SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release No. IC–27539; 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: Reproposed rule.

SUMMARY: The Commission is reproposing for comment an additional definition of the term ''eligible portfolio company'' under the Investment Company Act of 1940 (''Investment Company Act'' or ''Act''). The reproposed rule is intended 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 reproposed rule would expand the definition of eligible portfolio company to include certain companies that list their securities on a national securities exchange (''Exchange'').

DATES: Comments should be received on or before January 2, 2007.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/proposed*); or
- Send an e-mail to *rule-comments@sec.gov.* Please include File Number S7–37–04 on the subject line; or
- Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549–1090.

All submissions should refer to File Number S7–37–04. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/proposed*). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Rochelle Kauffman Plesset, Senior Counsel, or Elizabeth G. Osterman, Assistant Chief Counsel, Office of Chief Counsel, (202) 551–6825, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–5030.

SUPPLEMENTARY INFORMATION: The Commission today is reproposing Rule 2a–46(b) [17 CFR 270.2a–46] under the Investment Company Act [15 U.S.C. 80a *et seq.*].[1]

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I. Background

BDCs are closed-end investment companies that Congress established for the purpose of making capital more readily available to certain types of companies.[2] To accomplish this purpose, the Investment Company Act 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.'' [3]

The Investment Company Act defines eligible portfolio company to include domestic operating companies that, among other things, do not have any class of securities that are marginable under rules promulgated by the Federal Reserve Board.[4] In 1998, for reasons unrelated to small business capital formation, the Federal Reserve Board amended its definition of margin security to increase the types of securities that would fall within that definition under its rules. This amendment had the result of reducing the number of companies that qualify as eligible portfolio companies.

In November 2004, the Commission proposed Rule 2a–46 [5] and Rule 55a–1

[1] The Commission today issued a release adopting Rule 2a–46, which defines eligible portfolio company as a company whose securities are not listed on an Exchange, and Rule 55a–1, which conditionally permits BDCs to make additional (follow-on) investments in certain companies. Definition of Eligible Portfolio Company under the Investment Company Act of 1940, Investment Company Act Release No. 27538 (Oct. 25, 2006) (''Adopting Release'').

[2] Small Business Investment Incentive Act of 1980, Pub. L. No. 96–477, 94th Stat. 2274 (1980) (codified at scattered sections of the United States Code) (''SBIIA''). *See also generally* H.R. Rep. No. 1341, 96th Cong., 2d Sess. 21 (1980) (''House Report'').

[3] *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)].

[4] Section 2(a)(46)(C)(i) of the Investment Company Act. *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).

[5] 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.'' While stating that BDCs ''already have substantial freedom of action to purchase securities of companies which are not eligible portfolio companies,'' referring to the investments permitted to be made outside of the 70% basket, 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. 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

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to address the impact of the Federal Reserve Board's 1998 amendments on the definition of eligible portfolio company.[6] As proposed, Rule 2a–46(a) would have defined eligible portfolio company to include any domestic operating company[7] that does not have a class of securities listed on an Exchange;[8] and Rule 2a–46(b) would have defined eligible portfolio company to include any domestic operating company that has a class of securities listed on an Exchange, but is in danger of having its securities delisted because of financial difficulties. As proposed, Rule 55a–1 would have conditionally permitted a BDC to continue to invest in a company that had met the proposed definition of eligible portfolio company at the time of the BDC's initial investment(s) in it, but did not subsequently meet that definition.

Today, the Commission adopted Rule 2a–46, initially proposed as Rule 2a–46(a), and Rule 55a–1.[9] The Commission did not adopt proposed Rule 2a–46(b) based on commenters' concerns that the proposed rule would be unworkable and too narrow.

II. Discussion

A. Comments Received on 2004 Proposing Release

We received thirty-six comment letters that addressed the proposed rules.[10] Most commenters argued that proposed Rule 2a–46(b), which would have defined eligible portfolio company to include domestic operating companies whose securities were listed on an Exchange but were in danger of being delisted because of financial difficulties, would be unworkable.[11] Some commenters also argued that the proposed rule would be too narrow because it 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 capital markets. They argued that these companies should qualify as eligible portfolio companies under the rule.[12] Many commenters urged us to adopt a size-based standard and suggested a specific numeric threshold.[13]

B. Reproposed Rule 2a–46(b)

After considering the comments received, the Commission believes that it is appropriate to seek further input on including additional companies in the definition of eligible portfolio company. Accordingly, the Commission is revising and reproposing Rule 2a–46(b) to provide an additional definition of eligible portfolio company.[14] We have included two alternatives of reproposed Rule 2a–46(b) for comment. Each alternative would include certain domestic, operating companies that list their securities on an Exchange.[15] The first alternative would include companies whose public float is less than $75 million (''Alternative One'').[16] The second alternative (two versions) would include companies whose market capitalization is less than either $150 million or $250 million (''Alternative Two'').

Under both alternatives, a company's size would be calculated using the price at which the company's common equity was 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.[17] This provision is similar to the methodology used in current Commission rules that differentiate among companies based on their size,[18] and is intended to reduce regulatory complexity.

We discuss the use of a size-based standard and each of the alternatives below.

1. Size-Based Standard

In the 2004 Proposing Release, we questioned whether a size-based standard could: (1) Result in a company's eligible portfolio company status fluctuating frequently as a result of market and economic conditions; (2) allow a company to manipulate its capital structure to fall below a specified level; and (3) introduce regulatory arbitrage by encouraging

companies, the extent of their public ownership, and their operating history as going concerns and public companies.''). *See* House Report at 31.

[6] The rules were proposed in 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'').

[7] The proposed rule would have incorporated the provisions of Section 2(a)(46)(A) and (B). Section 2(a)(46)(A) of the Investment Company Act defines eligible portfolio company to include (among other things) companies organized under the laws of, and with their principal 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 that Act, but includes as an eligible portfolio company a small BDC that is licensed by the Small Business Administration and that is a wholly-owned subsidiary of a BDC.

[8] The rule as proposed also would have defined eligible portfolio company to include any domestic operating company that does not have any class of securities listed on an automated interdealer quotation system of a national securities association (*i.e.*, The NASDAQ Stock Market LLC) (''Nasdaq''). On August 1, 2006, Nasdaq began operating as a national securities exchange registered under Section 6(a) of the Exchange Act. *See www.nasdaq.com/newsroom/news/pr2006/ne_section06_097.stm.*

[9] *See supra* note 1.

