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Definition of Eligible Portfolio Company Under the Investment Company Act of 1940; Proposed Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release No. IC–26647; File No. S7–37–04]

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Definition of Eligible Portfolio Company Under the Investment Company Act of 1940

AGENCY: Securities and Exchange Commission (the ''Commission'').

ACTION: Proposed rule.

SUMMARY: The Commission is proposing for comments two new rules under the Investment Company Act of 1940 (''Investment Company Act'' or ''Act''). The proposed new rules are designed to realign the definition of eligible portfolio company set forth under the Investment Company Act, and the investment activities of business development companies (''BDCs''), with the purpose of the Small Business Investment Incentive Act of 1980 (''SBIIA''). These rules are intended to expand the definition of eligible portfolio company in a manner that would promote the flow of capital to small, developing and financially troubled companies.

DATES: Comments should be received on or before January 7, 2005.

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

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, 450 Fifth Street, NW., 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) 942–0660, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0506.

SUPPLEMENTARY INFORMATION: The Commission today is requesting public comment on proposed new Rule 2a–46 [17 CFR 270.2a–46] and proposed new Rule 55a–1 [17 CFR 270.55a–1], both under the Investment Company Act [15 U.S.C. 80a].

Table of Contents

I. Background
II. Discussion
A. Proposed Rule 2a–46
1. No Securities Listed on an Exchange or on NASDAQ
2. Financially Troubled Companies
B. Proposed Rule 55a–1
III. General Request for Comment
IV. Cost-Benefit Analysis
V. Consideration of Promotion of Efficiency, Competition, and Capital Formation
VI. Paperwork Reduction Act
VII. Initial Regulatory Flexibility Analysis
VIII. Statutory Authority

I. Background

In 1980, Congress enacted the SBIIA,[1] which, among other things, amended the Investment Company Act to establish BDCs as a new type of closed-end investment company.[2] Importantly, Congress emphasized that the primary purpose of the amendments to the Investment Company Act (the ''BDC Amendments'') was to make capital more readily available to small developing and financially troubled businesses.[3] To accomplish this purpose, the BDC Amendments relieved BDCs from the application of some of the restrictions applicable to registered closed-end investment companies under the Investment Company Act, while also retaining important investor protections.[4]

In amending the Investment Company Act, Congress underscored that the new provisions would apply only to BDCs that are operated for the purpose of investing in the securities of certain issuers and that make available significant managerial assistance to those issuers.[5] Accordingly, Section 55(a) of the Investment Company Act generally prohibits a BDC from making any investment unless, at the time of the investment, at least 70 percent of its total assets (other than certain specified non-investment assets[6]) are invested in securities of certain specified issuers (''70% basket'').[7] Among other things,

[1] Pub. L. 96–477, 94 Stat. 2275 (1980) (codified at scattered sections of the United States Code).

[2] *See* H.R. Rep. No. 1341, 96th Cong., 2d Sess. 21 (1980) (''House Report''). An issuer generally may qualify for BDC status if it: (1) Is a closed-end investment company (*i.e.*, it does not offer for sale or have outstanding redeemable securities) that is organized and operated in the United States; (2) is operated for purposes of investing in securities described in paragraphs (1) through (3) of Section 55(a) of the Investment Company Act [15 U.S.C. 80a–54(a)]; (3) makes available significant managerial assistance to most of its portfolio companies; and (4) registers a class of its equity securities under Section 12 of the Securities Exchange Act of 1934 [15 U.S.C. 78l] (''Securities Exchange Act''). *See* Section 2(a)(48) of the Investment Company Act [15 U.S.C. 80a–2(a)(48)] (defining ''business development company'') and Section 54 of the Investment Company Act [15 U.S.C. 80a–53] (setting forth the requirements for election as a BDC). The SBIIA also amended the Investment Advisers Act of 1940, the Securities Act of 1933, and the Trust Indenture Act of 1939 in such a manner as to promote small business capital formation.

[3] House Report at 23.

[4] For example, unlike with respect to traditional closed-end investment companies, the Investment Company Act does not prohibit persons that a BDC controls or of which the BDC holds at least five percent of the outstanding securities (so-called downstream affiliates) from engaging in transactions with the BDC. *See* House Report at 48. The BDC Amendments also provide some relief from the Investment Company Act's general prohibitions against affiliated transactions set forth in Section 17 of the Act [15 U.S.C. 80a–17] with certain non-controlling affiliates of BDCs. *See* Section 57(f) of the Investment Company Act [15.U.S.C. 80a–56(f)]. *See also* House Report at 24 and 47. In addition, BDCs have greater ability to invest in securities and issue debt securities because their asset coverage limit for debt is 200% (rather than 300%, as required for traditional closed-end investment companies); BDCs may offer other forms of executive compensation (such as stock options, warrants, and rights) in order to recruit experienced management; and BDCs have greater access to the capital markets because they may sell their stock at less than current net asset value. *See* Sections 57(j)(1), 61(a)(1) and (3), and 63(2) of the Investment Company Act [15 U.S.C. 80a–56(j)(1), –60(a)(1), –60(a)(3) and –62(2)]. *See also* Reginald L. Thomas and Paul F. Roye, *Regulation of Business Development Companies under the Investment Company Act,* 55 S. Cal. L. Rev. 895 (1982) (discussing the 1980 amendments to the Investment Company Act and regulatory issues affecting BDCs).

[5] House Report at 22.

[6] These assets include, for example, office furniture and equipment, deferred organization and operating expenses and notes of indebtedness of corporate insiders relating to certain executive compensation plans. *See* Section 55(a)(7) of the Investment Company Act.

