

Hercules Capital, Inc.  
Form 40-APP  
May 29, 2018  
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No. 812-

**U.S. SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

APPLICATION FOR AN ORDER PURSUANT TO SECTION 6(c) OF THE INVESTMENT COMPANY ACT OF 1940 (the ACT ) GRANTING AN EXEMPTION FROM SECTIONS 23(a), 23(b) AND 63 OF THE ACT, AND PURSUANT TO SECTIONS 57(a)(4) AND 57(i) OF THE ACT AND RULE 17d-1 UNDER THE ACT AUTHORIZING CERTAIN JOINT TRANSACTIONS OTHERWISE PROHIBITED BY SECTION 57(a)(4) OF THE ACT, AND PURSUANT TO SECTION 23(c)(3) OF THE ACT GRANTING AN EXEMPTION FROM SECTION 23(c)

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May 29, 2018

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**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

*In the Matter of:*

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**HERCULES CAPITAL, INC.**

)

400 Hamilton Avenue, Suite 310

Palo Alto, California 94301

File No. 812-

Investment Company Act of 1940

) APPLICATION FOR AN ORDER PURSUANT TO SECTION 6(c) OF THE INVESTMENT COMPANY ACT OF 1940 (the ACT ) GRANTING AN EXEMPTION FROM SECTIONS 23(a), 23(b) AND 63 OF THE ACT, AND PURSUANT TO SECTIONS 57(a)(4) AND 57(i) OF THE ACT AND RULE 17d-1 UNDER THE ACT AUTHORIZING CERTAIN JOINT TRANSACTIONS OTHERWISE PROHIBITED BY SECTION 57(a)(4) OF THE ACT, AND PURSUANT TO SECTION 23(c)(3) OF THE ACT GRANTING AN EXEMPTION FROM SECTION 23(c)

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## I. INTRODUCTION

Hercules Capital, Inc. ( *Applicant* ), an internally managed closed-end investment company that has elected to be regulated as a business development company ( *BDC* ) under the Investment Company Act of 1940 (the *Act*), hereby applies for an order (the *Order* ) of the U.S. Securities and Exchange Commission (the *Commission* ) pursuant to Section 6(c) granting an exemption from Sections 23(a), 23(b), and 63, and pursuant to Sections 57(a)(4) and 57(i) and Rule 17d-1<sup>3</sup> authorizing certain joint transactions otherwise prohibited by Section 57(a)(4), and pursuant to Section 23(c)(3) granting an exemption from Section 23(c). The Order would permit Applicant to (i) issue Restricted Stock (as defined below) as part of the compensation package for its non-employee directors (the *Non-Employee Directors* )<sup>4</sup> through its 2018 Non-Employee Director Plan (the *Non-Employee Director Plan* ) for Non-Employee Director Participants, (ii) issue Restricted Stock and Restricted Stock Units (as defined below)<sup>5</sup> as part of the compensation package for certain of its employees, officers and directors, excluding the Non-Employee Directors, through its Amended and Restated 2018 Equity Incentive Plan (the *Equity Incentive Plan*)<sup>6</sup> (iii) withhold shares of the Applicant's common stock or purchase shares of Applicant's common stock from Participants to satisfy tax withholding obligations relating to the vesting of Restricted Stock or Restricted Stock Units or the exercise of Options (as defined below) that will be granted pursuant to the

<sup>1</sup> Section 2(a)(48) defines a BDC to be any closed-end investment company that operates for the purpose of making investments in securities described in sections 55(a)(1) through 55(a)(3) of the Act and makes available significant managerial assistance with respect to the issuers of such securities.

<sup>2</sup> Unless otherwise indicated, all section references herein are to the Act.

<sup>3</sup> Unless otherwise indicated, all rule references herein are to rules under the Act.

<sup>4</sup> Employees, officers and employee directors, together the *Employee Participants* and each, an *Employee Participant* . The Employee Participants and the Non-Employee Directors, together the *Participants* and each, a *Participant* .

<sup>5</sup> For purposes of this Application, Restricted Stock and Restricted Stock Units are collectively referred to herein as Restricted Stock.

<sup>6</sup> The *Equity Incentive Plan* and the *Non-Employee Director Plan* , together the *Plans* .

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Equity Incentive Plan,<sup>7</sup> and (iv) permit Participants to pay the exercise price of Options that will be granted to them pursuant to the Equity Incentive Plan with shares of Applicant's common stock.

## II. BACKGROUND

### *Applicant*

Applicant is a specialty finance company focused on providing senior secured loans to high-growth, innovative venture capital-backed companies in a variety of technology, life sciences, and sustainable and renewable technology industries. Applicant sources its investments through its principal office located in Palo Alto, California, as well as through its additional offices in Boston, Massachusetts, New York, New York, Washington, D.C., Santa Monica, California, Hartford, Connecticut, and San Diego, California. Applicant was incorporated under the General Corporation Law of the State of Maryland in December 2003.

Applicant is an internally managed, non-diversified closed-end investment company that has elected to be regulated as a business development company under the Act. From incorporation through December 31, 2005, Applicant was subject to tax as a corporation under Subchapter C of the Internal Revenue Code of 1986, as amended (the *Code*). Effective January 1, 2006, the Company elected to be treated for tax purposes as a regulated investment company, or *RIC*, under Subchapter M of the Code.

Hercules Technology II, L.P. (*HT II*), Hercules Technology III, L.P. (*HT III*), and Hercules Technology IV, L.P. (*HT IV*), are Delaware limited partnerships that were formed in January 2005, September 2009 and December 2010, respectively. HT II and HT III were licensed to operate as small business investment companies (*SBICs*) under the authority of the Small Business Administration (*SBA*) on September 27, 2006 and May 26, 2010, respectively. As SBICs, HT II and HT III are subject to a variety of regulations concerning, among other things, the size and nature of the companies in which they may invest and the structure of those investments. HT IV was formed in anticipation of receiving an additional SBIC license; however, the Company has not received such license, and HT IV currently has no material assets or liabilities. The Company also formed Hercules Technology SBIC Management, LLC, or (*HTM*), a limited liability company in November 2003. HTM is a wholly owned subsidiary of Applicant and serves as the limited partner and general partner of HT II and HT III.

HT II and HT III hold approximately \$113.1 million and \$285.8 million in assets, respectively, and they accounted for approximately 5.7% and 14.4% of Applicant's total assets, respectively, prior to consolidation at March 31, 2018.

