

HARRIS & HARRIS GROUP INC /NY/
Form 40-APP/A
February 29, 2012

No. 812-13313

U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

AMENDMENT NO. 3 AMENDING AND RESTATING AN 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 23(c)

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UNITED STATES OF AMERICA

Before the

SECURITIES AND EXCHANGE COMMISSION

In the Matter of

HARRIS & HARRIS GROUP, INC.
1450 BROADWAY, 24TH FLOOR
NEW YORK, NEW YORK 10018

File No. 812-13313

Investment Company Act of 1940

AMENDMENT NO. 3 AMENDING AND
RESTATING AN APPLICATION FOR AN
ORDER PURSUANT TO SECTION 6(c)
OF THE INVESTMENT COMPANY ACT
OF 1940 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), AND
PURSUANT TO SECTION 23(c)(3)
GRANTING AN EXEMPTION FROM
SECTION 23(c)

I. INTRODUCTION

Harris & Harris Group, Inc. (“Applicant”), an internally managed company that has elected to be regulated as a business development company (“BDC”) under the Investment Company Act of 1940 (the “Act²”) 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-1³ 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 shares of its common stock as part of the compensation package for certain participants in its Amended and Restated 2012 Equity Incentive Plan (the “Plan”), (ii) withhold shares of the Applicant’s common stock or purchase shares of Applicant’s common stock from directors, including non-employee directors, officers and other employees (“Participants” and each a “Participant”) to satisfy tax withholding obligations relating to the vesting of restricted stock or the exercise of Options that were granted to them pursuant to a predecessor plan or will be granted pursuant to the Plan, and (iii) permit Participants to pay the exercise price of Options that were granted to them pursuant to a predecessor plan or will be granted to them pursuant to the Plan with shares of Applicant’s common stock.

¹ Section 2(a)(48) defines a business development company 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.

² Unless otherwise indicated, all section references herein are to the Act.

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

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II.

BACKGROUND

Applicant

Applicant is an internally managed venture capital company specializing in nanotechnology and microsystems that has elected to be regulated as a BDC under the Act. Applicant is headquartered in New York, New York, with an additional office in Palo Alto, California. Applicant was incorporated under the laws of the state of New York in August 1981. In 1983, Applicant completed an initial public offering and acquired a controlling interest in Otisville BioTech, Inc., which also completed an initial public offering later that year. In 1984, Charles E. Harris purchased a controlling interest in Applicant and became the control person in Otisville. Applicant subsequently divested its other assets and became a financial services company.

By 1988, Applicant operated two insurance brokerages and a trust company as wholly owned subsidiaries. In 1992, Applicant sold its insurance brokerage and trust company subsidiaries to their respective managements and registered as an investment company under the Act, commencing operations as a closed-end, non-diversified investment company. In 1995, Applicant elected to become a BDC subject to the provisions of Sections 55 through 65.

Since 2001, Applicant has made initial venture capital investments exclusively in nanotechnology and microsystems, which it sometimes refers to as “tiny technology.” Applicant considers a company to be a tiny technology company if the company employs or intends to employ technology that Applicant considers to be at the microscale or smaller and if the employment of that technology is material to its business plan. Applicant's entire portfolio now consists of investments exclusively in companies commercializing and integrating products enabled by nanotechnology or microsystems.

As of December 31, 2011, Applicant had 29 portfolio companies in its venture capital portfolio. Shares of Applicant's common stock are traded on the Nasdaq Global Market under the symbol "TINY." As of December 31, 2011, there were 31,000,601 shares of Applicant's common stock outstanding.

Applicant currently has a ten member board of directors (the “Board”) of whom eight are non-interested persons of Applicant within the meaning of Section 2(a)(19), and two are considered “interested persons” of Applicant. As of June 7, 2012, Applicant will have a nine member Board of whom eight will be non-interested persons of Applicant within the meaning of Section 2(a)(19), and one will be considered an “interested person” of the Applicant. As of December 31, 2011, Applicant had 10 employees.

⁴ For purposes of this relief, Applicant will be granting Restricted Stock pursuant to the Plan to the individuals who are directors as of June 7, 2012, including the Applicant's chief executive officer, who will then be the sole interested director.

