

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Part 270**

**[Release No. IC-28266; 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 an amendment to a rule under the Investment Company Act of 1940 to 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 amendment expands the definition of eligible portfolio company to include certain companies that list their securities on a national securities exchange.

**EFFECTIVE DATE:** July 21, 2008

**FOR FURTHER INFORMATION CONTACT:** Rochelle Kauffman Plesset, Senior Counsel, Office of Chief Counsel, Division of Investment Management, (202) 551-6840, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5030.

**SUPPLEMENTARY INFORMATION:** The Commission today is adopting amendments to Rule 2a-46 [17 CFR 270.2a-46] under the Investment Company Act of 1940 [15 U.S.C. 80a].<sup>1</sup>

---

<sup>1</sup> The amendments were proposed in Definition of Eligible Portfolio Company under the Investment Company Act of 1940, Investment Company Act Release No. 27539 (Oct. 25, 2006) [71 FR 64093 (Oct. 31, 2006)] (“Reproposing Release”).

## TABLE OF CONTENTS

- I. EXECUTIVE SUMMARY**
- II. BACKGROUND**
- III. DISCUSSION**
  - A. Rule 2a-46(b)**
  - B. Use of Standard Based on Market Capitalization**
  - C. Dollar Level of Standard**
- IV. COST-BENEFIT ANALYSIS**
- V. CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION**
- VI. PAPERWORK REDUCTION ACT**
- VII. FINAL REGULATORY FLEXIBILITY ANALYSIS**
- VIII. STATUTORY AUTHORITY**
- IX. TEXT OF RULE**

### **I. EXECUTIVE SUMMARY**

A BDC is a closed-end investment company that Congress established for the purpose of making capital more readily available to certain types of companies. Under the Investment Company Act (“Investment Company Act” or “Act”), a BDC must invest at least 70 percent of its assets in “eligible portfolio company” securities and certain other securities. Rule 2a-46 defines the term eligible portfolio company to include any company whose securities are not listed on a national securities exchange (“Exchange”).<sup>2</sup> When we adopted Rule 2a-46 in 2006, we also requested comment on whether to further expand the definition to include Exchange-listed companies that have (i) less than \$75 million in public float or (ii) less than \$150 million in market capitalization or less than \$250 million in market capitalization.<sup>3</sup> Today we are amending Rule 2a-46 to expand the definition of eligible portfolio company to include Exchange-listed companies that have less than \$250 million in market capitalization.

---

<sup>2</sup> Definition of Eligible Portfolio Company under the Investment Company Act of 1940, Investment Company Act Release No. 27538 (Oct. 25, 2006) [71 FR 64086 (Oct. 31, 2006)] (“Adopting Release”).

<sup>3</sup> See Reproposing Release, supra note 1.

## II. BACKGROUND

Congress established BDCs as a new category of closed-end investment companies when it enacted the Small Business Investment Incentive Act (“SBIIA”) in 1980.<sup>4</sup> Congress intended that BDCs would make capital more readily available to certain types of companies.<sup>5</sup> To accomplish this purpose, 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 (“70% basket”) are invested in securities of certain specific types of companies, including “eligible portfolio companies.”<sup>6</sup>

The Investment Company Act defines eligible portfolio company to include any domestic operating company<sup>7</sup> that does not have a class of securities with respect to which a member of an Exchange, broker, or dealer may extend margin credit pursuant to rules promulgated by the Federal Reserve Board under Section 7 of the Securities Exchange Act of 1934 (“Exchange

---

<sup>4</sup> Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2274 (1980) (codified at scattered sections of the United States Code).

<sup>5</sup> See generally H.R. Rep. No. 1341, 96<sup>th</sup> Cong., 2d Sess. 21 (1980) (“House Report”).

<sup>6</sup> See Section 2(a)(46) of the Investment Company Act (statutory definition of eligible portfolio company) [15 U.S.C. 80a-2(a)(46)]. See also Section 55(a) of the Investment Company Act (regulating the activities of BDCs) [15 U.S.C. 80a-54(a)]. Among other things, the 70% basket may include securities of eligible portfolio companies purchased in transactions not involving any public offering, securities of eligible portfolio companies already controlled by the BDC without regard to the nature of the offering, and securities of certain financially distressed companies that do not meet the definition of eligible portfolio company and that are purchased in transactions not involving any public offering. See Section 55(a).

<sup>7</sup> Section 2(a)(46) of the Investment Company Act defines eligible portfolio company to include any company that satisfies the criteria set forth in each of Section 2(a)(46)(A) and Section 2(a)(46)(B) in addition to one of the three criteria set forth in Section 2(a)(46)(C). Section 2(a)(46)(A) defines eligible portfolio company to include any company organized under the laws of, and with its principal place of 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.

Act”).<sup>8</sup> At the time that 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 for determining whether an issuer has ready access to the securities markets.”<sup>9</sup> 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.<sup>10</sup> 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>11</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

---

<sup>8</sup> Section 2(a)(46)(C)(i). See also Section 2(a)(46)(C)(ii) (defines eligible portfolio company to include companies that are controlled by the investing BDC or certain of its affiliates); Section 2(a)(46)(C)(iii) (defines eligible portfolio company to include certain very small companies).

<sup>9</sup> House Report at 31. The House Report also indicated that Section 2(a)(46)(C)(i) was “intended to cover companies which are unable to borrow money through conventional sources or which do not have ready access to the public capital markets.” Id. at 30. In 1980, the Federal Reserve Board periodically published lists of each company that had a class of securities that was marginable under its rules. Companies that were not listed as having a class of marginable securities qualified as eligible portfolio companies.