[7] Section 55(a) of the Investment Company Act. *See* House Report at 23 (''The restrictions are designed to assure that companies electing special treatment as [BDCs] are in fact those that [the 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.'').

the 70% basket may include securities of eligible portfolio companies, as defined in Section 2(a)(46) of the Investment Company Act, purchased in transactions not involving any public offering,[8] securities of eligible portfolio companies, as defined in Section 2(a)(46)(C)(ii), without regard to the nature of the offering,[9] and securities of financially troubled issuers purchased in transactions not involving any public offering.[10] At the same time, Congress allowed BDCs to invest in certain other assets that would not count toward the 70% basket (''30% basket''). Congress clarified, however, that a BDC would be required to invest its 30% basket consistent with the overall purpose of the SBIIA.[11]

Eligible portfolio company is defined in Section 2(a)(46) of the Investment Company Act to include any issuer that (1) is organized under the laws of, and has its principal business in, the United States and (2) generally does not meet the definition of an investment company under Section 3 of the Investment Company Act [12] or is excluded from the definition of investment company by Section 3(c) of that Act.[13] These provisions are intended to ensure that BDCs will invest most of their assets in domestic operating issuers.[14] In addition to these requirements, an eligible portfolio company must meet one of the criteria set forth in Section 2(a)(46)(C). Many BDCs invest in issuers that historically met the criteria set forth in Section 2(a)(46)(C)(i).[15]

Under Section 2(a)(46)(C)(i), an eligible portfolio company includes any issuer that does not have any class of securities with respect to which a member of a national securities exchange, broker, or dealer may extend margin credit pursuant to the rules or regulations adopted by the Federal Reserve Board under Section 7 of the Securities Exchange Act. This provision generally reflects Congress's view in 1980 that the issuers of margin securities ''generally are reasonably mature, at least from the standpoint that they generally have access to conventional public capital markets,'' [16] and that the Federal Reserve Board's definition of ''margin security'' would serve ''as a rational and objective test for determining whether a issuer has ready access to the securities markets.'' [17] Nevertheless, Congress recognized that the definition of eligible portfolio company as adopted, and, in particular, 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.[18]

Since 1980, the Federal Reserve Board has periodically amended its definition of margin security under Regulation T, the regulation governing the securities credit activities of broker-dealers, for reasons unrelated to small business capital formation. In 1998, the Federal Reserve Board amended the definition of margin security to reduce regulatory distinctions between broker-dealers and other lenders.[19] This amendment had the unintended consequence of limiting the investment opportunities of BDCs by expanding the definition of margin security to include all securities that trade on a national securities exchange (''Exchange'') or are listed on the NASDAQ Stock Market (both NASDAQ's National Market System and the NASDAQ's SmallCap Market).[20]

More significantly, however, the 1998 amendment also expanded the definition of margin security to include any security, regardless of whether it is publicly or privately offered, that is not an ''equity security'' within the meaning of Section 3(a)(11) of the Securities Exchange Act.[21] Thus, because the definition of eligible portfolio company is linked, in part, to the Federal Reserve Board's margin rules, the 1998 amendment appears to have had the effect of precluding most issuers that have issued debt securities from qualifying as an eligible portfolio

[8] Section 55(a)(1) of the Investment Company Act.

[9] *See* Section 55(a)(2) of the Investment Company Act, referring to Section 2(a)(46)(C)(ii) of the Act [15 U.S.C. 80a–2(a)(46)(C)(ii)], which generally includes in the definition of eligible portfolio company an issuer of which the BDC (either alone, or as part of a group acting together) owns a controlling interest.

[10] Section 55(a)(3) of the Investment Company Act. 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 (a)(1) through (a)(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.

[11] House Report 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.'').

[12] Section 3 of the Investment Company Act [15 U.S.C. 80a–3].

[13] Sections 2(a)(46)(A) and 2(a)(46)(B) of the Investment Company Act. Section 2(a)(46)(B) also includes as an eligible portfolio company a small BDC which is licensed by the Small Business Administration and which is a wholly-owned subsidiary of a BDC.

[14] *See* House Report at 29.

[15] Section 2(a)(46)(C)(i) of the Investment Company Act. Section 2(a)(46)(C)(ii) includes in the definition of eligible portfolio company an issuer in which the BDC or certain affiliates own a controlling interest. *See supra* note 9. In addition, in 1996, Congress expanded the definition of eligible portfolio company to include issuers that have total assets of not more than $4 million, and capital and surplus (shareholder equity minus retained earnings) of no less than $2 million. Section 2(a)(46)(C)(iii) of the Investment Company Act. A BDC is not required to make available significant managerial assistance to any issuer that meets the requirements of Section 2(a)(46)(C)(iii). Section 2(a)(48)(B) of the Investment Company Act.

[16] House Report at 30.

[17] *See* House Report at 30–31 (Section 2(a)(46)(C)(i) was ''intended to include companies which are unable to borrow money through conventional sources or which do not have ready access to the public capital markets.'').

[18] 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 specified standards''). *See also* House Report at 31 (discussing the expectation that ''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 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.''). In addition, Section 38(a) of the Investment Company Act [15 U.S.C. 80a–37(a)] authorizes the Commission to, among other things, adopt such rules as are necessary to define technical terms used in the Investment Company Act.

[19] Securities Credit Transactions; Borrowing By Brokers and Dealers, 63 FR 2805 (1998) (adopting final rule amendment).

[20] 12 CFR 220.2 (definition of margin security). Before the 1998 amendment, certain securities that were listed on NASDAQ's SmallCap Market were not considered to be margin securities. As such, the issuers of such securities could be treated as eligible portfolio companies for purposes of BDC investment.

[21] Section 3(a)(11) of the Securities Exchange Act [15 U.S.C. 78c(a)(11)]. That section defines an ''equity security'' as any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.

company.[22] As a result, issuers that would have been considered eligible portfolio companies in 1980 may no longer meet that definition.[23] Rules adopted and amended by the Federal Reserve Board for reasons unrelated to small business development therefore have resulted in reducing the number of businesses eligible for BDC investment. Congress clearly intended us to exercise our rulemaking authority under Section 2(a)(46)(C)(iv) when necessary to accomplish the purposes and policies of the SBIIA.[24] Thus, we are today proposing two rules that will realign the definition of eligible portfolio company, and the investment activities of BDCs, with the purpose intended by Congress when it enacted the SBIIA.

II. Discussion

The new rules that we propose today address the effect that the amendment to the margin rules had on the definition of eligible portfolio company under the Investment Company Act. The new rules are intended to realign the definition of eligible portfolio company with the purpose of the SBIIA by (1) defining eligible portfolio company with reference to whether an issuer has any class of securities listed on an Exchange or on an automated interdealer quotation system of a national securities association (''NASDAQ'') and (2) permitting BDCs to make certain additional (''follow-on'') investments in those issuers even after they list their securities on an Exchange or on NASDAQ.

