SEC OVERSIGHT OF BUSINESS DEVELOPMENT COMPANIES

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Business Development Companies, or BDCs, are the public face of the venture capital business. The BDC is a specialized type of Investment Company that combines the economic functions of venture capital with public disclosure, market trading, and regulation by the Securities and Exchange Commission. This article examines the regulatory issues of concern to the SEC, in its oversight of BDCs, as revealed by the SEC's enforcement activity. The article suggests that while the number of enforcement cases against BDCs has been relatively small, given the success of the business model, the cases reveal several continuing issues that warrant attention by every BDC.

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INTRODUCTION

When a credit crisis in the 1970s limited the flow of capital to small, growing businesses in the United States, policy makers became concerned that venture capital firms—an important source of capital for these businesses —were reluctant to extend financing over fears that such investments might subject them to the requirements of the Investment Company Act of 1940 (the "1940 Act").[1] Consequently, new and developing businesses found it difficult to obtain sufficient working capital, leading to slower economic growth.[2]

Faced with crisis, Congress was urged to ameliorate the situation and responded, in part, with the Small Business Investment Incentive Act of 1980 (the "1980 Amendments"),[3] amending the 1940 Act and the Investment Advisers Act of 1940 (the "Advisers Act")[4] to create a new category of closed-end investment company—the business development company ("BDC"). The purpose of the 1980 Amendments was to construct public vehicles that could invest in private equity by lessening certain restrictions under the 1940 Act, most notably those pertaining to compensation and borrowing. BDCs were designed to play that role.[5]

BDCs are publicly traded closed-end funds that make investments in private or thinly-traded public companies in the form of long-term debt or equity capital, with the goal of generating capital appreciation or current income. They serve an economic function similar to venture capital funds,

[1] Investment Company Act of 1940, 15 U.S.C. § 80a-1 et seq. *See also* Reginald L. Thomas and Paul F. Roye, *Regulation of Business Development Companies under the Investment Company Act*, 52 S. CAL. L. REV. 895, 903 (1982) ("Many [private equity and venture capital firms] felt that the [1940] Act's requirements were too burdensome and, to avoid them, either went out of business or limited their growth.").

[2] *See* Small Business Investment Incentive Act of 1980, H.R. 96-1341, 1980 U.S.C.C.A.N. 4800, 4801 (noting that while the contemporary economic slowdown was "the product of many economic forces," the law sought to "reduce some of the costs of government regulation imposed on the capital-raising process").

[3] Small Business Investment Incentive Act of 1980, P.L. 96-473, 94 Stat. 2275 (1980).

[4] Investment Advisers Act, 15 U.S.C. § 80b-1 et seq.

[5] *See* Small Business Investment Incentive Act of 1980, H.R. 96-1341, *supra* note 3, at 4803-04 (noting valuable function in the capital formation process that could be played by public companies engaged in venture capital activities).

investing in small companies early in their life cycles, playing active roles in their management, and profiting as they develop and grow.[6]

The BDC form, however, differs from venture capital funds in several important respects. Most importantly, while venture capital funds remain largely unregulated, BDCs are highly regulated by the U.S. Securities and Exchange Commission ("SEC" when referring to the agency or "Commission" when referring to the Commissioners). BDCs also provide extensive public disclosure about their investments and operations, and most are listed on exchanges, allowing the public to trade in their securities. Because of this unique combination of attributes—high levels of regulation, public disclosure, and an opportunity for public trading in a private equity strategy—BDCs have been very successful in gathering assets.[7]

This article reviews the SEC's oversight of BDCs, with a particular focus on how the agency's regulatory interests are revealed in its public enforcement actions. As a form of business organization, the BDC is now 35 years old. It is not surprising, over such a span of time, that BDCs have been subject to a certain number of enforcement actions. Indeed, considered in light of the success of the business model and the passage of time, the number of violations involving BDCs seems relatively small. However, more interesting than the number of cases are the continuing patterns that can be observed in the actions that have been brought. This article explores those patterns, the regulatory interests they reveal, and the compliance lessons that can be drawn from them.

Following this Introduction, Part II reviews the development of the SEC's oversight program for BDCs through a discussion of its formative cases. Part III reviews recent cases involving BDCs. Part IV suggests several steps BDCs can take to enhance their regulatory compliance and reduce the compliance risks highlighted in the SEC's public oversight; and finally, Part V concludes that the SEC's active oversight program helps validate BDCs' role as the public face of the private equity sector.

