [investor] protections, while at the same time reducing unnecessary regulatory burdens."). In this regard, the federal securities laws require, among other things, BDCs to disclose to their shareholders the risks associated with investment and to manage their business consistent with their fiduciary obligations.

<sup>25</sup> See "A Little About The Pink Sheets" at [www.PennyMarkets.com](http://www.PennyMarkets.com). See also Testimony of James A. Connolly III representing the CEO Council before the Subcommittee of Oversight and Investigations of the House Committee on Financial Services (Sept. 23, 2004) (the OTCBB and Pink Sheet companies are "'engines of economic growth, job creation and innovation.' Our market space of 7000 companies includes hundreds of millions of dollars in market capitalization, tens of thousands of employees, and likely hundreds of thousands of stockholders.").

listing agreement with the Exchange. Commenters, however, argued that a company that may meet the lowest initial quantitative listing of any Exchange may nevertheless not have access to the public capital markets.<sup>26</sup> These comments have persuaded us not to adopt this approach.

#### B. Rule 55a-1

Proposed Rule 55a-1, which virtually all commenters supported, is adopted.<sup>27</sup> As adopted, 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(s) 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(s) in the company, the company listed its securities on an Exchange), subject to certain 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 securities of such company 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.<sup>28</sup> Rule 55a-1 is appropriate in the public interest and consistent with the protection of investors and the purposes and policies fairly intended by the policy and provisions of the Act.

### III. Cost-Benefit Analysis

We are sensitive to the costs and benefits that result from our rules. In the Proposing Release we requested public comment and specific data regarding the costs and benefits of the proposed rules. Several commenters suggested that proposed Rule 2a-46(a) would benefit BDCs by addressing the impact caused

<sup>26</sup> See comments of Thompson & Knight (Jan. 4, 2005); comments of American Capital Strategies (Jan. 7, 2006).

<sup>27</sup> See *supra* note 19.

<sup>28</sup> The rule incorporates the conditions set forth in Section 55(a)(1)(B), the section that permits a BDC to make follow-on investments in a company that was an eligible portfolio company at the time of the BDC's initial investment(s), but that subsequently lost its status as an eligible portfolio company because it issued margin securities.

by changes in the margin rules.<sup>29</sup> Another commenter argued that the Commission calculated incorrectly the number of companies that the proposed rule would benefit and wrote that the proposal would benefit even fewer companies than the Commission estimated.<sup>30</sup> We received no comments on the costs and benefits of proposed Rule 55a–1.

#### A. Benefits

Rules 2a–46 and 55a–1 would more closely align the definition of eligible portfolio company with the purpose that Congress intended when it established BDCs as a source of financing for certain types of companies. These companies often need capital for continued development and growth, but may be unable to borrow money through conventional sources or may not have ready access to the public capital markets. Rules 2a–46 and 55a–1 would also benefit BDCs by recapturing companies that Congress originally intended to make eligible for BDC investment as part of a BDC's 70 percent basket.

A number of companies may have lost their eligible portfolio company status as a result of amendments to the Federal Reserve Board's margin rules. BDCs may be currently required to include in their 30 percent basket—rather than in their 70 percent basket—any investment in these companies, notwithstanding the fact that they may be the type of companies that Congress intended to benefit from BDC financing.

Rule 2a–46 defines an eligible portfolio company to include all private companies and those public companies whose securities are not listed on an Exchange. The Commission's Office of Economic Analysis ("OEA") estimates that, as of June 2006, there were a total number of 6,041 domestic operating companies with securities that were traded on the OTCBB and through Pink Sheets, and therefore would qualify as eligible portfolio companies under the rule. OEA reached this conclusion by first calculating the number of companies whose securities are trading on the OTCBB (3,295 companies) and through Pink Sheets (4,794 companies), and then removing from these figures

estimates of all foreign companies, investment companies and companies that are excluded from the definition of investment company by Section 3(c) of the Investment Company Act (e.g., REITS, banks, insurance companies) because both Section 2(a)(46) of the Investment Company Act and Rule 2a–46 exclude these types of companies from the definition of eligible portfolio company (a deduction of 776 companies from OTCBB and 1,273 companies from Pink Sheets). OEA thus concluded that, as of June 2006, there were a total of 6,041 domestic operating companies (2,519 OTCBB companies and 3,522 Pink Sheets companies) that would qualify as eligible portfolio companies. OEA estimates that these 6,041 companies represent approximately 61.4 percent (6,041/9,845)<sup>31</sup> of all public domestic operating companies that could qualify as eligible portfolio companies under Rule 2a–46.