Proposed Rule 2a–46 would modernize the definition of eligible portfolio company by creating a new, objective standard. The proposed rule is intended to recapture the type of issuers that Congress originally intended to make eligible for BDC investment as part of a BDC's 70% basket, *i.e.*, those issuers that do not have ready access to the public capital markets, but that may have lost their status as eligible portfolio companies because they have issued marginable securities. The proposed rule also would include certain financially troubled issuers that would not have been eligible portfolio companies before the 1998 amendment to the margin rules because they likely had a class of marginable securities outstanding.

Proposed Rule 55a–1 conditionally would permit a BDC to include in its 70% basket follow-on investments in an issuer that met the definition of eligible portfolio company under proposed Rule 2a–46 at the time of the BDC's initial investment(s) in it, but that subsequently lost its eligible portfolio company status because it listed a class of securities on an Exchange or on NASDAQ. The proposed rule incorporates the conditions set forth in Section 55(a)(1)(B), which permit a BDC to make follow-on investments in an issuer that was an eligible portfolio company at the time of the BDC's initial investment(s), but that subsequently lost its eligible portfolio company status because it issued marginable securities.

The proposed rules and their provisions are discussed in more detail below.

A. Proposed Rule 2a–46

Proposed Rule 2a–46 incorporates the requirements set forth in Sections 2(a)(46)(A) and (B) of the Investment Company Act. The proposed rule thus requires an eligible portfolio company, as defined under the rule, to be organized under the laws of, and have its principal business in, the United States. It also generally excludes from the definition any issuer that meets the definition of an investment company under Section 3(a) of the Investment Company Act or that is excluded from the definition of investment company by Section 3(c) of that Act. These requirements are intended to ensure that BDCs relying on the proposed rule will continue to invest most of their assets in domestic operating issuers.[25]

The proposed rule would further define eligible portfolio company to include either (1) any issuer that does not have any class of securities listed on an Exchange or on NASDAQ[26] or (2) any issuer that has a class of securities listed on an Exchange or on NASDAQ, but (a) that has received notice from the Exchange or NASDAQ that it does not meet the quantitative continued listing standards of the Exchange or NASDAQ and (b) does not satisfy the initial quantitative requirements for listing a class of its securities on *any* Exchange or NASDAQ.[27]

These provisions are further discussed below.

1. No Securities Listed on an Exchange or on NASDAQ

Paragraph (a) of proposed Rule 2a–46 links the definition of eligible portfolio company to whether an issuer has a class of securities listed on an Exchange or on NASDAQ.[28] As noted previously, Congress intended eligible portfolio companies to include those issuers that ''are unable to borrow through conventional sources or which do not have ready access to the public capital markets.''[29] We generally believe that most issuers that are able to list their securities on an Exchange or on NASDAQ have access to the public capital markets.[30]

In contrast, quotation mediums, such as the over-the-counter bulletin board (''OTCBB'') and Pink Sheets LLC (''Pink Sheets''), do not provide the capital formation benefits that an Exchange or NASDAQ offers to its members,[31] but

[22] Convertible debt falls within the definition of margin security if the security received upon the conversion is marginable. *See id.*

[23] It is difficult to quantify how many issuers may no longer meet the definition of eligible portfolio company as a result of the changes to the margin rules, as minimal information is available regarding which issuers have privately issued debt securities. Some industry participants, however, have informed us that, subsequent to the 1998 amendment, investments that previously were counted as part of a BDC's 70% basket were more likely to be required to be counted as part of the 30% basket.

[24] *See supra* note 18.

[25] *See supra* notes 12–14 and accompanying text.

[26] *See* proposed Rule 2a–46(a).

[27] *See* proposed Rule 2a–46(b).

[28] Under this provision, an issuer would be an eligible portfolio company if it does not have a class of securities listed on any of the New York Stock Exchange (''NYSE''), the American Stock Exchange (''Amex''), the NASDAQ National Market System or the NASDAQ SmallCap Market.

[29] *See supra* note 17.

[30] An issuer is eligible to list its securities on an Exchange or on NASDAQ if it, among other things, complies with initial quantitative listing standards. These include minimum financial requirements relating to, among other things, the issuer's total revenues, distribution, market capitalization and bid price. Listing standards serve to facilitate fair and orderly markets by screening issuers and providing listed status only to bona fide companies with sufficient float, investor base and trading interest. Once a security has been approved for initial listing, maintenance criteria allow an Exchange or NASDAQ to monitor the status and trading characteristics of that issue to ensure that it continues to meet the Exchange's or NASDAQ's standards for market depth and liquidity. Securities Act Release No. 7494 (Jan. 13, 1998) [63 FR 3032 (Jan. 21, 1998)]. 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.

[31] For example, issuers with securities traded solely through these quotation mediums do not have the same visibility and marketability benefits as issuers with securities listed on an Exchange or on NASDAQ. Few analysts cover these issuers and many databases do not include price and quotation data for their securities, making it difficult for investors to obtain information about them. Further, as a general matter, many of the securities trading on these markets are penny stocks, which are subject to heightened sales practice requirements. Section 3(a)(51) of the Securities Exchange Act [15 U.S.C. 78c(a)(51)] and Rule 3a51–1 thereunder [17 CFR 240.3a51–1] generally define ''penny stocks'' as equity securities that are not: (a) Reported securities as defined in Rule 11Aa3–1(a) under the Securities Exchange Act [17 CFR 240.11Aa3–1(a)]; (b) securities issued by an investment company registered under the Investment Company Act; (c) put or call options issued by the Options Clearing Corporation; (d) securities that have a price of five dollars or more; (e) securities that are registered or approved for registration upon notice of issuance on

serve as mediums for the over-the-counter securities market by collecting and distributing market maker quotes to subscribers. These quotation mediums do not maintain or impose listing standards or enter into listing agreements with issuers whose securities are quoted through them.[32] Moreover, most issuers that rely on these mediums for the trading of their securities do not meet the listing requirements of an Exchange or NASDAQ.[33] Thus, we believe that the proposed rule, which essentially includes in the definition of eligible portfolio company issuers that do not list their securities on an Exchange or on NASDAQ, 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.