[10] Commenters included members of Congress, BDCs, law firms, trade associations and small businesses that had received financing from a BDC. The comment 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). They also may be viewed at *http://www.sec.gov/rules/proposed/ic-26647.htm.*

[11] *See, e.g.*, comments of Shearman & Sterling LLP (Jan. 7, 2005) (''* * * we believe that the requirement for a delisting notice would frustrate one of the purposes of proposed Rule 2a–46(b), which as expressed in the proposing release, seeks to address the need of, and provide access to capital readily to, financially troubled issuers that have not reached the dire financial straits contemplated by Section 55(a)(3) of the 1940 Act. In our experience, the delisting process often lags the 'facts on the ground,' and properly so, as Exchanges are reluctant to impose a premature death sentence on listed companies. Thus, we submit that a company that receives a delisting notice would likely be in severe financial distress.''); comments of American Capital Strategies Ltd. (Jan. 7, 2005) (generally arguing that the minimum initial listing standards of an Exchange would exclude many of the companies Congress intended to benefit from BDC financing, and noting that the requirement for a delisting notice ''could result in substantially the same situation as was caused by the Federal Reserve Board changes to the margin securities regulations'').

[12] *See, e.g.*, comments of Allied Capital (Jan. 7, 2005); comments of UTEK (Jan. 7, 2005). But see comments of the Committee on Federal Regulation of Securities of the Business Law Section of the American Bar Association (Jan. 5, 2005) (supporting proposal in full); comments of the Investment Company Institute (Jan. 6, 2005) (supporting proposal in full).

[13] *See, e.g.*, comments of Capital Southwest Corporation (Dec. 28, 2004); comments of Representative Sue Kelly and Representative Nydia Velázquez (Jan. 5, 2005); comments of Shearman & Sterling LLP (Jan. 7, 2005); comments of UTEK (Jan. 7, 2005); comments of Allied Capital (Jan. 7, 2005); comments of Williams & Jensen (Feb. 17, 2006).

[14] We are also proposing to renumber Rule 2a–46 as Rule 2a–46(a). We are not proposing any other changes to that rule.

[15] Like Section 2(a)(46) and proposed Rule 2a–46, reproposed Rule 2a–46(b) would define eligible portfolio company to include only domestic operating companies. *See supra* note 7.

[16] Public float is the aggregate market value of a company's outstanding voting and non-voting common equity (*i.e.*, a company's market capitalization) minus the aggregate market value of common equity held by the company's affiliates. *See, e.g.*, Simplification of Registration Procedures for Primary Securities Offerings, Securities Act Release No. 6964 (Oct. 22, 1992) [57 Fed. Reg. 48970 (Oct. 29, 1992)]. Rule 2a–46(b)(2) would define the term ''affiliate'' for purposes of Alternative One by reference to the definition of the same term in Rule 405 under the Securities Act of 1933 (''Securities Act'') [17 CFR 230.405].

[17] Reproposed Rule 2a–46(b)(1). Reproposed Rule 2a–46(b)(2) would define the term ''common equity'' for purposes of Rule 2a–46(b) by reference to the definition of the same term in Rule 405 under the Securities Act.

[18] *See* Form S–3 [17 CFR 239.13]; Securities Offering Reform, Securities Act Release No. 8591 (July 19, 2005) [67 FR 44722 (Aug. 3, 2005)] (''Securities Offering Reform'').

registered closed-end funds to elect BDC status so that they could have the benefit of the lighter regulatory burdens applicable to BDCs under the Investment Company Act. We also noted that it was unclear what level of market capitalization would be appropriate to define an eligible portfolio company.[19]

After careful review, we have reconsidered our initial concerns about using a size-based standard and believe that these concerns may be addressed. First, we have addressed our concern that a company's eligible portfolio company status may fluctuate based on market conditions by proposing, in both Alternative One and Alternative Two of Rule 2a–46(b), that the size would be computed using the price at which the company's common equity was 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, determined as of a single date within 60 days immediately prior to a BDC's acquisition of the company's securities. Second, permitting a company to meet the size-based standard on a single date within the 60-day period immediately prior to a BDC's acquisition of the company's securities also lessens our concern that a company might manipulate its capital structure to meet that standard. Third, with respect to our regulatory arbitrage concern, based upon further evaluation of the differences between registered closed-end funds and BDCs, we believe that most closed-end funds probably would not elect BDC status merely because of the different regulatory framework. Unlike BDCs, most closed-end funds are not structured so as to be able to offer managerial assistance to their portfolio companies. In addition, we believe that most closed-end funds probably would not choose a regulatory framework that would cause them to forego some investment flexibility by requiring them to invest a large percentage of their assets in privately negotiated transactions. One commenter also noted that a closed-end fund would be unlikely to elect BDC status ''unless it was committed to the BDC mission to finance small and developing companies'' because of certain regulatory requirements to which BDCs, but not closed-end funds, currently are subject.[20] Finally, based on our review of the comments, we believe that a size-based standard would provide a bright-line test that is easy to administer.

2. Alternative Proposals

As one commenter pointed out, there is no single standard that precisely defines the types of companies that could benefit from BDC financing.[21] After carefully considering the comments on the original proposal and with this in mind, we are proposing the following two alternatives of Rule 2a–46(b) that we believe are consistent with the purpose Congress intended. In addition, as noted above, we have addressed the concerns we originally had regarding the use of a size-based standard.

(a) $75 Million Public Float (Alternative One)

Alternative One would define eligible portfolio company to include companies whose securities are listed on an Exchange and have a public float of less than $75 million.[22] Alternative One incorporates the size-based standard used in Form S–3 and Rule 12b–2 under the Exchange Act.[23] We have used this standard to delineate between small, unseasoned companies, and larger, seasoned companies whose securities are listed on an Exchange.[24] For example, to register a primary securities offering for cash on Form S–3, a company must have public float of at least $75 million.[25] Companies that meet the eligibility requirements of Form S–3 are mature enough to be able to take advantage of short-form registration, including the resultant benefits of incorporation by reference and quick access to the capital markets through ''shelf registration.'' Similarly, under Rule 12b–2 under the Exchange Act, a company with $75 million public float or more would be an ''accelerated filer,'' and thus be required to meet accelerated deadlines in filing certain Exchange Act reports.[26]

We believe that Alternative One would capture companies that Congress intended to benefit from BDC financing. In this regard, the Commission's Office of Economic Analysis (''OEA'') estimates that, based on June 2006 data, Alternative One would increase the percentage of public domestic operating companies that would meet the definition of eligible portfolio company by 9.1 percent (a total of 896 companies). OEA's calculations relating to public float are based, for the most part, on a public float definition that is similar to the definition of public float used for purposes of Form S–3 and is included in Alternative One.[27] New

[19] *See* 2004 Proposing Release, *supra* note 6 at nn. 34–36 and accompanying text.