In the Proposing Release, we explained that OEA estimated that 60 percent of public domestic operating companies do not have securities that trade on an Exchange, and thus would meet the definition of eligible portfolio company under proposed Rule 2a–46(a). We further explained that even more public companies should qualify as eligible portfolio companies by virtue of meeting the requirements of proposed paragraph (b) of that rule (which, as noted previously, is being repropounded).<sup>32</sup>

We note that one commenter argued that the Commission calculated incorrectly the number of companies that the proposed rule would benefit and wrote that the proposal would benefit even fewer companies than the Commission estimated. The commenter argued that proposed Rule 2a–46(a) (which we are adopting today as Rule 2a–46) would capture only 52.4 percent of public companies.<sup>33</sup>

The commenter's figure is lower than the figure calculated by OEA. It appears that the commenter did not remove from its data foreign companies, investment companies and companies that are excluded from the definition of

investment company by Section 3(c). As discussed previously, because Section 2(a)(46) excludes these companies from the definition of eligible portfolio company, we believe that they should be excluded from the total number of companies trading on U.S. markets when quantifying the benefits of the rule.

Rule 55a–1 provides additional benefits to certain companies that met the definition of eligible portfolio company under Rule 2a–46 at the time of the BDC's initial investment(s) in them but that subsequently lost their eligible portfolio company status under Rule 2a–46, by allowing BDCs to make follow-on investments in such companies under certain conditions.

Finally, we note that both Rule 2a–46 and Rule 55a–1 would benefit BDCs by expanding the universe of investments that may be included in their 70 percent baskets. It also benefits BDCs by addressing the uncertainty caused by changes in the margin rules in the operation of BDCs. As one commenter noted, a "technical flaw" in the definition of eligible portfolio company arose as a result of changes to the margin rules which imposed substantial constraints on BDC investments. The commenter expressed its view that proposed Rule 2a–46(a) had corrected this flaw.<sup>34</sup>

#### B. Costs

While Rules 2a–46 and 55a–1 might impose certain administrative compliance costs on BDCs, we expect such costs to be minimal and commenters provided no data as requested in the 2004 Proposing Release. Under Rule 2a–46, a BDC would need to determine, prior to investing in a company, whether the company has a class of securities listed on an Exchange. Such information is easily obtainable through reliable third-party sources. Furthermore, Section 55 of the Investment Company Act generally requires a BDC to invest in eligible portfolio companies through privately negotiated transactions. Thus, this information would also be readily available to a BDC from the company during the course of these negotiations.

We also expect that a BDC's costs relating to the requirements of Rule 55a–1 will be minimal. 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 when the BDC made its initial

<sup>29</sup> See, e.g., comment of American Capital Strategies (Jan. 7, 2005); comments of the Committee on Federal Regulation of Securities of the Business Law Section of the American Bar Association (Jan. 5, 2005).

<sup>30</sup> Comments of Williams & Jensen (Jan. 7, 2005). In addition, most commenters urged the Commission to modify the proposed rule to capture more small companies whose securities are listed on an Exchange. The Commission is repropounding Rule 2a–46(b) to address this concern. See *supra* note 1.

<sup>31</sup> OEA concluded that, as of June 2006, there were 9,845 public domestic operating companies by calculating the number of companies whose securities are listed on Nasdaq, NYSE and Amex, in addition to those companies whose securities are trading on the OTCBB and through Pink Sheets, corrected for cases where individual companies had multiple classes of securities listed (60 companies), and then removing from this number foreign companies, investment companies, and companies that are excluded from the definition of investment company by Section 3(c). See Sections 2(a)(46)(A) and (B), *supra* note 7.

<sup>32</sup> See 2004 Proposing Release, *supra* note 1 at n.49 and accompanying text.

<sup>33</sup> Comments of Williams & Jensen (Jan. 7, 2005).

<sup>34</sup> See, e.g., comment of American Capital Strategies (Jan. 7, 2005). See also comments of Capital Southwest Corp. (Dec. 28, 2004).

investment(s), but that does not meet that definition at the time of the follow-on investment. A BDC generally may make follow-on investments under the rule only if, at the time of the follow-on investment, the BDC owns at least 50 percent of (1) the greatest number of equity securities of such company, including securities convertible into or exchangeable for such securities and (2) the greatest amount of certain debt securities of such company held by the BDC at any time during the period when such company was an eligible portfolio company. In addition, the rule requires a BDC that makes such a follow-on investment to be one of the twenty largest holders of record of the company's outstanding voting securities at the time of that investment.

