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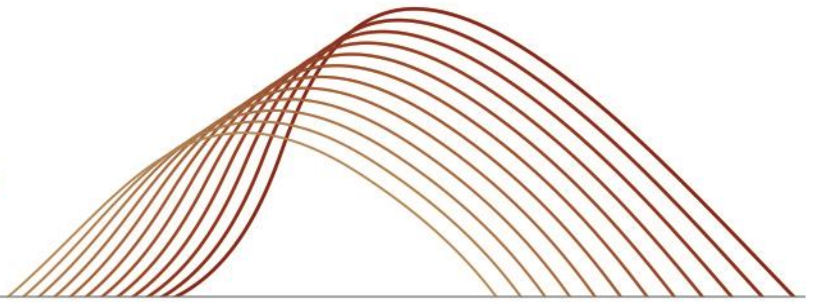

March 2020 Follow **@Paul_Hastings**

These Are Volatile Times: What BDC Managers and BDC Boards Need to Know and Do

By Investment Management Practice

Business Development Companies ("BDCs") have been gaining investor interest since the financial crisis. It is now estimated that BDCs manage approximately $100 billion in assets.[1] BDCs have experienced rapid growth as investors sought higher-yielding assets at the same time as traditional banks retreated from certain types of lending. Assets in BDCs are spread across publicly traded BDCs (which raise funds through an IPO and are listed on a national exchange), non-traded public BDCs (which continuously offer shares up to a maximum amount and typically make investments as shares are sold) and private BDCs (which offer shares in a private offering to accredited investors and generally make capital calls when investments are found).

With success, however, also comes greater regulatory and investor scrutiny. During this unprecedented time of market volatility,[2] asset managers to BDCs and BDC boards should (i) be prepared to address valuation challenges, (ii) have in place robust corporate governance frameworks and internal controls, (iii) timely disclose to the public material information relating to the BDC and its investments, and (iv) ensure adherence to existing compliance policies and procedures, and applicable Securities and Exchange Commission ("SEC" or the "Commission") issued exemptive relief. This Alert is designed provide an overview of some legal and compliance issues that some managers and BDC boards may face during this unprecedented time of market volatility.

Valuation

Contraction in bank lending and post 2008 financial crisis regulation have provided a greater opportunity for alternative providers of debt to U.S. small- and middle-market companies. As a result, BDCs have been able to step in and offer attractive investment opportunities for investors interested in an allocation to the private debt asset class. However, because BDCs typically focus on private debt, an asset class that at times may be hard to value, BDC managers should take note of past SEC guidance and enforcement actions that focused on valuation of hard-to-value assets.

Following the financial crisis, the Commission brought a number of valuation cases.[3] One of the more notable valuation cases was brought against Morgan Keegan & Company, Morgan Asset Management, and certain individuals, including the boards of directors of five registered investment companies.[4] Although not involving a BDC, this enforcement action is illustrative of the critical importance of valuation. The SEC's Division of Enforcement alleged that Morgan Asset Management failed to employ reasonable procedures to internally price the portfolio securities in five funds managed by Morgan Asset Management, and consequently did not calculate accurate net asset values for the funds.

The Commission alleged that the funds disclosed that the fair value of securities would be determined by Morgan Asset Management's valuation committee using procedures adopted by the board of directors, when in fact the responsibility was delegated to Morgan Keegan and Company, a broker-dealer and parent of the investment adviser which primarily staffed the valuation committee. The Commission alleged that (i) the valuation committee left pricing decisions to lower level employees who did not have the training or qualifications to make fair value pricing determinations, (ii) the personnel relied on the portfolio manager's price adjustments to determine the prices assigned to portfolio assets without obtaining a reasonable basis for or documentation supporting the price adjustments or applying the factors set forth in the procedures, (iii) the portfolio manager was given discretion beyond the parameters of the valuation procedures in validating the prices of portfolio securities by allowing him to determine which dealer price confirmations to use and which to ignore, without obtaining documentation to support his adjustments, and (iv) the valuation committee did not ensure that the fair value prices assigned to many of the portfolio securities were periodically reevaluated, allowing them to be carried at stale values for months at a time. The Commission also alleged that the directors of the funds failed to satisfy their responsibilities for determining the fair value of portfolio securities for which market quotations were not readily available, and failed to periodically reevaluate the appropriateness of the methodologies used to fair value securities.[5]

The Commission also has brought valuation enforcement actions against BDCs and their directors.[6] In one instance, the SEC alleged that valuing debt securities using enterprise valuation methodology instead of trade data from market transactions was inappropriate and caused the BDC to overstate the fair values for its debt securities.[7] More recently, the Commission brought another valuation case against an investment adviser to certain BDCs and alleged that the investment adviser failed in the valuation of two portfolio company investments held by a BDC.[8] These enforcement actions signify the importance of proper valuation, especially when an asset needs to be fair valued during times of market stress.

