



BDC Rules and Regulations

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Pursuant to the Small Business Investment Incentive Act of 1980 (the “**BDC Act**”), Congress established the Business Development Company (“**BDC**”) as a form of closed-end investment company designed to provide capital to small, developing and financially troubled companies lacking access to public capital markets, financial and operational management expertise and miscellaneous forms of traditional equity and debt capital.¹ In contrast to open-end investment funds (i.e., mutual funds), shares of a non-traded closed-end investment company, such as a non-traded BDC, are generally illiquid, especially in the early years of its lifecycle, and the BDC has no statutory obligation to redeem any shares.

Section 2(a)(48) of the 1940 Act defines “**Business Development Company**” to mean a domestic closed-end company that (i) operates for the purpose of making investments in certain securities specified in Section 55(a) of the 1940 Act and, with limited exceptions, makes available “significant managerial assistance” with respect to the issuers of such securities; and (ii) has elected BDC status.

Eligible Assets. Under Section 55(a) of the 1940 Act, a BDC generally must have at least 70% of its total assets in the following categories of eligible assets:

- (1) Securities purchased in transactions not involving a public offering from the issuer of such securities, which issuer (subject to certain limited exceptions) is an “eligible portfolio company” (“**EPC**”) or from an affiliate of the EPC or any other person subject to such rules and regulations as the Securities and Exchange Commission (the “**SEC**”) may prescribe;²

¹ The BDC Act is embodied in the latter portion (Sections 54 to 65) of the Investment Company Act of 1940, as amended (the “**1940 Act**”). BDCs are exempt from many of the regulatory constraints imposed on other investment companies by the 1940 Act and the rules thereunder.

² As defined in Section 2(a)(46) of the 1940 Act, an “**eligible portfolio company**” means an issuer that (A) is domiciled in the U.S.; (B) is neither an investment company (with a limited exception for a wholly owned subsidiary that is a licensed small business company) nor a company that would be an investment company except for the section 3(c) exclusion (i.e., certain banks, insurance companies, brokers, hedge funds, private equity funds and other entities); and (C) satisfies one of the following: (i) does not have any class of securities to which a member of a national securities exchange, broker or dealer may extend credit on margin, (ii) is controlled by a BDC with an affiliated person of the BDC as a director, (iii) has total assets of not more than \$4 million and capital and surplus (shareholders’ equity less retained earnings) of at least \$2 million, or (iv) meets such other criteria established by SEC rule, i.e., it either does not have any class of securities listed on a national securities exchange or has an aggregate market value of outstanding common equity of less than \$250 million (see Rule 2a-46 under the 1940 Act).

- (2) Securities of any EPC that the BDC controls;³
- (3) Privately issued securities of certain companies subject to a bankruptcy, reorganization, insolvency or similar proceeding;
- (4) Securities of an EPC purchased from any person in a private transaction if there is no ready market for such securities and the BDC already owns 60% of the outstanding equity of the EPC;
- (5) Securities received in exchange for securities described in (1) through (4) above or pursuant to the exercise of warrants or rights relating to such securities; and
- (6) Cash, cash equivalents, U.S. government securities or high quality debt securities maturing in one year or less.⁴

These provisions are intended to ensure that BDCs provide capital to small, developing and financially troubled companies.

Pyramiding Control Prohibitions. In addition to the Section 55 restrictions, pursuant to Section 60, a BDC also faces investment restrictions under Section 12 of the 1940 Act. Essentially, an investment company cannot: (i) own more than 3% of another investment company's voting stock; (ii) have more than 5% of its total assets in a single investment company's securities; or (iii) have more than 10% of its total assets in any number of investment companies' securities. These restrictions are intended to prevent pyramiding schemes in which individuals could use a relatively small amount of money to acquire control of a fund and use the fund's assets to acquire control of a second fund, which, in turn, could use that fund's assets to acquire control of a third fund, and so on.