Applicant also established wholly owned subsidiaries, all of which are structured as Delaware corporations and limited liability companies, to hold portfolio companies organized as limited liability companies, or LLCs (or other forms of pass-through entities). By investing through these wholly owned subsidiaries, Applicant is able to benefit from the tax treatment of these entities and create a tax structure that is more advantageous with respect to Applicant's RIC status. These taxable subsidiaries are consolidated for financial reporting purposes and in accordance with U.S. generally accepted accounting principles, and the portfolio investments held by these taxable subsidiaries are included in Applicant's consolidated financial statements and recorded at fair value. These taxable subsidiaries are not consolidated with Applicant for income tax purposes and may generate income tax expense, or benefit, and tax assets and liabilities as a result of their ownership of certain portfolio investments.

Applicant currently has an eight-member board of directors (the *Board*) of whom seven are Non-Employee Directors or non-interested persons of Applicant within the meaning of Section 2(a)(19), and one is considered an interested person of Applicant. As of March 31, 2018, Applicant had 64 employees.

- <sup>7</sup> Options will not be granted to Non-Employee Directors and, therefore, no relief is sought in this application for the grant of Options.



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***Applicant's Current Incentive Compensation Program***

Applicant must compete for leadership with other commercial banks, investment banks, and other publicly traded companies not regulated as investment companies, which are generally able to award many different types of stock-based compensation to their directors, (including their non-employee directors,) officers, and employees. Moreover, the Applicant also must compete for leadership with private equity funds, which generally have the discretion to offer a portion of their various carried interests to induce professional talent to associate with their funds without being required to obtain Commission approval each time. Such private equity funds have a tax advantage. Specifically, Section 57(n) prohibits Applicant from sharing profits in an amount that exceeds 20 per centum of the net income after taxes. When Applicant chooses to retain its net realized long-term capital gains for reinvestment for growth and declares a deemed dividend, rather than distribute such gains as a cash dividend, the staff of the Commission has determined that the taxes paid by Applicant on behalf of stockholders (who receive a tax credit for such taxes) reduce the amount of profit against which the profit sharing payable to employees is calculated. The practical effect of deducting the taxes paid on behalf of stockholders in conjunction with deemed dividends from net income after taxes in any fiscal year is to reduce the maximum payment under profit sharing plans governed by Section 57(n)(1)(B) to less than 16 percent of net income before these taxes (20% of 79% of the pre-tax profit (reflecting the 21% Federal income tax rate) before adjustment for state and local taxes).

In contrast, private equity funds typically have a carried interest of at least 20 percent of profits before any taxes, and that carried interest is usually in the form of long-term capital gains, not ordinary income. Thus, Applicant would be placed at a serious competitive disadvantage as a result of the taxes as described above. Although Applicant would be able to avoid this result by paying cash dividends in respect of its long-term gains, cash dividends would increase the cost of building Applicant's capital and, as a result, in certain circumstances may not be in the best interests of Applicant and its stockholders if other reasonably competitive compensation structures can be utilized.

The Applicant's 2006 Non-Employee Director Plan, as amended in 2007 (the **2006 Plan**), terminated in accordance with its terms in 2017, and no new awards are permitted to be granted under the 2006 Plan after its termination. The 2006 Plan provided for the grant of options to purchase shares of Applicant's common stock (**Options**) and shares of restricted stock (i.e., common stock that is subject to forfeiture unless specified retention and/or performance requirements are satisfied, and thus is restricted as to its transferability from the time of issuance until the requirements to avoid such forfeiture have been satisfied) (**Restricted Stock**) to Non-Employee Directors. As a result of the termination of the 2006 Plan, the Non-Employee Director Plan, a copy of which is attached to the Application as Exhibit A, was adopted on May 13, 2018 by the Board, including the required majority as defined in Section 57(o) (the **Required Majority**) and will be administered by a committee designated by the Board, the composition of which consists of non-employee directors within the meaning of Rule 16b-3 (the **Compensation Committee**). The Non-Employee Director Plan provides for the grant of Restricted Stock, but, unlike the 2006 Plan, does not provide for the grant of Options. Issuance of the Restricted Stock will allow Non-Employee Directors to become owners of the Applicant's stock with a vested interest in value maintenance, income stream and stock appreciation, which interests align with those of the Applicant's stockholders. The Board, including the Required Majority, considered, among other things, the impact of the Restricted Stock grants on outside stockholders, including the impact of dilution that the Non-Employee Director Plan, together with the Equity Incentive Plan and the 2006 Plan, would have with the limit on outstanding Restricted Stock of 10% of the Applicant's outstanding common stock. The Non-Employee Director Plan will be submitted for approval to the Applicant's stockholders, and will become effective upon such approval, subject to and following receipt of the Order. Unless sooner terminated by the Board, the Non-Employee Director Plan will terminate on the day before the tenth anniversary of the date the Non-Employee Director Plan is initially adopted by the Board or approved by stockholders, whichever is earlier.

- <sup>8</sup> Section 57(o) provides that the term required majority, when used with respect to the approval of a proposed transaction, plan, or arrangement, means both a majority of a BDC's directors or general partners who have no financial interest in such transaction, plan or arrangement and a majority of such directors or general partners who are not interested persons of such company.

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The Applicant's Amended and Restated 2004 Equity Incentive Plan (the **2004 EIP**) provides for grants of Options, Restricted Stock, restricted stock units (i.e., the right to receive, on the date of settlement, one share of common stock or an amount equal to the fair market value of one share of common stock) (**Restricted Stock Units**), Performance Restricted Stock Units and other performance-based awards (collectively, **Awards**) and warrants to Employee Participants. Applicant proposes to amend and restate the 2004 EIP, in its entirety, as the Equity Incentive Plan in the form presented in Exhibit B. The Equity Incentive Plan was adopted on May 13, 2018 by the Board, including the Required Majority, and will be administered by the Compensation Committee. The Equity Incentive Plan is subject to the issuance of the Order and stockholder approval. The Equity Incentive Plan provides for grants of Awards, but, unlike the 2004 EIP, does not provide for grants of warrants. The Board, including the Required Majority, found that the issuance of Awards will allow the Applicant to align its business plan, stockholder interests and employee interests based on the nature of the Applicant's business. Issuance of certain Awards will allow the Employee Participants to become owners of the Applicant's stock with a vested interest in value maintenance, income stream and stock appreciation, which interests align with those of the Applicant's stockholders. The Equity Incentive Plan permits Employee Participants, subject to approval of the Board and if permitted by law, to pay the exercise price of Options with shares of the Applicant's common stock. Unless sooner terminated by the Board, the Equity Incentive Plan will terminate on the day before the tenth anniversary of the date the Equity Incentive Plan is initially adopted by the Board or approved by stockholders, whichever is earlier.