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[6] *See* Small Business Investment Incentive Act of 1980, H.R. 96-1341, *supra* note 2, at 4804-05 (BDCs intended to provide capital to small developing or financially troubled businesses that are seeking to expand, not serve as passive investors in large well-established businesses).

[7] While the intent of Congress in 1980 was to subject BDCs to a "comprehensive framework of regulation," *id*. at 4804; venture capital funds remain largely unregulated. *See* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than $150 Million in Assets Under Management, and Foreign Private Advisers, Release No. IA-3222 (June 22, 2011), 76 Federal Register 39646 (July 6, 2011). In addition, Kevin Mahn recently reported on the growth in BDC assets. Kevin Mahn, "The ABCs of Business Development Companies," Forbes Magazine (Dec. 1, 2014) (reporting that as of October 2014, BDCs' combined market cap had risen to $35 billion), *available at* http://www.forbes.com/sites#/sites/advisor/2014/12/01/the-abcs-of-business-development-companies/.

I. DEVELOPMENT OF THE SEC'S OVERSIGHT PROGRAM FOR BDCS

The SEC's oversight program for BDCs developed in three steps. Approximately ten years after enactment of the BDC provisions, the SEC began to conduct an active program. An early case, filed in 1992, demonstrated many of the continuing regulatory concerns in this area: valuation, governance for the valuation process, and the legal sufficiency of portfolio investments.[8] Then, in 1998, the SEC brought forth a proceeding that would become the archetype BDC enforcement case. Through ten years of litigation, including a hearing before an administrative law judge, multiple opinions by the Commission, and two separate appeals to the U.S. Court of Appeals for the DC Circuit, the case would come to test the SEC's regulatory concerns.[9] Finally, in the fall of 2008, the SEC filed multiple cases resulting from a BDC oversight sweep. The sweep cases attracted much less attention than they deserved – perhaps because they were filed during the most critical weeks of the financial crisis. Nonetheless, they serve an important role in highlighting BDCs' responsibilities under the 1940 Act.[10]

A. EARLY OVERSIGHT: BDC ENFORCEMENT IN THE 1990S

The first major enforcement case involving a BDC was against a company called Corporate Capital Resources, Inc. ("CCRS").[11] In a series of actions in the early to mid-1990s, the SEC prosecuted CCRS and several of its officers and directors.[12] The SEC alleged that CCRS's financial statements for the period September 30, 1988 through March 31, 1990 were false and misleading because they materially overstated the value of its holdings in its portfolio companies.[13] The SEC alleged two specific flaws.

[8] *See infra* Section II.A.
[9] *See infra* Section II.B.
[10] *See infra* Section II.C.
[11] SEC v. Corporate Capital Resources, Inc., Litigation Release No. 13460, 52 SEC Docket 4704, 1992 WL 383829 (Dec. 7, 1992).
[12] *Id*.; *In re* Daniel D. Weston, Release No. IC-19754, 55 SEC Docket 295, 1993 WL 393613 (Sept. 30, 1993) (hereinafter cited as "Daniel D. Weston"); *In re* Lloyd Blonder, Release No. IC-19755, 55 SEC Docket 298, 1993 WL 393615 (Sept. 30, 1993) (hereinafter cited as "Lloyd Blonder"); *In re* William P. Hartl, Release No. IC-19840, 55 SEC Docket 991, 1993 WL 468571 (Nov. 8, 1993) (hereinafter cited as "William P. Hartl et al."); *In re* Morris L. Lerner, Release No. IC-21790, 61 SEC Docket 961, 1996 WL 86534 (Feb. 27, 1996) (hereinafter cited as "Morris L. Lerner"); *In re* R. Marvin Mears, Release No. IC-21783, 61 SEC Docket 947, 1996 WL 86539 (Feb. 27, 1996) (hereinafter cited as "R. Marvin Mears").
[13] *Id*.