[20] Comments of Allied Capital (Jan. 7, 2005). *See also* comments of UTEK (Jan. 7, 2005). These commenters noted compliance costs related to the Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (2002), and reporting obligations under the Exchange Act, as some of the regulatory burdens that might act to deter a closed-end fund that has no reason to elect BDC status, other than an interest in a different regulatory framework, from seeking to elect that status.

[21] Comments of Allied Capital (Jan. 7, 2005).

[22] Reproposed Rule 2a–46(b).

[23] Alternative One, while based on the requirements of Form S–3 and Rule 12b–2, does not incorporate any of the reporting requirements found in those rules out of concern that doing so could capture some companies that may not qualify to use Form S–3 or be considered an accelerated filer only because they were not in compliance with the reporting requirements. We are soliciting comments on this concern.

[24] Under recently adopted rules, an ''unseasoned issuer'' is defined as a company that is required to file reports under Section 13 or Section 15(d) of the Exchange Act [15 U.S.C. 78m or 78*o*(d)], but does not satisfy the requirements of Form S–3 for a primary offering of its securities; a ''seasoned issuer'' is defined as a company that is eligible to use Form S–3 for a primary offering of securities; and a ''well-known seasoned issuer'' is defined to include a company that, among other things, has at least $700 million public float. Securities Offering Reform, *supra* note 18.

[25] In addition to having public float of at least $75 million, a company is eligible to use Form S–3 to register a primary offering of its securities for cash if it: (1) is organized under the laws of the United States or any state and has its principal business operations in the United States; (2) has a class of securities registered under Section 12(b) or a class of equity securities registered under Section 12(g) of the Exchange Act [15 U.S.C. 78*l*(b) or (g)], or is required to file periodic reports under Section 15(d) of the Exchange Act [15 U.S.C. 78*o*(d)]; (3) has been subject to the requirements of Section 12 or Section 15(d) of the Exchange Act and has filed in a timely manner all of the material required to be filed under Sections 13, 14 or 15(d) of the Exchange Act for at least one year [15 U.S.C. 78m, 78n or 78*o*(d)]; and (4) has not failed to pay a dividend or sinking fund installment on preferred stock or defaulted on certain specified obligations since the end of the last fiscal year.

[26] Accelerated filers, in addition to having a public float of $75 million or more, are companies that meet the following conditions as of the end of their fiscal year: (1) they have been subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act for a period of at least 12 calendar months; (2) they previously have filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act; and (3) they are not eligible to use Forms 10–KSB and 10–QSB [17 CFR 249.310(b) and 17 CFR 249.308(b)]. *See* Acceleration of Periodic Report Filing Dates and Disclosure Concerning Web site Access to Reports, Securities Act Release No. 8128 (Sept. 5, 2002) [67 FR 58480 (Sept. 16, 2002)].

[27] OEA relied on the estimate of public float provided by Bloomberg LLP in calculating the estimates used in this Release. Bloomberg defines public float as the number of shares outstanding less shares held by insiders and those deemed to be ''stagnant shareholders.'' ''Stagnant shareholders'' include ESOPs, ESOTs, QUESTs, employee benefit trusts, corporations not actively engaged in managing money, venture capital companies and shares held by governments. Bloomberg provides estimates of public float for 3,471 out of 3,804 (91%) of the domestic operating companies identified. For the 333 companies for which OEA was unable to obtain an estimate of public float, OEA used each company's market capitalization. Since small public companies often have a high percentage of insider investors, using market capitalization most likely results in a number that underestimates the number of

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Rule 2a–46, based on June 2006 data, includes approximately 61.4 percent of public domestic operating companies (a total of 6,041 companies).[28] Thus, approximately 70.5 percent (6,937/9,845) of existing domestic public operating companies could qualify as eligible portfolio companies under new Rule 2a–46 and Alternative One of reproposed Rule 2a–46(b).[29]

We note that Alternative One is similar to a suggestion made by one commenter, a BDC.[30] This commenter suggested that we define eligible portfolio company to include public companies that have market capitalization of less than $100 million to ensure that BDCs continue to invest most of their assets in smaller companies.[31]

Finally, we note that Congress intended that we consider a number of factors in engaging in any rulemaking to define eligible portfolio company, including the extent of companies' public ownership.[32] We have considered this factor in proposing Alternative One, which, by using public float, excludes insider ownership of a company.[33] Nevertheless, as discussed below, we are also soliciting comment on using a market capitalization test.

(b) $150/$250 Million Market Capitalization (Alternative Two)

Alternative Two would define eligible portfolio company to include companies that have securities listed on an Exchange based on their market capitalizations. As discussed below, we propose two ceilings under this alternative—$150 million market capitalization and $250 million market capitalization.[34]

We solicited comment on the possibility of using a market capitalization standard in the 2004 Proposing Release. Many commenters urged us to adopt a numeric threshold based on market capitalization.[35] Some commenters noted that companies with market capitalization up to $300 million generally are followed by fewer analysts, have lower institutional ownership and have lower trading volume than companies at higher levels of market capitalization.[36] These commenters concluded that such companies have difficulty accessing the public capital markets. We recognize that, at some level of market capitalization, there may be a difference in public awareness of a company as measured by analyst coverage, institutional ownership and other factors that may be related to the company's ability to attract capital.[37]

In addition, we note that many investment companies classify themselves with reference to the size of the companies in which they invest.[38] Similar size-based classifications also are often used by market participants. These classifications generally assist investors in making their investment choices. In particular, we note the general use of the term ''microcap'' to identify some small, public companies. This classification typically refers to companies with market capitalization of less than $150 million to less than $300 million.[39] Microcap issuers often include, among others, small start-up companies.[40]

We believe that market-based classifications are useful to consider in designing a standard to define the type of company that could benefit from BDC financing. Nevertheless, we note that market participants use different bases to determine these classifications. Accordingly, we are proposing for comment two different market capitalization ceilings. The first ceiling would define an eligible portfolio company to include companies that have securities listed on an Exchange that have less than $150 million market capitalization. This is similar to the classification that some market participants use to identify some small, public companies.[41] The second ceiling would define an eligible portfolio company to include companies that have securities listed on an Exchange that have less than $250 million market capitalization. This ceiling mirrors legislation proposed last year[42] and is

companies that have a public float of less than $75 million.

