



John Cole Scott On What's Next For The BDC, Private Credit Markets

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Chuck Jaffe, in this episode of The NAVigator podcast interviews John Cole Scott, President of CEF Advisors. John discusses the changing landscape of business-development companies and the details he gleaned from attending the recent Eversheds BDC Roundtable, which focused on legislative and other issues that are creating challenges and opportunities for the industry. Scott, the Chairman of the Active Investment

Company Alliance, weighs in on the potential for changing quarterly reporting requirements, the impact of easing restrictions of holdings for retirement plans and more.

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CHUCK JAFFE: We're getting the latest update on business-development companies from John Cole Scott, president of CEF Advisors, welcome to The NAVigator. This is The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization representing all facets of the closed-end fund industry from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator will point you in the right direction. And returning to The NAVigator today, John Cole Scott, president of CEF Advisors in Richmond, Virginia, which is online at CEFData.com, but beyond CEF Advisors, John is the chairman of the Active Investment Company Alliance, which you can learn about at AICAlliance.org. John Cole Scott, great to have you back on The NAVigator.

JOHN COLE SCOTT: Always good to be here, Chuck.

CHUCK JAFFE: Business-development companies have been a compelling investment story this year for a lot of different reasons, not the least of which is the big yields. You and I spoke about them not too long ago on The NAVigator, but you were just at the 22nd Eversheds BDC Roundtable in Washington, D.C., and it's a big deal in the industry where a lot is discussed about what's happening and how structure and rules are changing, and how politics is impacting the industry and more. Because business-development companies, and for anybody who is listening to The NAVigator and says, "You're about closed-end funds," yeah, technically a BDC is not a closed-end fund, but we lump them together because they have all the same attributes, just a slightly different exchange structure, but we're looking at BDCs and they've been in the news because there's a lot going on with private credit, et cetera. So we should tell people, the Eversheds conference is all about the legal side of the industry, and one of the things that has been happening with BDCs, closed-end funds, private equity and more, is that the rules keep changing and a lot more people can now access BDCs and private credit. So let's start there, how much wider is access going to become?

JOHN COLE SCOTT: Yeah, so I'd say really the one thing we love about the conference is it allows me to hear the lawyers and regulators and valuation firms talk to their clients and prospects, not thinking that I'm in the audience deciding what data to collect or questions to ask, what BDCs to put in client portfolios. I've been going there for about 10 years, it's a great resource with what they put together. And really if you think about what's going on,

President Trump said we should allow stocks, which includes BDCs kind of as well, to only require semi-annual reporting, and they gave a great feedback on that. Well, if that becomes the new rules, they still would expect that most BDCs will report quarterly, because how are you going to get these quarterly private marks, four net asset values a year, doesn't seem like enough sometimes, I could never imagine buying only two a year in my database. You've really got to look at the updated leverage and non-accruals and all those data points we talk about to really understand which managers are doing better, how are they considering leverage, how are they raising capital, how are they treating shareholders? That huge mark of all the holdings marked every quarter is really a boon for the sector and a really wonderful part of being a BDC investor, and we really plan our life around these rhythms of quarterly earnings season which is about to start for the third quarter in the sector in a few weeks.

CHUCK JAFFE: Yeah, I certainly hope that we don't get to where we get less regular reporting, because the reporting is important with all public companies, but BDCs where you're dealing with a lot of stuff that's happening behind the scenes, it's not as easily watched, I think the loss of numbers would be a big deal. That is definitely one thing that's happening, of course you talked about politics and policies right now, what else do we need to know about the rules and what's going on? Because there are changes to some of the access and how people are going to access BDCs and how BDCs are going to be packaged.