When fair valuing an asset, Section 2(a)(41) of the Investment Company Act of 1940, as amended ("1940 Act"), requires that a board of directors of a BDC make a good-faith determination as to the fair value of a particular asset when market quotations are not readily available. In addition, FASB Topic 820[9] provides further guidance to BDC boards when fair valuing assets that do not have Observable Market Inputs ("Level 3 assets"). Because no single standard exists for determining the fair value of an asset, fair value will depend on facts and circumstances of the specific situation.[10] In such instances a BDC board will need to consider all information available to it, including information provided by third-party pricing sources, broker quotes, recent sales, and the cost of a similar asset that was recently purchased.

Collectively, the foregoing enforcement actions signify the SEC's historical focus on valuation. In addition, since the last financial crisis, the Commission increased its focus and access to data that can assist it in accessing certain market sectors and provide it with greater ability to monitor registrants' exposure to certain sectors of the market, including private debt.[11] As a result, during this unprecedented time of market volatility, BDCs must ensure that that they have in place a robust process of valuing investments, valuation disclosure, and governance of the valuation process. In addition, past SEC enforcement actions also illustrate the SEC's focus on the role of fund directors in fair valuing hard-to value securities. Thus, it is imperative that BDC directors periodically review the appropriateness of valuation procedures and how they apply to a BDC's holdings. The guidance and focus is particularly relevant when valuing private debt assets held by many BDCs today.

Compliance with Policies and Procedures and Conditions of Applicable Exemptive Relief

During this unprecedented time of market volatility, certain BDC managers may find themselves relying on certain 1940 Act rules and regulations in order to conduct certain transactions. For example, a BDC manager may decide that it is in the best interests of a BDC to engage in cross-trades with certain affiliated parties. In the past, the Commission has noted that cross-trades can benefit clients in a number of ways, including: (i) enabling the transfer of securities among client accounts without having to expose the security to the market, thereby saving transaction and market costs that would otherwise be paid, (ii) eliminating counterparty risk, and (iii) providing an adviser with added flexibility when dealing with an illiquid asset.[12]

However, due to the fact that many of the recently launched BDCs primarily trade in debt securities, they must ensure that any proposed cross-trade is consistent with the applicable regulatory guidance[13] and their own policies and procedures.[14] For example, in the past, the SEC has noted that while "cross-trades can be appropriate in many circumstances, they also can create the possibility of a conflict of interest for an adviser: the better the price the adviser obtains for the selling clients, the worse it is for the buying clients, and vice versa."[15] It also should be noted that Rule 17a-7 under the 1940 Act would allow cross-trades between a BDC and its affiliates if, among other things, the price is effected at the current market price. Debt securities that are not traded on an exchange must be effected at the average of the highest current independent bid and lowest current independent offer determined on the basis of a reasonable inquiry.

In addition, BDC managers must also ensure transactions are entered into consistent with applicable exemptive relief that has been issued to the BDC, the BDC manager, and affiliated accounts.[16] For example, in the past, SEC staff have noted the importance of adhering to specific exemptive relief that has been issued to a registrant, in May 2013, the staff of the SEC's Division of Investment Management issued IM Guidance 2013-02,[17] which noted that entities that receive and rely upon exemptive orders are at risk of violating the federal securities laws if they fail to comply with the representations and conditions of such orders, and consequences of non-compliance may be severe. Further, the IM Guidance noted that one way for such entities to address such risk is to adopt and implement policies and procedures, in accordance with rule 206(4)-7 under the Investment Advisers Act of 1940, as amended, or rule 38a-1 under the 1940 Act, that are reasonably designed to ensure ongoing compliance with each representation and condition of the order. Moreover, in the past, the Commission has brought an enforcement action against a BDC for engaging in certain prohibited transactions prior to the issuance of the applicable exemptive relief.[18]