[28] *See* Adopting Release, *supra* note 1 at text following n.17.

[29] We note that our estimates reflect only those companies with less than $75 million public float whose securities are listed on Nasdaq, the New York Stock Exchange (''NYSE'') and the American Stock Exchange (''Amex''). The estimates do not reflect those companies whose securities are exclusively listed on a regional exchange (*i.e.*, those companies whose securities are not dually listed on the NYSE, the Amex or Nasdaq) because such information is not available on our primary data source. While there are only a limited number of these companies, we believe that most of them have a public float of less than $75 million and thus would also be eligible portfolio companies under either of the proposed alternatives of Rule 2a–46(b).

[30] Comments of Capital Southwest Corporation (Dec. 28, 2004).

[31] We estimate that there is little difference between the number of companies that would be included under the standard proposed under Alternative One and a standard using $100 million market capitalization. OEA estimates that approximately 918 public domestic operating companies would be included under a $100 million market capitalization standard, compared to 896 public domestic operating companies that would be included under a $75 million public float standard (a difference of 22 companies).

[32] *See supra* note 5.

[33] *See supra* note 16.

[34] Reproposed Rule 2a–46(b).

[35] *Supra* note 13.

[36] Comments of Representatives Sue Kelly and Nydia Velázquez at n.12 (Jan. 5, 2005); comments of Williams & Jensen (Feb. 17, 2006). These commenters referred to analysis prepared by OEA in connection with Securities Offering Reform. *See* memorandum dated December 3, 2004 (''OEA Memorandum'') 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''). We note that OEA prepared this memorandum to support differentiating among public companies for purposes of defining well-known seasoned issuers. *See supra* note 24. Also, the OEA Memorandum does not exclude foreign companies and certain domestic, financial companies. *See* Sections 2(a)(46)(A) and (B), *supra*, note 5. The set of companies discussed in that memorandum therefore is not directly comparable to the set of companies that might be defined as eligible portfolio companies under Rule 2a–46 and proposed Rule 2a–46(b). *See also* comments of Allied Capital (Jan. 7, 2005) (data compiled by Banc of America Securities LLC at Appendix A used to make similar point); comments of UTEK (Jan. 7, 2005) (general statement of similar point).

[37] *See* Background Statistics: Market Capitalization & Revenue of Public Companies, August 1, 2005 revision, prepared by OEA and included at Appendix I of Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies, Securities Act Release No. 8666 (modified Mar. 15, 2006), available at *www.sec.gov/rules/other/33-8666.pdf*. This data does not exclude foreign companies and certain domestic, financial companies. Like the set of companies discussed in the OEA Memorandum, it therefore is not directly comparable to the set of companies that might be defined as eligible portfolio companies under Rule 2a–46 and proposed Rule 2a–46(b). *See* Sections 2(a)(46)(A) and (B), *supra*, note 5.

[38] *See, e.g., http://biz.yahoo.com/funds/sm_mf2.html.*

[39] There is no one generally accepted definition of microcap issuer. Morgan Stanley and the Motley Fool define a microcap issuer to be issuers with market capitalizations of less than $150 million. *See e.g., http://www.fool.com/school/glossary/glossaryc.htm; http://www.morganstanleyindividual.com/customerservice/dictionary.* Yahoo generally refers to microcap funds as funds that invest in companies with less than $250 million. *Supra* note 38. *See also http://www.investorwords.com/3050/micro_cap.html* (microcap companies include those companies with market capitalization of under $250 million). Lipper Inc. defines microcap funds as those funds that invest primarily in companies with market capitalization less than $300 million at the time of purchase. Lipper, U.S. Open-End, Closed-End, Variable Annuity, and Overseas Fund Classifications Descriptions (Version 1.2, updated: April 11, 2006), available at *www.Lipperweb.com.*

[40] Some larger, more established public companies, in addition to small, start-up public companies, would qualify as eligible portfolio companies under Alternative Two. We note that certain larger companies were historically included under the definition of eligible portfolio company before 1998. *See* 2004 Proposing Release, *supra* note 6.

[41] *See supra* note 39.

[42] The ''Increased Capital Access for Growing Business Act'' was passed by the House of Representatives on April 6, 2005. H.R. 436, 109th Cong., 1st Sess. (2005) (previously H.R. 3170); S. 1396, 109th Cong., 1st Sess. (2005) (mirrors H.R. 436). Both H.R. 436 and S. 1396 currently are pending before the Senate Committee on Banking, Housing and Urban Affairs.

also similar to the classification that other market participants use to identify some small, public companies.[43]

OEA estimates that based on June 2006 data, Alternative Two would increase the percentage of public domestic operating companies that would meet the definition of eligible portfolio company. A ceiling of $150 million market capitalization would increase the percentage of eligible portfolio companies by 11.8 percent (a total of 1,168 companies). Since new Rule 2a–46, based on June 2006 data, includes approximately 61.4 percent of public domestic operating companies (a total of 6,041 companies), approximately 73.2 percent (7,209/9,845) of existing domestic public operating companies could qualify as eligible portfolio companies under the combination of the two provisions. A ceiling of $250 million market capitalization would increase the percentage of eligible portfolio companies by 16 percent (a total of 1,562 companies), for a total of approximately 77.2 percent (7,603/9,845) of existing domestic public operating companies under the combination of new Rule 2a–46 and this version of Alternative Two.

3. Solicitation of Comments

We are requesting comment on whether Alternative One, one of the two versions of Alternative Two, or another alternative not discussed in this Release, would accomplish the objective of more closely aligning the definition of eligible portfolio company with the purpose that Congress intended. We are particularly interested in comments from small businesses with respect to the impact that the alternatives (Alternative One and both versions of Alternative Two) may have on them. We are also interested in receiving information about small businesses' experiences relating to their ability to raise capital through securities offerings or to borrow money through conventional sources (*e.g.*, banks).

We specifically request comment on the following points:

• Please provide your view as to whether Alternative One or one of the two versions of Alternative Two more closely aligns the definition of eligible portfolio company with the purpose that Congress intended. Do any of the proposals (Alternative One or one of the two versions of Alternative Two) better expand the definition of eligible portfolio company consistent with the purpose of SBIIA? Please provide empirical and analytical evidence that supports your response. If you believe that none of the proposals meets the objective of expanding the definition consistent with the purpose of SBIIA, please provide us with another suggestion that meets this objective, with supporting empirical and analytical evidence. In particular, please comment on whether the ceiling in any suggestion should be lower or higher than those included in the proposals. Please also comment on whether it is more appropriate to use a standard based on public float or market capitalization. For example:

○ Alternative One mirrors the standard used in Form S–3 and Rule 12b–2 of $75 million public float. Would it be more appropriate to use a lower ceiling based on Regulation S–B under the Securities Act of 1933 and the Exchange Act, which defines a ''small business issuer'' as, among other things, an issuer that has revenues of less than $25 million, but would not include an issuer that has public float of $25 million or more?