<sup>10</sup> See House Report at 31.

<sup>11</sup> 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 of the SBIIA 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.” 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.” See House Report at 31. In providing the Commission with rulemaking authority, Congress noted “[a]mong the objective factors which the Commission may consider in [rulemaking] proceedings are the size of such companies, the extent of their public ownership, and their operating history as going concerns and public companies.” Id.

amended its definition of margin security to include all equity securities that trade on an Exchange or are listed on the NASDAQ Stock Market, and most debt securities. This amendment had the result of significantly reducing the companies that qualify as eligible portfolio companies under Section 2(a)(46) of the Investment Company Act.<sup>12</sup>

In 2006, we adopted two rules, Rules 2a-46 and 55a-1 under the Act, to address the impact of the Federal Reserve Board's amendment to its definition of margin security on the definition of eligible portfolio company.<sup>13</sup> Rule 2a-46 defines eligible portfolio company to include all domestic operating companies<sup>14</sup> whose securities are not listed on an Exchange.<sup>15</sup> Rule 55a-1 conditionally permits a BDC to continue to invest in any company that qualified as an eligible portfolio company under Rule 2a-46 when the BDC made its initial investment(s) in it, but that subsequently does not meet the definition of eligible portfolio company because it no longer meets the requirements of that rule.<sup>16</sup>

When we adopted Rules 2a-46 and 55a-1, we also proposed to amend Rule 2a-46 to expand the definition of eligible portfolio company to include certain public domestic operating companies that list their securities on an Exchange.<sup>17</sup> This proposal was designed to address

---

<sup>12</sup> Securities Credit Transactions; Borrowing By Brokers and Dealers, 63 FR 2805 (1998) (adopting final rule amendment). As a result of these amendments, companies that would have been considered eligible portfolio companies in 1980 may no longer meet that definition. See 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”) at nn.19-24.

<sup>13</sup> See Adopting Release, supra note 2.

<sup>14</sup> Rule 2a-46 incorporates the provisions of Sections 2(a)(46)(A) and (B). See supra note 7.

<sup>15</sup> 17 CFR 270.2a-46.

<sup>16</sup> 17 CFR 270.55a-1.

<sup>17</sup> See Reproposing Release, supra note 1.

concerns that part of the rule (proposed in 2004, but not adopted<sup>18</sup>) would be unworkable and too narrow.<sup>19</sup>

In the Reproposing Release, we requested comment on alternatives that would expand the definition of eligible portfolio company to include domestic operating companies with securities listed on an Exchange. We asked whether we should expand the definition to include any such company with (i) a public float of less than \$75 million or (ii) market capitalization of less than \$150 million or market capitalization of less than \$250 million.<sup>20</sup> We explained that the \$75 million public float standard incorporates the size-based standard used in Form S-3 and Rule 12b-2 which the Commission has used to delineate between small, unseasoned companies, and larger seasoned companies whose securities are listed on an Exchange.<sup>21</sup> We explained that the market capitalization alternatives are similar to definitions of “micro-cap” company used generally by market participants.<sup>22</sup> We also noted that some who had commented on Rule 2a-46 when it was initially proposed had stated that companies with market capitalizations in this range generally have limited (if any) analyst coverage, have lower trading volume and are owned by fewer institutional investors than companies with higher market capitalizations.<sup>23</sup> These commenters concluded that such companies have difficulty accessing the public capital

---

<sup>18</sup> See 2004 Proposing Release, supra note 12 (proposed a definition of eligible portfolio company that would have included certain financially-troubled Exchange-listed companies).

<sup>19</sup> For example, some commenters had stated that the proposed rule would not include some small companies that list their securities on an Exchange but that nevertheless may have difficulties accessing conventional sources of capital and raising additional capital on the public markets. See Reproposing Release, supra note 1 at n.12 and accompanying text.

<sup>20</sup> See Reproposing Release, supra note 1.

<sup>21</sup> See, e.g., Form S-3 [17 CFR 239.13]; Rule 12b-2 under the Exchange Act [17 CFR 240.12b-2].

<sup>22</sup> See Reproposing Release, supra note 1 at nn.38-40 and accompanying text.

<sup>23</sup> Id. at nn.34-43 and accompanying text.

markets.<sup>24</sup>

We received letters from fifteen commenters (including eight BDCs and one legal counsel to BDCs).<sup>25</sup> Fourteen commenters favored the \$250 million market capitalization standard.<sup>26</sup> Several commenters specifically noted that companies meeting such a standard “often have difficulty accessing traditional capital sources.”<sup>27</sup> Commenters also stated that the \$250 million market capitalization standard is similar to what most market participants use to identify micro-cap companies, and that these companies have less analyst coverage, institutional ownership and lower trading volume.<sup>28</sup>

In addition, in support of the \$250 million market capitalization standard, one commenter provided information about public companies that have received financing over the past several

---

<sup>24</sup> E.g., comments of Williams & Jensen (Feb. 17, 2006); comments of Representatives Sue Kelly and Nydia Velázquez (Jan. 5, 2005) (commenting on the 2004 Proposing Release).