First, the SEC alleged that CCRS improperly claimed ownership of several portfolio companies.[14] In four separate instances, the SEC alleged that CCRS did not own the portfolio companies for three reasons: there was no acquisition agreement, no consideration had been passed, and no shares had been transferred.[15] In two instances, CCRS had entered into acquisition contracts, and had breached their obligations, leaving the contracts with no legally enforceable claim of ownership.[16] Finally, in another four instances, CCRS had entered into acquisition contracts, but the contracts were executory as of the close of the accounting period.[17]

Second, the SEC alleged that CCRS improperly valued its portfolio holdings. These allegations had several elements. Instead of following the appropriate accounting literature, and valuing its holdings at what it could realistically expect to receive upon a current sale, CCRS used retail indications of interest appearing in the "pink sheets."[18] This approach, the SEC noted, "wholly ignored the underlying financial condition and business prospects of the investee companies."[19] Moreover, on several occasions CCRS acquired a holding and claimed, within days of the acquisition, that it had a value several times its cost.[20] For example, in one transaction, CCRS acquired a holding for $600,000 and on the same day claimed it was worth $3,500,000.[21] Finally, CCRS failed to follow the valuation procedures set forth in its filings with the SEC.[22] The filings contained CCRS's "Valuation Policy," which both called for the Board of Directors to periodically value the fund's portfolio, and stated with regard to restricted securities that the valuation would be "in such a manner as reflects their fair value in the opinion of the Board of Directors acting in good faith."[23] In practice, the SEC alleged, this policy was "all but ignored."[24] Instead, the process consisted of the BDC's President setting the valuations,[25] followed by routine approval by the Valuation Committee[26] and the Board of Directors.[27]

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[14] Daniel D. Weston, *supra* note 12, at 295.
[15] *Id*.
[16] *Id*.
[17] *Id*.
[18] CCRS took the indications of interest and multiplied the price by the number of shares in the portfolio and applied a haircut. *Id*. at 296. The Pink Sheets were a publication of the National Quotation Bureau that contained indications of interest for securities. *Id*.
[19] *Id*.
[20] *Id*.
[21] *Id*.
[22] *Id*. at 297.
[23] *Id*.
[24] *Id*.
[25] *Id*.
[26] *Lloyd Blonder*, *supra* note 12, at 299.
[27] *William P. Hartl et al*, *supra* note 12, at 993.

On the basis of these allegations, the SEC brought an enforcement action alleging fraud,[28] disclosure violations,[29] and false filings with the SEC.[30] The SEC obtained injunctions against the BDC, its President and Chairman of the Board, and several other officers and directors, and barred the named individuals from the securities business.[31]

It is interesting to note the different bases for individual culpability in the CCRS case. Three separate categories can be identified. First, the President and CEO played an active role in the valuation process. He prepared the quarterly valuation sheets for each portfolio holding, and knew about the problems with the valuations, including CCRS's lack of ownership of certain shares, that CCRS could not realistically expect to realize the values upon a current sale, and that CCRS did not follow the Valuation Policy set out in its periodic filings.[32] Second, certain officers and directors were members of a Valuation Committee, and as such, the SEC stated that they were "responsible for substantially participating in the valuation process."[33] However, the SEC found that "they completely failed to do so."[34] Third, certain Directors who were not members of the Valuation Committee were found culpable because they did not consider the criteria set out in the disclosure documents and instead "blindly relied" on the valuations submitted by the Valuation Committee.[35] In summary, the SEC brought actions against the senior management of the firm: the President who prepared the offending valuations, the members of the Valuation Committee who failed to consider and review them, and the members of the Board who blindly relied on the Valuation Committee.

The SEC's action against CCRS established an active oversight program for BDCs.[36] The SEC demonstrated that it was ready to review the details of the agreements between the BDC and its portfolio investments to

[28] Corporate Capital Resources, Inc., *supra* note 11, at 4704 (alleging violation of Securities Act § 17(a), Securities Exchange Act § 10(b), and Rule 10b-5).
[29] *Id*. (alleging violation of Securities Exchange Act § 13(a), and Rules 12b-20, 13a-1, and 13a-13).
[30] *Id*. (alleging violation of Investment Company Act § 34(b)).
[31] *See supra* notes 11 to 12.
[32] *Daniel D. Weston*, *supra* note 12.
[33] *Morris L. Lerner*, *supra* note 12, at 296; *R. Marvin Mears*, *supra* note 12; *Lloyd Blonder*, *supra* note 12.
[34] *Id*.
[35] *William P. Hartl et al*., *supra* note 12. It should be noted that the members of the Board who were not on the Valuation Committee were charged in administrative proceedings, not in federal court.
[36] CCRS was not the only case against a BDC in the 1990s. The SEC also took action against similar problems at a BDC called the Vintage Group. *See In re* James A. Merriam, Release No. IC-21062, 59 SEC Docket 0895, 1995 WL 296994 (May 11, 1995) (sanctioning Vintage Group's CEO, President, and Chairman of the Board); *In re* Beatrice Brown, Release No. IC-20004, 55 SEC Docket 2652, 1994 WL 5055 (Jan. 6, 1994) (sanctioning a Vintage Group director).

assess their contractual status. The SEC was ready to challenge the BDC's valuations: how they were disclosed, how they were conducted, and who was responsible. The SEC was fully prepared to go up the managerial chain, including Directors, when assessing culpability. This new program would be quickly put to the test.