**III. EXEMPTION TO ISSUE RESTRICTED STOCK**

Applicant is applying for an order of the Commission pursuant to Section 6(c) granting an exemption from Sections 23(a), 23(b), and 63, and from Section 57(a)(4) pursuant to Sections 57(a)(4) and 57(i) and Rule 17d-1 to enable Applicant to issue Restricted Stock to its officers, employees and Non-Employee Directors pursuant to the Plans, and pursuant to Section 23(c)(3) granting an exemption from Section 23(c). In particular, the Order would (1) enable the Applicant to appropriately compensate employees and Non-Employee Directors in the form of Restricted Stock, in the amount of which would be determined by the Applicant's Compensation Committee, provided that, in no event shall the number of shares of Restricted Stock subject to the annual grant to each Non-Employee Director exceed 20,000 shares of Restricted Stock, and (2) allow the Applicant to remain competitive within its sector of the financial services industry to attract and retain qualified employees and non-employee directors.

***Reason for Request*****Compensation Practices in the Asset Management Industry**

While Applicant believes that, because the market for superior investment professionals is highly competitive, the Applicant's successful performance depends on its ability to offer fair compensation packages to its professionals that are competitive with those offered by other investment management businesses. While the Applicant recognizes that employee and non-employee director retention is critical for all companies, the Applicant also believes that the highly specialized nature of its business, the competitiveness of its market and the small size of its employee base relative to its assets and revenue make such retentions even more critical for the Applicant. In that regard, the ability to offer equity-based compensation to its employees and Non-Employee Directors, which both aligns employee and Board behavior with stockholder interests and provides a retention tool, is vital to the Applicant's future growth and success.

The Plans would enable Applicant to offer employees and Non-Employee Directors compensation packages that are more competitive with those offered by other lending businesses and investment management businesses, which would enhance the ability of Applicant to attract and retain superior senior management, qualified non-employee directors and other key personnel. Offering competitive compensation packages is critical to Applicant's ability to

generate the best possible risk-adjusted returns for its stockholders.

**Use of Restricted Stock**

Applicant strongly believes that Restricted Stock offers an attractive form of equity-based compensation for certain employees and Non-Employee Directors. Relative to other forms of equity-based compensation, Restricted Stock will allow Applicant to (1) compete more successfully with commercial banks, investment banks, other publicly traded companies, and private equity funds

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for skilled employees and directors; (2) develop superior alignment of Applicant's business strategy, stockholder interests and employee interests; (3) manage dilution and cash expenses associated with equity-based compensation and salaries and bonuses; and (4) match the return expectations of the business more closely with its equity-based compensation. The Applicant believes the Restricted Stock will have a clear and meaningful benefit to its stockholders and its business prospects that supports approval of this application.

### **Successfully Competing with Private Equity Firms**

In order to compete successfully with private equity funds for talented portfolio and business management personnel, Applicant ideally would be able to pass through to its employees, in the form of long-term capital gain payments, at least 20 percent of the net realized income of Applicant over time. Inasmuch as Applicant, as a publicly traded corporation, cannot utilize the pass through of capital gain payments to its employees that is available to the general partners of partnerships and desires to build capital rather than make cash payments to its employees and Non-Employee Directors, the equity-based compensation structure that Applicant believes comes closest to replicating the fund structure is Restricted Stock. Restricted Stock requires no cash outlay by Applicant. Furthermore, an employee or Non-Employee Director who receives Restricted Stock and pays tax at ordinary rates based on the value of the stock at the time of vesting<sup>9</sup> will be able to treat as long-term gain any subsequent appreciation prior to sale.

### **Developing Alignment in Business Plan, Stockholder Interests and Employee Interests**

Alignment of a company's business plans, its stockholder expectations and its employee compensation is an essential component of long-term business success. Long-term business success is in the interest of the Applicant's stockholders and employees. The Applicant typically makes longer term investments primarily in privately held businesses that typically stay in its portfolio for the long term. Its business plan involves taking on investment risk over an extended period of time and a premium is placed on its ability to maintain stability of net asset values and continuity of earnings to pass through to its stockholders in the form of a reoccurring dividend. The Applicant's strategy is to generate income from its portfolio of investments in the debt and equity securities of its customers. This income supports the payment of a quarterly dividend to the Applicant's stockholders equal to or greater than 98% of the Applicant's taxable income (and 98.2% of capital gains). As a taxpayer that will elect to be regulated as a RIC under Subchapter M of the Code, the Applicant will be required to pay out 90% of its annual taxable income to maintain its tax advantaged status and 98% of its annual taxable income (and 98.2% of capital gains) to avoid non-deductible excise taxes. This pass through configuration means that, assuming the Applicant performs successfully, the shares of the Applicant's common stock will appreciate modestly if at all over time since earnings are distributed currently and not accumulated. Rather, the primary return for the Applicant's stockholders is in the form of current income through the payment of dividends rather than capital appreciation through a rising stock price. This recurring payout requires a methodical asset acquisition approach and active monitoring and management of the investment portfolio over time. A meaningful part of the Applicant's employee base is dedicated to the maintenance of asset values and expansion of this recurring revenue to support and grow dividends.

The implications of the Applicant's business model, as described above, on the attractiveness of using Restricted Stock are relatively clear. Restricted Stock has intrinsic value that may not be offered through other forms of equity-based compensation. Holders of Restricted Stock, over time, become owners of the stock with a vested interest in value maintenance and, importantly in the Applicant's case, the income stream and stock appreciation. These interests are completely aligned with those of the Applicant's stockholders. Stock option holders, by way of comparison, only earn compensation if the stock price increases and do not benefit from dividends or valuation protection, two concepts that have high priority for the Applicant's stockholders. Stock options are arguably less effective for the Applicant in terms of motivating behaviors consistent with the business objectives of moderate appreciation and stable and growing dividends, in part because the Act does not provide a mechanism for business development companies to adjust the

exercise price of a stock option when a dividend is issued or to issue dividend equivalent rights in order to align the interests of an option holder with those of a stockholder.