<sup>25</sup> The eight BDCs were Allied Capital Corp., American Capital Strategies Ltd., Apollo Investment Corp., Ares Capital Corp., Gladstone Management, Harris & Harris Group, Inc., MCG Capital Corp. and NGP Capital Resources Company. We also received comments from two trade associations (The Financial Roundtable and U.S. Chamber of Commerce), one legal counsel to BDCs (Williams & Jensen), one investment banker (Ferghana Partners Inc.), one investment adviser (ThinkEquity Partners LLC) and two individuals. These 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), and may be viewed at [www.sec.gov/rules/proposed/s73704.shtml#27539](http://www.sec.gov/rules/proposed/s73704.shtml#27539).

<sup>26</sup> One commenter did not address this issue. Comments of Kathryn Ellis (Nov. 26, 2006). In addition, commenters generally disagreed with the adoption of a public float standard. See infra Section III.B.

Two commenters also suggested that we include a provision that would in the future adjust the standard that we adopt today to reflect inflation. Comments of American Capital Strategies Ltd. (Dec. 24, 2006); comments of Apollo Investment Corp. (Jan. 2, 2007). We did not propose such a provision and therefore have not included it in Rule 2a-46.

<sup>27</sup> See, e.g., comments of Apollo Investment Corp. (Jan. 2, 2007); comments of Gladstone Management (Nov. 2, 2006). See also comments of Allied Capital Management (Dec. 21, 2006) (“Public companies with a market capitalization of up to \$250 million . . . often have trouble accessing the traditional capital markets despite the fact that their shares are listed on an exchange.”).

<sup>28</sup> See, e.g., comments of Gladstone Management (Nov. 2, 2006); comments of American Capital Strategies Ltd. (Dec. 24, 2006); comments of Apollo Investment Corp. (Jan. 2, 2007).

years and the types of financing that they have received.<sup>29</sup> Specifically, the commenter submitted information regarding public companies that were able to access the public markets, either by engaging in initial public offerings or by issuing follow-on equity and debt financing.<sup>30</sup> The commenter also provided information regarding the public companies that had obtained capital through private investment transactions.<sup>31</sup> In addition, the commenter provided information regarding the average institutional leveraged loan size and average high yield issuance size.<sup>32</sup> Based on this information, the commenter concluded that companies with less than \$250 million market capitalization are having difficulty accessing traditional capital sources.<sup>33</sup> Accordingly, the commenter urged the Commission to adopt the \$250 million market capitalization standard.<sup>34</sup>

### **III. DISCUSSION**

#### **A. Rule 2a-46(b)**

After carefully considering the comments received in response to both the Reproposing Release and the 2004 Proposing Release, we are amending Rule 2a-46 to include new paragraph (b).<sup>35</sup> Rule 2a-46(b) expands the definition of eligible portfolio company to include any domestic operating company that has a class of securities listed on an Exchange and that has a

---

<sup>29</sup> Comments of Williams & Jensen (Apr. 19, 2007, May 30, 2007). This commenter also provided information regarding the investment practices of BDCs. The commenter, focusing on five of the largest BDCs, provided a description of each BDC's investment focus, the number of companies in each BDC's portfolio, and the number of individual investments each BDC made that was greater than \$100 million. The commenter also provided the average revenue of the portfolio companies that are held by four BDCs. Comments of Williams & Jensen (May 30, 2007).

<sup>30</sup> Comments of Williams & Jensen (Apr. 19, 2007).

<sup>31</sup> Comments of Williams & Jensen (May 30, 2007).

<sup>32</sup> Id.

<sup>33</sup> Comments of Williams & Jensen (Apr. 19, 2007, May 30, 2007).

<sup>34</sup> Comments of Williams & Jensen (Feb. 17, 2006, Apr. 19, 2007, May 30, 2007).

<sup>35</sup> We are also designating the current text of Rule 2a-46 as paragraph (a) of the rule.

market capitalization<sup>36</sup> of less than \$250 million (calculated using the price at which the company's common equity is last sold, or the average of the bid and asked prices of the company's common equity, in the principal market for such common equity) on any day in the 60-day period immediately before the BDC's acquisition of its securities.<sup>37</sup> We believe that the new rule 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.

### **B. Use of Standard Based on Market Capitalization**

As discussed above, one of the alternatives that we proposed used a public float standard, and the options proposed in the other alternative used a market capitalization standard.<sup>38</sup> We have decided to adopt a market capitalization standard for the reasons discussed below. For purposes of Rule 2a-46(b), market capitalization is the aggregate value of a company's outstanding voting and non-voting equity securities.<sup>39</sup> In contrast, a company's public float is a company's market capitalization minus the aggregate market value of common equity held by the company's affiliates.<sup>40</sup>

We requested comment on whether it would be burdensome for a BDC to determine a company's eligible portfolio company status if the standard is based on public float rather than

---

<sup>36</sup> A company's market capitalization for purposes of the rule is the aggregate market value of the company's outstanding voting and non-voting common equity securities. See, e.g., Reproposing Release, supra note 1 at n.16.

<sup>37</sup> Rule 2a-46(b). This method of calculating market capitalization was used in both of the proposed market capitalization alternatives in the reproposal. See Reproposing Release, supra note 1 at n.16. We received no comment on this method, and we are adopting it as proposed.

We note that the method of calculating market capitalization is stated solely for purposes of determining a company's qualification as an eligible portfolio company. A BDC is required to value its interests in portfolio companies for purposes of calculating the BDC's net asset value consistent with Section 2(a)(41) of the Investment Company Act.

<sup>38</sup> See supra note 20 and accompanying text.

<sup>39</sup> See supra note 36.