Restrictions on Transactions with Affiliates. Unlike traditional investment companies, which are subject to the affiliated transaction prohibitions of Section 17 of the 1940 Act, BDCs are subject to Section 57 of the 1940 Act, which is a substantially modified and relaxed version of Section 17. Section 57 generally prohibits a BDC from effecting or participating in transactions involving conflicts of interest unless certain procedures are satisfied. Subsections 57(a) and (d) prohibit certain affiliates from participating in the following types of transactions ("**Restricted Transactions**") that such persons (and certain affiliated persons of those persons), acting as principal, may not enter into with the BDC without prior approval:

³ The BDC must exercise such a controlling influence over the management or policies of such EPC that, as a result, the BDC has an affiliated person who is a director of such EPC. A controlling interest is presumed if the BDC owns more than 25% of a portfolio company's voting securities.

⁴ A BDC may also own a limited amount of office furniture and equipment, interests in real estate and leasehold improvements and facilities maintained to conduct the business of the BDC.

- (1) An affiliate may not knowingly sell any securities or other property to the BDC, unless either the BDC or the affiliate is the issuer and the security is part of a general offering to the holders of a class of its securities;
- (2) An affiliate may not knowingly purchase from the BDC any security or other property except securities issued by the BDC;
- (3) An affiliate may not knowingly borrow from the BDC, with limited exceptions; and
- (4) An affiliate is prohibited from knowingly effecting any joint transactions with the BDC in contravention of SEC rules.

The following categories determine the approval required to engage in a Restricted Transaction:

- Close Affiliates. The following 57(b) affiliates are prohibited from engaging in Restricted Transactions with the BDC without prior approval from the SEC:
 - (1) Any director, officer, employee or member of an advisory board of the BDC (or any person controlling, controlled by or under common control with such affiliate);
 - (2) The BDC's investment adviser, promoter, general partner, principal underwriter or a person controlling, controlled by⁵ or under common control with the BDC (or any officer, director, partner, copartner or employee of such affiliate or any person controlling, controlled by or under common control with such affiliate).
- Remote Affiliates. The following 57(e) affiliates are prohibited from engaging in Restricted Transactions with the BDC without the approval of both a majority of the BDC's independent directors/trustees and a majority of the directors/trustees who have no financial interest in the transaction:
 - (1) Any 5% shareholder of the BDC (or any director, executive officer or general partner of such affiliate or any person controlling, controlled by or under common control with such affiliate);
 - (2) Essentially any person who is an "affiliated person" of a 57(b) affiliate.⁶

⁵ Downstream affiliates of the BDC are exempt under Rule 57b-1.

⁶ "Affiliated person" is defined in section 2(a)(3) of the 1940 Act and essentially means (A) a 5% shareholder of such other person; (B) an entity 5% owned by such other person; (C) a person controlling, controlled by or under common control with such other person; (D) any director, officer, partner, copartner or employee of such other person; (E) the investment adviser or member of the advisory board of an investment company; and (F) the depositor of an unincorporated investment company not having a board of directors.

Section 57(h) requires the directors of the BDC to maintain procedures to monitor the possible involvement of affiliates in Restricted Transactions.

BDCs and their investment advisors commonly apply for an exemptive relief order from the SEC permitting co-investment with affiliated funds advised by the investment advisor, subject to certain conditions designed to ensure fair and equitable treatment of all participating entities.

Significant Managerial Assistance. Unlike typical investment companies, BDCs are not expected to be passive investors. Rather, a BDC is required to make available “significant managerial assistance” to the companies that it treats as satisfying the 70% standard. Making available significant managerial assistance means any arrangement whereby a BDC, through its directors, officers or employees, offers to provide significant guidance and counsel concerning the management, operations or business objectives and policies of the company.⁷ Significant managerial assistance may also mean the exercise by a BDC of a controlling influence over the management or policies of a company by the BDC acting individually or together with a group which controls such company.⁸

Capital Structure (Limit on Debt). Generally, a BDC may not issue securities unless it meets the following 1940 Act requirements: (1) the BDC must maintain an “Asset Coverage” ratio of at least 200% (or 150% if certain requirements are met);⁹ (2) holders of preferred stock, if any is issued, must be entitled as a class to elect two directors at all times and to elect a majority of the directors if distributions on such preferred stock are in arrears by two years or more; and (3) preferred stock shall have complete priority over any common stock as to the distribution of assets and payment of dividends, which dividends shall be cumulative. The 1940 Act also requires a separate majority vote of the holders of preferred stock, if any, on certain extraordinary actions.

