Business Development Companies Face Increasing Regulatory Risks

Business development companies (BDCs) are increasingly targeted by private litigants and are the subject of enforcement actions by securities regulators, raising concerns for such companies and their directors and officers. Although BDCs are not subject to all of the same constraints as other types of investment companies, regulators are closely examining whether BDCs are complying with their regulatory obligations, particularly in the areas of fees, valuation, and compliance programs. It is imperative that BDCs and their directors and officers ensure that they are protected by well-structured management and professional liability insurance programs in the event of civil litigation, a regulatory investigation, or an enforcement matter.

A BDC is a special type of closed-end investment company — authorized by Congress in 1980 — that is intended to facilitate capital formation for small- and middle-market companies. BDCs limit their investments to securities of US-domiciled, generally private, smaller companies to which they must offer “significant managerial assistance.”[1]

Although they are structured as closed-end investment companies, BDCs are not required to register as investment companies under the Investment Company Act of 1940 (1940 Act) and are not subject to all of the regulatory constraints imposed on registered funds. However, some of the key protections of the 1940 Act apply to BDCs. For example, BDCs are subject to limits on the amount of leverage they can incur and are restricted in their ability to enter into certain transactions with affiliates. Also, like registered investment companies, BDCs are required to adopt a code of ethics and a comprehensive compliance program.

BDCs register their securities under the Securities Act of 1933 and, if they publicly offer their shares, are subject to the reporting requirements imposed on public reporting companies under the Securities Exchange Act of 1934 (Exchange Act). Many

[1] Section 2(a)(48) of the Investment Company Act of 1940.

BDCs list their shares on an exchange and thus are also subject to the rules of the listing exchange. In addition, BDCs often establish wholly-owned subsidiaries that are regulated as small business investment companies (SBICs) subject to the oversight of the Small Business Administration.

POTENTIAL RISKS

Due to the varying statutory and regulatory requirements with which BDCs must comply, potential plaintiffs have several opportunities to challenge the manner in which a BDC is managed and operated. For example, in terms of private litigation, BDCs may face:

- Excessive fee litigation:
  - Statutory: Like directors of any other corporation, BDC directors owe the company and its shareholders a fiduciary duty in connection with their supervision of the affairs of the company. In addition, Section 15(c) of the 1940 Act imposes affirmative duties on BDC directors when considering investment advisory agreements.[2] A breach of these duties may result in administrative enforcement actions brought by the US Securities and Exchange Commission (SEC) against the company, its directors, or its officers.
  - Representative actions: Excessive fee litigation under Section 36(b) of the 1940 Act has historically been brought on a derivative basis by shareholders in registered open-end investment companies. Recently, however, excessive fee cases have expanded to publicly traded BDCs, with plaintiffs alleging that the advisory fees paid to an investment adviser, and administrative fees paid to an administrator affiliated with the investment adviser, are excessive. Courts analyzing excessive fee cases apply the test for analyzing advisory fees set forth in *Gartenberg v. Merrill Lynch Asset Management*.[3] Under *Gartenberg*, the relevant assessment is whether fees are so disproportionately large that they could not be the product of arms-length bargaining.

Independent members of a BDC's board should acquaint themselves with the line of cases following *Gartenberg*, including the decision of the US Supreme Court in *Jones v. Harris Associates L.P.*,[4] which stated that the essence of the test for determining if the fees paid to an adviser of an investment company are appropriate is "whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain." Moreover, a BDCs' independent board members should be cognizant of the process to be undertaken by them. The Supreme Court stated, "[w]here a board's process for negotiating and reviewing investment-adviser compensation is robust...their decision to approve a particular fee agreement is entitled to considerable weight, even if a court might weigh the factors differently."[5]

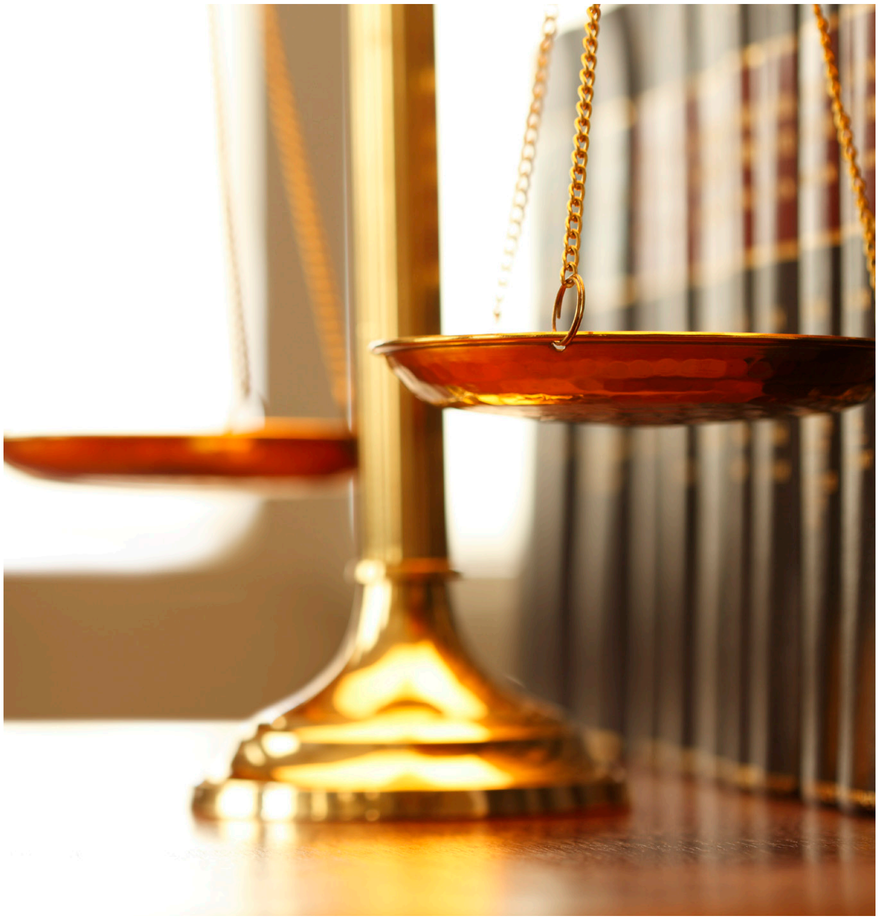
Several recent BDC cases provide useful insights regarding the types of inquiries that directors should undertake in connection with evaluating an advisory contract.