B. THE CLASSIC BDC CASE: THE ROCKIES FUND

On June 1, 1998, the SEC instituted a contested administrative proceeding that would eventually become the archetype of BDC enforcement action. Proceedings were brought against a BDC, the Rockies Fund, Inc. ("Rockies Fund"), its President and two Directors.[37] Unlike the case against CCRS, which was resolved relatively quickly, the case against the Rockies Fund would continue for ten years. Moreover, where the case against CCRS sketched out the concerns that would characterize the SEC's BDC oversight program, the case against the Rockies Fund litigated the concerns in depth, both at trial and in multiple levels of appellate review. Given the importance of this case, some detail of its chronology is appropriate.

The Rockies Fund began to receive SEC oversight in March 1994, when examiners visited the fund. The timing of this examination is noteworthy – only about four months after the SEC had filed its case against CCRS. The Rockies Fund would later argue that the examiners had never raised the concerns that would figure prominently in the enforcement action, most importantly how it valued its portfolio holdings.[38] The fund would also argue that the staff had contributed to its belief that its valuation process "had passed inspection."[39] These arguments would ultimately be rejected by the Commission twice.[40] Certainly, however, the examiners' silence would weigh heavily on the fund's defense team, as shown by its

[37] *In re* the Rockies Fund Inc., Release No. 34-40049, 67 SEC Docket 566, 1998 WL 275914 (June 1, 1998) (hereinafter cited as: "*Rockies Fund, Order Instituting Proceedings*"). The SEC also named an outside party who was engaged in certain transactions with the fund's President, *id*., (proceedings against John C. Power), and brought a separate proceeding pursuant to SEC Rule 102(e) against the fund's auditor, which resulted in yet another Commission opinion. *In re* Carol A Wallace, CPA, Release No. 34-48372, 80 SEC Docket 2641, 2003 WL 21982215 (Aug. 20, 2003) (imposing a one-year suspension from practice before the SEC based on various failures in the Rockies Fund audits).

[38] *In re* the Rockies Fund, Inc., Release No. 34-48590, 56 SEC 1198, 2003 WL 22273596 (Oct. 2, 2003) (hereinafter cited as "*Rockies Fund, First Opinion of the Commission*").

[39] *In re* the Rockies Fund, Inc., Release No. 34-56344, 91 SEC Docket 1289, 2007 WL 2471612 (Aug. 31, 2007) (Order Denying Request for Reconsideration).

[40] *Id*.; *Rockies Fund, First Opinion of the Commission*, 56 SEC at 1239.

repeated efforts to introduce it as a defense to, or at least in mitigation of, the SEC's charges.

The enforcement action itself began on June 1, 1998 with an order instituting administrative proceedings. The order alleged that the fund defrauded investors by overstating its assets between June 1994 and December 1995. Among other things, the order instituting alleged that the fund improperly claimed ownership of certain securities, overstated assets by classifying and valuing restricted securities as if they were unrestricted, and by manipulating the market for a portfolio company's stock. The order instituting also alleged that the BDC's President improperly obtained undisclosed compensation, in the form of a waiver of liability, through a transaction in which the fund purchased a portfolio security in return for the seller agreeing to forgo a potential legal claim that ran personally against the BDC President.

