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January 4, 2005

Via Electronic Delivery

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Investment Company Release No. 26647 (File Number S7-37-04); Definition of Eligible Portfolio Company under the Investment Company Act (the "Release")

Dear Mr. Katz:

We submit this letter in response to a request from the Securities and Exchange Commission (the "SEC" or "Commission"), for comments with respect to the above-referenced proposal (the "Proposal") to amend the definition of eligible portfolio company under the Investment Company Act of 1940, as amended (the "1940 Act"). Terms used in this letter and defined in the Proposal have the meaning assigned to them in the Proposal.

Thompson & Knight LLP is an international law firm with a wide-ranging financial services practice that serves clients in the United States and worldwide. Among our clients are two companies that have elected to be business development companies ("BDCs") under the 1940 Act, one of which, attorneys for the firm have represented for more than 20 years. Although we have discussed the matters addressed in the Release with some of our clients, the comments that follow reflect our own views, and not necessarily those of any client of the firm.

The Commission has requested comment on its 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 the Commission's 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 the Commission's 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 the Commission 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.

- The Commission recognizes 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. The 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 the Commission 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.

The Proposal provides that 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 1940 Act and that "Does not have any class of securities listed on a national securities exchange (an "Exchange") or on an automated interdealer quotation system of a national securities association ("NASDAQ"). The discussion in the Proposal indicates that this definition is intended generally to exclude companies whose shares are listed on the New York Stock Exchange, the American Stock Exchange, the Nasdaq National Market, and the Nasdaq Smallcap Market, but not companies whose shares are quoted on the OTC Bulletin Board or the Pink Sheets LLC.

We believe that the use of the phrase "interdealer quotation system of a national securities association" may be confusing. While this reference is intended to include the Nasdaq National Market and the Nasdaq Smallcap Market, it may also unintentionally include the OTC Bulletin Board. The OTC Bulletin Board, which is operated by the National Association of

Securities Dealers, Inc.[1], or NASD, a national securities association, describes itself as a regulated quotation service that displays real-time quotes, last-sale prices, and volume information in over-the-counter (OTC) equity securities. The name "OTC Bulletin Board" is a registered service mark of The Nasdaq Stock Market, Inc. While the OTC Bulletin Board is unlike the Nasdaq Stock Market in certain aspects,[2] it arguable falls within the context of an "interdealer quotation system of a national securities association."

While at one point the Nasdaq Stock Market referred to itself as an interdealer quotation system, it now refers to itself as an electronic securities market comprised of competing market makers whose trading is supported by a communications network linking them to quotation dissemination, trade reporting, and order execution systems.[3] We also note that the Nasdaq National Market and the Nasdaq Smallcap Market are market tiers of The Nasdaq Stock Market.

We would suggest that the Commission change this reference to either (1) specifically reference the Nasdaq National Market, the Nasdaq Smallcap Market, and any other market tier established by the Nasdaq Stock Market, (2) conform to the Nasdaq Stock Market's current description of itself, or (3) include other specific criteria, such as order execution, that would exclude the OTC Bulletin Board from the definition.

We do not believe that the Commission's approach adequately describes 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. While the proposed definition of eligible portfolio company conforms to the exclusion of exchange-listed securities contained in Regulation T at the time the SBIIA was adopted, over-the-counter, or OTC, securities were required to meet certain conditions to be eligible for extension of margin at such time.

These conditions included, four or more market makers, the stock had 1,200 or more holders of record, the issuer had been in existence for at least three years and the stock had been publicly traded for at least 6 months, a public float of at least 500,000 shares, and at least two of the following conditions: (1) per share value of at least $5, (2) a market capitalization of at least $5,000,000, and (3) capital of at least $5,000,000.[4]

The House Report notes that it was estimated that there were approximately 12,000 publicly held operating companies in 1980 and that the definition of eligible portfolio company would include about two-thirds, or 8,000 of those companies.[5] The Nasdaq National Market did

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[1] The rules governing operation and use of the OTC Bulletin Board service are set out in Rules 6500 and 6600 of the National Association of Securities Dealers, Inc.