Applicant's Current Incentive Compensation Program

Applicant must compete with private sector venture capital firms to hire and retain personnel; however, such private sector venture capital firms have a tax advantage. Specifically, Section 57(n) prohibits Applicant from paying profit sharing in an amount that exceeds "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 13 percent of our net income before these taxes (20% of 65% of the pre-tax profit (reflecting the 35% Federal income tax rate) before adjustment for state and local taxes).

In contrast, private sector venture capital firms 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 could 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 would not, in the view of the Board, be in the best interests of Applicant and its stockholders if other reasonably competitive compensation structures can be utilized.

Accordingly, on March 21, 2006, and March 23, 2006, the Compensation Committee and the Board voted to establish the Harris & Harris Group, Inc. 2006 Equity Incentive Plan (the “2006 Plan”). The 2006 Plan was approved by stockholders of Applicant on May 4, 2006.

The 2006 Plan provides for the grant of options to purchase share’s of Applicant’s common stock (“Options”) and equity-based awards of restricted stock to Participants. Both restricted stock and, to a limited extent, Options, provide the opportunity for recipients to earn long-term capital gain and both components of the 2006 Plan enable Applicant to build capital more efficiently than would a profit-sharing plan. Applicant has issued 8,200,647 Options to Participants under the 2006 Plan, all of whom were employees at the time of the Option grants. As of December 31, 2011, there were 3,389,117 Options outstanding. Applicant has not issued any restricted stock pursuant to the 2006 Plan. The 2006 Plan provides for standard anti-dilution adjustments. However, no such adjustments will be made except pursuant to written assurance from the staff of the Commission or exemptive relief from the Commission. Applicant proposes to amend and restate the 2006 Plan as the Plan in the form presented in Exhibit A. The Plan will supersede the 2006 Plan, subject to the issuance of the requested order. The Plan provides for the periodic issuance of Options and shares of restricted stock (*i.e.*, stock that is subject to forfeiture unless specified employee 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) (the “Restricted Stock”) to Participants. It also permits Participants to pay the exercise price of Options that were granted to them under the 2006 Plan or will be granted to them pursuant to the Plan with shares of the Applicant’s common stock. Unless sooner terminated by the Board, the Plan will terminate on the tenth anniversary of its effective date, which will be the date on which the Applicant obtains stockholder approval of the Plan.

The Plan was approved on February 29, 2012 by a committee designated by the Board to administer the Plan, the composition of which consists of "non-employee directors" within the meaning of Rule 16b-3, and "outside directors" within the meaning of Section 162(m) of the Code (the "Compensation Committee") and the Board, including the required majority as defined in Section 57(o) (the "Required Majority").⁵ The Board, including the Required Majority, found that an appropriate compensation plan involving the issuance of Restricted Stock that supports the Company's objectives and aligns the interests of stockholders and employees is essential to long-term success in the investment business in general and critical to the Company's business in particular and will have a clear and meaningful benefit to the Company and its stockholders. The Board, including the Required Majority, also found that the issuance of Restricted Stock will allow the Company to align its business plan, stockholder interests and employee interests based on the nature of the Company's business as well as the characteristics of Restricted Stock. Issuance of the Restricted Stock will allow the Participants to become owners of the stock with a vested interest in value maintenance, income stream and stock appreciation, which interests align with those of the Company'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 Plan would have with the limit on outstanding Restricted Stock of 10% of the Company's outstanding common stock. The Plan will be submitted for approval to the Company's stockholders, and will become effective upon such approval, subject to and following receipt of the Order.

⁵ 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.

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 pursuant to Sections 57(a)(4) and 57(i) and Rule 17d-1 so as to enable Applicant to issue Restricted Stock to its officers, employees and to directors of Applicant who are not officers or employees of Applicant (“Non-Employee Directors”) pursuant to the Plan, and pursuant to Section 23(c)(3) granting an exemption from Section 23(c).