These requirements mirror the requirements set forth in Section 55(a)(1)(B) of the Investment Company Act, the provision that permits a BDC to include in its 70 percent basket certain follow-on investments in companies that were eligible portfolio companies at the time of the BDC's initial investment(s), but that subsequently lost that status because they issued marginable securities. Accordingly, BDCs already make similar types of determinations when considering whether to make follow-on investments in a company that had lost their eligible portfolio company status because they had issued marginable securities. We anticipate that the rule will impose only minimal, if any, costs on companies.

#### IV. Consideration of Promotion of Efficiency, Competition and Capital Formation

Section 2(c) of the Investment Company Act mandates that the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.<sup>35</sup> In the Proposing Release, we requested comment on our analysis of the impact of the proposed rules on efficiency, competition and capital formation. Although we did not receive any comments that specifically addressed proposed Rule 2a-46(a), which is the provision that we are adopting today, we did receive comments about the entire rule.

Specifically, some commenters argued that proposed Rule 2a-46 was too narrow and did not capture all of the very small public companies that could

benefit from BDC financing.<sup>36</sup> We interpreted this comment to suggest that capital formation may have been limited under the proposed rule. We are sensitive to this concern and therefore are seeking comment on repropose Rule 2a-46(b) in a separate release.<sup>37</sup>

Some commenters also expressed a concern that proposed Rule 2a-46(a), when coupled with the definition set forth in proposed paragraph (b), would cause BDCs to focus their investment activities on companies that are in financial distress because of their view that most public companies that are quoted on the OTCBB or through Pink Sheets are financially troubled.<sup>38</sup> We interpret this comment to suggest that the rule does not promote efficiency and would impede capital formation. Rule 2a-46 as adopted, however, does not require BDCs to focus their investment activities in financially troubled companies. Rather, Rule 2a-46 allows BDCs to invest in all companies whose securities are traded on the OTCBB and through Pink Sheets, including small, developing, financially stable public companies, which are among the types of companies that Congress intended to benefit from BDC financing.<sup>39</sup>

As discussed, the new rules more closely align the definition of eligible portfolio company, and the investment activities of BDCs, with the purpose that Congress intended. Rule 2a-46 defines eligible portfolio company to include all private companies and approximately 61.4 percent of public domestic operating companies. 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 when the BDC made its initial investment(s), but that does not meet that definition at the time of the follow-on investment. Both rules will promote efficiency, competition and capital formation.

Specifically, both rules promote efficiency by more closely aligning the definition of eligible portfolio company with the purpose of SBIIA. To the extent that BDC investments represent additional capital to certain small companies, these rules enhance efficiency. Efficiency will be enhanced because the rules address the unintended adverse impact that the amendments to the margin rules have had on the ability of BDCs to provide financing to these companies. Rule 2a-46 in our view also promotes efficiency

by providing a workable and appropriate test for determining whether a company is an eligible portfolio company. Rule 55a-1 will further enhance efficiency by making it easier for BDCs to make follow-on investments in companies that no longer meet the definition of eligible portfolio company under Rule 2a-46.

We also anticipate that these rules will promote competition. The market for private equity and debt investments can be highly competitive. Since their establishment, BDCs have competed with various sources of capital, including private equity funds, hedge funds, investment banks and other BDCs, to provide financing to certain small businesses. We expect that the rules will encourage competition by addressing the impact and uncertainty caused by changes in the margin rules on BDC investment. Under the rules, BDCs will be able to compete with other entities that provide capital to small, developing and financially troubled companies in a manner that is consistent with the statutory requirement that at least 70 percent of a BDC's assets must be invested in those businesses at the time of any new investment. We further note that shareholders of companies that had lost their status as eligible portfolio companies will benefit under the rules because such companies may now more readily consider BDCs as a source of financing.

Finally, we anticipate that the new rules will promote capital formation. As mentioned above, eligible portfolio company is broadly defined to include all private companies and a significant portion of public domestic operating companies. The definition, however, is designed to ensure that the investment activities of BDCs remain focused primarily on the types of companies that Congress intended BDCs to assist.

#### V. Paperwork Reduction Act

The Commission has determined that these rules do not involve a collection of information pursuant to the provisions of the Paperwork Reduction Act [44 U.S.C. 3501 *et seq.*].