○ Would a ceiling other than the one included under Alternative One or one of the two versions of Alternative Two, or another ceiling not discussed in this Release, be a better way of achieving our objective of more closely aligning the definition of eligible portfolio company with Congress's intent? For example, one commenter suggested a ceiling of $300 million market capitalization based on its analysis of companies that have difficulty accessing capital.[44]

○ We are particularly mindful of the unique position of BDCs as regulated investment companies under the Investment Company Act. Congress amended the Investment Company Act in recognition of the differences between BDCs and other investment companies, and the ''valuable function in the capital formation process'' that BDCs provide.[45] In enacting these amendments, Congress was careful to balance investor protections against the benefits of increasing the flow of public capital to certain companies.[46] One commenter expressed its concern that a high size-based standard could result in BDCs focusing their investment activities on larger companies to the detriment of the companies that BDCs were intended to help.[47] We solicit comment on this concern. We also request comment on whether either of the proposed alternatives, or a different alternative, would have a negative impact on BDC investors.

○ Congress noted that we may consider a number of factors in adopting rules to define eligible portfolio company, including the extent of companies' public ownership.[48] We have used public float (which excludes insider ownership of a company[49]) as the basis for Alternative One. We have used market capitalization (which includes all public ownership, including insiders' interests) as the basis for Alternative Two. Please comment on which standard (public float or market capitalization) you believe more closely aligns the definition of eligible portfolio company with Congress's purpose.

○ We understand that it is more difficult to obtain a company's public float from reliable third-party sources than it would be to obtain a company's market capitalization, which is readily available through such sources.[50] Although public float information is not readily available through third-party sources, we expect that the costs involved in a BDC complying with these requirements would be minimal. Section 55 of the Investment Company Act generally requires a BDC to invest in eligible portfolio companies through privately negotiated transactions, and we anticipate that a BDC would be able to obtain this information from the company during the course of those

This ceiling is also consistent with some commenters' suggestions. *See* comments of Williams & Jensen (Feb. 17, 2006) (''The $250 million market capitalization level included in the legislation is consistent with the original Congressional intent.''). *See also* comments of Representatives Sue Kelly and Nydia Velázquez (Jan. 5, 2005); comments of UTEK (Jan. 7, 2005); comments of Allied Capital (Jan. 7, 2005); comments of American Capital (Jan. 7, 2005); comments of Representative Michael Oxley, Representative Richard Baker and Representative Sue Kelly (Nov. 15, 2005); comments of Chamber of Commerce of the United States of America (Dec. 13, 2005); comments of Senator Charles Schumer and Senator Robert Menendez (Apr. 24, 2006).

[43] *See supra* note 39.

[44] Comments of Williams & Jensen (Feb. 17, 2006).

[45] House Report at 21. *See* Section I, 2004 Proposing Release, *supra* note 6.

[46] House Report at 22 (''the Committee is cognizant of the need to avoid compromising needed protection for investors in the name of reducing regulatory burdens. * * * Consequently, [SBIIA] is intended to preserve to the fullest possible extent [the application of investor protections of the federal securities laws to BDCs and their operators], while at the same time reducing unnecessary regulatory burdens.''). *See* 2004 Proposing Release, *supra* note 6 at n.4 and accompanying text (discussing regulatory flexibility given to BDCs).

[47] *See* supra notes 30–31and accompanying text. *See also* comments of Investment Company Institute (Jan. 6, 2005).

[48] *See supra* note 5.

[49] *See supra* note 16.

[50] Although companies required to file reports with us under the Exchange Act are required to disclose their public float on the cover page of Form 10–K [17 CFR 249.310], that information may be outdated at the time a BDC seeks to invest in that company.

negotiations.[51] Are these assumptions accurate, or would it be burdensome for a BDC to determine a company's eligible portfolio company status if it is based on public float rather than market capitalization?

• Unlike Form S–3 and Rule 12b–2, Alternative One of reproposed Rule 2a–46(b) does not incorporate any of the qualifying requirements included in Form S–3 or Rule 12b–2 based on the issuer's reporting history under the Exchange Act out of concern that doing so could capture some larger companies that may not qualify to use Form S–3, or be considered accelerated filers, solely because they had not complied with the respective regulation's reporting requirements (*e.g.*, company missed deadlines because of auditing issues). We solicit comment on this concern. Should such reporting requirements be included in the definition of eligible portfolio company under Alternative One? In other words, to the extent that you believe Alternative One is an appropriate standard, should it exclude a company from the definition of eligible portfolio company because the company cannot meet all of the eligibility requirements for use of Form S–3 or because it does not meet the definition of accelerated filer under Rule 12b–2?

• We are proposing that a company must only meet the standard on a single date within the 60-day period immediately prior to the BDC's acquisition of the company's securities for purposes of determining its status as an eligible portfolio company under the reproposed definition. Is this timing appropriate? Should a company be required to meet the standard for more than one day during the 60-day period (*e.g.*, at least for 5, 10, 20 non-consecutive days within the 60-day period, or an average over a specified period of time)? Should the requirement be that a company must meet the size-based standard using the average of the 60-day period immediately before an acquisition by a BDC? Is the 60-day period appropriate? Would a shorter or longer time period (*e.g.*, 30 days, 75 days), or an average over a specified period of time, be more appropriate? In your response, please explain why your alternative would be more appropriate than the 60-day period that we are proposing.