<sup>40</sup> See, e.g., Reproposing Release, supra note 1 at n.16.

market capitalization.<sup>41</sup> Adopting a public float standard in Rule 2a-46(b) would have imposed burdens that are not present in other Commission rules that incorporate such a standard. These other Commission rules typically are rules in which a company is responsible for calculating its own public float to determine its eligibility in connection with certain registration or reporting requirements.<sup>42</sup> Section 55 of the Investment Company Act, however, effectively requires a BDC to determine whether a target company qualifies as an eligible portfolio company before investing in it as part of the BDC's 70% basket.<sup>43</sup> Consequently it is the BDC, rather than the target company, that must determine whether a target company meets the definition of eligible portfolio company under Rule 2a-46(b).

Accordingly, although several commenters stated that both public float and market capitalization are good indicators of whether a company is small and unseasoned, all commenters who addressed this issue preferred a market capitalization standard.<sup>44</sup> Commenters stated that information about a company's market capitalization is readily available through third-party sources, while information about a company's public float is not.<sup>45</sup> Commenters generally explained that, in order for a BDC to calculate a company's public float, as proposed, it would have to determine the number of shares owned by the company's affiliates, which is information not readily available on a current basis through third-party sources.<sup>46</sup> The BDC therefore would

---

<sup>41</sup> Id. at text following n.51.

<sup>42</sup> See supra note 21.

<sup>43</sup> Section 55(a) of the Investment Company Act.

<sup>44</sup> See, e.g., comments of American Capital Strategies Ltd. (Dec. 24, 2006); comments of Gladstone Management (Nov. 2, 2006); comments of Apollo Investment Corp. (Jan. 3, 2007).

<sup>45</sup> See, e.g., id.

<sup>46</sup> See, e.g., comments of American Capital Strategies Ltd. (Dec. 24, 2006); comments of Ares Capital Corp. (Jan. 2, 2007). Although Exchange Act reporting companies are required to disclose their public float on the cover of Form 10-K [17 CFR 249.310], the form requires a filer to disclose its public float as of the last business day of the filer's most recently completed second fiscal quarter. Because Rule 2a-

have to communicate with possible target companies to determine whether they would qualify under the definition of eligible portfolio company before making any investment decision.

Commenters argued that requiring BDCs to determine a company's public float within the requirements of the proposed rule would place an unnecessary burden on BDCs and thereby impede appropriate investment activity.<sup>47</sup> In contrast, under the adopted market capitalization standard, a BDC may use information obtained from third parties to assist it in determining whether a possible investment target is an eligible portfolio company. In this regard, we note that under the adopted market capitalization standard, a BDC may use information obtained from independent third parties to assist it in determining whether a possible target company is an eligible portfolio company without communicating with the target company directly. In light of these burdens and the general public availability of information regarding a company's market capitalization, we agree with commenters that a market capitalization standard is appropriate for purposes of Rule 2a-46.

### **C. Dollar Level of Standard**

We are adopting new Rule 2a-46(b) to define eligible portfolio company to include any company that is listed on an Exchange with market capitalization of less than \$250 million. The new standard, consistent with legislative intent, broadens the definition of eligible portfolio company.<sup>48</sup> We estimate that, based on January 31, 2008 data, 6,062 companies, representing 61.3% (6,062/9,883) of all public domestic operating companies, qualify as eligible portfolio

---

46(b) defines an eligible portfolio company to be a company that meets the requisite size standard on any day in the 60-day period immediately before the BDC's acquisition of the company's securities, the public float information on a company's Form 10-K always would have been outdated for purposes of the proposed public float alternative.

<sup>47</sup> See, e.g., comments of American Capital Strategies Ltd. (Dec. 24, 2006).

<sup>48</sup> Supra note 11. As discussed above, the \$250 million market capitalization standard is a level similar to what most market participants generally view to be "micro-cap" companies, a term used to identify small public companies. See Reproposing Release, supra note 1 at nn.38-40 and accompanying text.

companies under Rule 2a-46(a). We further estimate that 1,649 Exchange-listed companies qualify as eligible portfolio companies under Rule 2a-46(b).<sup>49</sup> Accordingly, we estimate that 7,711 companies, representing 78% (7,711/9,883) of all public domestic operating companies qualify as eligible portfolio companies under Rule 2a-46 as amended.

In the Reproposing Release, we noted a general concern raised by commenters in response to the 2004 Proposing Release<sup>50</sup> that companies with market capitalization up to \$300 million are followed by fewer analysts, have lower institutional ownership and have lower trading volume than companies at higher levels of market capitalization.<sup>51</sup> These commenters concluded that companies having market capitalization below that amount may have more difficulty accessing public capital. We generally agreed that there may be some correlation between the size of a company, based on these factors, and the ability of a company to access public capital.<sup>52</sup> We specifically requested comment on whether any of the alternative standards would better align the definition of eligible portfolio company with the purpose that Congress intended when it adopted the SBIIA.

Commenters universally favored the \$250 million market capitalization standard. Commenters argued that companies with market capitalization of less than \$250 million often have difficulty accessing traditional forms of capital and that adoption of the standard thus would

---

<sup>49</sup> We note that our estimates reflect only companies with less than \$250 million market capitalization whose securities are listed on Nasdaq, the New York Stock Exchange (“NYSE”) and the American Stock Exchange (“Amex”).

<sup>50</sup> Supra note 12.

