Client Alert

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Best Practices for Independent Directors of Business Development Companies

By Jay G. Baris

As business development companies (BDCs) grow in popularity, the role of their independent directors grows in importance. Here we look at the increasingly important role that BDC independent directors play and how their responsibilities differ from the responsibilities of independent directors to traditional investment companies.

WHAT ARE BUSINESS DEVELOPMENT COMPANIES?

A BDC is a special type of closed-end investment company that Congress authorized in 1980 as a way to make capital more readily available to small, developing, financially troubled companies that do not have ready access to the public capital markets or to other forms of conventional financing. BDCs are subject to a more relaxed regulatory structure. In exchange, they must limit most of their investments to securities of private, smaller companies ("eligible portfolio companies") and must make available "significant managerial assistance" to the issuers of those securities. The special nature of BDCs creates special challenges for their independent directors.

WHY ARE BDCs SO POPULAR?

In just 10 years, BDC assets have grown tenfold. As of June 30, 2013, there were 68 active BDCs with combined total assets of $53 billion; those assets totaled just $5 billion at the end of 2003. Part of this growth is attributable to private equity and venture capital firms that find the BDC structure attractive because it allows them to pursue alternative investment strategies with permanent capital.

BDCs are structured as closed-end investment companies but are not subject to many of the restrictions that apply to traditional registered closed-end funds. In some important respects, they are subject to "Investment Company Lite" regulation. For example:

- BDCs essentially operate as private equity funds. But investors in BDCs do not need to meet income, net worth, or sophistication criteria required for investment in traditional private equity funds.
- BDCs have more flexibility than registered closed-end funds to co-invest with certain "second-tier" affiliates.
- Investment advisers can charge BDCs performance-based fees that traditional registered closed-end funds cannot pay.
- BDCs have more flexibility than registered closed-end funds to leverage their investments.
- Like mutual funds and registered closed-end funds, BDCs can qualify for "pass-through" tax treatment if they comply with IRS portfolio diversification and income tests.

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HOW DOES THE SEC REGULATE BDCs?

The Investment Company Act of 1940, as amended (the "1940 Act") provides special treatment for a closed-end investment company that files an election to be treated as a BDC. Once the fund elects BDC treatment, it is subject to specific sections of the 1940 Act that apply only to BDCs, as well as a host of other requirements that apply to traditional open- and closed-end funds.

BDCs register under the Securities Act of 1933, as amended (the "Securities Act"), and the Securities Exchange Act of 1934, as amended (the "1934 Act"), and are subject to the disclosure and reporting rules of those laws.

WHAT CAN BDCs INVEST IN?

A BDC must invest at least 70% of its total assets (measured at the time of investment) in these types of assets:

- Privately issued securities purchased from issuers that are "eligible portfolio companies" (or from certain affiliated persons)
- Securities of eligible portfolio companies already controlled by the BDC without regard to the nature of the offering
- Securities of certain financially distressed companies that do not meet the definition of eligible portfolio company that are purchased in transactions not involved in any public offering
- Cash, cash items, government securities, or high-quality debt securities maturing in one year or less from the time of investment
- Office furniture and equipment, interests in real estate, and leasehold improvements and facilities needed to operate as a BDC

The definition of eligible portfolio company is central to the restrictions that apply to a BDC's investments. Broadly, eligible portfolio companies include domestic companies that are not "investment companies" under the 1940 Act, or (with limited exceptions) would be investment companies but for an exclusion from the definition of an investment company under Section 3(c) of the 1940 Act and that also meet either the statutory criteria or alternative criteria that the SEC adopted by rule.

The statute provides that the issuer also must satisfy one of the following three criteria:

1. The issuer does not have a class of securities that are margin securities; or
2. The BDC controls the issuer and an affiliated person of the BDC serve as a director of the issuer; or
3. The issuer has total assets of not more than $4 million and capital and surplus (shareholder equity less retained earnings) of not less than $2 million.

Alternatively, the rule provides that the issuer must satisfy one of the following two criteria:

1. The issuer does not have any class of securities listed on a national securities exchange, or
2. The issuer has a class of securities listed on a national securities exchange but has an aggregate market value of outstanding voting and nonvoting common equity of less than $250 million.

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WHAT KINDS OF SECURITIES MAY BDCs ISSUE?