JOHN COLE SCOTT: Yeah, so to be fair, we're not just talking about listed [exchange-traded 0:04:53] BDCs, we're also covering the non-traded, which is generally sold to retail through the wealth channel, and so is private which is generally sold through the institutional channel to accredited investors and qualified purchasers. What's interesting about the structure for both of it is the acquired fund fees, which is again more impactful for listed. We've talked about it before, it's gotten through the House, it's stuck in the Senate. One of the cool things we learned at the conference is the actual role of lobbying and the fact that a New York senator has no more power than an Idaho senator, and really going and finding the stories in the portfolios. So one thing we did at CEF Data is we've got almost all the portfolio holding companies' corporate headquarters by zip code to then give to the lobbyists, because that's not what we are, to try to help push the needles towards that ruling. There's also, we talked about the tax parity, where BDCs were excluded from the way MLPs and REITs are taxed for people that are income investing, there's a chance to move that forward because it really

wasn't a contentious issue in Congress, it was more overlooked because there's a smaller bucket of those that use them. And then the really why do we even have BDCs, is for capital formation to promote small business growth, and we really recognize that you must work through the staff because congressmen are busy. We even heard from a congressman in New York on the Finance Committee, about how his staff, he has a finance staff member that digs into all these issues, so he really tries to bring to light, when the vote comes up, he looks to his guy or girl and goes, "Should we say yes or no?" If we can get to those people, we can hopefully make these things happen, which would be dramatically useful to retail investors, income investors, and financial advisors that serve them.

CHUCK JAFFE: Yeah, of course right now they're not looking to their people and seeing anything because the government is shut down, that's going to hold up a lot of things. It's also going to create more of a backlog for changes going forward, so that may slow some of this progress that I think BDC folks were expecting.

JOHN COLE SCOTT: It is, and they also talked about the regulations and how in some ways, one point they brought up at the conference was that the last commissioner said that, "Oh, my gosh, now 20% of investors are accredited and we need to bring it back down to five-ish," and the current footing feels more like it's 20, it should be 50. And so just by the feeling of the priorities of the Commission, the current commissioner, he actually had a fireside chat with the head of the practice, and really thinking about what I heard the lawyers tell the BDCs, "Okay, you've still got to worry about doing the right work, you can't make mistakes, you will get in trouble." One interesting thing they said, "Well, if we find a problem, should we serve it on a silver platter to the regulators?" And again, one of the reasons why I love to be in the room, Chuck, they go, "Well, you should be prepared to answer for it, when you found it, how you corrected, but wait till they find it too," which unfortunately seems to be relatively normal in capital markets in most places, not just the US.

CHUCK JAFFE: That's also why regulators close the barn door after the horse is gone, they're always kind of looking after the last problem, not the next one, because they're not trying to solve it.

JOHN COLE SCOTT: But also I imagine with the priority of AI being brought into [inaudible 0:07:54], they'll be able to go through much more data far more quickly to look for things

like this that I think done right will bring more problems to light and create a better experience for most investors in the market.

CHUCK JAFFE: A lot of things, like private credit, which is the heart of the BDC business, are now going to be more readily available in retirement plans. What does that do for the BDC business? Does it create more demand for BDCs so we'll see more product creation? Or does it just create more opportunities so the big BDCs will become the bigger BDCs?

JOHN COLE SCOTT: Well, I mean, there's more BDCs forming, we have 116 non-listed private plus the 51 listed, we just crossed the half trillion dollar asset mark in CEF Data while at the conference, but they focus heavily on you gotta make sure that your fund isn't more than 25% in a retirement plan [inaudible 0:08:42] which in some ways are beautiful but create tons of complicated rights for investors and class action lawsuits. They want to make sure that that is something that if you're going to bring these products into these plans, you're very thoughtful on the sizing that is in these plans. But however they also said there is a benefit to BDCs because they're 40 Act, independent board, they are a registered fund product, they're probably generally the better structure than a private fund. We learned about these new things that I never heard of, Chuck, these venture capital operating companies, where from my understanding talking to people that create them, they do a prospectus, they collect capital, and never report more data again. Which I can't imagine that's true, but I heard that from a guy that creates them for a living at a firm I won't share, and I was like, "BDCs are much better structures because of the transparency, because of the limits on leverage." I even heard from a BDC, "If we go higher leverage, but we won't get investment-grade rated, so our leverage would cost more if we go a little bit higher, so we can't raise more debt capital because want to make sure we keep our investment-grade rating." So even the lenders help keep BDCs in check, which is a really interesting thing to learn about.

CHUCK JAFFE: Yeah, and it's why investors need to look under the hood and understand the credit quality that they're buying into and all the rest. So what does this mean for BDCs, or maybe more importantly for investors in BDCs moving forward? Because the yields, they're going to stay attractive, they have been very attractive, they're going to stay attractive, but the environment is changing, and that also means the rate environment as we're watching the start of rate cuts, so what's the near-term outlook?