<sup>51</sup> Comments of Representatives Sue Kelly and Nydia Velázquez at n.12 (Jan. 5, 2005); comments of Williams & Jensen (Feb. 17, 2006). These commenters also referred to analysis prepared by our Office of Economic Affairs (“OEA”) in connection with Securities Offering Reform. See memorandum dated December 3, 2004 (“OEA Memorandum”) attached to comments of Williams & Jensen (Feb. 17, 2006), infra note 58.

<sup>52</sup> See Reproposing Release, supra note 1 at text following n.36.

be consistent with Congressional intent.<sup>53</sup> One commenter also provided information regarding the limited number of follow-on offerings of equity and debt securities by Exchange-listed companies and stated that this information “clearly demonstrates that the vast majority of companies with market capitalizations of \$250 million or less . . . have significantly limited access” to the public equity and debt markets.<sup>54</sup> This commenter also argued that market participants that provide public capital are not servicing the needs of these companies.<sup>55</sup>

Most commenters responding to the alternatives proposed in the Reproposing Release also argued that companies with less than \$250 million market capitalization have difficulty accessing public capital because generally these companies are followed by fewer analysts, have lower institutional ownership and lower trading volume than larger companies.<sup>56</sup> One commenter specifically noted that companies with less than \$250 million market capitalization “have spotty analyst coverage at best, . . . few or no institutional investors, and . . . thin trading volumes” and that “these are characteristics of companies that would not in today’s market have ready access to public capital.”<sup>57</sup> This commenter referred to information developed by our Office of Economic Analysis (“OEA”) about those factors that were prepared for purposes other than this rulemaking.<sup>58</sup>

---

<sup>53</sup> E.g., comments of Allied Capital Management (Dec. 21, 2006); comments of Apollo Investment Corp. (Jan. 2, 2007).

<sup>54</sup> See comments of Williams & Jensen (Apr. 19, 2007).

<sup>55</sup> Comments of Williams & Jensen (May 30, 2007).

<sup>56</sup> See, e.g., comments of Gladstone Management (Nov. 2, 2006); comments of Apollo Investment Corp. (Jan. 2, 2007); comments of Ares Capital Corp. (Jan. 2, 2007).

<sup>57</sup> Comments of Williams & Jensen (Apr. 19, 2007).

<sup>58</sup> The commenter had attached to its comment letter statistics that were prepared in connection with the Final Report of the Advisory Committee on Smaller Public Companies. See Background Statistics: Market Capitalization & Revenue of Public Companies, August 1, 2005, at Table 7 (Analyst Coverage and Institutional Holdings by Market Capitalization), attached to comments of Williams & Jensen (Apr. 19, 2007). This commenter had attached to a prior comment letter an earlier memorandum prepared by

As we stated in the Reproposing Release, we believe that there is some correlation between analyst coverage, institutional ownership and trading volume and the ability of a company to access public capital.<sup>59</sup> Based on the comments we received, and our review of those factors with respect to companies with less than \$250 million market capitalization, we believe that a distinction can be made with respect to a company's ability to access public capital at \$250 million market capitalization. OEA has considered this information and determined that fewer than 50% of companies with market capitalizations of less than \$250 million are followed by more than two analysts and that these companies generally have lower institutional ownership and are more thinly traded than larger companies.

Moreover, in the Reproposing Release we requested comment on whether adoption of a \$250 million market capitalization standard would result in BDCs focusing their investment activities in companies at the higher end of the standard to the detriment of smaller companies.<sup>60</sup> Commenters responded that adoption of a \$250 million market capitalization standard would not have this result, with some arguing further that larger companies do not necessarily present a more attractive investment in comparison to smaller companies.<sup>61</sup> Commenters also argued that historically, BDCs have not invested in larger non-public companies at the expense of smaller

---

OEA that sets forth data regarding analyst coverage, institutional ownership and average daily trading for publicly traded companies between 1997 and 2003. See OEA Memorandum dated December 3, 2004 attached to comments of Williams & Jensen (Feb. 17, 2006) (exhibit entitled "SEC Data Demonstrates Lack of Market Following for Companies with Market Capitalizations of \$300 million or Less"). OEA prepared this memorandum in connection with the Securities Offering Reform rulemaking. See Securities Offering Reform, Securities Act Release No. 8591 (July 19, 2005) [70 FR 44722 (Aug. 3, 2005)].

<sup>59</sup> See Reproposing Release, supra note 1 at n.37 and accompanying text.

<sup>60</sup> See id. at n.47 and accompanying text. We requested comment on this issue in response to a comment made by one commenter to the 2004 Proposing Release. This commenter raised the concern that BDCs might not provide financing for smaller Exchange-listed companies if the Commission adopts a standard higher than \$100 million market capitalization. See comments of Capital Southwest Corp. (Dec. 28, 2004).

<sup>61</sup> See, e.g., comments of MCG Capital Corp. (Dec. 27, 2006); comments of American Capital Strategies Ltd. (Dec. 24, 2006).

non-public companies, and that there is no reason to suggest that this would occur in the context of public companies.<sup>62</sup> In light of these comments, we are persuaded that our adoption of the \$250 million market capitalization standard is not likely to result in BDCs focusing their investment activity on larger companies to the detriment of smaller companies.