[2] The OTC Bulletin Board (1) does not impose listing standards; (2) does not provide automated trade executions; (3) does not maintain relationships with quoted issuers; and (4) does not have the same obligations for market makers.

[3] NASD Rule 4200(27).

[4] See H.R. Report No. 1341, 96th Cong., 2d Sess. 30 (Footnote 1) (1980)("House Report").

[5] House Report at 23.

not exist as a tier of the Nasdaq Stock Market in 1980. While the Commission notes that the Office of Economic Analysis has estimated that 60% of public issuers currently do not have securities that trade on a national securities exchange or on the Nasdaq Stock Market, the intention of Congress was clear that the definition of eligible portfolio company was not to encompass all issuers listed on the Nasdaq Stock Market.

While the Nasdaq National Market started in 1982 with the 40 highest volume issuers, today it accounts for approximately 80% of the NASDAQ listings.[6] The Nasdaq Smallcap Market is comprised of 621 issuers, less than 20% of the total NASDAQ listings. In addition, there are approximately 850 NASDAQ listed issuers (approximately 25% of all listed issuers) that have a market capitalization of less than $100 million.

Senator Lugar in his comments on the SBIIA stated that the use of the margin rules was "intended to be a rough test of the maturity of companies whose stock is owned by the public, since the margin list is based upon factors such as size, degree of public ownership and operating history."[7]

The types of listing standards for the Nasdaq National Market correlate with the types of standards used by the Federal Reserve Board as margin requirements in 1980. There are three entry standards for the Nasdaq National Market. Each requires (1) at least 1,100,000 publicly held shares, (2) a minimum of 400 round lot shareholders, and (3) a bid price per share of $5 or more. Entry standard 1 has the following additional requirements: (1) the issuer of the security had annual income from continuing operations before income taxes of at least $1,000,000 in the most recently completed fiscal year or in two of the last three most recently completed fiscal years, (2) the market value of publicly held shares is at least $8 million, (3) the issuer of the security has stockholders' equity of at least $15 million, and (4) there are at least three registered and active market makers with respect to the security. The additional requirements for entry standard 2 are: (1) the issuer of the security has stockholders' equity of at least $30 million, (2) the market value of publicly held shares is at least $18 million, (3) there are at least three registered and active market makers with respect to the security, and (4) the issuer has a two-year operating history. The additional requirements for entry standard 3 are: (1) The market value of publicly held shares is at least $20 million, (2) there are at least four registered and active market makers with respect to the security, and (3) the issuer has: (a) a market value of listed securities of $75 million; or (b) total assets and total revenue of $75 million each for the most recently completed fiscal year or two of the last three most recently completed fiscal years.

On the other hand the listing requirements for the Nasdaq Smallcap Market are: (1) three registered and active market makers, (2) either (a) stockholders' equity of $5 million; (b) market value of listed securities of $50 million, or (c) net income from continuing operations of $750,000 in the most recently completed fiscal year or in two of the last three most recently completed fiscal years, (3) an operating history of at least one year or a market value of listed

[6] There are 2,654 Nasdaq National Market companies out of a total of 3,300 NASDAQ companies.
[7] Congressional Record – Senate at 27268 (September 25, 1980)

securities of $50 million, (4) a minimum bid price of $4 per share, (5) 300 round lot holders, and (6) 1,000,000 publicly held shares.

Based on the NASDAQ's standards for separating national market and smallcap issuers, it would be reasonable to conclude that Nasdaq Smallcap Market issuers are the type of entity that Congress envisioned as eligible portfolio companies. We believe that at a minimum the exclusion from the definition of eligible portfolio companies for NASDAQ issuers should be limited to Nasdaq National Market issuers.