• The 2004 Proposing Release was intended to address the need of financially troubled companies that are at risk of losing their listing status to access BDC capital, as well as small, developing companies.[52] One commenter indicated that proposed Rule 2a–46(b) would not include all of the financially troubled companies that provision was intended to include—that is, companies that have a class of securities listed on an Exchange, but that are in danger of having their securities delisted because they no longer meet the relevant Exchange's quantitative requirements for continued listing on that Exchange and that do not satisfy an Exchange's initial quantitative requirements for listing any class of their securities.[53] We believe that many of such companies would meet the size-based criteria specified under either alternative of reproposed Rule 2a–46(b), and therefore be included under the reproposed definition. In addition, such companies might be permissible investments for BDCs to make under Section 55(a)(3), which permits a BDC to include in its 70 percent basket securities of a company purchased from the company or certain affiliates of the company in specific situations demonstrating financial distress, including bankruptcy proceedings. Nevertheless, we request comment as to whether there are some financially troubled companies that could benefit from BDC financing but would not meet the definition of eligible portfolio company under Alternative One or Alternative Two of reproposed Rule 2a–46(b). If you believe that there are, we request comment on how such companies could be defined. For example, should the definition be based on a company's failure to meet one or more initial or continuing quantitative listing standards of any Exchange for a certain period of time? If yes, which quantitative listing standard(s) would be appropriate on which to base eligibility? How long must a company be out of compliance with the quantitative listing standard(s) before it would meet the definition?

III. General Request for Comment

We request comment on reproposed Rule 2a–46(b) and on other matters that might have an effect on our proposal. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, we also request information regarding the potential impact of reproposed Rule 2a–46(b) on the economy on an annual basis. Commenters are requested to provide empirical data to support their views.

IV. Cost-Benefit Analysis

We are sensitive to the costs and benefits that result from our rules. In the Proposing Release we requested public comment and specific data regarding the costs and benefits of reproposed Rule 2a–46(b). While commenters agreed that proposed Rule 2a–46 would benefit some companies, most urged the Commission to modify the proposed rule to expand the definition to include more companies.

A. Benefits

Both Alternative One and Alternative Two of the expanded definition of eligible portfolio company are designed to benefit many of the companies that may have lost their eligible portfolio company status because of the 1998 changes to the Federal Reserve Board's definition of margin stock. Specifically, both alternatives are designed to benefit certain companies by expanding the definition of eligible portfolio company to include any domestic operating company with a class of securities listed on an Exchange that meets the specified size-based standard. Many public companies that would be included under reproposed 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 conventional sources. By including such companies within the definition of eligible portfolio company, those companies and their shareholders would benefit because of the expanded sources of capital from which the companies may seek to obtain financing.

Both Alternative One and Alternative Two of reproposed Rule 2a–46(b) would also benefit BDCs by expanding the universe of investments that BDCs may include as part of their 70 percent basket. In addition, both would benefit BDCs by addressing the uncertainty caused by changes in the margin rules in the operation of BDCs.[54] Industry participants have informed us that the 1998 amendment to the margin rules has substantially reduced the number of issuers which BDCs may include in their 70 percent basket and accordingly has adversely affected their business operations.

OEA estimates that as of June 30, 2006, there were a total of 896 domestic operating companies whose securities

[51] We also understand that the question of whether a company would meet the public float standard would only be at issue if that company has a market capitalization of the dollar amount specified under the standard (*e.g.*, in the case of Alternative One, $75 million) or greater.

[52] *See* 2004 Proposing Release, *supra* note 6 at nn. 37–41 and accompanying text.

[53] Comments of Shearman & Sterling LLP (Jan. 7, 2005).

[54] *See, e.g.*, comment of American Capital Strategies (Jan. 7, 2005).

are listed on Nasdaq, the NYSE and the Amex that have a public float of less than $75 million, and therefore would qualify as eligible portfolio companies under Alternative One. OEA reached this estimate by first calculating the number of companies whose securities were listed on Nasdaq, the NYSE and the Amex (a total of 6,786 companies), corrected for cases where individual companies had multiple classes of securities listed (60 companies), and then removing from the 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 (*e.g.*, REITS, banks, insurance companies) 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 (a deduction of 2,982 companies) to reach a total of 3,804 companies.[55] OEA determined that of these companies, 896 had a public float of less than $75 million.[56] OEA further estimates that Alternative One, together with new Rule 2a–46 (which would be redesignated as Rule 2a–46(a)),[57] would include within the definition of eligible portfolio company 6,937 companies, representing 70.5 percent (6,937/9,845 [58]) of public domestic operating companies.

OEA estimates that there are a total of 1,168 domestic operating companies whose securities are listed on Nasdaq, the NYSE and the Amex that have a market capitalization of less than $150 million,[59] and therefore would qualify as eligible portfolio companies under the $150 million market capitalization standard set forth in Alternative Two.[60] Accordingly, OEA estimates that this standard, together with new Rule 2a–46 (which would be redesignated as Rule 2a–46(a)), would include within the definition of eligible portfolio company 7,209 companies, representing 73.2 percent (7,209/9,845) of public domestic operating companies.[61]

Finally, OEA estimates that there are a total of 1,562 domestic operating companies whose securities are listed on Nasdaq, the NYSE and the Amex that have a market capitalization of less than $250 million,[62] and therefore would qualify as eligible portfolio companies under the $250 million market capitalization standard set forth in Alternative Two.[63] Accordingly, OEA estimates that this standard, together with new Rule 2a–46, would include within the definition of eligible portfolio company 7,603 companies, representing 77.2 percent (7,603/9,845) of public domestic operating companies.[64]

B. Costs

Both Alternative One and Alternative Two of reproposed Rule 2a–46(b) might impose certain administrative compliance costs on BDCs. It is our understanding, however, that these costs are similar to the types of compliance costs that a BDC currently undertakes when it invests in an issuer.

Under Alternative One, a BDC would need to determine, prior to investing in a company, if the company has a class of securities on an Exchange and whether that company's public float was less than $75 million as of a date within 60 days prior to the date of the BDC's investment. Although public float information is not readily available through third-party sources,[65] we expect that the costs involved in a BDC complying with these requirements would be minimal. Section 55 of the Investment Company Act generally requires a BDC to invest in eligible portfolio companies through privately negotiated transactions, and we anticipate that a BDC would be able to obtain this information from the company during the course of those negotiations.

Under the $150 million market capitalization version of Alternative Two, a BDC would need to determine, prior to investing in a company, if the company has a class of securities on an Exchange and whether that company's market capitalization was less than $150 million as of a date within 60 days prior to the date of the BDC's investment. Similarly, under the $250 million market capitalization version of Alternative Two, a BDC would need to determine, prior to investing in a company, if the company has a class of securities 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 expect that the compliance costs on BDCs might be slightly lower under either version of Alternative Two because information about the market capitalization of companies is readily available from third-party sources. Finally, we anticipate that both Alternative One and Alternative Two of reproposed Rule 2a–46(b) would impose only minimal, if any, costs on portfolio companies.

