

BUSINESS DEVELOPMENT COMPANIES—TRANSACTIONS WITH CERTAIN SECOND-TIER AFFILIATES

The Investment Company Act of 1940 (“1940 Act”) places restrictions on transactions between investment companies regulated under the 1940 Act, including business development companies (“BDCs”), and their affiliated persons¹ and affiliated persons of such persons (“second-tier affiliates”). These restrictions are designed to protect such investment companies from undue influence and overreaching.

The staff is issuing this guidance in response to a public inquiry that the staff has received concerning a BDC’s co-investment transactions. The guidance is meant to assist BDCs and their counsel in determining the restrictions that apply to a BDC’s co-investment transactions with certain second-tier affiliates, specifically, limited partners of a partnership that is an affiliated person of the BDC.

Background

With respect to BDCs, the 1940 Act distinguishes between transactions involving “close affiliates”² and those involving “remote affiliates.”³ Certain transactions between a close affiliate and a BDC are prohibited.⁴ Certain transactions between a remote affiliate and a BDC are permitted subject to approval by a required majority of the BDC’s directors as specified in the 1940 Act.⁵ A second-tier affiliate of a BDC may be a close affiliate or a remote affiliate, depending on various factors.

The Specific Question

The staff was recently asked whether a certain second-tier affiliate of a BDC may be treated as a remote affiliate in the following situation:

- The BDC and a private fund organized as a limited partnership (“Private Fund”) are under common control—the BDC’s investment adviser (“Adviser”) controls the BDC and either is the Private Fund’s general partner or controls, is controlled by or



is under control with the general partner.⁶ Because the general partner controls the Private Fund, the Private Fund is under common control with the BDC. The Private Fund is therefore a close affiliate of the BDC.⁷

- One of the limited partners of the Private Fund (“Limited Partner”) is an affiliated person of the Private Fund because the Limited Partner (1) is a partner of the Private Fund and (2) owns 5% or more (but 25% or less) of the Private Fund’s outstanding voting securities.⁸ Because the Limited Partner, as a partner of the Private Fund, is a close affiliate of the Private Fund, and the Private Fund is a close affiliate of the BDC, the Limited Partner is also a close affiliate of the BDC.⁹ Accordingly, the Limited Partner is prohibited from engaging in certain transactions with the BDC under the 1940 Act.
- Under the same facts, if the Private Fund were organized as a corporation, the Limited Partner would be a shareholder of the Private Fund and, as such, a remote, rather than a close, affiliate of the BDC.¹⁰

The staff was asked whether the Limited Partner may be viewed as a shareholder of the Private Fund and therefore as a remote affiliate of the BDC that may engage in transactions with the BDC subject to the approval of a required majority of the BDC’s directors. Prior Commission and staff positions have recognized that, in many circumstances, limited partners and shareholders should be treated comparably.¹¹ Similarly, under the facts presented above, where the Limited Partner is a close affiliate of the BDC solely because the Private Fund is organized as a limited partnership and the Limited Partner is seeking to co-invest with the BDC, the staff believes that the Limited Partner may be treated as if it were a shareholder of the Private Fund for purposes of determining whether it is a close or a remote affiliate of the BDC.

Endnotes

- 1 Section 2(a)(3) of the 1940 Act defines an “affiliated person” of another person as: (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5% or more of the outstanding voting securities of such other person; (B) any person 5% or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

- 2 “Close affiliates” are persons that fall within section 57(b) of the 1940 Act. Such persons generally include (with certain exceptions): (1) any director, officer, employee or member of a BDC’s advisory board or any person who is, within the meaning of section 2(a)(3)(C) of the 1940 Act, an affiliated person of any of these persons; and (2) any investment adviser or promoter of, general partner in, principal underwriter for, or any person directly or indirectly either controlling, controlled by, or under common control with, a BDC, or any person who is, within the meaning of Sections 2(a)(3)(C) or (D) of the 1940 Act, an affiliated of any of these persons.
- 3 “Remote affiliates” are persons that fall within section 57(e) of the 1940 Act. Such persons generally include (with certain exceptions): (1) any person (A) who is, within the meaning of Section 2(a)(3)(A) of the 1940 Act, an affiliated person of a BDC; (B) who is an executive officer or a director of, or general partner in, any such affiliated person; or (C) who directly or indirectly either controls, is controlled by, or is under common control with, such affiliated person; and (2) any person who is an affiliated person of a director, officer, employee, investment adviser, member of an advisory board or promoter of, principal underwriter for, general partner in, or an affiliated person of any person directly or indirectly either controlling or under common control with a BDC.
- 4 See Section 57(a) of the 1940 Act.
- 5 See Section 57(f) of the 1940 Act. Section 57(o) of the 1940 Act defines “required majority,” when used with respect to the approval of a proposed transaction, plan, or arrangement, as both a majority of a BDC’s directors or general partners who have no financial interest in such transaction, plan, or arrangement and a majority of such directors or general partners who are not interested persons of the BDC.
- 6 Under section 2(a)(9) of the 1940 Act, a person has control over a company if the person has the power to exercise a controlling influence over the management or policies of the company, unless the power is solely the result of an official position with the company. Section 2(a)(9) also provides, among other things, that any person who does not own more than 25% of the outstanding voting securities of a company is presumed not to control the company.
- 7 As noted above, under section 57(b)(2) of the 1940 Act, a close affiliate generally includes, among others, any person directly or indirectly controlling, controlled by, or under common control with the BDC, subject to certain exceptions.

- 8 Because the Limited Partner owns 25% or less of the Private Fund's outstanding voting securities, the Limited Partner is presumed not to control the Private Fund under section 2(a)(9) of the 1940 Act. The situation presented assumes that the Limited Partner does not control the Private Fund and is therefore not an affiliated person of the Private Fund by virtue of section 2(a)(3)(C) of the 1940 Act. The Limited Partner is, however, an affiliated person of the Private Fund by virtue of Sections 2(a)(3)(A) and 2(a)(3)(D) of the 1940 Act.
- 9 If the Adviser is also the Private Fund's general partner, then under section 57(b)(2) of the 1940 Act, the Limited Partner also would be a close affiliate of the BDC because the Limited Partner is a copartner of the Adviser, which is a close affiliate of the BDC. In either situation, however, under the facts presented, the Limited Partner is a close affiliate of the BDC solely because the Private Fund is organized as a limited partnership.
- 10 The Limited Partner would not be a close affiliate of the BDC under section 57(b) of the 1940 Act because it would not be an affiliated person of the Private Fund by virtue of section 2(a)(3)(D) of the 1940 Act. The Limited Partner would be a remote affiliate of the BDC, however, under section 57(e)(2) of the 1940 Act, because, as a shareholder that owns 5% or more (but 25% or less) of the Private Fund's outstanding voting securities, the Limited Partner would be an affiliated person of the Private Fund, which in turn is a person under common control with the BDC.
- 11 See Rule 2a3-1 under the 1940 Act (limited partners of a registered investment company or a BDC, organized as a limited partnership and relying on Rule 2a19-2 under the 1940 Act, are not deemed to be affiliated persons of the investment company or BDC solely by virtue of their status as limited partners). See *also* First Financial Fund, SEC Staff No-Action Letter (June 5, 1997) (stating that the staff would not recommend enforcement action to the Commission if certain registered investment companies do not treat a named director of each of the investment companies as an "interested person" under section 2(a)(19) of the 1940 Act despite the director owning limited partnership interests in private funds whose general partner is an affiliated person of the investment companies' investment adviser).

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