The administrative law judge presiding over the Rockies Fund case held a five-day public hearing and, on March 9, 2001, issued her Initial Decision.[41] She found that the fund had engaged in several types of violative conduct. It claimed to own shares that it did not.[42] It misclassified material holdings of restricted stock as unrestricted.[43] It valued the restricted stock as if it were unrestricted, and not as the fund's prospectus had disclosed restricted stock would be valued.[44] It filed various periodic reports with the SEC that contained these misstatements.[45] She found this conduct constituted fraud,[46] and violated the fund's disclosure obligations.[47] She also found the fund's President and two Directors liable for this conduct.[48]

In addition, the administrative law judge found that the fund's President had engaged in fraudulent manipulation of the market for one of the fund's portfolio securities through matched orders and wash sales with an outside party.[49] She also found that the President had committed fraud in the transaction where he obtained a waiver of personal liability because he

[41] *In re* the Rockies Fund, Inc., Initial Decision Release No. 181, Admin. Proc. 3-9615 (Mar. 9, 2001) (hereinafter cited as "Rockies Fund, Initial Decision").
[42] *Id*. In reaching this decision the administrative law judge ("ALJ") found that certain other holdings challenged by the staff were owned by the fund, and appropriately reported in its periodic reports.
[43] *Id*.
[44] *Id*.
[45] *Id*.
[46] *Id*. The ALJ found the conduct to have violated Securities Exchange Act § 10(b) and Rule 10b-5.
[47] *Id*. The ALJ found the conduct to have violated Securities Exchange Act § 13(a), and Rules 12b-20, 13a-1, and 13a-13.
[48] *Rockies Fund, Initial Decision*, *supra* note 42. On some of the claims she held them directly liable; on others she held them liable for aiding and abetting.
[49] *Id*. She found that this conduct violated Securities Exchange Act § 10(b) and Rule 10b-5.

did not disclose this personal compensation to the Board of Directors.[50] Finally, she rejected the fund's and individuals' defense that even if violations had occurred, they were only technical.[51] She ordered them to cease and desist from future violations, barred the individuals from affiliation with a registered investment company,[52] and imposed penalties.[53] The respondents appealed to the Commission.[54]

On appeal, the Commission received briefs, held oral argument, and on October 2, 2003, issued its decision and opinion.[55] The Commission upheld the findings and conclusions of the administrative law judge both as to violations and as to the sanctions she had imposed. After the Commission denied the respondents' motion for reconsideration,[56] they appealed to the U.S. Court of Appeals for the DC Circuit.[57]

On appeal, the DC Circuit received briefs, held oral argument, and on November 15, 2005, issued its decision and opinion.[58] At this point, the case had been in litigation for more than seven years. The court rejected several of the SEC's findings, and upheld others.

The court rejected the SEC's findings regarding manipulation and fraudulent personal compensation. The court held that the SEC had failed to show that the trades between the BDC's President and the outside party were manipulative.[59] Specifically, the court said the SEC had failed to show manipulative intent. The court stated: "the simple fact that a party has conducted a matched order or wash sale (or a series of them) does not establish manipulative intent of any kind."[60] Similarly, the court held that the SEC had failed to show that the President had received improper compensation through the waiver of personal liability.[61] Specifically, the court said, the SEC had failed to show that the waiver had any value.[62] Accordingly the court vacated the SEC's order as to these two findings.

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[50] *Id*. She found that this conduct violated Securities Exchange Act § 10(b) and Rule 10b-5, as well as Investment Company Act § 57(k)(1).
[51] *Id*.
[52] The President was given a permanent bar. The two Directors were barred for three years. *Id*.
[53] The President was assessed a penalty of $500,000 and the two Directors penalties of $160,000 each.
[54] In any proceeding in which an initial decision is made by a hearing officer, any party (and certain others) may file a petition for review with the Commission. SEC Rules of Practice, 17 C.F.R. § 201.410(a).
[55] *See supra* note *38*.
[56] *In re the Rockies Fund, Inc*., Release No. IC 49788, 82 SEC Docket 3342, 2004 WL 1209117 (June 1, 2004) (Order Denying Motion for Reconsideration).
[57] A person aggrieved by a final order of the Commission may obtain review in the U.S. Court of Appeals. 15 U.S.C. § 78a-25(a).
[58] Rockies Fund, Inc. v. SEC, 428 F.3d. 1088 (D.C. Cir. 2005).
[59] *Id*. at 1093-95.
[60] *Id*.
[61] *Id*. at 1098.
[62] *Id*.

On the other hand, the court upheld the SEC's findings on several crucial grounds. It upheld the SEC's finding based on the fund's misclassifying restricted stock as unrestricted.[63] The court noted the SEC's contention that such a misclassification was material both because it affected the value of the holding, and its liquidity.[64] The court also upheld the SEC's finding based on the fund claiming to own shares it did not.[65] The court found that until the Directors approved the purchase amount and price, several months after the relevant filing, the fund had not established ownership.[66] The court also concluded that because these shares constituted 46% of the fund's holdings in that particular issuer, and 11% of its total securities holdings, the ownership error was material.[67] Finally, the court upheld the SEC's findings with regard to the fund's valuation of the securities and its valuation process.[68] This last point warrants elaboration.