Accordingly, we conclude that adoption of the \$250 million market capitalization standard is an appropriate standard for purposes of the amended rule and we believe that it is consistent with the public interest, the protection of investors and the purposes fairly intended by the policies and provisions of the Investment Company Act.<sup>63</sup>

#### **IV. COST-BENEFIT ANALYSIS**

We are sensitive to the costs and benefits that result from our rules. In the Reproposing Release we requested public comment and specific data regarding the costs and benefits of repropose Rule 2a-46(b). As discussed below, we received one comment regarding the Commission's estimate of the companies that would benefit from the repropose rule.<sup>64</sup>

##### **A. Benefits**

Rule 2a-46(b) more closely aligns the definition of eligible portfolio company, and the investment activities of BDCs, with the purpose that Congress intended. Specifically, Rule 2a-

---

<sup>62</sup> See comments of Harris & Harris Group (Jan. 3, 2007); comments of ThinkEquity Partners LLC (Dec. 6, 2006).

<sup>63</sup> We are persuaded that our adoption of the \$250 million market capitalization standard is not inconsistent with our other rules that distinguish between smaller and larger companies because of the different purposes of these rules. For example, Form S-3 incorporates a \$75 million public float standard (in addition to other factors) to identify those companies about which sufficient information is publicly available to allow them to take advantage of our integrated disclosure system. See Revisions to the Eligibility Requirements for Primary Securities Offerings on Forms S-3 and F-3, Securities Act Release No. 8878 (Dec. 19, 2007) [72 FR 73534 (Dec. 27, 2007)]; Simplification of Registration for Primary Securities Offerings, Securities Act Release No. 6943 (July 16, 1992) [57 FR 32461 (July 22, 1992)]. In contrast, Rule 2a-46(b) incorporates a \$250 million market capitalization standard to identify companies that are having difficulty accessing public capital and may benefit from greater access to BDC financing.

<sup>64</sup> Comments of Williams & Jensen (Apr. 19, 2007).

46(b) expands the definition of eligible portfolio company to include any domestic operating company with a class of securities listed on an Exchange that has a market capitalization of less than \$250 million.

Many public companies that are included as eligible portfolio companies under Rule 2a-46(b) may need capital for continued development and growth, but, notwithstanding that their securities are listed on an Exchange, may find it difficult to raise capital through additional offerings or borrow money through other sources. By amending the definition of eligible portfolio company to include these companies, such companies will benefit because of the expanded sources of capital from which the companies may seek to obtain financing. Increased competition among capital providers will benefit shareholders of companies seeking capital.

Rule 2a-46(b) also benefits BDCs by expanding the universe of investments that BDCs may include as part of their 70% basket. This will allow BDCs to make additional investments to companies that qualify as eligible portfolio companies under the rule, which in turn could benefit BDC shareholders. Rule 2a-46(b) also benefits BDCs by addressing the uncertainty caused by changes in the margin rules in the operation of BDCs.

In the Reproposing Release, OEA estimated, using June 30, 2006 data, that there were a total of 1,562 domestic operating companies whose securities were listed on Nasdaq, the NYSE and Amex that have a market capitalization of less than \$250 million. At that time OEA estimated that 6,041 domestic operating companies that qualified as eligible portfolio companies under Rule 2a-46 as initially adopted. Accordingly, OEA calculated that 7,603 companies, representing 77.2% (7,603/9,845<sup>65</sup>) of public domestic operating companies, would qualify as eligible portfolio companies if the \$250 million market capitalization standard was adopted.

---

<sup>65</sup> See infra note 69.

Using January 31, 2008 data, OEA estimates that there were a total of 1,649 domestic operating companies whose securities were listed on Nasdaq, the NYSE and the Amex that have a market capitalization of less than \$250 million. OEA further estimates that approximately 6,062 companies qualify as eligible portfolio companies under Rule 2a-46, as initially adopted (now Rule 2a-46(a)). Accordingly, OEA calculates that 7,711 companies, representing 78 percent (7,711/9,883<sup>66</sup>) of public domestic operating companies, qualify as eligible portfolio companies under amended Rule 2a-46.

OEA reached its estimates by first calculating the number of companies whose securities were listed on Nasdaq, the NYSE and the Amex. OEA then deducted from this estimate 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 (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), and corrected for cases where individual companies had multiple classes of securities listed. OEA then determined the number of companies that had a market capitalization of less than \$250 million.<sup>67</sup> Using the same methodology, OEA determined the number of companies that qualify as eligible portfolio companies under Rule 2a-46(a).<sup>68</sup> OEA then calculated the total number of eligible portfolio companies and the percentage of the total public domestic operating companies that would qualify as eligible portfolio companies under amended Rule 2a-46.<sup>69</sup>

---

<sup>66</sup> Id.

<sup>67</sup> See supra note 49.

<sup>68</sup> See Adopting Release, supra note 2 at text preceding n.31.

<sup>69</sup> OEA estimated the total number of public domestic operating companies by calculating the number of companies whose securities were listed on Nasdaq, the NYSE and the Amex, in addition to those companies whose securities were trading through the over-the-counter bulletin board and on Pink Sheets LLC, correcting these figures for cases where individual companies had multiple classes of securities

As noted above, one commenter stated that the Reproposing Release overstated the percentage of companies that would benefit under Rule 2a-46, as amended by the repropose rule.<sup>70</sup> The commenter noted, however, that regardless of whether or not the Commission overstated the percentage of companies, “the percentage in and of itself adds little analytical weight in describing which public companies need access to capital . . .” The commenter concluded that “we believe that there is no precise percentage of public companies that can or should be targeted . . .”<sup>71</sup> While the commenter agreed that foreign companies, investment companies and most companies that are excluded from the definition of investment company by Section 3(c) of the Investment Company Act are excluded from qualifying as eligible portfolio companies under the Investment Company Act, the commenter suggested that these companies should still be included as part of the total number of public companies. Thus, the commenter suggested that the benefits of the rule should be calculated by comparing the total number of companies that would be eligible portfolio companies under the rule to the total number of public companies.