Reason for Request

Compensation Practices in the Venture Capital and Asset

Management Industry

Applicant believes that, because the market for highly qualified investment professionals is highly competitive, Applicant’s success depends on its ability to offer compensation packages to its professionals that are competitive with those offered by other venture capital firms and investment management businesses. While Applicant recognizes that employee and Non-Employee Director retention is critical for all companies, Applicant also believes that the highly technical, specialized nature of the Company’s investments in nanotechnology and microsystems, and the small size of its employee base relative to its assets make such retention even more critical for Applicant. In that regard, the ability to offer equity-based compensation to its professionals, which both aligns employee behavior with stockholder interests and provides a retention tool, is vital to Applicant’s future growth and success.

The Plan would enable Applicant to offer the employees and Non-Employee Directors compensation packages that are more competitive with those offered by other venture capital businesses, which would enhance the ability of Applicant to hire and retain superior senior management 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 the most appropriate form of equity-based compensation that it can offer is Restricted Stock. Relative to other forms of equity-based compensation, Restricted Stock will allow Applicant to (1) compete more successfully with private venture capital firms for skilled employees and directors; (2) develop superior alignment of Applicant's business strategy, stockholder interests and employee interests; and (3) manage dilution and cash expenses associated with equity-based compensation and salaries and bonuses. 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 Venture Capital Firms

In order to compete successfully with private venture capital firms 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 (which in a venture capital fund is substantially entirely long-term capital gain under current law) of Applicant over time. Inasmuch as Applicant, as a publicly traded corporation, cannot utilize the passthrough of capital gain payments to its employees that is available to the general partners of venture capital partnerships and desires to build capital rather than make cash payments to its stockholders, employees and Non-Employee Directors, the equity-based compensation structure that Applicant believes comes closest to replicating the venture capital 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 vesting⁶ will be able to treat as long-term gain any subsequent appreciation prior to sale.

⁶ A Participant who receives a grant of Restricted Stock may, however, elect to be taxed at the time of receipt, as further described below.

Developing Alignment in Business Strategy, Stockholder Interests
and Employee Interests

Alignment of a company's business strategy, its stockholder expectations and its employee compensation is an important component of long-term business success. Long-term business success is in the interest of Applicant's stockholders and employees. Applicant makes investments primarily in privately held businesses that typically stay in its portfolio for five to ten years. Its business strategy involves taking on investment risk over an extended period of time. Since February 2002, when Applicant announced its focus on tiny technology, Applicant's stock price has generally traded at widely varying premiums, and even at discounts, to net asset value.

Since December 31, 2001, through December 31, 2011, Applicant's net asset value per share has increased from \$2.75 at December 31, 2001, to a high of \$5.95 at June 30, 2008. Net asset value per share was \$4.38 at September 30, 2011. During the same period, the stock price has fluctuated between \$1.80 and \$23.60. The following chart illustrates Applicant's net asset value from December 31, 2001 through September 30, 2011 and stock price from December 31, 2001 through December 31, 2011.

In light of this history of volatility with respect to the stock price in relation to the net asset value per share, Applicant's stock price may well decline even if management is successful in increasing net asset value per share through making successful investments. In that case, management's Options would be worthless in spite of management doing a good job on behalf of stockholders. Under these circumstances, the best way to align the interests of management and the stockholders is to motivate management to remain with Applicant and to continue to produce increases in net asset value by granting Restricted Stock, rather than only Options.

Restricted Stock has intrinsic value while Options represent an arbitrage on the strike price of the option against the future value of the stock. Holders of Restricted Stock, over time, become owners of the stock with a vested interest in value maintenance and, importantly in Applicant's case, appreciation and the tax credits from the deemed dividends. These interests are completely aligned with those of Applicant's stockholders. Option holders only earn compensation if the stock price increases and do not benefit from the tax credits from deemed dividends or valuation protection, two elements that have high priority for Applicant's stockholders.

Moreover, the private equity and private venture capital firms 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.

Managing Dilution and Cash Expenses

Dilution is an important consideration for stockholders, and Restricted Stock is inherently more predictable than Options. Because Restricted Stock has intrinsic value, it takes fewer shares of Restricted Stock to generate a similar level of economic benefit to employees. Applicant believes that the availability of Restricted Stock awards may reduce the number of option shares that it will need to grant in order to be competitive with the compensation offered by private venture capital firms.