- Valuation of shares.
  - Statutory: Under Section 2(a)(41) of the 1940 Act, assets held by a BDC for which market quotations are readily available should be valued at their market value. Other assets should be valued at fair value determined in good

[2]Section 15(c) is made applicable to BDCs by Section 59 of the 1940 Act.
[3]694 F.2d 923 (2d Cir. 1982).
[4]559 U.S. 335 (2010).
[5] *Id.* at 350 (internal citations omitted).

faith by a BDCs' board of directors. The Exchange Act requires BDCs to disclose the identity, cost basis, and fair value of their investments in quarterly filings with the SEC. Section 10(b) of the Exchange Act prohibits any fraudulent act or omission in connection with the purchase or sale of any security.

— Representative actions: Class actions alleging violations of Section 10(b) have been brought against BDCs' and their directors and officers, claiming that the defendants artificially inflated the value of BDCs' holdings. Civil litigation involving the improper valuation of portfolio assets can be challenging. A BDC is required to invest at least 70% of its assets in "eligible portfolio companies,"[6] private companies subject to bankruptcy or reorganization, cash and certain fixed assets. Accordingly, many BDC portfolios contain a significant portion of illiquid investments — that is, assets for which no market exists and that cannot be easily disposed of. Under the 1940 Act, such investments must be valued at fair value as determined in good faith by the board of directors. The SEC has recognized, however, that there is no single standard for determining the fair value of assets, which depends on the specific circumstances of each case and cannot be determined with any level of certainty. It is, rather a matter of subjective, good faith judgment.



A BDC should take steps to ensure that it has adequate policies and procedures in place to determine the fair value of its holdings. Such policies and procedures should be appropriately detailed and records should be kept to demonstrate that the board has undertaken a meaningful inquiry to determine fair value in light of not only market developments but also reflecting company-specific developments.

In terms of regulatory enforcement, BDCs need to consider:

- Their valuation and compliance programs:

  — Statutory: In addition to fulfilling its obligation to fairly value certain securities, BDCs are required by regulation under the 1940 Act to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws.

  — Representative actions: The SEC has brought administrative proceedings against multiple BDCs. In one case, the SEC found that the BDC materially overstated the value of its interests in certain portfolio companies in reports filed with the SEC. Moreover, the SEC found that the BDC misrepresented its valuation policies in filings with the SEC and had deficient internal accounting controls. Among other things, the CEO of the BDC was found to have failed to properly implement the BDC's valuation policies.

  — The SEC remains focused on valuation issues under the

[6] "Eligible portfolio companies" are domestic issuers that either (i) do not have any securities listed on a national exchange or (ii) have listed equity securities, but have an aggregate market value of less than $250 million.

For more information on this topic and others, visit marsh.com or contact:

GREGG B. SARTORIUS
Senior Vice President,
Marsh's FINPRO Practice
+1 212 345 9851
gregg.sartorius@marsh.com

SARAH D. KATZ DOWNEY
Marsh's US FINPRO D&O Product Leader
+1 212 345 3122
sarah.d.downey@marsh.com

KELLEY HOWES
Of Counsel,
Morrison & Foerster LLP
+1 303 592 2237
khowes@mofo.com

ANNA T. PINEDO
Partner,
Morrison & Foerster LLP
+1 212 468 8179
apinedo@mofo.com

1940 Act. In this case, the valuations were found to have been unreasonable because they were based on limited, private sales of the portfolio companies' securities without reflecting other relevant factors. In addition, the BDC was found to have made misrepresentations in its valuation policy and to have failed to follow its own policy.

— Most companies held in a BDC's portfolio are small private companies whose shares are not actively traded. Disclosing in reasonable detail the policies and procedures used to arrive at their valuations — including the use of third-party valuation firms — where applicable, is critical. BDCs should also keep in mind that regulations under the 1940 Act require each BDC to appoint a chief compliance officer. Involving that individual in valuation matters is considered best practice.

MANAGEMENT AND PROFESSIONAL LIABILITY INSURANCE PROTECTION

With the regulatory and civil litigation focus on BDCs, it has become increasingly important for BDCs and their senior leaders to focus on their directors and officers (D&O) insurance. As the regulatory and litigation environment for BDCs continues to evolve, D&O insurers are increasingly providing coverage options to address the new risk environment.

For example, historically insurers were only willing to advance defense costs in excessive fee cases where the case was resolved in favor of the insured or once a settlement approved by the insurers had been reached. For the most part, this limitation has been removed from the typical D&O policy.

Also, several insurers now offer coverage for regulatory investigations, even when the investigation is at an early stage and no wrongdoing has been alleged. Millions of dollars of expenses can be incurred during the discovery phase of an investigation. In the absence of a well-structured insurance program, the advisor or the BDC may be responsible for these expenses.

In order to best protect themselves and the company, BDCs and their directors and officers should work with their insurance advisors to incorporate into their insurance program the most favorable terms and enhancements that are available in what is a constantly changing insurance environment.