As discussed previously, Section 2(a)(46) excludes from the definition of eligible portfolio companies foreign companies, investment companies and most companies that are excluded from the definition of investment company by Section 3(c). Therefore, in determining the benefits of Rule 2a-46 as amended for purposes of this analysis, we believe that it is appropriate to compare the number of companies that meet the definition of eligible portfolio

---

listed, and then removing from these figures foreign companies, investment companies, and companies that are excluded from the definition of investment company by Section 3(c).

<sup>70</sup> Williams & Jensen (Apr. 19, 2007).

<sup>71</sup> Id.

company under the rule with the number of companies that are not statutorily precluded from being treated as eligible portfolio companies.

This commenter also argued that public companies listed on the OTC Bulletin Board with market capitalizations of between \$0 and \$25 million should be excluded from OEA's calculations.<sup>72</sup> The commenter explained that although these companies qualify as eligible portfolio companies, "they are not likely to seek or be seriously considered appropriate investments for a BDC."<sup>73</sup> OEA's calculations are intended to show the number of all companies that would fall within the definition of eligible portfolio company under Rule 2a-46(b), however, regardless of whether any particular company or size of company would be seriously considered by a BDC for investment purposes. Accordingly, we have not recalculated the numbers and percentages stated above to reflect the commenter's view.

#### **B. Costs**

We received no comments on the potential costs of our adoption of the new standard. Although Rule 2a-46(b) might impose certain administrative compliance costs on BDCs, it is our understanding that these costs are similar to the types of compliance costs that a BDC currently undertakes when it invests in a company. Specifically, a BDC will need to determine, prior to investing in a company, if the company has a class of securities listed on an Exchange and whether that company's market capitalization was less than \$250 million as of a date within 60 days prior to the date of the BDC's investment. Costs in obtaining this information, however, will be minimal because information about the market capitalization of companies is readily available from third-party sources. Finally, we anticipate that Rule 2a-46(b) will impose only minimal, if any, costs on portfolio companies.

---

<sup>72</sup> Id.

<sup>73</sup> Id.

## 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, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.<sup>74</sup> In the Reproposing Release, we requested comment on our analysis of the impact of Rule 2a-46(b) on efficiency, competition and capital formation. As discussed in Section II of this Release, commenters generally supported expanding the definition to include Exchange-listed companies with less than \$250 million market capitalization because of their belief that these companies often have difficulty accessing capital.<sup>75</sup> Some commenters also argued that expanding the rule to include Exchange-listed companies with less than \$250 million market capitalization would allow BDCs to compete with other capital providers, and that such competition would benefit shareholders of companies seeking capital.<sup>76</sup> We have decided to amend Rule 2a-46 to expand the definition of eligible portfolio company to include Exchange-listed companies that have a market capitalization of less than \$250 million.

Rule 2a-46(b) is designed to promote efficiency, competition and capital formation. Efficiency will be enhanced because Rule 2a-46(b) expands the definition of eligible portfolio company so as to allow BDCs to compete with other entities that provide capital to certain companies. Competition for financing may result in lower cost capital for current funding needs or may replace higher cost capital previously issued, which could potentially allow companies

---

<sup>74</sup> 15 U.S.C. 80a-2(c).

<sup>75</sup> See supra note 27 and accompanying text.

<sup>76</sup> See, e.g., comments of Williams & Jensen (Apr. 19, 2007); comments of Apollo Investment Corp. (Jan. 2, 2007).

desiring capital to take on additional or different investment projects. Thus, Rule 2a-46(b) will promote a more efficient allocation of capital. Rule 2a-46(b) in our view also will promote efficiency by providing a workable test for determining whether a company is an eligible portfolio company.

We also believe Rule 2a-46(b) will promote competition. Rule 2a-46(b) allows BDCs more easily to compete with other capital providers, and such competition benefits shareholders of BDCs, companies receiving the capital and shareholders of companies receiving capital. 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 (including venture capital funds), hedge funds, investment banks and other BDCs, to provide financing to certain companies. We believe that Rule 2a-46(b) will encourage such competition. Such competition also benefits the qualifying companies in need of capital and their shareholders because such companies can more readily consider BDCs as a source of financing. To the extent that BDCs provide either additional or less expensive capital to these companies, those companies may be more competitive in the marketplace.

Finally, we believe that Rule 2a-46(b) may promote capital formation. BDC investments represent additional capital to companies. By expanding the definition of eligible portfolio company, Rule 2a-46(b) may result in additional capital investments by BDCs. We estimate that a total of 1,649 public domestic operating companies would qualify as eligible portfolio companies under Rule 2a-46(b). The rule provides greater access to public capital by increasing these companies' access to BDC financing.

## **VI. PAPERWORK REDUCTION ACT**

The Commission has determined that Rule 2a-46 as amended does not involve a

collection of information pursuant to the provisions of the Paperwork Reduction Act [44 U.S.C. 3501 et seq.].