- <sup>9</sup> A Participant who receives a grant of Restricted Stock may, however, elect to be taxed at the time of receipt, as further described below.

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Moreover, the private equity funds with which the Applicant competes are able to pay higher total cash compensation, composed of salaries and bonuses than the Applicant is able to pay because of the expenses that the Applicant must pay that are related to the maintenance of its status as a publicly held company. In addition, the private firms with which Applicant must compete for personnel typically permit their employees to co-invest with them, which Applicant is not permitted to do under the Act absent a Commission order.

## **Managing Dilution and Cash Expenses**

Dilution is an important consideration for stockholders, and Restricted Stock is inherently less dilutive and more predictable than other common forms of equity based compensation, such as stock options. Because Restricted Stock has intrinsic value, it takes fewer shares of Restricted Stock to generate a similar level of economic benefit to employees and Non-Employee Directors. This is particularly true given the high level of dividend statutorily embedded in the Applicant's business model and regulatory structure, which does not accrue to the benefit of the option holder. In other words, the Applicant believes that the number of shares of Restricted Stock that it will grant will be less than the number of shares that would be subject to option were the Applicant to offer equivalent economic incentives through its stock option plans.

The Board, including the Required Majority, found that permitting an annual grant of Restricted Stock to each Non-Employee Director will allow the Applicant to better align its business plan with stockholder interests based on the nature of the Applicant's business as well as the characteristics of Restricted Stock.

Applicant can also pay less cash compensation if it can issue Restricted Stock to the Participants. Holding down cash compensation, like declaring deemed dividends rather than cash dividends, is significant to the Applicant's ability to maximize its cash available for investments.

## **Matching Return Expectations**

Restricted Stock motivates behavior that is consistent with the type of return expectations that the Applicant has established for its stockholders. The Applicant's strategy is to originate high quality, medium-term assets and to support the risk management activity of its portfolio companies over a period of time. Further, the Applicant's business plan is to execute a methodical and conservative accumulation of assets that have a risk-based pricing premium relative to similar securities. To this end, Restricted Stock places more value on the quality of originated assets over the quantity of originated assets, and thus, Restricted Stock is an attractive compensation tool for the Applicant to align employee and Non-Employee Director interests with stockholder interests. Shares of Restricted Stock that vest over time or are based upon performance targets will allow the Applicant to set objectives and provide meaningful rewards over time to employees who effectuate the targeted outcome of income and principal stability.

Applicant's management and the Board, including the Compensation Committee, have considered each of the factors discussed above and believe that the issuance of Restricted Stock as a form of equity-based compensation is in the best interest of Applicant's stockholders, employees and business.

## ***The Plans***

### **The Non-Employee Director Plan**

The Non-Employee Director Plan, a copy of which is attached to this Application as Exhibit A, provides for automatic grants of Restricted Stock to Non-Employee Directors. Upon initial election to the Board, each Non-Employee Director will automatically be granted the lesser of (i) 7,500 shares of Restricted Stock or (ii) that number of shares of

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Restricted Stock equal to \$67,500 divided by the greater of (x) the closing price per share of common stock on the date of grant and (y) the net asset value per share of common stock on the date of grant. Upon reelection to the Board, each Non-Employee Director will automatically be granted the lesser of (i) 6,667 shares of Restricted Stock or (ii) that number of shares of Restricted Stock equal to \$60,000 divided by the greater of (x) the closing price per share of stock on the date of grant and (y) the net asset value per share of stock on the date of grant.



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Shares of Restricted Stock granted automatically under the Non-Employee Director Plan (i) upon initial election to the Board, are no longer subject to forfeiture restrictions, as to one-third immediately after the expiration of 33% of the initial three-year term, as to an additional one-third immediately after the expiration of 66% of the initial three-year term and the remaining one-third on the third anniversary of the commencement date of the applicable three-year staggered class term, and (ii) upon reelection to the Board, are no longer subject to forfeiture restrictions as to one-third of such shares on the anniversary of such grant over three years.

The maximum aggregate number of shares of common stock that may be authorized for issuance under awards of Restricted Stock under the Non-Employee Director Plan is 300,000 shares. The maximum number of shares of common stock for which any Non-Employee Director may be granted awards under the Non-Employee Director Plan in any calendar year is 20,000 shares. If any award of Restricted Stock for any reason is forfeited or otherwise terminates, in whole or in part, the shares not acquired under such award of Restricted Stock will revert to and again become available for issuance under the Non-Employee Director Plan on a one-for-one basis.

Under the Non-Employee Director Plan, the Board may, subject to and consistent with the express provisions of the Non-Employee Director Plan, (i) prescribe any award agreements and the terms and conditions thereof, to the extent permitted by the requirements of the Act and any exemptive relief that may be granted by the Commission or other relief that may be granted by the Commission's staff, (ii) construe and interpret the Non-Employee Director Plan and award agreements granted thereunder and correct defects, supply omissions, or reconcile inconsistencies therein, (iii) amend the Non-Employee Director Plan and awards thereunder, (iv) terminate or suspend the Non-Employee Director Plan, and (v) make all other decisions and determinations as the Board may deem necessary or expedient to promote the best interests of the Applicant and that are not in conflict with the provisions of the Non-Employee Director Plan.

Unless the Board expressly provides otherwise, if a Non-Employee Director holding shares of Restricted Stock ceases to be an eligible Non-Employee Director, any shares of Restricted Stock held by such Non-Employee Director or the Non-Employee Director's permitted transferee that have not vested will be terminated and such shares will be returned to the Applicant and again be available for issuance under the Non-Employee Director Plan.

The Non-Employee Director Plan also provides that upon the occurrence of certain changes in the Applicant's common stock, such as a stock dividend, stock split or combination of shares (including a reverse stock split), recapitalization or other change in the Applicant's capital structure, the Board will make appropriate adjustments to the maximum number of shares that may be delivered under the Non-Employee Director Plan, to the maximum per-participant share limit and will also make appropriate adjustments to the number and kind of shares of stock or securities subject to awards then outstanding or subsequently granted, any exercise prices relating to awards and any other provision of awards affected by such change.