BDCs may issue debt and equity securities, as well as certain derivative instruments, including options, warrants and rights that convert into voting securities. BDCs that issue debt and other types of "senior securities" must maintain asset coverage of 200%, which is less than the asset coverage requirement that applies to traditional registered closed-end funds and mutual funds.

WHAT IS THE REQUIREMENT TO MAKE AVAILABLE "SIGNIFICANT MANAGERIAL ASSISTANCE"?

BDCs must offer to provide "significant managerial assistance" to the eligible portfolio companies in which they invest, and if accepted, they must provide such assistance. (There is no requirement for a portfolio company to accept the offer for managerial assistance.) Significant managerial assistance includes arrangements in which a BDC, through its directors, officers, or employees, provides significant guidance and counsel concerning management, operations or business objectives and policies. It also means exercising a controlling influence on the management or policies of an eligible portfolio company by the BDC acting individually or as part of a group. There is no requirement that the company accept the offer.

WHAT IS THE ROLE OF A BDC's INDEPENDENT DIRECTORS?

In addition to having responsibilities that are similar to those of directors of traditional registered funds, BDC directors assume additional layers of responsibility, especially concerning conflicts of interest. Some of the unique responsibilities of BDC directors include:

- *Transactions with affiliates*. Unlike traditional investment companies, in which certain "joint transactions" with affiliates are prohibited, BDCs may enter into joint transactions with second-tier affiliates subject to approval by the BDC's independent directors.

- *Co-investing*. Many BDCs obtain orders from the SEC that allow them to co-invest with affiliates of the BDC's investment adviser. To rely on a co-investment order, the BDC must comply with several conditions designed to prevent overreaching. The responsibility to oversee these transactions and ensure compliance with the SEC's conditions falls on the independent directors.

- *Pay-in-kind income*. Not infrequently, portfolio companies pay interest "in-kind"-that is, with shares of stock rather than cash. The independent directors should monitor the amount of "PIK" income, especially when the non-cash income figures into the amount of the cash compensation that the BDC pays its adviser.

- *Valuation*. By their very nature, many BDC portfolio holdings are not liquid and thus there is no readily available market value for them. The independent directors are primarily responsible for valuation of portfolio securities.

- *Alternative asset classes*. BDC investments have become more complex over the past 10 years, requiring sophisticated directors who understand unitranche structures and other alternative investment classes.

And, just like their counterparts who serve as directors of traditional registered funds, BDC independent directors must approve the investment advisory agreement, service providers, and independent auditors annually and generally exercise their business judgment in the context of carrying out their fiduciary duties.

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COMPLIANCE TRENDS AND BEST PRACTICES FOR BDC DIRECTORS

BDCs are designed to accommodate private company investments, have their own unique regulatory structure, and may involve multiple potential conflicts of interests. As BDCs grow in size and number, scrutiny by securities regulators, the press, and investors also is likely to increase, and so will the challenges facing independent directors.

One senior SEC official recently testified in an administrative proceeding: “My view of BDCs is that every one of them is an enforcement case waiting to happen.” This telling statement may indicate that the SEC’s interest in BDCs is growing.

What can BDC independent directors do to ensure that they are satisfying their oversight and fiduciary responsibilities? Among other things, they should consider the following steps:

- Meet regularly to review proposed co-investments and monitor transactions with affiliates.
- Periodically review the appropriateness of valuation procedures and how they apply to the BDC’s holdings issued by eligible portfolio companies.
- Continuously monitor BDC use of leverage.
- Meet regularly with the chief compliance officer of the BDC and its investment adviser to ensure that the adviser has established and follows compliance procedures tailored specifically for the BDC.
- Appoint independent legal counsel. Although BDCs are not required to retain independent legal counsel for their independent directors, this practice is growing more commonplace, as it is for mutual funds and traditional registered closed-end funds. Independent legal counsel can guide the independent directors through the myriad of complex requirements, restrictions, and the increasingly frequent potential conflicts of interest that arise.

The growing responsibilities of independent directors, coupled with increased scrutiny of BDCs by regulators, investors, and the press, suggest that independent directors should use whatever tools they have available to ensure that they carry out their fiduciary duties. These tools include increased reliance on the chief compliance officer, retaining independent legal counsel, and learning more about the complex regulatory, operating, and governance environments of BDCs.

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