The court noted that the SEC centered its analysis of the valuation process on the fund's 1983 prospectus, the fund's only public statement on valuation procedures.[69] The prospectus endorsed four methods of valuation, none of which had been used in regards to the values at issue.[70] Instead, the court said: "The SEC found that, unmoored from its prospectus, the Fund used an ad hoc process that mainly consisted of rubber-stamping [the President's] recommendations. The SEC concluded that the prospectus – and good accounting practice – would have directed a different approach."[71] The court also noted the fund's argument that even if the stock was technically overvalued, the overvaluation caused no harm, only to disagree. The court stated that because the fund rejected its publically stated valuation procedures, and did not discount its largest holding, substantial evidence supported the SEC's finding.[72] Finally, the court concluded its discussion of valuation by saying: "Such a haphazard process for valuing the largest holding of the Fund constitutes an 'extreme departure from the standards of ordinary care' that should have been obvious to all of the Fund's directors."[73]

The decision of the Court of Appeals did not end the litigation. The matter was remanded to the SEC, which issued a second opinion upholding

[63] *Id*. at 1096.
[64] *Id*.
[65] *Id*. at 1097-98.
[66] *Id*.
[67] *Id*. at 1098.
[68] *Id*. at 1096-97.
[69] *Id*. at 1097. It is worth noting that the prospectus was eleven years old at the time of the challenged valuations.
[70] *Id*.
[71] *Id*.
[72] *Id*.
[73] *Id*.

its prior findings and reducing its sanctions.[74] For the first time, the Commission considered various mitigating factors. It said:

> The record fails to identify any actual losses to investors resulting from respondent's misconduct; it similarly shows no unjust enrichment to respondents. Moreover, although we made no explicit findings as to these facts in our previous opinion, the record contains Forms 10-K showing that the Fund was relatively small, with net assets of approximately $1.7 million as of December 31, 1994 and $41.3 million as of December 31, 1995, and counsel for respondents stated in respondent's brief and at oral argument, and the Division conceded in its brief, that the Fund was thinly traded. Additionally, the Forms 10-K show that [the President] received a salary of only $48,000 annually in 1994 and 1995 for his service to the Fund, and [the Directors] testified that they received only $500 for each quarterly meeting of the Fund's board of directors that they attended.[75]

In light of these mitigating factors, the Commission determined to reduce the penalties from $500,000 for the president, to $50,000; and from $160,000 each for the directors, to $20,000.[76] After the Commission rejected their motion for reconsideration,[77] several of the respondents appealed this decision to the Court of Appeals, which, on October 21 2008, rejected their petition.[78] More than ten years after the litigation began, and more than fourteen years after the examination, the case was over.

The SEC's action against The Rockies Fund thoroughly tested its oversight program involving BDCs. Although two important elements of the case were rejected by the Court of Appeals, after ten years of litigation, the core regulatory concerns identified in the CCRS case, and continued in the Rockies Fund case, had been upheld. The concerns based on ownership and classification of portfolio securities, valuation, and governance for the valuation process, had survived.

C. THE 2008 BDC SWEEP

[74] *In re* the Rockies Fund, Inc., Release No. 34-54892, 89 SEC Docket 1384, 2006 WL 3542989 (Dec. 7, 2006) (Opinion on Remand).
[75] *Id.*
[76] *Id.*
[77] *In re* the Rockies Fund, Inc. (Order Denying Request for Reconsideration), *supra* note 57.
[78] The Rockies Fund, Inc. v. SEC, Case 07-1438 (D.C. Cir. Oct. 21, 2008) (*per curiam*) (Denying Petition for Review), *available at* http://www.sec.gov/litigation/opinions/2007/34-56344_appeal.pdf.

In the fall of 2008 the SEC brought nine settled enforcement cases against BDCs. Seven were brought over a two day period: four on September 29,[79] and three on September 30.[80] The remaining two were brought in November.[81] All of the cases resembled each other in their organization and findings, and plainly had emerged from an enforcement sweep.[82] However, they drew little contemporary attention. This is understandable. On September 15, about two weeks before, Lehman Brothers had declared bankruptcy, triggering a massive financial crisis. The BDC Sweep cases were probably lost in the general atmosphere of financial crisis.