Shares of Restricted Stock will not be transferable except for disposition by will or the laws of descent and distribution or by gift to a permitted transferee. Amendments required to be approved by the stockholders under the laws of Maryland, the Commission under the Act (including Section 61), the rules of the New York Stock Exchange or in order to comply with the exemptions set forth in Rule 16b-3 under the Exchange Act, will not be effective until so approved. The automatic grants of shares of Restricted Stock will be administered in accordance with the terms of the Non-Employee Director Plan. All questions of interpretation with respect to the Non-Employee Director Plan and awards granted thereunder will be determined by the Board.

Applicant acknowledges that awards of Restricted Stock granted under the Non-Employee Director Plan would have a dilutive effect on the shareholders' equity of the Applicant, but, as further explained herein, believes that effect would be outweighed by the anticipated benefits of the Non-Employee Director Plan to the Applicant and its stockholders.



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**The Equity Incentive Plan**

The Equity Incentive Plan, a copy of which is attached to this Application as Exhibit B, provides for grants of Awards to Employee Participants, subject to certain vesting and forfeiture provisions. Each Award will contain the terms and conditions that the Board deems appropriate.

The maximum aggregate number of shares of common stock that may be authorized for issuance under Awards granted under the Equity Incentive Plan is 9,261,229 shares, less one share for every one share issued under the plan after March 31, 2018 and prior to the date the plan is approved by stockholders. The maximum number of shares of common stock for which any Employee Participant may be granted Awards in any calendar year is two million five hundred thousand shares. If any Award for any reason expires or otherwise terminates or is settled in cash, in whole or in part, the shares not acquired under such Award will revert to and again become available for issuance under the Equity Incentive Plan on a one-for-one basis. If withholding tax liabilities arising from an Award other than an Option are satisfied by tendering shares (either actually or by attestation) or by the withholding of shares by the Applicant, the shares so tendered or withheld will revert to and again become available for issuance under the Equity Incentive Plan on a one-for-one basis. Notwithstanding anything to the contrary, the following shares will not revert to and again be available for issuance: (i) shares tendered by an Employee Participant or withheld by the Applicant in payment of the purchase price of an Option; (ii) shares tendered by an Employee Participant or withheld by the Applicant to satisfy any tax withholding obligation with respect to Options; and (iii) shares reacquired by the Applicant on the open market or otherwise using cash proceeds from the exercise of Options.

Under the Equity Incentive Plan, the Board may, subject to and consistent with the express provisions of the Equity Incentive Plan, (i) prescribe any Award agreements and the terms and conditions thereof, to the extent permitted by the requirements of the Act and any exemptive relief that may be granted by the Commission or other relief that may be granted by the Commission's staff, (ii) construe and interpret the Equity Incentive Plan and Award agreements granted thereunder and correct defects, supply omissions, or reconcile inconsistencies therein, (iii) amend the Equity Incentive Plan and Awards thereunder, (iv) terminate or suspend the Equity Incentive Plan, and (v) make all other decisions and determinations as the Board may deem necessary or expedient to promote the best interests of the Applicant and that are not in conflict with the provisions of the Equity Incentive Plan.

Unless the Board expressly provides otherwise, immediately upon the cessation of an Employee Participant's continuous service that portion, if any, (i) of any Award (other than an Option) held by the Employee Participant or the Employee Participant's permitted transferee that is not then vested will terminate, and, in the case of Restricted Stock, the unvested shares will be returned to the Applicant and will be available to be issued as Awards under the Equity Incentive Plan and (ii) of any Option held by an Employee Participant or such Employee Participant's permitted transferee that is not yet exercisable will terminate and the balance will remain exercisable for the less of (x) a period of three months or (y) the period ending on the latest date on which such Option could have been exercised, and will thereupon terminate subject to certain provisions.

The Equity Incentive Plan also provides that upon the occurrence of certain changes in the Applicant's common stock, such as a stock dividend, stock split or combination of shares (including a reverse stock split), recapitalization or other change in the Applicant's capital structure, the Board will make appropriate adjustments to the maximum number of shares that may be delivered under the Equity Incentive Plan, to the maximum per-participant share limit and will also make appropriate adjustments to the number and kind of shares of stock or securities subject to Awards then outstanding or subsequently granted, any exercise prices relating to Awards and any other provision of Awards affected by such change.

Awards will not be transferable except for disposition by will or the laws of descent and distribution or by gift to a permitted transferee. Amendments required to be approved by the stockholders under the laws of Maryland, the Commission under the Act (including Section 61), the rules of the New York Stock Exchange or in order to comply with the exemptions set forth in Rule 16b-3 under the Exchange Act, will not be effective until so approved. All questions of interpretation with respect to the Equity Incentive Plan and Awards granted thereunder will be determined by the Board.

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Applicant acknowledges that Awards granted under the Equity Incentive Plan would have a dilutive effect on the shareholders' equity of the Applicant, but, as further explained herein, believes that effect would be outweighed by the anticipated benefits of the Equity Incentive Plan to the Applicant and its stockholders.

Applicant will comply with all disclosure requirements applicable to BDCs, including the amended disclosure requirements for executive officer and director compensation, related party transactions, director independence and other corporate governance matters, and security ownership of officers and directors to the extent adopted and applicable to BDCs and Applicant.<sup>10</sup>

### *Applicable Law and Need for Relief*

Section 63 makes applicable to BDCs the provisions of Section 23(a) generally prohibiting a registered closed-end investment company from issuing securities for services or for property other than cash or securities and of Section 23(b) generally prohibiting a registered closed-end investment company from selling any common stock of which it is the issuer at a price below the stock's current net asset value, except with the consent of a majority of the company's common stockholders or under certain other enumerated circumstances not applicable to the Plans. Section 63(2) provides that, notwithstanding Section 23(b), a BDC may sell any common stock of which it is the issuer at a price below the current net asset value of such stock and may sell warrants, options, or rights to acquire any such common stock at a price below the current net asset value of such stock if, (1) the holders of a majority of the BDC's outstanding voting securities, and the holders of a majority of the BDC's voting securities who are not affiliated persons of the BDC, approved the BDC's policy and practice of making such sales of securities at the last annual meeting of stockholders within one year immediately prior to any such sale; (2) the Required Majority has determined that such sale would be in the best interests of the BDC and its stockholders; and (3) the Required Majority, in consultation with the underwriter or underwriters of the offering if it is to be underwritten, has determined in good faith, and as of a time immediately prior to the first solicitation by or on behalf of such company of firm commitments to purchase such securities or immediately prior to the issuance of such securities that the price at which such securities are to be sold is not less than a price which closely approximates the market value of those securities, less any distributing commission or discount.