## **VII. FINAL REGULATORY FLEXIBILITY ANALYSIS**

This Final Regulatory Flexibility Analysis has been prepared in accordance with 5 U.S.C. 604. It relates to Rule 2a-46(b) under the Investment Company Act. An Initial Regulatory Flexibility Analysis (“IRFA”) was prepared in accordance with 5 U.S.C. 603 and was published in the Reproposing Release.<sup>77</sup>

### **A. Reasons for and Objectives of the Amendment**

As described previously in this Release, Rule 2a-46(b) more closely aligns the definition of eligible portfolio company, and the investment activities of BDCs, with the purpose that Congress intended. Specifically, Rule 2a-46(b) will expand the definition of eligible portfolio company to include any domestic operating company with a class of securities listed on an Exchange that has a market capitalization of less than \$250 million. These companies may need BDC financing for continued growth and development, but, notwithstanding the fact that their securities are listed on an Exchange, may find it difficult to raise additional capital in new offerings or borrow money through other conventional sources.

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

When the Commission repropounded Rule 2a-46(b), comment was requested on the reproposal and the accompanying IRFA. None of the comment letters specifically addressed the IRFA.

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

Rule 2a-46(b) will affect BDCs and companies that qualify as small entities under the

---

<sup>77</sup> Reproposing Release supra note 1 at Section VII.

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>78</sup> As of June 2007, there were 73 BDCs, of which 43 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>79</sup> We estimate there are approximately 20 Exchange-listed companies that may be considered small entities.<sup>80</sup>

As discussed in this Release, Rule 2a-46(b) is intended to benefit certain companies that need capital for continued development and growth, but may be unable to borrow money through conventional sources despite their securities being listed on an Exchange. Rule 2a-46(b) will also benefit BDCs, including those that are small entities, by expanding the number of companies that BDCs may include as part of their 70% basket. Because none of the comment letters specifically addressed the IRFA, we continue to believe that those BDCs and companies that are small entities for purposes of the Regulatory Flexibility Act would not be disproportionately affected by the amended rule.

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

Rule 2a-46(b) will not impose any new reporting or recordkeeping requirements on BDCs or on companies. It also will impose only minimal, if any, compliance requirements on portfolio companies.

---

<sup>78</sup> 17 CFR 270.0-10.

<sup>79</sup> 17 CFR 230.157; 17 CFR 240.0-10.

<sup>80</sup> We noted in the Reproposing Release that at that time we calculated that there were approximately 2,500 companies, other than investment companies, that may be considered small entities. See Reproposing Release supra note 1 at text following n.72. This figure inadvertently included companies whose securities are not listed on an Exchange. Rule 2a-46(b), however, only pertains to companies whose securities are listed on an Exchange. As discussed above, we estimate that there are only approximately 20 Exchange-listed companies that may be considered small entities.

Rule 2a-46(b) will impose minimal compliance requirements on BDCs, including small entities. A BDC would need to determine, prior to investing in a company, if the company has a class of securities listed on an Exchange and whether that company's market capitalization was less than \$250 million as of a date within 60 days prior to the date of the BDC's investment. We anticipate that the costs associated with obtaining this information would be minimal because such information is readily available from third-party sources. 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.

**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 for small entities; (3) the use of performance rather than design standards; and (4) exempting small entities from the coverage of the rules, or any part thereof.

Establishing different compliance or reporting requirements for small entities would not be appropriate under Rule 2a-46(b). Rule 2a-46 will not impose any reporting requirements on BDCs or on companies. It will also not impose any compliance requirements on portfolio companies. Rule 2a-46(b) will, however, impose some compliance requirements on BDCs that are intended to ensure that BDCs invest primarily in certain types of companies. These requirements should, however, impose only minimal burdens on BDCs.

We believe that clarifying, consolidating or simplifying the compliance requirements for

small entities would be inappropriate. As discussed above, Rule 2a-46(b) will not impose any compliance requirements on portfolio companies. As noted, Rule 2a-46(b) will impose some compliance requirements on BDCs, which we believe will impose minimal burdens on BDCs. These requirements are designed to ensure that BDCs will invest in companies in accordance with the rule.

We believe that using performance rather than design standards would add unnecessary complexity. Rule 2a-46(b) provides 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 in determining whether they meet the definition of eligible portfolio company.

Finally, we believe that it would be inappropriate to exempt BDCs that are small entities from the coverage of Rule 2a-46(b). Rule 2a-46(b) should benefit BDCs and companies, including those that are small entities, by expanding the definition of eligible portfolio company to include certain companies whose securities are listed on an Exchange. Exempting BDCs and companies that are small entities from the amended rule would be contradictory to the purpose of this rulemaking.

## **VIII. STATUTORY AUTHORITY**

We are amending Rule 2a-46 pursuant to our rulemaking authority under Sections 2(a)(46)(C)(iv) and 38(a) of the Investment Company Act.

### **List of Subjects in 17 CFR Part 270**

Investment companies, Reporting and recordkeeping requirements, Securities.

## IX. TEXT OF RULE

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

\* \* \* \* \*

2. Revise § 270.2a-46 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
- (b) Has a class of securities listed on a national securities exchange, but has an aggregate market value of outstanding voting and non-voting common equity of less than \$250 million. For purposes of this paragraph:

- (1) The aggregate market value of an issuer's outstanding voting and non-voting common equity shall be computed by use of the price at which the common equity was last sold, or the average of the bid and asked prices of such common equity, in the principal market for such common equity as of a date within 60 days prior to the date of acquisition of its securities by a business development company; and

(2) Common equity has the same meaning as in 17 CFR 230.405.

By the Commission.

Nancy M. Morris  
Secretary

May 15, 2008