Independent Directors. Section 56 of the 1940 Act requires that a majority of a BDC’s directors be independent, i.e., not “Interested Persons” of the BDC. “Interested Person” is defined in section 2(a)(19) of the 1940 Act and covers an extensive array of affiliated and otherwise interested persons. The independent director requirement is necessitated, in part, by the unique structure of investment companies. Unlike a typical corporation, an investment company usually has no employees of its own. Its officers are typically employed and compensated by its investment advisor, which provides most of the services. Independent directors are intended to play a critical role in policing the potential conflicts of interest that may arise between the investment company and its investment advisor and affiliates.

⁷ There is no requirement that the company has to accept such offer.

⁸ With respect to a small business investment company (“SBIC”) licensed by the Small Business Administration to operate under the Small Business Investment Act of 1958, the making of loans to a portfolio company would satisfy the “significant managerial assistance” requirement.

⁹ “Asset Coverage” is defined in Section 18(h) of the 1940 Act. Essentially, a BDC subject to the 200% Asset Coverage requirement cannot use greater than 50% leverage (1 to 1 debt-to-equity ratio). Pursuant to the Small Business Credit Availability Act of 2018, a BDC may elect to lower its Asset Coverage ratio requirement to 150% (i.e., such an electing BDC may use up to 66.66% leverage (2 to 1 debt-to-equity ratio)), subject to certain requirements relating to board/shareholder approval.

Under certain sections of the 1940 Act and the rules promulgated thereunder, various activities require not only the approval of a majority of the entire Board, but also a majority of the independent directors. A majority of independent directors must:

- Approve contracts with the investment advisor and principal underwriter;
- Approve the compliance policies and procedures (for securities laws) of the company and its investment advisor, principal underwriter, administrator and transfer agent;
- Approve the codes of ethics of the company, the investment advisor and the principal underwriter;
- Approve the designation, compensation and removal of the chief compliance officer;
- Select the public accountant;
- Select and nominate individuals to fill independent director vacancies resulting from the assignment of an advisory contract;
- Approve and oversee transactions with affiliates; and
- Set the form and amount of the fidelity bond.

Internal v. External Management. A BDC may be internally or externally managed. Generally, an internally managed BDC must develop the infrastructure and hire employees, or establish a subsidiary to manage the BDC, and must address issues related to having custody of the portfolio assets. In contrast, an externally managed BDC contracts with a third party to provide investment advisory services. An external investment advisor already has the infrastructure, staff and expertise to satisfy the regulatory requirements applicable to BDCs, including issues relating to custody of assets. Certain inherent conflicts of interest may exist regarding an advisor's allocation of investment opportunities between the BDC and the advisor's other clients. External investment advisors to BDCs must be registered with the SEC.

Fees. Section 205(b)(3) of the Investment Advisers Act of 1940 (the "**Advisers Act**") permits an investment advisor of a BDC to receive performance-based compensation, *provided that* it does not exceed 20% of the realized capital gains of the BDC, net of realized capital losses and unrealized capital appreciation over a specified time period or as of specified dates. The SEC staff has stated that the 20% limitation is the maximum performance fee and not the maximum total compensation. Thus, an investment advisor can receive a management fee and an incentive fee on income (often subject to a hurdle rate) in addition to the capital gains performance fee/allocation.

Operational Considerations. As with other investment companies, a BDC must adhere to certain regulatory requirements with respect to its operations, which are summarized below.