We considered a variety of alternative approaches in proposing a standard that would capture the type of issuers that Congress intended to benefit from the SBIIA (*i.e.*, small, developing businesses or financially troubled businesses). In particular, we considered an approach based on market capitalization.[34]

It is unclear, however, what level of market capitalization would be appropriate to set as a measure of small, developing or financially troubled businesses. ''Small business'' is used to mean different things in different contexts.[35] Further, issuers that are near a specified cutoff level may be able to adjust their capital structure so that they fall below the specified level. In addition, given that an issuer's market capitalization fluctuates depending on various market and economic conditions, issuers near the cutoff may find their eligibility changing frequently over time. Finally, it is possible that defining eligible portfolio company using a market capitalization standard could result in some registered investment companies electing BDC status to take advantage of the less restrictive provisions of the Investment Company Act generally applicable to BDCs.[36] Although we would not necessarily object to such a result, we would need to engage in additional study before we could conclude that such regulatory arbitrage would be appropriate.[37]

We request comment on our proposal to link the definition of eligible portfolio company to whether an issuer has a class of securities listed on an Exchange or on NASDAQ and, in particular, the following issues:

- Does our approach adequately describe issuers that meet the purpose of the SBIIA, *i.e.*, small, developing or financially troubled businesses that do not have ready access to the public capital markets? Is there an alternative approach that would (1) better describe those issuers and (2) be more objective and workable than our proposal? For example, would linking the definition of eligible portfolio company to whether an issuer has market capitalization equal to the lowest initial quantitative listing standard of any Exchange or NASDAQ, regardless of whether it lists its securities on an Exchange or on NASDAQ, more appropriately describe the category of issuers that Congress intended to capture in 1980? Is there enough public information available so that BDCs may readily ascertain whether an issuer is an eligible portfolio company under such an alternative approach? Please include in your response a detailed description of any alternative approach that you may propose and an explanation of its benefits compared with our proposal.
- What is the likelihood that registered investment companies would determine to elect BDC status if the definition of eligible portfolio company was linked to an issuer's market capitalization? Are there investment companies that could easily reorganize themselves as BDCs to take advantage of a rule that defines eligible portfolio company based on market capitalization? Among other things, please provide information about the composition of the portfolios of registered investment companies that might determine to elect BDC status if we adopted a market capitalization test (*e.g.*, what percentage of such companies' portfolios consists of issuers that would meet the proposed rule's definition of eligible portfolio company) and whether those investment companies would be in a position to make significant managerial experience available to issuers.
- We recognize that, before the 1998 amendment to the margin rules, Section 2(a)(46)(C)(i) would have included in the definition of eligible portfolio company certain large, financially healthy issuers that had ready access to capital, but that did not have any class of marginable securities outstanding. Our proposed rules similarly would permit BDCs to invest in certain large, financially healthy issuers that choose not to list their securities on an Exchange or on NASDAQ. Please comment on whether we should modify proposed Rule 2a–46 to exclude from the definition of eligible portfolio company any issuer that would meet the initial listing standards (quantitative and qualitative) of an Exchange or NASDAQ, regardless of whether the issuer enters a listing agreement with the Exchange or NASDAQ.

2. Financially Troubled Companies

Paragraph (b) of the proposed rule would include in the definition of eligible portfolio company any issuer that has a class of securities listed on an Exchange or on NASDAQ subject to two conditions discussed below. In comparison to proposed paragraph (a), which includes as an eligible portfolio company only issuers that either have never had, or no longer have, a class of securities listed on an Exchange or on NASDAQ, proposed paragraph (b) is intended to include certain issuers that exhibit financial distress while their

an Exchange; (f) securities that are authorized or approved for authorization upon notice of issuance on NASDAQ; or (g) securities issued by companies that have net tangible assets or average annual revenues exceeding certain specified minimums. Solicited sales of penny stocks are subject to, among other things, enhanced suitability and disclosure obligations. *See* Rules 15g–1 through 15g–9 under the Securities Exchange Act [17 CFR 240.15g–1—240.15g–9], collectively known as the ''Penny Stock Rule.''

[32] In order for a security to be eligible for quotation on the OTCBB, however, its issuer must either make current filings with the Commission pursuant to Sections 13 and 15(d) of the Securities Exchange Act [15 U.S.C. 78m, 78o(d)], be a depository institution that is exempt from Securities Exchange Act filing requirements but file publicly available reports with the appropriate regulatory agency, be a registered closed-end investment company or be an insurance company that is exempt from registration under Section 12(g)(2)(G) of the Securities Exchange Act [15 U.S.C. 78*l*(g)(12)G)]. There are no such requirements with respect to issuers of securities quoted on the Pink Sheets.

[33] We recognize that, although many of the securities that are traded on the OTCBB or the Pink Sheets are small or financially troubled companies, there are a few, large, financially sound companies that have chosen not be listed on an Exchange or on NASDAQ, even though they may meet applicable listing requirements.

[34] H.R. 3170, 108th Cong. 1st Sess. (2003) (passed in the House of Representatives, Apr. 28, 2004) embodies such an approach.

[35] For example, for purposes of its compliance with the Regulatory Flexibility Act [5 U.S.C. 601 *et seq.*], and the Securities Exchange Act, the Commission has classified a securities issuer (other than an investment company) as a small business if it has total assets of $5 million or less. *See* Rule 0.0–10(a) under the Securities Exchange Act [17 CFR 240.0–10a]. Regulation S–B under the Securities Act of 1933 and the Securities Exchange Act defines a ''small business issuer'' as, among other things, an issuer that has revenues of less than $25 million, but would not include an issuer that has public float of $25 million or more. Rule 10 of Regulation S–B [17 CFR 228.10].

[36] *See supra* note 4.

[37] Certain investment companies make investments similar to those of BDCs in that they also purchase privately offered securities of small issuers. It is possible that defining eligible portfolio company using a market capitalization standard would result in investment companies deciding to elect BDC status based on the level of regulation under the Investment Company Act, instead of based on their investment objectives and the best interests of their shareholders.

securities are listed on an Exchange or on NASDAQ.