We do not believe that 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 describes the category of issuers that Congress intended to capture in 1980. The House Report clearly indicates that all private companies were intended to be eligible portfolio companies.[8]

The concept of market capitalization presupposes that there is a market for a company's securities. While it may be possible to put a fair market value on the stock of a private company, this should not be confused with market capitalization. The absence of any trading market and other restrictions on transfer would require that any value be significantly discounted. Moreover, the concept of market capitalization is a relevant standard only to the extent a company has access to the public capital markets, which is not the case with a private company. In addition, there clearly would not be enough public information available so that BDCs may readily ascertain whether an issuer is an eligible portfolio company under such an alternative approach.

While there may be investment companies that could reorganize themselves as BDCs to take advantage of a rule that defines eligible portfolio company based on market capitalization, we do not believe that there is any significant 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. As a general proposition, most closed-end funds invest in publicly traded securities that are purchased and sold on domestic and foreign exchanges. These funds conduct or acquire research based on information publicly available with respect to such companies. Transactions do not require any significant documentation or due diligence or the assistance of counsel or accountants.

Under Section 55(a)(1), a BDC generally must purchase securities in transactions not involving a public offering directly from the issuer.[9] Transactions are consummated after substantial due diligence and drafting and negotiation of detailed purchase agreements and ancillary documentation usually by counsel. A typical closed-end fund would not be staffed with individuals experienced in conducting due diligence and negotiating private securities purchases. Due diligence and legal expenses would add additional expenses to the cost structure of these

[8] House Report at 23.
[9] Securities may be purchased otherwise than from the issuer if a BDC controls the issuer and has a director or a BDC owns at least 60% of the outstanding equity securities of the issuer. See Section 55(a)(2) and (4).

funds. In addition, the securities acquired would be restricted and not resalable absent registration under the Securities Act of 1933. This adds additional expense and risk to such investments.

We also note that including Nasdaq Smallcap Market issuers as eligible portfolio companies or imposing a $100 million market capitalization test, would only add some 600 to 850 companies to the sphere of eligible portfolio companies. Any closed-end funds entering this market would be competing with the existing BDCs and the many private equity funds in the marketplace.

As noted above we do not believe that the Commission should modify proposed Rule 2a-46 to exclude from the definition of eligible portfolio company any issuer that would meet the lowest initial quantitative listing standards of an Exchange or NASDAQ, regardless of whether the issuer enters a listing agreement with the Exchange or NASDAQ. As a practical matter, unless certain of the quantitative standards were not applied, this concept would not be workable. For example, the NASDAQ quantitative standards include a requirement for at least three market makers and the standards of all Exchanges and NASDAQ require registration under the Securities Exchange Act of 1934, a certain number of "publicly held shares," and a minimum bid price. Moreover, neither the New York Stock Exchange, the American Stock Exchange, nor the Nasdaq Stock Market is obligated or required to accept for listing any issuer that meets the quantitative and qualitative listing standards.[10] Thus, even if an issuer met the lowest initial listing standards, there is no assurance it will be accepted for listing.

The Section 2(a)(46)(C)(i) category of eligible portfolio companies 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."[11] By definition, a company that cannot or does not choose to list its securities on an Exchange or NASDAQ does not have access to the public capital markets.

We also note that while, 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, it is unlikely that any such issuers would have been interested in selling securities to or borrowing funds from BDCs because of the economics or cost inherent in such transactions. That is, such issuers could acquire funds at a lower cost from financial institutions or investors other than BDCs. In addition, BDCs generally would not be interested in such issuers because they could not achieve their necessary return on their investment in such companies.

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[10] For example, Nasdaq may deny initial inclusion or apply additional or more stringent criteria for inclusion of particular securities based on any event, condition, or circumstance which exists that makes initial inclusion inadvisable or unwarranted in the opinion of Nasdaq even though the securities meet all enumerated criteria for initial inclusion. NASD Marketplace Rule 4300. See also Section 101.00 of the NYSE Listed Company Manual and Section 101 of the Amex Company Guide.