C. Request for Comments

We request comment on the potential costs and benefits identified above and any other costs and benefits that may result from either Alternative One or Alternative Two of reproposed Rule 2a–46(b). Are there any direct or indirect costs that we have not identified? For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, the Commission also requests information regarding the impact of each alternative on the economy on an annual basis. Commenters are requested to provide data to support their views.

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[55] As we discussed in the Adopting Release, one commenter argued that the Commission incorrectly calculated the number of companies that the proposed rule would benefit and wrote that the proposal would benefit even fewer companies than the Commission estimated. The commenter's figure is lower than the figure calculated by OEA. It appears that the commenter did not deduct from its calculation foreign companies, investment companies and companies that are excluded from the definition of investment company by Section 3(c). *See* Adopting Release, *supra* note 1 at n.33.

[56] *See supra* note 27.

[57] OEA estimated that, based on June 2006 data, Rule 2a–46 as adopted today includes 6,041 domestic operating companies (61.4% of all domestic operating companies). *See* Adopting Release, *supra* note 1 at Section III.A.

[58] OEA estimates that, as of June 2006, there were 9,845 public domestic operating companies by calculating the number of companies whose securities are listed on Nasdaq, the NYSE and the Amex, in addition to those companies whose securities are 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 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).

[59] As with Alternative One, OEA reached this estimate after first calculating the number of companies whose securities are listed on Nasdaq, the NYSE and the Amex, corrected for cases where individual companies had multiple classes of securities listed, and then removing from these figures all foreign companies, investment companies and companies that are excluded from the definition of investment company by Section 3(c) (*e.g.*, REITS, banks, insurance companies) because both Section 2(a)(46) and Rule 2a–46 exclude these types of companies from the definition of eligible portfolio company.

[60] Market capitalization data was obtained from CRSP, Center for Research in Security Prices, Graduate School of Business, The University of Chicago [2006]. Used with permission. All rights reserved. *www.crsp.uchicago.edu.*

[61] *See supra* note 57.

[62] *See supra* note 59.

[63] *See supra* note 60.

[64] *See supra* note 57. OEA's analysis of the number and percentage of companies that could qualify as eligible portfolio companies under Alternative One and the two versions of Alternative Two are based on market capitalization and public float calculated as of a particular day. Because both Alternative One and Alternative Two allow for companies to meet the test on any date within a 60-day period, OEA's figures may underestimate the number of companies that would be eligible under either version.

[65] Although companies required to file reports with us under the Exchange Act are required to disclose their public float on the cover page of Form 10–K [17 CFR 249.310], that information may be outdated at the time a BDC seeks to invest in that company.

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.[66] In the 2004 Proposing Release, we requested comment on our analysis of the impact of proposed Rule 2a–46 on efficiency, competition and capital formation. As discussed in Section II of this Release, some commenters argued that proposed Rule 2a–46(b) would be too narrow and would not capture all of the companies that could benefit from BDC financing. We interpreted these comments to suggest that capital formation may have been limited under the proposed rule. In addition, one commenter wrote that the proposal failed to identify private investments in public equity (''PIPE'') as one source of competition for BDC financing.[67] The commenter also believed that the proposal failed to consider the impact on the shareholders of companies receiving BDC or PIPE financing.[68]

In light of the comments received, the Commission is reproposing Rule 2a–46(b) to more closely align the definition of eligible portfolio company, and the investment activities of BDCs, with the purpose intended by Congress. Both alternatives of the reproposed definition are designed to promote efficiency, competition and capital formation.

Specifically, efficiency would be enhanced because both Alternative One and Alternative Two of reproposed Rule 2a–46(b) would expand the definition of eligible portfolio company so as to allow BDCs to compete with other entities that provide capital to certain companies. To the extent that BDCs provide capital at lower cost to these companies, the rules promote a more efficient flow of capital, potentially allowing those companies to take on additional or different investment projects. Both alternatives of reproposed Rule 2a–46(b) in our view also would promote efficiency by providing a workable test for determining whether a company is an eligible portfolio company.

We also believe that both Alternative One and Alternative Two of reproposed Rule 2a–46(b) would promote competition. 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, hedge funds, investment banks and other BDCs, to provide financing to certain companies. We believe that both alternatives of the reproposed rule would encourage such competition.[69] In addition, to the extent that BDCs provide either additional or less expensive capital to these companies, those companies may be more competitive in the marketplace.

In response to the commenter's concern that the proposal did not consider the impact on shareholders of companies receiving BDC or PIPE financing, we note that shareholders of companies that had lost their status as eligible portfolio companies would benefit under either version of the reproposed rule because such companies would be able to more readily consider BDCs as a source of financing. We anticipate that these companies would consider both the type of financing offered and the entity offering the financing when determining the type and source of financing that would be in their best interests and the best interests of their shareholders.

Finally, we believe that both Alternative One and Alternative Two of reproposed Rule 2a–46(b) would promote capital formation. BDC investments represent additional capital to companies. Each version would expand the definition of eligible portfolio company. We estimate that a total of 896 public domestic operating companies would qualify as an eligible portfolio company under Alternative One, 1,168 public domestic operating companies would qualify as an eligible portfolio company under the $150 million market capitalization version of Alternative Two, and 1,562 public domestic operating companies would qualify as an eligible portfolio company under the $250 million market capitalization version of Alternative Two.[70]

VI. Paperwork Reduction Act

The Commission has determined that these rules do not involve a collection of information pursuant to the provisions of the Paperwork Reduction Act [44 U.S.C. 3501 *et seq.*].

VII. Initial Regulatory Flexibility Analysis

This Initial Regulatory Flexibility Analysis (''IRFA'') has been prepared in accordance with 5 U.S.C. 603. It relates to reproposed Rule 2a–46(b) under the Investment Company Act. The Commission is proposing two alternatives of an additional definition of eligible portfolio company. Both alternatives would expand the definition of eligible portfolio company to include certain companies whose securities are listed on an Exchange. Alternative One would define eligible portfolio company to include a company whose securities are listed on an Exchange but that has public float of less than $75 million. Alternative Two would define eligible portfolio company to include a company whose securities are listed on an Exchange but has a market capitalization of less than either $150 million or $250 million.

A. Reasons for the Proposed Action

As described in Section I of this Release, the reason for reproposed Rule 2a–46(b) is to further address the unintended impact of the Federal Reserve Board's 1998 amendments to the definition of eligible portfolio company.

B. Objectives of the Proposed Action

As described in Section II of this Release, the Commission today adopted Rule 2a–46 under the Investment Company Act, which defines eligible portfolio company to include all companies whose securities are not listed on an Exchange. Reproposed Rule 2a–46(b) would expand the definition of eligible portfolio company to include certain companies with a class of securities listed on an Exchange. These companies may need BDC financing for continued development and growth,

[66] 15 U.S.C. 80a–2(c).