Paragraph (b) of the proposed rule is consistent with Congress's intent of providing financially troubled issuers with a more readily available source of capital.[38] Although Section 55(a)(3) of the Investment Company Act generally permits BDCs to invest in certain issuers that are experiencing financial difficulties, those issuers generally must be in dire financial straits before BDC capital will be readily available to them.[39] Paragraph (b) of the proposed rule addresses the need of other financially troubled issuers to access BDC capital more readily by including in the definition of eligible portfolio company certain issuers that are in danger of losing their listing status.

Paragraph (b) of the proposed rule is subject to two conditions. These conditions are designed to ensure that only an issuer that is at risk of having its securities delisted from the Exchange or NASDAQ, and that cannot list its securities on any other Exchange or on NASDAQ because of its inability to meet initial quantitative listing standards, falls within the definition of eligible portfolio company.

Paragraph (b)(1) of the proposed rule provides that an issuer that has securities listed on an Exchange or on NASDAQ will meet the definition of eligible portfolio company if the issuer has received a notice from the Exchange or NASDAQ that it does not satisfy a rule or standard setting forth quantitative requirements for continued listing[40] on that Exchange or on NASDAQ. We have determined that an issuer's receipt of such a notice is an early indication that an issuer is experiencing some degree of financial distress. Every year issuers are forced to delist their securities because they can no longer satisfy the minimum quantitative requirements for the continued listing of their securities.[41] Delisting is highly detrimental to an issuer and its shareholders.[42] We have therefore designed the proposed rule to permit BDCs to provide capital to issuers at risk of losing their listing status as evidenced by the issuer's receipt of a notice from an Exchange or NASDAQ stating that the issuer does not meet relevant continued quantitative listing requirements on that Exchange or NASDAQ.

Paragraph (b)(2) of the proposed rule would exclude from the definition of eligible portfolio company an issuer that otherwise meets the conditions of paragraph (b)(1) of the proposed rule if that issuer meets the initial quantitative listing requirements of *any* Exchange or NASDAQ. An issuer that is able to meet the initial quantitative listing requirements of an Exchange or NASDAQ, which generally are higher than the continued listing requirements, is not the type of issuer that Congress intended to aid through the establishment of BDCs. Thus, proposed paragraph (b)(2) is designed to preclude an issuer from qualifying as an eligible portfolio company if it is able to list its securities on one of those markets, even though its securities are delisted from another.

We request comment on our proposal to define as an eligible portfolio company an issuer whose securities are listed on an Exchange or on NASDAQ but that (1) has received a notice from the Exchange or NASDAQ that it does not satisfy the continued quantitative listing requirements of that Exchange or NASDAQ and (2) does not meet the initial quantitative listing standards on any Exchange or NASDAQ. In particular, we request comment on the following issues:

- Does the proposal capture those financially troubled issuers that could benefit from BDC financing? If not, please provide an alternative approach that would better capture these issuers but yet ensure that financially healthy issuers are not included.
- We recognize that an issuer may continue to have a class of securities listed on an Exchange or on NASDAQ long after receiving a notice that it does not satisfy a rule or standard setting forth quantitative requirements for continued listing on an Exchange or on NASDAQ.[43] Should the proposed rule be modified so that an issuer would be an eligible portfolio company for only a specified period of time after it has received such notice? If so, what would be the appropriate time period (*e.g.*, 12 months following the receipt of the notice)? Please include in your response a detailed description of any alternative that you may propose and an explanation of its benefits compared with our proposal.
- Rule 2a–46(b)(1) requires that an issuer that has a class of securities listed on an Exchange or on NASDAQ must have received a notice from the Exchange or NASDAQ that the issuer does not satisfy a quantitative listing standard of such Exchange or NASDAQ before it qualifies as an eligible portfolio company. Is there another objective factor that would serve as a clearer indicator that an issuer listed on an Exchange or NASDAQ is beginning to experience financial distress? In your response, please discuss whether you believe using that factor as a different or alternate condition under the rule would more accurately identify financially troubled issuers that are likely to lose their ability to access the public capital markets. Please also discuss the benefits and burdens of using such a factor as a condition.
- Proposed Rule 2a–46(b)(2) excludes any issuer from the definition of eligible

[38] Absent this provision, a BDC could invest in such issuers, but that investment would be counted as part of the BDC's 30% basket. *See supra* notes 5–11 and accompanying text.

[39] Section 55(a)(3) permits a BDC to count in its 70% basket securities of an issuer purchased from the issuer or certain affiliates of the issuer in specific situations demonstrating financial distress, including bankruptcy proceedings.

[40] The Exchanges and NASDAQ all have quantitative continued listing requirements with which an issuer must comply in order for its securities to remain listed. The quantitative continued listing requirements are lower than the quantitative initial listing requirements. Although actual procedures differ among the Exchanges and NASDAQ, as a general matter, all send a deficiency notice to a listed issuer upon detecting noncompliance with quantitative listing requirements, and the issuer typically is given a grace period—the amount dependent on the requirement in noncompliance—to rectify the situation before delisting proceedings begin.

The Exchanges and NASDAQ also have qualitative standards that an issuer must meet to list its securities. These standards include certain corporate governance and shareholder voting requirements, and require that the issuer's securities be registered with the Commission under Section 12(g) of the Securities Exchange Act. An issuer that is subject to delisting because the issuer did not comply with these standards would not be treated as an eligible portfolio company under the proposed rule. *But see infra* text accompanying note 44.

[41] While we cannot quantify how many additional companies would be treated as eligible portfolio companies by virtue of meeting the requirements of proposed paragraph (b)(i), we note that the percentage of issuers that ultimately were delisted as of December 31, 2003, after trading while noncompliant with their markets' quantitative standard at any time during calendar year 2003 was as follows: Amex—43% (40/94); NYSE—59% (40/68) and NASDAQ—31% (191/617). According to NASDAQ, 486 of the 617 noncompliant issuers (79%) were noncompliant with standards related to bid price. GAO Report: Securities Markets—Opportunities Exist to Enhance Investor Confidence and Improve Listing Program Oversight (April 2004), available at *www.gao.gov/cgi-bin/getrpt?GAO–04–75 at 19.*

[42] Economic studies have shown that companies whose shares are delisted face potentially higher costs of capital and operating costs and greater difficulty in obtaining financing due to the loss of suppliers, customers, employees, analyst coverage, institutional investor interest and business development opportunities. Shareholders suffer because the value of their securities typically declines and they may face significantly higher trading costs. *See, e.g.*, Ventagesh Panchapagesan and Ingrid M. Werner, *From Pink Slips to Pink Sheets: Market Quality Around Delisting From NASDAQ,* available at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=565325,* at pp. 3, 9, and 23.