Because Restricted Stock that would be granted under the Plans would not meet the terms of Section 63(2)(A) (i.e., the Plans will not be approved by the holders of a majority of the company's outstanding voting securities that are not affiliated persons of the Company), Section 23(b) would prevent the issuance of Restricted Stock.

Section 57(a) proscribes certain transactions between a BDC and persons related to the BDC in the manner described in Section 57(b) (*57(b) persons*), absent a Commission order. Section 57(a)(4) generally prohibits a 57(b) person from effecting a transaction in which the BDC is a joint participant absent such order. Rule 17d-1, made applicable to transactions subject to Sections 57(a)(4) by Section 57(i) to the extent the Commission has not adopted a rule under Section 57(a)(4), generally proscribes participation in a joint enterprise or other joint arrangement or profit-sharing plan, which includes, pursuant to paragraph 17d-1(c), a stock option or purchase plan. Employees and directors of a BDC are 57(b) persons. Thus, although a compensation plan involving grants of Restricted Stock is not specifically referred to by Section 57(a)(4) or Rule 17d-1, the issuance of shares of Restricted Stock could be deemed to involve a joint transaction involving a BDC and a 57(b) person in contravention of Section 57(a)(4).

Section 6(c) provides, in part, that the Commission may, by order upon application, conditionally or unconditionally exempt any person, security, or transaction, or any class or classes thereof, from any provision of the Act, if and to the extent that the exemption is necessary or appropriate, in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.

- <sup>10</sup> See Executive Compensation and Related Party Disclosure, Securities Act Release No. 8655 (Jan. 27, 2006) (proposed rule); Executive Compensation and Related Party Disclosure, Securities Act Release No. 8732A (Aug. 29, 2006) (final rule and proposed rule), as amended by Executive Compensation Disclosure, Securities Act Release No. 8756 (Dec. 22, 2006) (adopted as interim final rules with request for comments).

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Section 57(a)(4) and Rule 17d-1 provides that the Commission may, by order upon application, grant relief under Section 57(a)(4) and Rule 17d-1 permitting certain joint enterprises or arrangements and profit-sharing plans. Rule 17d-1(b) further provides that in passing upon such an application, the Commission will consider (i) whether the participation of the BDC in such enterprise, arrangement, or plan is consistent with the policies and purposes of the Act and (ii) the extent to which such participation is on a basis different from or less advantageous than that of other participants.

### ***Applicant's Legal Arguments***

The Commission and Congress have recognized the need for certain types of investment companies, including closed-end investment companies and BDCs, to be able to offer their employees and non-employee directors equity-based compensation. Applicant believes that its ability to offer equity-based compensation in the form of the Restricted Stock is necessary for Applicant to recruit and retain management talent and align that talent with the interests of its stockholders. Thus, Applicant believes that its request for an Order is consistent with the policies underlying the provisions of the Act permitting the use of equity compensation by BDCs as well as prior exemptive relief granted by the Commission.

### **Similarity to Issuances Currently Permitted under the Act**

Congress recognized the importance of equity-based compensation as a means of attracting and retaining qualified management personnel, including Non-Employee Directors, in the Small Business Investment Incentive Act of 1980 (the **1980 Amendments**). Section 61, enacted as part of the 1980 Amendments, permits BDCs to issue to their directors, officers, employees, and general partners warrants, options, and rights to purchase voting securities of such companies pursuant to executive compensation plans in compliance with certain conditions.<sup>11</sup> Applicant believes that the issuance of Restricted Stock to Applicant's employees and Non-Employee Directors, for purposes of investor protection under the Act, is substantially similar to what is currently permitted under Section 61.

Applicant is not aware of any specific discussion in the legislative history of the 1980 Amendments regarding the use of direct grants of stock as incentive compensation; however, the legislative history recognizes the crucial role that equity-based compensation played in the operation of a private equity fund and its ability to attract and retain employees. Congress endowed BDCs with the ability to issue derivative securities to employees in order to ensure that BDCs would be able to compete for skilled personnel in light of compensation practices as they existed in 1980. In the late 1970s, direct grants of stock were not a widely used form of compensation. In fact, publications in the late 1970s indicate that it was stock options—which the 1980 Amendments made permissible for use by BDCs—that were the most widely used type of incentive compensation.<sup>12</sup>

### **Prior Commission Orders Relating to Compensation for Employees and Non-Employee Directors**

The Applicant notes that the relief requested herein is substantially similar to prior relief the Commission provided the Applicant in connection with allowing the Applicant to issue shares of its Restricted Stock as part of the compensation packages for certain of its employees and directors (and certain employees of its wholly-owned consolidated subsidiaries).<sup>13</sup> The Applicant also notes that the relief requested herein is substantially similar to the relief contained in orders issued by the Commission to Newtek Business Services Corp<sup>14</sup> and Equus Total Return, Inc.<sup>15</sup>

<sup>11</sup> See Section 61(a)(3)(B) of the Act.

<sup>12</sup>

See, *Successors to the Qualified Stock Option* Harvard Business Review (Jan/Feb. 1978) stating: Stock options predominate among the long-term incentives for executives and Restricted stock, once widely used in executive compensation, declined in popularity after the 1969 tax law changes and is now a rarity. See also, *Annual Survey of Executive Compensation* Business Week (May 14, 1979) stating: Most companies still use stock option grants and appreciation rights as their predominant incentives.

<sup>13</sup> *The Company (then known as Hercules Technology Growth Capital, Inc.)*, Investment Company Act Release No. 27838 (May 23, 2007).

<sup>14</sup> *Newtek Business Services Corp.*, Investment Company Act Release No. 32109 (May 10, 2016).

<sup>15</sup> *Equus Total Return, Inc.*, Investment Company Act Release No. 32421 (Jan 10, 2017).



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***Order Relating to the Use of Restricted Stock by a BDC***

The important role that restricted stock can play in attracting and retaining qualified personnel has been expressly recognized by the Commission with respect to BDCs.