Finally, during times of extreme market volatility, BDC management and boards must ensure that a BDC is in compliance with applicable asset coverage requirements. As applicable to BDCs, Section 18 of the 1940 Act, as modified by Section 61(a), prohibits a BDC from issuing any class of senior security representing indebtedness (e.g., drawing under a revolving credit facility or issuing notes) or stock unless the BDC, after giving effect to the issuance of the senior security, has an asset coverage of at least 200 percent. In 2018, the 200 percent asset coverage requirement was modified with the enactment of Small Business Credit Availability Act (the "Act").[19] Under the Act, a BDC that takes certain actions is able to reduce its statutory asset coverage ratio from 200 percent to 150 percent, effectively permitting the BDC to lever 2:1. Those BDCs that have implemented the modified asset coverage requirement[20] and others that are continuing to rely on the 200 percent asset coverage requirement must ensure that they are in compliance with the applicable coverage requirements as their portfolios weather current market conditions. In addition, in many instances, a BDC that has

outstanding debt or preferred securities will be subject to additional, stricter asset coverage requirements, levied on them by certain rating agencies or by agreement with their counterparty. As a result, if found to be out of compliance with the applicable asset coverage requirements, a BDC may need to take drastic action at the most inopportune time. Such actions may include paying down outstanding debt, redeeming preferred shares or notes, or selling investments into a falling market. Thus, it is paramount that BDC management and boards understand the BDC's leverage structure and stress test their portfolios in order to be prepared when markets are overwhelmed by extreme volatility.

Activist Investors

These times also may present opportunities for activist investors. Over the last few years the BDC sector has experienced increased consolidation,[21] some of which activist investors have been brought about.[22] Current market turmoil may exacerbate activist activity in the publicly traded BDC sector. Being prepared for an activist is paramount for publicly traded BDCs, as their public trading prices often will diverge significantly from their net asset values per share, especially during times of prolonged market dislocation.

In order to be prepared to deal with an activist campaign, BDC managers and BDC boards must take certain steps. First, before an activist comes calling, the investment manager to a BDC and the BDC's board must proactively consider various options available to them. Such steps may include (i) benchmarking a BDC's performance and management fees against relevant peers, (ii) tracking ownership trends of the BDC, (iii) knowing the BDC's shareholders and policies of such shareholders regarding proxy contests, and (iv) familiarization with the policies of ISS and Glass Lewis, in case a proxy contest arises. Boards also should continuously self-evaluate their own performance and evaluate structural defenses available to them. These include staggered boards, super-majority voting requirements, obstacles to removing a director, advance notice provisions, restrictions on shareholder meetings, ownership or voting power limitations, opt-in to state business combination laws, director qualification provisions, and exclusive board control of bylaws.[23]

Second, if an activist comes calling, is important to understand what the activist is looking for. Historically, closed-end fund activists have been primarily interested in realizing net asset value when a closed-end fund has been trading at a discount. In the BDC space it appears that some recent activists have been interested in pushing through BDC consolidation through M&A. For example, in a recent activist campaign, the largest shareholder of Alcentra Capital Corporation ("Alcentra"), a publicly traded business development company, the Stilwell Group, urged that the board of Alcentra consider certain strategic transactions including a sale of the company. Shortly after this, it was announced that a merger agreement was entered into under which Crescent BDC would acquire Alcentra.[24] In other instances, activists have pushed for representation on the board of a BDC[25] or the termination of the investment management agreement between the BDC and its investment manager.[26]

Third, if a proxy contest becomes inevitable, it is paramount that the BDC have a strategy. For example, should the activist be engaged or simply ignored and dealt with at the shareholder meeting? It is important to note that ISS typically will ask the BDC management what steps were taken to deal with the activist (and if the BDC management does not address the concerns of the activist, it may make it harder in convincing ISS to recommend a vote in favor of management). In addition, the board and management should establish internal and external teams that will be responsible for conducting the proxy campaign. The internal team should include certain officers of the

BDC, including the CCO, legal counsel, and the client-facing team. The external team should consist of a proxy advisory firm, outside legal counsel, and in certain instances, a public relations firm. While strong performance is the only sure way to deter an activist campaign, being prepared in case an activist comes calling is a close second.

To Sum It Up

When the current market volatility will abate is uncertain. Asset managers therefore must be proactive in addressing the legal and compliance risks posed by the topics discussed in this Alert. Those who ignore these risks and operate in a manner inconsistent with applicable SEC rules and regulations or internal firm policies and procedures run the risk of reputational damage, regulatory scrutiny, or being a target of an activist campaign.

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[5] *Id.*

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[9] Fair Accounting Standard Board ASC 820.

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