#### VI. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Analysis has been prepared in accordance with 5 U.S.C. 604, which relates to new Rules 2a-46 and 55a-1 under the Investment Company Act. An Initial Regulatory Flexibility Analysis ("IRFA") was prepared in accordance

<sup>36</sup> See *supra* note 16 and accompanying text.

<sup>37</sup> See *supra* note 1.

<sup>38</sup> See *supra* note 24 and accompanying text.

<sup>39</sup> See *supra* note 25 and accompanying text.

<sup>35</sup> 15 U.S.C. 80a-2(c).

with 5 U.S.C. 603 and was published in the Proposing Release.<sup>40</sup>

#### *A. Reasons and Objectives of the New Rules*

As described more fully in Sections I. and II. of this Release, the objectives of the new rules are to more closely align the definition of eligible portfolio company set forth under the Investment Company Act, and the investment activities of BDCs, with the purpose intended by Congress when it established BDCs in 1980. The rules are designed to recapture in the definition of eligible portfolio company companies that Congress originally intended to include within the definition, but that may have lost their eligible portfolio company status as a result of the 1998 amendment to the Federal Reserve Board's margin rules.

#### *B. Significant Issues Raised by Public Comment*

When the Commission proposed the rules that are being adopted today, comment was requested on the proposal and the accompanying IRFA. We received thirty-six comment letters that addressed the proposed rules. As discussed, some commenters believed that proposed Rule 2a-46 was too narrow and did not include some small public companies that can benefit from BDC financing. In a separate release, we are seeking comment on re-proposed Rule 2a-46(b), which would address this concern. None of the comment letters, however, specifically addressed the IRFA.

#### *C. Small Entities Subject to the Rule*

Rules 2a-46 and 55a-1 affect both BDCs and companies that qualify as small entities under the Regulatory Flexibility Act. For purposes of the Regulatory Flexibility Act, a BDC is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of \$50 million or less as of the end of its most recent fiscal year.<sup>41</sup> As of December 2005, there were 87 BDCs, of which 66 were small entities. A company other than an investment company is a small entity under the Regulatory Flexibility Act if it had total assets of \$5 million or less on the last day of its most recent fiscal year.<sup>42</sup> We estimate that there are approximately 2,500 companies, other than investment companies, that may be

considered small entities under the Regulatory Flexibility Act.

As discussed in this Release, the rules are intended to more closely align the definition of eligible portfolio company with the purpose that Congress intended when it established BDCs as a source of financing for certain small companies. These companies often need capital for continued development and growth, but may be unable to borrow money through conventional sources or may not have ready access to the public capital markets. The rules would also benefit BDCs, including those that are small entities, by recapturing the types of companies that Congress originally intended to make eligible for BDC investment as part of a BDC's 70 percent basket. We have no reason to expect that those BDCs and companies that are small entities for purposes of the Regulatory Flexibility Act will be disproportionately affected by the rules.

#### *D. Reporting, Recordkeeping and Other Compliance Requirements*

The rules do not impose any new reporting or recordkeeping requirements on BDCs or on companies. The rules also do not impose any compliance requirements on companies. They do, however, impose minimal compliance requirements on all BDCs, including small entities. Under Rule 2a-46, a BDC, prior to investing in a company, would need to determine whether the company has a class of securities listed on an Exchange. This information is readily available, and we believe that all BDCs, including those that are small entities, already evaluate similar types of information when considering whether to invest in a company.

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 when the BDC made its initial investment(s), but that does not meet that definition at the time of the follow-on investment. A BDC generally may make follow-on investments under the rule only if, at the time of the follow-on investment, the BDC owns at least 50 percent of (1) the greatest number of equity securities of such company, including securities convertible into or exchangeable for such securities and (2) the greatest amount of certain debt securities of such company held by the BDC at any time during the period when such company was an eligible portfolio company. In addition, the rule requires a BDC that makes such a follow-on investment to be one of the twenty largest holders of record of the company's outstanding voting securities at the time of

investment. These requirements are the same requirements set forth in Section 55(a)(1)(B) of the Investment Company Act, the provision that permits a BDC to include in its 70 percent basket certain follow-on investments in companies that were eligible portfolio companies at the time of the BDC's initial investment(s), but that subsequently lost that status because they issued marginable securities. Accordingly, BDCs, including those that are small entities, already make similar types of determinations when considering whether to make follow-on investments in companies that had lost their eligible portfolio company status because they had issued marginable securities.