*Triangle Capital Corporation.* On March 21, 2013, the Commission issued an amended order granting Triangle relief under Sections 6(c), 23(a), 23(b), 57(a)(4), 57(i), and 63 and Rule 17d-1 (the *Amended Triangle Order* ). The Amended Triangle Order increases the number of restricted shares of common stock Triangle can issue to its non-employee directors.<sup>16</sup>

*Harris & Harris Group, Inc.* On April 3, 2012, the Commission issued an order granting Harris & Harris Group, Inc. ( *Harris & Harris* ) relief under Sections 6(c), 23(a), 23(b), 57(a)(4), 57(i) and Rule 17d-1 (the *Harris & Harris Order* ). The Harris & Harris Order permits Harris & Harris, a BDC, (i) to issue restricted stock pursuant to its equity-based employee and director compensation plan; (ii) to withhold shares of common stock or purchase shares of common stock from directors, officers, and other employees to satisfy tax withholding obligations; and (3) to allow such individuals to pay the exercise price of Options that were granted to them pursuant to a predecessor plan.<sup>17</sup>

*Medallion Financial Corp.* On April 26, 2010, the Commission issued an order granting Medallion Financial Corp. ( *Medallion* ) relief under Sections 6(c), 23(a), 23(b), 57(a)(4), 57(i), and 63 and Rule 17d-1 (the *Medallion Order* ). The Medallion Order permits Medallion, a BDC, to issue restricted shares of its common stock, pursuant to an equity compensation plan, as part of compensation packages for certain of its employees and certain employees of its wholly owned subsidiaries.<sup>18</sup>

*Triangle Capital Corporation.* On March 18, 2008, the Commission issued an order granting Triangle Capital Corporation ( *Triangle* ) relief under Sections 6(c), 57(a)(4) and 57(i) and Rule 17d-1 (the *Triangle Order* ). The Triangle Order permits Triangle, a BDC, to issue restricted stock pursuant to its equity-based employee and director compensation plan.<sup>19</sup>

*Main Street Capital Corporation.* On January 16, 2008, the Commission issued an order granting Main Street Capital Corporation and certain affiliated entities relief under Sections 6(c), 57(a)(4) and 57(i) and Rule 17d-1 (the *Main Street Order* ). The Main Street Order permits Main Street Capital Corporation and certain affiliated entities to issue restricted stock pursuant to its equity-based employee compensation plan.<sup>20</sup>

*MCG Capital Corporation.* On April 4, 2006, the Commission issued an order granting MCG Capital Corporation ( *MCG Capital* ) relief under Sections 6(c), 57(a)(4) and 57(i) and Rule 17d-1 (the *MCG Order* ). The MCG Order permits MCG Capital Corporation, a BDC, to issue restricted stock pursuant to its equity-based employee and director compensation plans.<sup>21</sup>

<sup>16</sup> *Triangle Capital Corporation*, Investment Company Act Release No. 30432 (March 21, 2013).

<sup>17</sup> *Harris & Harris Group, Inc.*, Investment Company Act Release No. 30027 (April 3, 2012).

<sup>18</sup> *Medallion Financial Corp.*, Investment Company Act Release No. 29258 (April 26, 2010).

<sup>19</sup> *In the Matter of Triangle Capital Corporation*, Investment Company Act Release No. 28196 (March 18, 2008).

<sup>20</sup> *Main Street Capital Corporation*, Investment Company Act Release No. 28120 (January 16, 2008).

<sup>21</sup> *See MCG Capital Corporation*, Investment Company Act Release No. 27280 (April 4, 2006).



**Table of Contents****Orders Relating to Use of Equity-Based Compensation by Internally Managed Closed-End Investment Companies**

The important role that equity compensation can play in attracting and retaining qualified personnel has been expressly recognized by the Commission with respect to internally managed closed-end investment companies.

*Baker, Fentress & Company and Adams Express Company, et al.* In 1998, the Commission issued an order granting Baker, Fentress & Company ( *Baker Fentress* ) exemptive relief from Sections 17(a) and (d), 18(d), and 23(a), (b), and (c) and Rule 17d-1. More recently, in 2005, the Commission issued a similar order granting Adams Express Company and Petroleum and Resources Corporation ( *Adams Express* ) exemptive relief from Sections 17(d), 18(d), and 23(a), (b), and (c) and Rule 17d-1. These orders permitted the companies to implement broad equity-based compensation plans that included the issuance of restricted stock to their employees.<sup>22</sup>

Although each of the plans permitted under the Adams Express Order and Baker Fentress Order provides a distinct method of providing for equity-based compensation, the fundamental purpose of each is similar; awarding individuals equity-based compensation for competitive purposes, and each was deemed ultimately to benefit the stockholders of the underlying investment company. Importantly, relief in each of the above cases was granted to closed-end funds that had not elected BDC status and, thus, were not within the class of entities that, like Applicant, Congress had determined should be allowed to issue equity compensation to officers, employees and directors.

**Standards for Exemption under Section 6(c)**

Section 6(c), which governs Applicant's request for exemptive relief from Section 23 provides, in part, that the Commission may, by order upon application, conditionally or unconditionally exempt any person, security, or transaction, or any class or classes thereof, from any provisions of the Act, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the Act's policy and provisions.<sup>23</sup>

**Necessary or Appropriate in the Public Interest**

As indicated above, both the Commission and Congress have long recognized the importance of equity-based compensation in attracting and retaining qualified personnel. Applicant submits that maintaining the ability of a BDC that identifies, invests in and actively works with early stage growth oriented companies to attract and retain highly qualified personnel is in the public interest, including the interests of Applicant's stockholders. Applicant competes for talent with commercial banks, investment banks, and other publicly traded companies that also are not investment companies registered under the Act and are not subject to the limitations of the Act. These organizations are able to offer all types of equity-based compensation to their employees and directors, including restricted stock, and, therefore, have an advantage over Applicant and its subsidiaries in attracting and retaining highly qualified personnel. For Applicant to compete on a more equal basis with such organizations, it must be able to attract and retain talented personnel and offer them comparable compensation packages.