- Indemnification. A BDC is prohibited from protecting any director, officer, investment advisor or principal underwriter against any liability to the company or to its security holders arising from willful misfeasance, bad faith, gross negligence or reckless disregard of such person's duties.
- Valuation of Assets. A BDC's board of directors is required to value portfolio assets on a quarterly basis in connection with filing certain periodic reports. Assets must be valued on the basis of market value if available. In the absence of a readily ascertainable market value for an asset, the board must in good faith determine the "fair value."
- Fiduciary Duties and Code of Ethics. A BDC's directors, officers and external investment advisor are all subject to general fiduciary duties with respect to the conduct of their duties as they impact the BDC.¹⁰ A BDC (and its investment advisor and principal underwriter) must adopt a code of ethics and institute procedures reasonably necessary to ensure that employees and certain affiliates adhere to the code of ethics.
- Fidelity Bond. A BDC must provide and maintain a bond issued by a reputable fidelity insurance company to protect the company against larceny and embezzlement. The fidelity bond must cover each officer and employee with access to securities and funds of the BDC, with the required coverage tied to the amount of the company's assets.
- BDC Election. A BDC may not withdraw its election to operate as a BDC unless authorized by the vote of "a majority of the outstanding voting securities" (i.e., the lesser of (i) 50% of the voting securities or (ii) 67% or more of the voting securities present at a meeting if the holders of more than 50% of the outstanding voting securities are present or represented by proxy).

RIC Tax Treatment; Requirements. A BDC may elect to be treated for U.S. federal income tax purposes as a regulated investment company ("RIC") under Subchapter M of the Internal Revenue Code of 1986, as amended (the "**Code**"). Taxation as an RIC allows "pass through" tax treatment for income and capital gains that are distributed to shareholders.

In order to qualify as an RIC, a BDC must, among other things, meet certain source-of-income, asset diversification and distribution requirements (as described below):

- Distribute to investors, for each taxable year, at least 90% of its "investment company taxable income," which is generally net ordinary income plus the excess, if any, of realized net short-term capital gain over realized net long-term capital loss (the "**Annual Distribution Requirement**");
- Qualify to be treated as a BDC (or be registered as a management investment company) under the 1940 Act at all times during each taxable year;

¹⁰ Directors and officers have fiduciary duties under state statutory and common law. Investment advisors have fiduciary duties with respect to the receipt of compensation for services under Section 36(b) of the 1940 Act.

- Derive in each taxable year at least 90% of gross income from: dividends, interest, payments with respect to certain securities loans, gains from the sale of stock or other securities or foreign currencies, net income derived from “qualified publicly traded partnerships” (as defined in the Code) or other income derived with respect to its business of investing in such stock or securities (the “**90% Income Test**”); and
- Diversify holdings so that at the end of each quarter of the taxable year:
 - At least 50% of the value of its assets consist of cash, cash equivalents, U.S. government securities, securities of other RICs and other securities if such other securities of any one issuer do not represent more than 5% of the value of the Company’s assets or more than 10% of the outstanding voting securities of any one issuer; and
 - Other than U.S. government securities or securities of other RICs, no more than 25% of the value of the Company’s assets is invested in the securities of either: (i) a single issuer; (ii) two or more issuers controlled by the Company and engaged in the same or similar or related trades or businesses; or (iii) one or more qualified publicly traded partnerships (the “**Diversification Tests**”).

As an RIC, a BDC may still be subject to corporate-level federal income tax on undistributed taxable income (if any), and it could be subject to federal excise, state, local and foreign taxes. A BDC will be subject to a 4% nondeductible federal excise tax on certain undistributed income as an RIC unless it distributes in a timely manner an amount at least equal to the sum of: (i) 98% of net ordinary income for the calendar year, (ii) 98.2% of net capital gains for the one-year period ending October 31 of that calendar year, and (iii) any net ordinary income and net capital gains recognized, but not distributed, in preceding years and on which the BDC paid no federal income tax (the “**Excise Tax Avoidance Requirement**”).



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