Applicant can also pay less cash compensation if it can issue Restricted Stock to its employees. 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.

Applicant's management and the Board, including the independent Compensation Committee of the Board, 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 Plan

The Plan, a copy of which is attached to this Application as Exhibit A, authorizes the issuance of Options and Restricted Stock subject to certain forfeiture provisions. The 2006 Plan, which provides that Restricted Stock will not be issued unless Applicant receives the Order, has been approved by the Board, including the Required Majority. The 2006 Plan was approved by Applicant's stockholders on May 4, 2006; however, stockholders were advised that Restricted Stock would not be issued under the 2006 Plan until applicable exemptive relief was issued consistent with the requested Order. The Plan, consistent with the relief obtained in the requested Order, will be presented to Applicant's stockholders after the issuance of the Order, and no Restricted Stock will be issued unless the Plan is approved by the stockholders. Approval of the Required Majority is required prior to the issuance of Restricted Stock pursuant to the Plan. Under the Plan, Non-Employee Directors will each receive a grant of up to 2,000 shares of Restricted Stock at the beginning of each one-year term of service on the Board, for which forfeiture restrictions will lapse as to one-third of such shares each year for three years. The Plan will be administered by the Compensation Committee and the Board will have the responsibility to ensure that the Plan is operated in a manner that best serves the interests of Applicant and its stockholders. All compensation decisions made by the Compensation Committee will be evidenced in the minutes of the Compensation Committee meetings at which such decisions are made. A maximum of twenty percent (20%) of Applicant's total shares of common stock issued and outstanding (as of the Effective Date or any date following it)⁷ will be available for awards under the Plan, subject to adjustment as described below. Shares issued under the Plan may be authorized but unissued shares or treasury shares. If any shares subject to an award granted under the Plan are forfeited, cancelled, exchanged or surrendered or if an award terminates or expires without an issuance of shares, those shares will again be available for awards under the Plan. Under the Plan, no more than fifty percent (50%) of the shares of stock reserved for the grant of the awards under the Plan may be Restricted Stock awards at any time during the term of the Plan. The Restricted Stock will not be transferable except for disposition by will or intestacy.

⁷ Effective Date is defined in section 2(i) of the Plan as the date on which the Plan is approved by Applicant's stockholders.

The Plan will make Restricted Stock grants available to employees and Non-Employee Directors recommended by the Compensation Committee, and only with the vote of the Board. Each grant of Restricted Stock to employees will be approved by the Required Majority. Each grant of Restricted Stock to Non-Employee Directors will be made pursuant to the schedule described above. The restrictions on the Restricted Stock may relate to continued employment or service as a director, (lapsing either on an annual or other periodic basis or on a “cliff” basis, *i.e.*, at the end of a stated period of time), the performance of the Applicant pursuant to performance goals as set forth in the Plan, or other restrictions deemed by the Required Majority and the Compensation Committee from time to time to be appropriate and in the best interests of Applicant and its stockholders. The Restricted Stock granted to Participants will be subject to restrictions on transferability and other restrictions as required by the Required Majority, and such grants of Restricted Stock may be conditioned on the satisfaction of performance goals as stated in the Plan. The terms and conditions of awards of Restricted Stock granted to employees under the Plan will be determined by the Required Majority and set forth in an award agreement between the Company and the award recipient. The Required Majority may determine that an employee who is the holder of Restricted Stock may receive dividends, including deemed dividends, that may be deferred during the restricted period applicable to these awards. Restricted Stock may not be transferred, pledged, hypothecated, margined, or otherwise encumbered by the Participant during the Restricted Period, except for disposition by will or intestacy.

Under the Plan, no more than 1,000,000 shares of our common stock may be made subject to awards under the Plan to any Participant in any year. No Participant will be granted more than 25% of the shares of stock reserved for issuance under the Plan. If the Company does not receive the Order to issue Restricted Stock, all shares granted under the Plan may be subject to Options.⁸ If the Company does receive such Order and issues fifty percent (50%) of the shares of stock reserved for grant under the Plan as Restricted Stock, no more than fifty percent (50%) of the shares granted under the Plan may be subject to Options. All Option awards will be issued to employees in accordance with the statutory provisions set forth in Section 61. An Option may not be exercised unless (1) the Participant is then in the employ of, or providing services to the Company and (2) the Participant has remained continuously so employed, or continuously maintained such relationship, since the date of grant of the Option; provided, that the award agreement may contain or be amended to contain provisions providing for the exercisability of any Option until not later than the expiration date of such Option.