[43] *See, e.g.,* Section 802.02 of the NYSE Listed Company Manual, and Section 1009 of Amex Company Guide, which provide up to 18 months for an issuer to regain compliance with continued listing standards if the Exchange accepts the issuer's plan for regaining compliance.

portfolio company if it meets the initial quantitative listing requirements of any Exchange or NASDAQ. How burdensome would it be for BDCs to determine whether an issuer meets such requirements? What public information is available that would enable BDCs to make this determination? Can we be confident that an issuer will make publicly available information that will enable BDCs to readily ascertain that the issuer is not an eligible portfolio company? If you believe that another alternative may better address the purpose of this provision, please describe that alternative in detail and explain what public information is available that would allow BDCs to readily ascertain that an issuer meets your proposal.

• We considered, but did not tie paragraph 2a–46(b) of the proposed rule to, whether an issuer may lose its listing because of its failure to comply with qualitative listing standards,[44] generally based on our belief that such standards generally are directly under the control of the issuer, and are not necessarily indicative of the issuer's ability to access the public markets in the future. Should the proposal include an issuer's failure to meet qualitative listing standards, as well as quantitative listing standards, as a measure of whether that issuer is financially troubled? If you believe that it should, please provide your analysis of why such standards objectively help to measure an issuer's financial stability.

• In light of the purpose of paragraph 2a–46(b) of the proposed rule, would it be more appropriate for this provision to be set forth as a separate exemption to Section 55(a) rather than as part of a definitional rule?

B. Proposed Rule 55a–1

In enacting the SBIIA, Congress took note of BDCs' interest in providing additional capital to issuers that had prospered after receiving BDC capital.[45] As a result, Section 55(a)(1)(B) permits a BDC to include in its 70% basket certain follow-on investments in issuers 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. Section 55(a)(1)(B) requires such investments to be acquired in private transactions from the issuer or certain of the issuer's affiliates. In addition, the section is conditioned on the BDC having at the time of the follow-on investment, and subsequently maintaining, a significant investment presence in the issuer.[46]

Proposed Rule 55a–1 would mirror the approach established in Section 55(a)(1)(B). It would conditionally permit a BDC to make follow-on investments in certain issuers that met the definition of eligible portfolio company under proposed Rule 2a–46 when the BDC made its initial investment(s) in the issuer, but that do not meet that definition at the time of the follow-on investment because the issuer subsequently listed a class of securities on an Exchange or on NASDAQ.[47] As in follow-on investments under Section 55(a)(1)(B), the proposed rule would permit BDCs to purchase the securities only in non-public offerings from the issuer or certain of its affiliates.

We request comment on our proposal to permit a BDC to include in its 70% basket certain follow-on investments in an issuer that no longer meets the definition of eligible portfolio company because it has a class of securities listed on an Exchange or on NASDAQ and, in particular, on the following issues:

• We have not proposed any time restriction on follow-on investments under the proposed rule. Should we modify the proposed rule to apply a time restriction to such follow-on investments (*e.g.*, 12 months following the date of the issuer's receipt of the notice referred to in Rule 2a–46(b)(1))? Please address whether any such a restriction would interfere with a BDC's ability to manage its investments in the best interests of shareholders and consistent with the purposes and policies of the Act. Would such a restriction provide necessary discipline to the markets by providing an incentive to issuers to delist their securities promptly?

• If you believe that restricting some follow-on investments is appropriate, please provide us with a description of those restrictions, including your analysis of the benefit that such restrictions would provide, and to whom those benefits would inure.

III. General Request for Comment

We request comment on the rules proposed in this Release and on other matters that might have an effect on our proposals. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, we also request information regarding the potential impact of the proposed rules on the economy on an annual basis. Commenters should provide empirical data to support their views.

IV. Cost-Benefit Analysis

We are sensitive to the costs and benefits that result from our rules. Proposed Rules 2a–46 and 55a–1 seek to realign the definition of eligible portfolio company under the Investment Company Act, and investment activities of BDCs, with the original purpose of the SBIIA. Proposed Rule 2a–46(a) would define eligible portfolio company with reference to whether an issuer has securities that are listed on an Exchange or on NASDAQ. Proposed Rule 2a–46(b) would also include in the definition of eligible portfolio company certain financially troubled issuers that are listed on an Exchange or on NASDAQ but are in danger of losing their listing status. Proposed Rule 55a–1 would permit BDCs to make follow-on investments in issuers that meet the new definition, subject to certain conditions.

We have identified certain costs and benefits that may result from the proposed rules. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding these or any additional costs and benefits.

A. Benefits

The proposed rules would benefit small, developing and financially troubled companies by making them more accessible to BDC financing. These companies often need capital for continued development and growth but are unable to borrow money through conventional sources or do not have ready access to the capital markets.

As discussed previously, Congress established BDCs in 1980 in order to promote the flow of capital and provide assistance to these small, developing or financially troubled companies. A significant number of such issuers, however, may have lost their eligible portfolio company status because, as a result of a 1998 amendment to the Federal Reserve Board's margin rules, they have a class of securities outstanding that are now considered to

[44] *See supra* note 40.

[45] House Report at 23.

[46] Section 55(a)(1)(B)(i) requires BDCs making follow-on investments in an issuer that no longer meets the definition of eligible portfolio company because it issued marginable securities to own, at the time of the follow-on investment, at least 50% of (1) the greatest number of equity securities of such issuer, including securities convertible into or exchangeable for such securities and (2) the greatest amount of certain debt securities of such issuer held by the BDC at any time during the period when such issuer was an eligible portfolio company. Section 55(a)(1)(B)(ii) requires a BDC that makes such a follow-on investment to be one of the twenty largest holders of record of the issuer's outstanding voting securities.