<sup>22</sup> See *Baker, Fentress & Company*, Investment Company Act Release No. 23619 (Dec. 22, 1998) (the *Baker Fentress Order* ) and *Adams Express Company, et. al*, Investment Company Act Release No. 26780 (March 8, 2005) (the *Adams Express Order* ). Applicant notes that, in each of their respective applications, Adams Express and Baker Fentress cited the legislative history of the 1980 Amendments as standing for the idea that Congress had recognized the importance of equity-based compensation as a means of attracting and retaining qualified

management personnel. Both Adams Express and Baker Fentress received orders from the Commission permitting the issuance of equity-based compensation, including direct grants of stock. Baker Fentress and Adams Express were also granted relief to issue stock options to their Non-Employee Directors.

<sup>23</sup> We note that the staff has previously stated that it would not recommend enforcement action to the Commission under Section 23(a) if closed-end funds directly compensate their directors with fund shares, provided that the directors' services are assigned a fixed dollar value prior to the time that the compensation is payable. *Statement of Staff Position, Interpretive Matters Concerning Independent Directors of Investment Companies* (Oct. 14, 1999).

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With respect to Applicant's primary competition, private equity funds, Applicant has proportionately greater overhead unrelated to its investment personnel and therefore cannot pay total salaries and bonuses as high as those of its competition without increasing its total overhead. Availability of Restricted Stock would enable Applicant to substitute Restricted Stock for overall cash compensation, and compensate for the loss of the carried interest that our investment professionals would receive at a private equity firm, among other things. The Plan will enhance the ability of Applicant to compensate its personnel and Non-Employee Directors competitively, while also aligning the interests of its personnel and Non-Employee Directors with the success of the company and the interests of its stockholders and preserving cash for further investment.

## **Consistency with the Protection of Investors**

Investors will be protected to at least the same extent that they are currently protected under Section 61(a)(3). The Plans will be approved by stockholders in accordance with Section 61(a)(3)(A)(iv). A proxy statement submitted to Applicant's stockholders will contain a concise plain English description of the Plans and their potential dilutive effect. If a Plan is not approved by stockholders, it will not be implemented. Furthermore, each grant of Restricted Stock will be approved by the Required Majority on the basis that the issuance is in the best interests of Applicant and its stockholders. Applicant is subject to the standards and guidelines adopted by the Financial Accounting Standards Board for operating companies relating to the accounting for and disclosure of the Restricted Stock, and the Securities Exchange Act of 1934 ( *Exchange Act* ) requirements relating to executive compensation disclosure.

Based on the manner in which the issuance of Restricted Stock pursuant to the Plans will be administered, the Restricted Stock will be no more dilutive than if Applicant were to issue only Options to Participants who are employees, as is permitted by Section 61(a)(3). Because it takes fewer shares of Restricted Stock, as compared with Options, to compensate an employee at the same level, the number of shares of Restricted Stock awarded would be fewer than the number of shares on which an employee would have to be given an Option. Furthermore, there is a limit on the total number of shares that Applicant can issue under the Plans. Applicant acknowledges that awards granted under the Plans may have a dilutive effect on the stockholders' equity per share in Applicant, but believes that effect would be outweighed by the anticipated benefits of the Plans to Applicant and its stockholders.

Section 61(a)(3) provides that the amount of voting securities that would result from the exercise of all of a BDC's outstanding warrants, options, or rights, at the time of issuance, may not exceed 25 percent of the outstanding voting securities of such BDC, except that if the amount of voting securities that would result from the exercise of all outstanding warrants, options, and rights issued to such BDC's directors, officers, and employees, would exceed 15 percent of the outstanding voting securities of such BDC, then the total amount of voting securities that would result from the exercise of all outstanding warrants, options, and rights, at the time of issuance shall not exceed 20 percent of the outstanding voting securities of such BDC. Under the Plans and the 2006 Plan, the maximum amount of Restricted Stock that may be outstanding at any particular time will be ten percent of the Applicant's voting securities. For purposes of determining Applicant's compliance with the limits in Section 61(a)(3), Applicant will treat Restricted Stock issued under the Plans and the 2006 Plan as voting securities that would result from the exercise of all outstanding warrants, options and rights issued to directors, officers and employees.<sup>24</sup>

## **Consistency with the Purposes of the Act**

As indicated earlier, Applicant is at a disadvantage in competing with other financial services companies, particularly private equity firms, in attracting and retaining management personnel because it cannot offer shares of the company in the form of Restricted Stock as part of a compensation plan that would have a long-term capital gain component and its overhead associated with being publicly held reduces the cash compensation it can pay to its employees. In addition, Applicant believes it also competes directly for experienced executives and other professionals with other

public companies and non-public companies, many of which offer restricted stock as part of their equity incentive plans.

- <sup>24</sup> For purposes of calculating compliance with this limit, the Applicant will count as Restricted Stock all shares of its common stock that are issued under the Plans and the 2006 Plan less any shares that are forfeited back to the Applicant and cancelled as a result of forfeiture restrictions not lapsing.

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The Commission previously recognized the problem of restricting equity compensation in the context of small business investment companies in 1971 and granted a limited exemption from the Act's provisions to permit them to issue qualified stock options. Congress amended the Act in 1980 to permit BDCs also to issue warrants, options, and rights subject to certain conditions and limitations. The Commission again recognized these problems in the context of closed-end investment companies in 1985 and granted a limited exemption from the Act's provisions to permit certain internally managed closed-end investment companies to issue incentive stock options. In 1998, the Commission issued the Baker Fentress Order and in 2005, the Commission issued the Adams Express Order, both Orders permitting numerous types of equity compensation, including the issuance of restricted stock by a registered closed-end investment company. Finally, the SEC issued the MCG Order, the Main Street Order and Triangle Order permitting BDCs to issue restricted stock. In each of these instances, it was found that equity compensation would not offend the Act's policies and purposes.

In the present case, Applicant is requesting that it be allowed to issue Restricted Stock in a similar manner as in the 2006 Plan and the version of the Equity Incentive Plan prior to its amendment and restatement as described herein for which Applicant obtained relief from the Commission. Applicant notes if the Order is granted, it would be subject to greater restrictions as to the number of shares of Restricted Stock that may be issued as compared to the number of Options. The Commission has, by way of exemptive order, permitted other BDCs to issue restricted stock to employees and directors and numerous BDCs to issue warrants, options and rights to purchase to directors.

Applicant further submits that the Plans would not violate the purposes behind Sections 23(a) and (b). The concerns underlying the enactment of those provisions included (i) preferential treatment of investment company insiders and the use of options and other rights by insiders to obtain control of the investment company; (ii) complication of the investment