Impact of DOL's Final Rule on Business Development Companies

On April 6, 2016, the U.S. Department of Labor (DOL) released its final rule defining who is a fiduciary in connection with investment advice that is provided to benefit plans subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA). The new rule is currently scheduled to become effective on April 10, 2017. Only employer-sponsored retirement accounts such as 401(k)s, defined benefit plans and certain types of individual retirement accounts (IRAs) are subject to the rule change because these accounts are under the authority of the DOL. Broker-dealers providing services to all other types of investment accounts, including traditional and Roth IRAs, would generally not be deemed fiduciaries, but would remain subject to the suitability requirements set forth in FINRA rules and SEC cases. Investment advisers are deemed fiduciaries with respect to all managed accounts.

Under the current fiduciary standard, a person is considered a fiduciary only if he or she provides investment advice on a regular basis pursuant to a mutual agreement, arrangement or understanding that is the primary basis for investment decisions and is individualized for the particular needs of the retirement investor. Under the new rule, the requirements that the investment advice (i) be given on a regular basis; (ii) be pursuant to a mutual agreement, arrangement or understanding; and (iii) be the primary basis for investment decisions are each removed. The new rule also expands the definition of investment advice to include any communication that could be reasonably viewed as a suggestion that the client take a certain action or refrain from taking a certain action in relation to a security or investment strategy.

A fiduciary under a plan subject to ERISA is required to give investment advice to the client or plan with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use. A determination that an investment is suitable for a particular client or plan is not sufficient for a fiduciary providing investment advice. Additionally, a fiduciary providing investment advice cannot cause itself or any of its affiliates to receive commission or transaction-based compensation unless there is an available exemption.

Exemptions from the new fiduciary rule include (i) the "seller's exception" which generally carves out investment advice provided to certain sophisticated clients or professionally managed plans, and (ii) the best interest contract exemption (BICE). The proposed BICE as released in 2015 would have strictly excluded transactions involving securities of business development companies. Following the receipt of over 3,000 comment letters, the DOL's final rule omitted business development companies as a restricted asset class. While this change technically permits all business development companies (and other asset classes) to continue to be used in self-directed IRAs and other benefit plans, the conditions associated with the BICE may specifically limit its practical benefit for business development company investments.

While the BICE does create an avenue for undertaking transactions on a commission or transaction basis with retail retirement clients who would otherwise not qualify for the seller's exception, the fee disclosure required by

the BICE may make it unworkable for broker-dealers that would like to recommend business development company investments. One of the conditions of the BICE requires a relying broker-dealer to provide its client or plan with disclosures regarding the fees charged by the assets sold and purchased by the broker-dealer on behalf of the client or plan. However, when determining fees, business development companies are required by SEC rules to aggregate the amount of total annual fund operating expenses of acquired funds (which are indirectly paid by the business development company) and transaction fees (which are directly paid by the business development company) and express the total amount as a percentage of average net assets of the business development company (this is referred to as "AFFE"). As a result, the AFFE disclosure typically results in overstated expense ratios because a business development company's indirect expenses required to be included in the calculation of AFFE can often be significantly greater than the direct expenses, and the expense ratios of BDCs can therefore be extremely high. From a practical perspective, broker-dealers relying on the BICE may encounter difficulty justifying fees associated with business development company investments, including associated advisor and administrator fees, to their clients and plans when compared to other similar investments that are not required to include AFFE disclosure. We expect many broker-dealers will simply avoid recommending business development company investments to their clients and plans instead of relying on the technical availability of the BICE.

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