[47] Proposed Rule 55a–1 incorporates by reference the conditions set forth in Section 55(a)(1)(B). *See supra* note 46.

be marginable. Accordingly, BDCs are currently required to include in their 30% basket—rather than in their 70% basket—any investment in these issuers notwithstanding the fact that they are the type of issuers that Congress intended to benefit from BDC financing.[48] Proposed Rule 2a–46 is intended to recapture the type of issuers that Congress originally intended to make eligible for BDC investment as part of a BDC's 70% basket. The proposed rule would also benefit certain financially troubled issuers that would not have been eligible portfolio companies before the 1998 amendment to the margin rules because they likely had a class of marginable securities outstanding. Proposed Rule 55a–1 would provide additional benefits to certain issuers that meet the definition of eligible portfolio company under proposed Rule 2a–46 by allowing BDCs to make follow-on investments in such companies under certain conditions, notwithstanding the fact that they no longer meet the definition of eligible portfolio company because the issuer subsequently listed a class of securities on an Exchange or on NASDAQ.

Although it is difficult to quantify how many issuers would benefit under the proposed rules, the Office of Economic Analysis has estimated that 60% of public issuers currently do not have securities that trade on an Exchange or on NASDAQ, and thus would meet the definition of eligible portfolio company in proposed Rule 2a–46(a). Even more public issuers should qualify as eligible portfolio companies by virtue of meeting the requirements of proposed paragraph (b) of that rule, although we cannot quantify how many additional issuers this would be.[49]

The proposed rules would benefit BDCs by expanding the universe of investments that may be included in their 70% basket. Industry participants have informed us that the 1998 amendment to the margin rules has substantially reduced the number of issuers which BDCs may include in their 70% basket and accordingly has adversely affected their business operations.

B. Costs

The proposed rules might impose certain administrative compliance costs on BDCs. Under Proposed Rule 2a–46, a BDC would need to determine, prior to investing in an issuer, whether the issuer has a class of securities listed on an Exchange or on NASDAQ. If the issuer has a class of securities listed on an Exchange or on NASDAQ, a BDC could invest in the issuer only if the BDC determines that the issuer (1) has received a notice from the Exchange or NASDAQ that it does not satisfy a rule or standard setting forth quantitative requirements for continued listing on that Exchange or on NASDAQ and (2) does not meet the initial quantitative listing requirements of any Exchange or NASDAQ. We expect the costs involved in a BDC complying with these requirements to be minimal. Furthermore, it is our understanding that these costs are similar to the types of compliance costs that a BDC currently undertakes when it invests in an issuer. We do not anticipate that the proposed rule would impose any costs on issuers.

We also expect that the costs involved in a BDC complying with the requirements of Proposed Rule 55a–1 to be minimal. Proposed Rule 55a–1 would permit a BDC to include in its 70% basket follow-on investments in an issuer that met the definition of eligible portfolio company under Proposed 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 because the issuer subsequently listed a class of securities on an Exchange or on NASDAQ. A BDC generally may make follow-on investments under the proposal only if, at the time of the follow-on investment, the BDC owns at least 50% of (1) the greatest number of equity securities of such issuer, including securities convertible into or exchangeable for such securities and (2) the greatest amount of certain debt securities of such issuer held by the BDC at any time during the period when such issuer was an eligible portfolio company. In addition, the proposal would require a BDC that makes such a follow-on investment to be one of the twenty largest holders of record of the issuer's outstanding voting securities. 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% basket certain follow-on investments in issuers 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 issuers that had lost their eligible portfolio company status because they had issued marginable securities. We also do not anticipate that the proposed rule would impose any costs on issuers.

C. Request for Comments

We request comment on the potential costs and benefits identified in the proposal and any other costs and benefits that may result from the proposed rules. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, the Commission also requests information regarding the impact of the proposed rules on the economy on an annual basis. Commenters are requested to provide data to support their views.

V. 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, consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.[50]

As discussed above, the two proposed rules would expand the definition of eligible portfolio company set forth in Section (2)(a)(46) of the Investment Company Act and provide for certain follow-on investments in issuers meeting the expanded definition. We intend for these new rules to promote efficiency by realigning the definition of eligible portfolio company with the purpose of the SBIIA.

We do not anticipate that these proposed rules would harm competition. The proposed rules are designed to recapture within the definition of eligible portfolio company those issuers originally intended to be funded by BDCs under the SBIIA. BDCs would be able to take advantage of the new rules equally. Moreover, the proposed rules would not affect investment opportunities generally available to other investors, including registered investment companies. The proposed rules also could foster greater competition among small, developing or financially troubled issuers for BDCs' initial and follow-on investments of capital and provision of managerial assistance. Thus, the proposed rules are designed to enhance competition.

We anticipate that the proposed new rules would promote capital formation by increasing the flow of capital from BDCs to small, developing businesses or financially troubled businesses. Thus,

[48] *See* Section I of this Release.

[49] *But see supra* note 41.

[50] 15 U.S.C. 80a–2(c).

we anticipate that the proposed new rules would promote capital formation.

We request comment on whether the proposed new rules will affect efficiency, competition and capital formation. Comments will be considered by the Commission in satisfying its responsibilities under Section 2(c) of the Investment Company Act. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

VI. 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.*].

VII. Initial Regulatory Flexibility Analysis

This Initial Regulatory Flexibility Analysis (''IRFA'') has been prepared in accordance with 5 U.S.C. 603. It relates to proposed new Rules 2a–46 and 55a–1, both under the Investment Company Act, which would modernize the definition of eligible portfolio company set forth under that Act.

A. Reasons for the Proposed Action

As described more fully in Section I of this Release, the proposed rules are designed to recapture the type of issuers that Congress originally intended to include as eligible portfolio companies when it established BDCs in 1980, but may have lost their eligible portfolio company status as a result of the 1998 amendment to the Federal Reserve Board's margin rules.

B. Objectives of the Proposed Action

As described more fully in Section II of this Release, the objectives of the proposed rules are to realign 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.

C. Legal Basis

Rule 2a–46 is being proposed pursuant to the authority set forth in Section 2(a)(46)(C)(iv) [15 U.S.C. 80a–2(a)(46)(c)(iv)] of the Investment Company Act. Rule 55a–1 is being proposed pursuant to the authority set forth in Section 6(c) [15 U.S.C. 80a–6(c)] of the Investment Company Act and Section 55(a)(1) [15 U.S.C. 80a–54(a)(1)] of the Investment Company Act. Both rules are also being proposed pursuant to the authority set forth in Section 38(a) [15 U.S.C. 80a–37(a)] of the Investment Company Act.