[67] The commenter explained that entities that provide financing through PIPE transactions include hedge funds and private venture capital funds, both of which compete with BDCs in providing capital in the small business market. The commenter also noted its belief that the use of PIPE transactions illustrates the lack of access to traditional forms of capital for certain public companies. Comments of Williams & Jensen (Feb. 17, 2006).

[68] *Id.*

[69] Williams & Jenson commented that we did not consider PIPE transactions in our discussion in the 2004 Proposing Release of how proposed Rule 2a–46 would promote competition. This argument, however, focuses on one particular type of financing that is used by entities that compete with BDCs in funding small businesses. Neither Rule 2a–46 adopted today, nor reproposed Rule 2a–46(b), however, differentiates among the types of financing that may be offered to eligible portfolio companies. Instead, the rule, as adopted and reproposed, provides a definition of eligible portfolio company that would permit BDCs to invest their 70% baskets without regard to the type of financing offered. Thus, BDCs and eligible portfolio companies would be permitted to negotiate the type of financing (including PIPE transactions) that is most appropriate under the circumstances.

[70] *See supra* notes 55–64 and accompanying text.

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.

C. Small Entities Subject to the Rule

Both Alternative One and Alternative Two of reproposed Rule 2a–46(b) would affect BDCs and companies that qualify as small entities under the Regulatory Flexibility Act. For purposes of the Regulatory Flexibility Act, a BDC is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.[71] As of December 2005, there were 87 BDCs, of which 66 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.[72] We estimate that there are approximately 2,500 companies, other than investment companies, that may be considered small entities.

As discussed in this Release, reproposed 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. Both Alternative One and Alternative Two of reproposed Rule 2a–46(b) would also benefit BDCs, including those that are small entities, by expanding the universe of investments that BDCs may include as part of their 70 percent basket. We have no reason to expect that those BDCs and companies that are small entities for purposes of the Regulatory Flexibility Act would be disproportionately affected by either alternative. We request comment on the effects and costs of both Alternative One and Alternative Two on small entities.

D. Reporting, Recordkeeping and Other Compliance Requirements

Neither Alternative One nor Alternative Two of reproposed Rule 2a–46(b) would impose any new reporting or recordkeeping requirements on BDCs or on companies. They also would impose only minimal, if any, compliance requirements on portfolio companies.

Both Alternative One and Alternative Two of reproposed Rule 2a–46(b), however, would impose minimal compliance requirements on BDCs, including small entities. 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.

Under Alternative One, a BDC, prior to investing in a company, would need to determine whether the company has a class of securities listed on an Exchange and whether that company's public float was less than $75 million as of a date within 60 days prior to the date of the BDC's investment in the company. Public float information is not readily available through third-party sources. Section 55 of the Investment Company Act, however, generally requires a BDC to invest in eligible portfolio companies through privately negotiated transactions, and so we anticipate that a BDC would be able to obtain this information from the company during the course of these negotiations.

Similarly, we expect that the compliance burden imposed on BDCs, including those that are small entities, would be minimal under either the $150 million market capitalization version of Alternative Two or the $250 million market capitalization version of Alternative Two. Under the $150 million market capitalization version, a BDC would need to determine, prior to investing in a company, if the company has a class of securities on an Exchange and whether that company's market capitalization was less than $150 million as of a date within 60 days prior to the date of the BDC's investment. Similarly, under the $250 million market capitalization version, a BDC would need to determine, prior to investing in a company, if the company has a class of securities 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 expect that the compliance burden imposed on BDCs, including those that are small entities, would be slightly lower under either version of Alternative Two than it would be under Alternative One because information about the market capitalization of companies is readily available from third-party sources.

Finally, we anticipate that both Alternative One and Alternative Two of reproposed Rule 2a–46(b) would impose only minimal, if any, compliance requirements on portfolio companies, including those that are small entities.

E. Duplicative, Overlapping or Conflicting Federal Rules

There are no rules that duplicate, overlap or conflict with either Alternative One or Alternative Two of reproposed Rule 2a–46(b).

F. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. Alternatives in this category would include: (1) Establishing different compliance or reporting standards that 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 reproposed Rule 2a–46(b). As discussed above, neither Alternative One nor Alternative Two would impose any reporting requirements on BDCs or on companies. In addition, neither of the alternatives would impose any compliance requirements on portfolio companies. Both Alternative One and Alternative Two of reproposed Rule 2a–46(b) would, 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 under either alternative would be inappropriate. As discussed above, neither Alternative One nor Alternative Two would impose any compliance requirements on portfolio companies. Although both alternatives of reproposed Rule 2a–46(b) would impose some compliance requirements on BDCs, as discussed above, these requirements, which we believe would impose minimal burdens on BDCs, are designed to ensure that BDCs would invest in companies in accordance with the proposed rule.

We believe that using performance rather than design standards would add unnecessary complexity. Both Alternative One and Alternative Two of reproposed Rule 2a–46(b) provide a clear, bright-line, workable test for determining whether a company is an eligible portfolio company. A standard

[71] 17 CFR 270.0–10.

[72] 17 CFR 230.157; 17 CFR 240.0–10.

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 the reproposed Rule 2a–46(b). Both Alternative One and Alternative Two of reproposed 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 all or part of either proposed alternative would be contradictory to the purpose of this rulemaking.

G. Solicitation of Comments

We encourage the submission of comments with respect to any aspect of this IRFA. Comment is specifically requested on the number of small entities that would be affected by Alternative One and each version of Alternative Two and the likely impact on Alternative One and Alternative Two (both versions) on small entities. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. These comments will be considered in connection with the adoption of reproposed Rule 2a–46(b) and will be reflected in the Final Regulatory Flexibility Analysis.

VIII. Statutory Authority

We are proposing to amend Rule 2a–46 and reproposing Rule 2a–46(b) 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.

Text of Proposed Rules

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

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The authority citation for Part 270 continues to read in part as follows:

Authority: 15 U.S.C. 80a–1 *et seq.*, 80a–34(d), 80a–37, and 80a–39, unless otherwise noted.

*   *   *   *   *

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 [held by non-affiliates of less than $75 million] [of less than $150 million] [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] [and *affiliate* have] the same meaning[s] as in 17 CFR 230.405.

Dated: October 25, 2006.

By the Commission.

Nancy M. Morris,

Secretary.

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