[11] House Report at 30.

The Commission has also requested comment on its 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, the Commission requested 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.

- 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 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.

- 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?

Our comment above as to the use of the term "automated dealer quotation system" applies to Proposed Rule 2a-46(b) as well. In addition, if retained, the reference in paragraph (1) to "national securities association" and "association" should be to the system or market.

With respect to Proposed Rule 2a-46(b), we have concerns with the wording of both subparagraphs (1) and (2). With respect to 2a-46(b)(1), we note that NASDAQ has the right to apply additional or more stringent criteria for continued inclusion for particular securities or terminate inclusion of particular securities based on any event, condition, or circumstance which occurs that makes continued inclusion inadvisable or unwarranted in the opinion of NASDAQ, even though the securities meet enumerated criteria for continued inclusion in NASDAQ.[12] In addition, even though the Commission staff believes that failure to meet qualitative standards may be within the control of an issuer, loss of a listing for whatever reason means the loss of access to the public capital markets, which is the issue. The issue is one of availability of the public capital markets and the cost of capital. It is not logical to think that a listed company would intentionally violate the qualitative listing standards and be delisted in order to obtain more expensive funds from a BDC. If an issuer wanted to become an eligible portfolio company, it could just delist and meet the standard set forth in Proposed Rule 2a-46(a).

As to the question of whether failure to meet qualitative criteria is within the control of an issuer, is the inability of an issuer to have the required number of independent directors within its control if for some reason it cannot find qualified directors willing to serve? The issue is not if or why qualitative standards objectively help measure an issuer's financial stability, it is that loss of a listing means a loss of access to the public capital markets.

The condition set forth in Proposed Rule 2a-46(b)(2) adds a requirement that an issuer that has received a notice of delisting is not an eligible portfolio company if it can satisfy the initial quantitative listing requirement of an Exchange or the NASDAQ. That is, while the NYSE may be delisting an issuer's securities, it arguably could move to the Amex or the NASDAQ. There are a number of problems with this approach. First, as noted above the issue is one of access to the public capital markets. Thus, the condition cannot be limited to quantitative listing requirements. It must include qualitative requirements as well as discretionary requirements. Receipt of a notice of delisting for any reason, would adversely affect an issuer's ability to access the public capital markets. Second, there are multiple listing standards. Is paragraph (2) to be read as "any" initial quantitative listing requirement? Third, the Exchanges and NASDAQ have discretion not to list an issuer's securities. If an issuer is denied listing or delisted by one exchange, such facts must be disclosed to any other exchange where the issuer

[12] NASD Marketplace Rule 4300. See also NYSE Exchange Rule 499, Sections 801.00 and 802.01D of the NYSE Listed Company Manual, and Section 1001, 1002, and 1003 of the Amex Company Guide.

seeks to list its shares. There is no assurance that an issuer that is delisted by the NYSE for any reason could obtain a listing on either the Amex or NASDAQ.

We suggest that the requirement of 2a-46(b)(2) be eliminated as proposed and the following concept be substituted in its place:

> (2) Has (A) not applied for listing of its securities on another national securities exchange or automated interdealer quotation system of a national securities association or (B) had its application(s) for listing of its securities on another national securities exchange or automated interdealer quotation system denied; and
>
> (3) Has not been advised by the national securities exchange or automated interdealer quotation system that it has returned to compliance with all applicable listing requirements.

Finally, the Commission requested comment on its 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:

- Should the Commission 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.

We do not believe that there should be any time restriction on follow-on investments made in accordance with Proposed Rule 55a-1. Section 55(a)(1)(B), which permits follow-on investments, does not contain any time restriction and it would appear to be the view of that no time restriction was necessary.

We appreciate the opportunity to comment on the Proposal. Please feel free to contact John T. Unger at 713-653-8811 if you would like to discuss any of our comments.

Very truly yours,

Thompson & Knight, LLP