Restricted Stock will be awarded to certain employees, officers and directors, including Non-Employee Directors, from time to time as part of the employees', officers' or directors' compensation based on their actual or expected performance and value to the Applicant. All awards of Restricted Stock to employees will be approved by the Required Majority; awards of Restricted Stock to Non-Employee Directors will be made on the schedule described above and will not be changed without Commission approval. Unless otherwise determined by the Board, a Participant granted Restricted Stock will have all of the rights of a stockholder including, without limitation, the right to vote Restricted Stock and the right to receive dividends, including deemed dividends, thereon. Upon termination of a Participant's employment or director relationship with the Company during the applicable restriction period, the Participant's Restricted Stock and any accrued but unpaid dividends that are then subject to restrictions shall be forfeited; provided, that the Board may provide, by rule or regulation or in any award agreement, or may determine in any individual case, that restrictions or forfeiture conditions relating to Restricted Stock will be waived in whole or in part in the event of terminations resulting from any cause, and the Board may in other cases waive in whole or in part the forfeiture of Restricted Stock.

⁸ Options will not be granted to Non-Employee Directors and, therefore, no relief is sought in this application for the grant of Options.

Applicant will comply with all disclosure requirements applicable to BDCs, including the amended disclosure requirements for executive 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.⁹

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 Plan. 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.

⁹ 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).

Because Restricted Stock that would be granted under the Plan would not meet the terms of Section 63(2)(A) (*i.e.*, the Plan 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.

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 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 for Employees

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.¹⁰ Applicant believes that the issuance of Restricted Stock to Applicant's officers and employees, including any officer or employee who is also a director, 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.¹¹

¹⁰ See Section 61(a)(3)(B) of the Act.

¹¹ '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."

Prior Commission Orders Relating to Employee Compensation

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.

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.¹²

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.¹³

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.¹⁴

¹² See *MCG Capital Corporation*, Investment Company Act Release No. 27280 (April 4, 2006).

¹³ *Main Street Capital Corporation*, Investment Company Act Release No. 28120 (January 16, 2008).

¹⁴ *In the Matter of Triangle Capital Corporation*, Investment Company Act Release No. 28196 (March 18, 2008).

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.¹⁵

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.

¹⁵ See *Baker, Fentress & Company*, Investment Company Act Release No. 23619 (Dec. 22, 1998) (the "BakerFentress 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.

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.

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 talented personnel primarily with private venture capital firms, and secondarily with private equity funds, start-up companies, investment banks, and other financial services 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.

With respect to Applicant's primary competition, private venture capital 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 venture capital firm, among other things. The Plan will enhance the ability of Applicant to compensate its personnel competitively, while also aligning the interests of its personnel 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 Plan 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 Plan and its potential dilutive effect. If the Plan is not approved by stockholders, it will not be implemented. Furthermore, each issuance of Restricted Stock to employees will be approved by the Required Majority of directors 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 Plan 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 Plan. Applicant acknowledges that awards granted under the Plan 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 Plan 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. A maximum of 20 percent of our total voting securities will be available for awards under the Plan. Under the 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. No Restricted Stock has been issued; therefore, any specified maximums under the Plan do not include outstanding Restricted Stock. For purposes of determining Applicant's compliance with the limits in Section 61(a)(3), Applicant will treat Restricted Stock issued under the Plan as voting securities that would result from the exercise of all outstanding warrants, options and rights issued to directors, officers and employees.¹⁶

¹⁶ For purposes of calculating compliance with this limit, the Company will count as Restricted Stock all shares of its common stock that are issued under the Plan less any shares that are forfeited back to the Company and cancelled as a result of forfeiture restrictions not lapsing.

Consistency with the Purposes of the Act

As indicated earlier, Applicant is at a disadvantage in competing with other financial services companies, particularly private venture capital 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.

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.