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How Biz Development Cos. Can Mitigate Regulatory Risks

By **Mark Schonfeld, Gregory Merz and Chris Hamilton** (May 11, 2020, 6:17 PM EDT)

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Over the last decade, business development companies, or BDCs, became increasingly popular, and profitable, vehicles for private fund managers to raise and deploy capital. With the current pandemic hitting the portfolios of BDCs particularly hard, investors are already sounding the alarm for greater regulatory scrutiny.

In addition, the U.S. Securities and Exchange Commission's focus on protection of retail investors makes BDCs a particularly ripe target. Moreover, because BDCs are subject to many of the complex constraints of the Investment Company Act, managers of BDCs are often caught off guard by requirements not typically confronted by managers of private funds.

Nevertheless, timely attention to compliance challenges today can mitigate the risk of encountering regulatory issues down the road.

Growth of BDCs

BDCs are the result of a congressional effort in 1980 to encourage capital accessibility for small and developing businesses lacking access to public markets and other financing. BDCs are closed-end investment companies that elect to be subject to special treatment under the Investment Company Act if they invest at least 70% of their assets in small and mid-sized businesses (generally, businesses with market capitalization below $250 million).

BDCs are regulated like other registered investment companies, or RICs, although compared to RICs they receive relaxed treatment with respect to leveraging, compensation and affiliated transaction restrictions. In 2018, in part to maintain the ability of BDCs to keep pace in the increasingly competitive middle-market lending segment, Congress further relaxed BDC leveraging restrictions by allowing BDCs to double their debt-to-equity leverage ratios from 1 to 1, to 2 to 1.[1]

BDCs not only provide small and developing businesses with flexible capital-raising options, they also provide retail and other investors with access to potentially lucrative credit markets that would be otherwise unavailable. BDCs did not become particularly popular until the mid-2000s.

Today, however, there are over 90 active BDCs representing more than $60 billion in aggregate assets. The rapid growth in popularity led many private fund managers to add BDCs to their existing stable of fund offerings.

Acute Impact of the Crisis on BDCs Heightens Risk of Regulatory Scrutiny

Now, as governments, markets and businesses react to a global pandemic, the small business lending space in which BDCs operate is likely to come under heightened regulatory scrutiny.

Many small businesses that comprise BDC portfolios have become distressed and despite some small businesses being able to obtain loans under government programs, many have not yet received relief.

As small businesses struggle to meet payroll, the likelihood increases that many of these businesses will be unable to meet their debt obligations. As a result, over the past month, several large BDCs have had their valuations drop by 45% to 68%, significantly exceeding the decline of the broader equity and credit markets. Not surprisingly, investors have begun to call on the SEC to investigate.[2]

Declining value and calls for action are not the only reason BDCs may face heightened SEC scrutiny. Small business economics will likely be an area of focus in the economic response to the pandemic, which will likely require regulators to become more familiar with the operation of small business lenders, including BDCs.

The SEC staff has already started contacting managers of RICs for information on how they are responding to the crisis and it is likely that there will be an increase in SEC examinations of BDC advisers. Furthermore, focus on BDCs would dovetail with the SEC's focus on protecting retail investors.

In addition, unlike other RICs, BDCs attract private fund managers that may not otherwise be accustomed to the technical requirements of the Investment Company Act.

While BDCs are not subject to every provision of the Investment Company Act, management of BDCs requires compliance with a number of technical restrictions, including constraints on investment parameters, co-investing and cross trading, not typically imposed on managers of private funds.

As a result, in recent SEC enforcement actions, managers of BDCs have been cited for running afoul of the Investment Company Act, notwithstanding efforts at compliance.

For example, as BDCs are often advised by managers that predominately advise private funds, unique issues can arise when managing both a BDC and a private fund side by side. Section 57(a) of the Investment Company Act and Rule 17d-1 thereunder prohibit RICs, including BDCs, from entering into joint transactions, including co-investments, absent an order from the Commission permitting such joint enterprise.

The SEC staff has historically granted exemptive relief to facilitate certain joint transactions.

However, the process for obtaining such relief does not always fit neatly within the constraints of a time-sensitive deal. In a recent settled enforcement action, the commission found a violation of the Investment Company Act because a fund manager effected joint investments by a BDC and other managed funds while the application for an exemptive relief order was still pending and because the

order eventually obtained failed to accurately identify all involved co-investment vehicles and related fees.[3]

Notably, the settled order also cited violations of the custody rule, Rule 206(4)-2 under the Advisers Act, relating to the co-investment entities, demonstrating that SEC scrutiny relating to BDCs can spill over into other aspects of an adviser's business.

In another example, Section 19(a) of the Investment Company Act prohibits a BDC from paying a dividend from any source other than its current-year or accumulated net income unless the payment is accompanied by a written statement to stockholders. In a settled order, the commission found that an adviser to a BDC had violated Section 19(a) by providing notice with its Form 1099 tax forms sent to stockholders distributed by the transfer agent at year end.[4]

Even more notable, the commission instituted the enforcement action even though, according to the order, the adviser acted at least in part on legal advice.

