Business development companies in the spotlight

by Matt Forstenhausler

Created by Congress in 1980, business development companies (BDCs) existed in relative obscurity until the credit crisis of 2007–08. With capital scarce and banks hesitant to lend, investors and asset managers embraced BDCs as effective mechanisms for providing funding to small and mid-sized businesses. In this, the first of a three-part series, we will review the history of BDCs and examine their operational and regulatory advantages and challenges. We will also explain the key requirements for establishing and operating a BDC under current law. In the second and third articles, we will take an in-depth look at BDC accounting and tax considerations.

BDCs have been in existence for more than 30 years providing retail investors opportunities to get into private equity-type investments. But the last decade has seen a significant increase in the popularity of BDCs. During and in the aftermath of the credit crisis, with liquidity tight and banks hesitant to lend, BDCs proved to be an effective mechanism for providing funding to capital-hungry small and mid-size companies. Likewise, those who invest in BDCs have achieved positive returns that have often exceeded those of many other available investment opportunities. From an asset manager’s perspective, BDCs present an opportunity to raise more permanent-type assets under management.

Beyond these factors, there is another driver behind the recent growth in the BDC market: the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Under Dodd-Frank, many previously unregistered asset managers must now register with the Securities and Exchange Commission (SEC). Prior to Dodd-Frank, the same asset managers may have been hesitant to manage a pool of capital like that found in a BDC because it would have required them to register as investment advisors. But the advent of Dodd-Frank has leveled the playing field to some degree and has removed one of the perceived disadvantages of managing a BDC. Thus, some asset managers are now embracing these entities.
The regulatory history of BDCs

BDCs were born decades ago out of a sense of dissatisfaction among some private venture capital pools. In the 1970s, Heitzer Corporation managed a number of small, private venture capital pools operating under section 3(c)(1) of the Investment Company Act of 1940 (the 1940 Act), the primary regulation at the time. Heitzer discovered that raising money was very difficult without very quickly running afoul of the 1940 Act and felt that portions of the law were not only onerous, but were also incompatible with challenges endemic to venture capital pools and private equity investments. Heitzer and others launched a lobbying campaign directed at the SEC, which culminated in the passage of the Small Business Investment Incentive Act of 1980 (the 1980 Act). This law created the current BDC regulatory structure. Some rule-making and several no-action letters have been issued since then, but the 1980 Act has remained relatively unchanged since its passage.

Initially, there was considerable interest in BDCs, but their popularity had largely dissipated by the early 1990s. Activity ticked upward again in the early 2000s with the realization that BDCs made it legally possible to charge two performance fees in a registered fund structure: one based on capital gains and the other based on income. The fee based on capital gains is driven by the regulatory restrictions in Section 205 of the 1940 Act. The performance fee, based on income, is not subject to such limitations. When managers recognized that they could charge these parallel performance fees, BDCs became much more attractive. Recently, there have been more investment opportunities in providing financing to small and mid-size capitalized companies as traditional forms of financing (banks) have left that market. Almost all BDCs since then have had a debt-investment focus to take advantage of that income-based performance fee, as well as the fee for capital gains.

Forming a BDC and registering with the SEC

To form a BDC, an asset manager must 1) register a class of securities with the SEC under the terms of the Securities Exchange Act of 1934 (the 1934 Act) and 2) formally choose election as a BDC.

A BDC can be registered through the initial filing of a Form N-2 under the 1940 Act or the filing of a Form 10 under the 1934 Act, which can be used to register shares either under Section 12(b), an exchange registration, or 12(g), over the counter. As a preliminary matter, this contemplates a delayed public offering. Therefore, no initial public offering under the Securities Act of 1933 is required. Either the Form N-2 or the Form 10 is an acceptable route to registration. However, if a Form 10 is filed, the BDC would also be required to file a Form N-54A, a relatively short, simple form that subjects the new BDC to the relevant provisions of the 1940 Act.
Initial operational steps
To become operational, newly established BDCs must accomplish the following:

- **Establish a board of independent directors.** A BDC must have at least three directors to provide oversight. These individuals sometimes serve for long periods of time, so it is vital that they understand the product, strategy and underlying investments; the concept of fair value; and their roles and responsibilities as directors. The board must be composed of a majority of independent directors, which means they must have no affiliation with the BDC’s advisors, managers or auditors. During the selection process, all candidates should be vetted by legal counsel, the auditors and through all areas of the business.

- **Hire legal counsel.** BDCs should hire legal counsel that has specific experience with BDC issues and SEC registration requirements. The independent directors may ask for their own counsel and if they do, management should oblige.

- **Appoint a principal financial officer and a chief executive officer.** BDCs are required to have a principal financial officer and the chief executive officer take responsibility for regulatory filings. As most BDCs do not have employees, these positions are filled by members of the manager or the administrator.

- **Hire a chief compliance officer.** Because BDCs are registered entities, they must have a chief compliance officer (CCO), who will report to the board, to ensure the BDC adopts and implements appropriate compliance policies and procedures. The CCO role is generally filled by a compliance officer of the manager or the administrator.

- **Hire external service providers.** BDCs may engage external administrators, valuation specialists or custodians. Managers often find that having outside administrators make it easier to comply with the internal control reporting requirements of the Sarbanes-Oxley Act. When selecting an audit firm and other service providers, management should choose those who are familiar with the regulations and requirements that apply to BDCs, as well as the challenges that may arise.

Ongoing operational demands
Once a BDC is fully operational, it must meet the following requirements on a regular basis.

Recurring regulatory requirements. BDC offerings are registered products under the 1934 Act. Consequently, they must file an annual 10-K, quarterly 10-Qs, and all other forms that traditional public companies file, which can be challenging because these forms were not created with BDCs in mind. In the early 2000s, some BDCs claimed that, because of their size, it would be sufficient to adhere to small business (SB) regulations. They filed the abbreviated forms 10-KSB and 10-QSB only to discover that SB regulations do not apply to investment companies. The BDC is also required to comply with the rules under Sarbanes-Oxley, sometimes referred to as Section 404 of the 1934 Act. Sarbanes-Oxley calls for management to document and test internal controls, among other things, and for the auditors to test and report on those control procedures. Such compliance can add significant costs to the operations of the BDC.

If the BDC is listed on an exchange, it must also make annual proxy filings and comply with other requirements of the exchange.

Board meetings. The board must meet at least quarterly to accomplish the following important tasks:

- **Approval of valuations.** Under the 1940 Act, directors have the responsibility to oversee the valuation of portfolio securities for which market quotations are not readily available. Because the BDC must report its net asset value quarterly, it will need to hold a board meeting that coincides with the filing of each 10-Q and the 10-K to obtain the board’s approval of the fair valuations.

- **Annual in-person approvals.** Investment advisory agreements must be approved annually. It is also a good practice to approve underwriters to the extent that the BDC makes secondary offerings.

Final thoughts
It remains to be seen how long the factors currently driving interest in BDCs – scarce business capital and newly implemented financial regulation – will retain their potency. Eventually, capital markets may loosen and the political will to maintain more stringent regulatory regimes may ebb. But until then, BDCs offer an advantageous funding and investment alternative for businesses, asset managers and investors alike.
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