JOHN COLE SCOTT: There were 11 panels and I think 12 hours of content, so this is definitely a summary version of what we learned, but I'd say one thing we learned is there's a lot of people thinking about PIK, "Oh, PIK, it must be terrible to not get paid." They made it very clear to their peers and the environment that when you put a deal together where PIK income or payment-in-kind is part of the plan, part of the deal and the structure, it is a useful tool. It's different when you plan not to get PIK and then bumps happen, the company's in trouble, and then PIK is the only way to keep it solvent, that's a much less common situation but we definitely learned that the BDCs think about that one data point differently. And then we think about how they're looking at how they keep their leverage at a certain level, they keep their equity capital growing, imagine a public BDC can always bring new stock to market, but if you do it aggressively and frustrate shareholders, not just institutional but even retail, they tend to trade you worse. We also learned there's a lot of unique strategies, imagine there's some BDCs like Ares Capital that do potentially everything bottom to top, relatively unique, there's lots of only larger, and there's a bunch of smaller ones, like we had Gladstone at the conference last summer, there's ones at Capital Southwest, Mainstreet, even Trinity, that do a lower level of size, but the way they structure their deals, there's so much uniqueness here. It's so hard because so many investors sift on two things, Chuck, discount and yield, and you know I've said this for the six years we've done the podcast, it's always more than that, it's manager quality, it's how they care about leverage, it's how they look at their fee structure, it's how they choose to grow, and what their ROE and NAV performance and all those important minutiae. The cool thing is, as I said over and over again, the diversity and competition has brought fees down a little bit and is creating better quality managers. But like you said, J.P. Morgan, I met with them after a previous conference, they have yet to launch their BDC. I said, "You're a little bit late to the party, but you'll probably get to a billion dollars by snapping your fingers because you're J.P. Morgan." More are coming, but I love the competition, because as you might know from most fund structures, competition squeezes fees, and I think that's good for my clients and good for your listeners.

CHUCK JAFFE: The other thing that it does is it makes it that there's going to be more BDC-oriented products. They may not be the individual BDCs but they'll be the funds or the ETFs of BDCs, so an ETF of BDCs, we're seeing more of those come to market as well.

JOHN COLE SCOTT: We recently had a First Trust [inaudible 0:12:48] product become from a closed-end fund to an active ETF, it's still very small and gaining traction, there's a more mature Putnam fund, and there's other more passive and growing strategies. There was even talk at the conference about private equity and private credit being in an ETF wrapper, but they said definitely look under the hood, it's usually through wrappers like a closed-end fund or BDC in the guts of an ETF, or it can be a derivative-based strategy. It's nearly improbable that you could load up an open-end fund wrapper with illiquid things you can't trade regularly, even the BDCs themselves rarely trade their holdings amongst each other, and they're a relatively small group. And so I'd say whether it's a closed-end fund, interval fund, a tender-offer fund, a BDC, listed or private, a lot of interesting places there, the investors in these funds are very different. You and I, we like things that we can see on the stock exchange, if we want to we can trade them, I don't dislike the private and non-traded but I like more control over choice. I've taught my clients volatility can be an asset, not a deficit to the experience, because we change our minds with conviction regularly. I think there's really interesting things, there's even a white paper out now about an interval fund electing to be a BDC and not a closed-end fund, and that idea, to my knowledge, didn't exist 10 days ago.

CHUCK JAFFE: The changes are happening fast, they're making more opportunities, we'll be following them, or more importantly we'll be having you follow them. John, thanks as always for joining me on The NAVigator.

JOHN COLE SCOTT: Great to be here, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe, and yeah, I'm Chuck Jaffe, I'd love it if you'd check out my hour-long weekday show by going to MoneyLifeShow.com or by searching wherever you find your favorite podcasts. Now if you're searching for more details on business-development companies, closed-end funds, interval funds and more, go to AICalliance.org, it's the website for the Active Investment Company Alliance. Thanks to my guest John Cole Scott, he's president of CEF Advisors in Richmond, Virginia, he's also the chairman of the Active Investment Company Alliance. His firm is online at CEFData.com and all of their data is there for you to dig through, by the way, John is on X @JohnColeScott. The NAVigator podcast is available for you every Friday, make sure you don't miss any of our episodes by

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