Yet another example demonstrates that managers of BDCs are also subject to many of the same compliance risks for which private fund managers have been cited previously, such as the need to maintain controls regarding material, nonpublic information and fee and expense allocations.

However, given the involvement of retail investors, these matters may receive additional scrutiny from the commission.[5]

10 Tips for Mitigating Risks for BDC Managers

While management of BDCs can give rise to unique compliance risks in the current market and regulatory environment, there are strategies that can be employed to mitigate those risks. Below is a checklist of recommended steps that can help promote compliance, particularly as businesses evolve and react to market events, and also build a robust record in the event of a subsequent review.

1. Assess compliance.

Periodically assess compliance with regulatory requirements generally and discuss potential issues with counsel early. Remind personnel of relevant policies and emphasize the importance of compliance. Note that the SEC commonly bases enforcement actions on an alleged failure to maintain adequate policies and procedures.

2. Review disclosures.

Review the accuracy and completeness of disclosures in light of new developments with portfolio businesses and the markets and consider if updates or modifications are appropriate, especially with respect to discussions of fund performance.

3. Consider joint transactions, cross trades and other transactions.

The evaluation of potential joint transactions, cross trades or other transactions involving BDC portfolio companies requires careful consideration of specific Investment Company Act requirements. Review procedures and consult with counsel as appropriate to ensure compliance.

4. Identify and manage potential conflicts.

Many distressed BDC portfolio companies will explore potential restructuring opportunities. Managers of BDCs may have multiple clients invested in different layers of a portfolio company's capital structure giving rise to potential conflicts of interest among clients and between the manager and its clients. Managers need to identify and properly manage the potential conflicts and evaluate disclosures for potential updating.

5. Adhere to valuation policies.

Valuation of investments in distressed companies can be particularly challenging during a crisis. It is important to continue to adhere to valuation policies and to accord appropriate weight to relevant valuation inputs. Documenting the valuation process and factors considered can help demonstrate the exercise of good faith judgment. Remember, regulators inevitably review valuations in hindsight.

6. Apply stress tests.

Stress-test portfolios, considering a range of potential outcomes under best, worst and mid-case scenarios, and anticipate the possibility of needing to manage unusual liquidity demands.

7. Be diligent with record-keeping.

Diligent record-keeping can demonstrate compliance in the event of inspections or investigations. Continue to maintain contemporaneous records, especially with respect to transactions involving both the BDC and affiliates, follow-on and restructuring transactions in distressed portfolio companies and other transactions having a heightened risk of conflicts of interest.

8. Acknowledge risks of receiving material nonpublic information.

Insider trading risks are heightened by financial crises. The financial condition of portfolio companies can change rapidly and potential restructuring or strategic options may give rise to material nonpublic information.

In addition, managers of private equity funds, or private equity positions within other funds, may provide access to material nonpublic information in companies in which the manager's clients may also hold credit positions. It is important that investment professionals be attentive to the risks of receiving material nonpublic information and take appropriate steps to ensure that trading restrictions or other appropriate controls are properly implemented.

9. Communicate with the BDC boards.

Maintain lines of communication with independent directors of BDCs and their counsel.

10. Seek help.

Remind and encourage investment professionals to bring issues and questions to legal and compliance professionals as early as possible. Often, a brief discussion with counsel and a note to file can help mitigate regulatory risks.

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[1] The Consolidated Appropriations Act of 2018 was enacted on March 23, 2018. The enacted legislation contained a number of amendments to the 1940 Act that impacted BDCs. See Consolidated Appropriations Act, Pub. L. No. 115-141; 132 Stat. 348 (2018).

[2] Business Development Companies Hit Hard by Coronavirus Market Turmoil, the Wall Street Journal (April 14, 2020), available at https://www.wsj.com/articles/high-risk-lenders-have-been-hit-hard-by-coronavirus-market-turmoil-11584744602 (quoting a former pension fund executive on regulatory oversight of BDCs, "If anybody deserves heightened SEC scrutiny, this is the industry that needs it.").

[3] Garrison Investment Group LP and Garrison Capital Advisers LLC, Administrative Order No. 3-19452, the U.S. Securities and Exchange Commission (September 13, 2019), available at https://www.sec.gov/litigation/admin/2019/ia-5345.pdf.

[4] KCAP Financial, Inc., Administrative Order No. 3-18912, the U.S. Securities and Exchange Commission (December 4, 2018), available at https://www.sec.gov/litigation/admin/2018/34-84718.pdf.

[5] Fifth Street Management, LLC, Administrative Order No. 3-18909, the U.S. Securities and Exchange Commission (December 3, 2018), available at https://www.sec.gov/litigation/admin/2018/33-10581.pdf.