D. Small Entities Subject to the Rule

The proposed rules affect both BDCs and issuers 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.[51] There are 64 BDCs, of which 46 are small entities. An issuer 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.[52] We estimate that there are approximately 2,500 issuers, other than investment companies, that may be considered small entities.

As discussed in this Release, the proposed rules are intended to benefit small, developing and financially troubled companies by making BDC capital more accessible to them. The proposed rules would also benefit BDCs, including those that are small entities, by expanding their universe of investment opportunities. We have no reason to expect that those BDCs and issuers that are small entities for purposes of the Regulatory Flexibility Act would be disproportionately affected by the proposed rules. We request comment on the effects and costs of the proposed rules on small entities.

E. Reporting, Recordkeeping and Other Compliance Requirements

The proposed rules do not include any new reporting or recordkeeping requirements on BDCs or on issuers. While the proposed rules would not impose any compliance requirements on issuers, they would impose minimal compliance requirements on all BDCs, including small entities. Under Proposed Rule 2a–46, a BDC, prior to investing in an issuer, must determine whether that issuer has listed a class of its securities on an Exchange or on NASDAQ. In the event that the issuer does have securities listed on an Exchange or on NASDAQ, the BDC may only invest in the issuer if the BDC determines that the issuer (1) has received notice that it does not meet the quantitative continued listing requirements of the Exchange or NASDAQ and (2) does not satisfy the initial quantitative requirements for listing a class of its securities on any Exchange or on NASDAQ. We believe that all BDCs, including those that are small entities, already make similar types of determinations when considering whether to invest in an issuer.

Proposed Rule 55a–1 would permit a BDC to include in its 70% basket follow-on investments in an issuer that met the definition of eligible portfolio company under Proposed 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 because the issuer subsequently listed a class of securities on an Exchange or on NASDAQ. A BDC generally may make follow-on investments under the proposal only if, at the time of the follow-on investment, the BDC owns at least 50% of (1) the greatest number of equity securities of such issuer, including securities convertible into or exchangeable for such securities and (2) the greatest amount of certain debt securities of such issuer held by the BDC at any time during the period when such issuer was an eligible portfolio company. In addition, the proposal would require a BDC that makes such a follow-on investment to be one of the twenty largest holders of record of the issuer's outstanding voting securities. 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% basket certain follow-on investments in issuers 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 issuers that had lost their eligible portfolio company status because they had issued marginable securities.

F. Duplicative, Overlapping, or Conflicting Federal Rules

There are no rules that duplicate, overlap, or conflict with the proposed rules.

G. Significant Alternatives

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

[51] 17 CFR 270.0–10.

[52] 17 CFR 230.157; 17 CFR 240.0–10.

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 proposed 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 proposed rules do not impose any reporting requirements on BDCs or on issuers. In addition, the proposed rules do not impose any compliance requirements on issuers. While the proposed rules do impose some compliance requirements on BDCs, these requirements are designed to insure that BDCs invest primarily in those issuers that Congress intended them to invest in when it established BDCs in 1980. We believe at this time that these requirements impose minimal burdens on BDCs. Furthermore, we believe that to comply with these requirements, a BDC would be required to engage in the types of activities that they already undertake before making most investments.

We also believe that clarifying, consolidating, or simplifying the compliance requirements under the proposed rules for small entities is inappropriate. As discussed above, the proposed rules do not impose any compliance requirements on issuers. Although the proposed rules do impose some compliance requirements on BDCs, as discussed above, these requirements, which we believe impose minimal burdens on BDCs, are designed to insure that BDCs invest primarily in those issuers that Congress intended them to invest in when it established BDCs in 1980.

We do not believe that the use of performance rather than design standards is feasible. The proposed rules are designed to recapture the type of issuers that Congress originally intended to include as eligible portfolio companies when it established BDCs in 1980—small developing or financially troubled companies that do not have access to capital—but may have lost their eligible portfolio company status as a result of the 1998 amendment to the Federal Reserve Board's margin rules. They are also intended to ensure that BDCs do not invest primarily in those large, established companies that Congress did not intend to receive the benefits of BDC investment.

Finally, it would be inappropriate to exempt small entities from coverage of the proposed rules. The proposed rules are intended to benefit BDCs, including those that are small entities, by expanding the universe of their investment opportunities. The proposed rules are also intended to benefit small, developing and financially troubled issuers, including those that are small entities, by making BDC capital more readily available to them. Exempting small entities from all or part of the proposed rules would be contradictory to the purpose of the proposed rules.

H. Solicitation of Comments

We encourage the submission of comments with respect to any aspect of this IRFA. Comment is specifically requested on the number of small entities that would be affected by the proposed rules, and the likely impact of the proposals on small entities. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. These comments will be considered in connection with the adoption of the proposed rules and will be reflected in the Final Regulatory Flexibility Analysis.[53]

VIII. Statutory Authority

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

List of Subjects in 17 CFR Part 270

Investment companies, Reporting and recordkeeping requirements, Securities.

Text of Proposed Rules

For reasons set forth in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be 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.

* * * * *

[53] Comments on the IRFA will be placed in the same public file that contains comments on the proposed rules themselves.

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:

(a) Does not have any class of securities listed on a national securities exchange or on an automated interdealer quotation system of a national securities association; or

(b) Has a class of securities listed on a national securities exchange or on an automated interdealer quotation system of a national securities association, but that:

(1) Has received a notice from the national securities exchange or national securities association (or facility thereof) that it does not satisfy a rule or standard setting forth quantitative requirements for continued listing on the exchange or association; and

(2) Does not satisfy the initial quantitative requirements for listing any class of its securities on any national securities exchange or on an automated interdealer quotation system of a national securities association.

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 section 2(a)(46)(A) and (B) of the Act (15 U.S.C. 80a–2(a)(46)(A) and (B)), but is not an eligible portfolio company because it has a class of securities that is listed on a national securities exchange or on an automated interdealer quotation system of a national securities association, and the BDC 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: November 1, 2004.

By the Commission.

Jill M. Peterson,

Assistant Secretary.

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