#### *E. Commission Action to Minimize Adverse Impact on Small Entities*

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. Alternatives in this category would include: (1) Establishing different compliance or reporting standards that take into account the resources available to small entities; (2) clarifying, consolidating, or simplifying the compliance requirements under the proposed rules for small entities; (3) the use of performance rather than design standards; and (4) an exemption from coverage of the rules, or any part thereof, for small entities.

Establishing different compliance or reporting requirements for small entities would not be appropriate. As discussed above, the rules do not impose any reporting requirements on BDCs or on companies. In addition, the rules do not impose any compliance requirements on companies. Both Rules 2a-46 and 55a-1, however, do impose some compliance requirements on BDCs that are intended to ensure that BDCs invest primarily in those companies that Congress intended them to invest in when it established BDCs in 1980. These requirements should, however, impose minimum burdens on BDCs. We note that Rule 2a-46 as adopted does not include proposed paragraph (b) in part because of commenters' concerns that the conditions of that provision are unworkable and burdensome.

We also believe that clarifying, consolidating, or simplifying the compliance requirements under the rules for small entities is inappropriate. As discussed above, neither rule imposes any compliance requirements on companies. Although the rules do impose some compliance requirements on BDCs, as discussed above, these requirements, which we believe will

<sup>40</sup> 2004 Proposing Release, *supra* note 1 at Section VII.

<sup>41</sup> 17 CFR 270.0-10.

<sup>42</sup> 17 CFR 230.157; 17 CFR 240.0-10.

impose minimal burdens on BDCs, are designed to insure that BDCs invest primarily in those companies that Congress intended them to invest in when it established BDCs in 1980.

We believe that the use of performance rather than design standards would add unnecessary complexity. The rules are intended to address the impact and the uncertainty as a result of the 1998 amendment to the Federal Reserve Board's margin rules by providing a clear, bright-line, workable test for determining whether a company is an eligible portfolio company. A standard based on performance could be unduly complicated and cause further uncertainty to BDCs, including those that are small entities, when determining whether a company is an eligible portfolio company. Likewise, the use of a performance standard would bring uncertainty to companies, including those that are small entities, in determining whether they meet the definition of eligible portfolio company.

Finally, we believe that it would be inappropriate to exempt small entities from the coverage of the rules. The rules are intended to benefit BDCs and certain companies that qualify as eligible portfolio companies, including those BDCs and other companies that are small entities. These eligible portfolio companies often need capital for continued development and growth. Exempting small entities from all or part

of the rules would be contradictory to the purpose of the rules.

## VII. Statutory Authority

We are adopting Rules 2a–46 and 55a–1 pursuant to our rulemaking authority under Sections 2(a)(46)(C)(iv), 6(c) and 38(a) of the Investment Company Act.

### List of Subjects in 17 CFR Part 270

Investment companies, Reporting and recordkeeping requirements, Securities.

### Text of Rules

■ For reasons set forth in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

## PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

■ 1. The authority citation for part 270 continues to read in part as follows:

**Authority:** 15 U.S.C. 80a–1 *et seq.*, 80a–34(d), 80a–37, and 80a–39, unless otherwise noted.

\* \* \* \* \*

■ 2. Section 270.2a–46 is added to read as follows:

### § 270.2a–46 Certain issuers as eligible portfolio companies.

The term *eligible portfolio company* shall include any issuer that meets the

requirements set forth in paragraphs (A) and (B) of section 2(a)(46) of the Act (15 U.S.C. 80a–2(a)(46)(A) and (B)) and that does not have any class of securities listed on a national securities exchange.

■ 3. Section 270.55a–1 is added to read as follows:

### § 270.55a–1 Investment activities of business development companies.

Notwithstanding section 55(a) of the Act (15 U.S.C. 80a–54(a)), a business development company may acquire securities purchased in transactions not involving any public offering from an issuer, or from any person who is an officer or employee of the issuer, if the issuer meets the requirements of sections 2(a)(46)(A) and (B) of the Act (15 U.S.C. 80a–2(a)(46)(A) and (B)), but the issuer is not an eligible portfolio company because it does not meet the requirements of § 270.2a–46, and the business development company meets the requirements of paragraphs (i) and (ii) of section 55(a)(1)(B) of the Act (15 U.S.C. 80a–54(a)(1)(B)(i) and (ii)).

Dated: October 25, 2006.

By the Commission.

Nancy M. Morris,

Secretary.

[FR Doc. E6–18255 Filed 10–30–06; 8:45 am]

BILLING CODE 8011–01–P