The BDC Sweep cases were very different from CCRS and the Rockies Fund. Where the earlier cases had alleged over-valued portfolios, and sounded in fraud and disclosure, the sweep cases all focused on compliance with the 1940 Act.[83] None of them alleged fraud.[84] Instead,

[79] *In re* CLX Medical, Inc., Release No. 33-8966, 94 SEC Docket 655, 2008 WL 4394236 (Sept. 29, 2008) (hereinafter cited as "CLX Medical"); *In re* Green Globe International, Inc., Release No. 33-8965, 94 SEC Docket 653, 2008 WL 4394233 (Sept. 29, 2008) (hereinafter cited as "Green Globe International"); *In re* S3 Investment Company, Inc., Release No. 33-8967, 94 SEC Docket 658, 2008 WL 4394238 (Sept. 29, 2008) (hereinafter cited as "S3 Investment Company"); *In re* Starinvest Group, Inc., Release No. 33-8964, 94 SE Docket 651, 2008 WL 4394232 (Sept. 29, 2008) (hereinafter cited as "Starinvest Group").

[80] *In re* American Energy Production, Inc., Release No. 8972, 94 SEC Docket 668, 2008 WL 4411339 (Sept. 30, 2008) (hereinafter cited as "American Energy Production"); Atlantis Technology Group, Release No. 33-8971, 94 SE Docket 666, 2008 WL 4411338 (Sept. 30, 2008) (hereinafter cited as "Atlantis Technology Group"); *In re* Global Beverage Solutions, Inc., Release No. 33-8973, 94 SEC Docket 671, 2008 WL 4411340 (Sept. 30, 2008) (hereinafter cited as "Global Beverage Solutions").

[81] *In re* Renew Energy Resources, Inc., Release No. 33-8986, 94 SEC Docket 1919, 2008 WL 5030169 (Nov. 26, 2008) (hereinafter cited as "Renew Energy Resources"); *In re* 5G Wireless Communications, Inc., Release No. 33-8985, 94 SEC Docket 1916, 2008 WL 4999110 (Nov. 25, 2008) (hereinafter cited as "*5G Wireless Communications*").

[82] A tenth case appears to have emerged from the sweep, but it is not discussed herein because the respondent simply defaulted on the findings. *In re* Rudy 45, Release No. 34-59028, 94 SEC Docket 2506, 2008 WL 5055736 (Nov. 28, 2008) (hereinafter cited as "Rudy 45"). Nonetheless, the default findings were consistent with those discussed in this article.

[83] The sweep's focus on BDCs' compliance with the 1940 Act was not without precedent. In 2000 the SEC brought a settled administrative proceeding against a BDC based on similar violations: investing in non-qualifying assets in violation of Section 55(a), issuing shares below net asset value in violation of Section 23(b), failing to maintain required books and records in violation of Rule 31a-1, as well as, in the 2000 case, failing to file required and periodic reports with the SEC. *See In re* Nova Communications Ltd., Release No. 33-7849, 71 SEC Docket 382, 2000 WL 816866 (Apr. 10, 2000).

[84] It should be noted that the BDCs caught in the sweep were generally small firms that claimed exemption from the standard 1933 Act disclosure requirements pursuant to Regulation E. *See* 17 C.F.R. §§ 230.601-610. Regulation E is limited to companies with $5 million or less in offered securities. *Id*. at § 230.603(a). However, many of the BDCs in the sweep had failed to file Forms 2-E pursuant to the claimed exemption. As a result of these failures, the SEC revoked the Regulation E exemptions of all nine BDCs in the sweep, CLX Medical, Green Globe International, S3 Investment Company, Starinvest Group, *supra* note 80; American Energy Production, Atlantis Technology Group, Global Beverage Solutions, *supra* note 81; Renew

they provide a fairly comprehensive illustration of how a BDC can violate the 1940 Act.

Fidelity Bonds

All nine of the sweep cases included a finding that the BDC had violated the 1940 Act's fidelity bond requirement. Section 17(g) of the 1940 Act,[85] and Rule 17g-1 thereunder,[86] which are made applicable to BDCs by Section 59,[87] require each BDC to provide and maintain a bond issued by a reputable fidelity insurance company against larceny and embezzlement by officers and employees of the BDC. All of the BDCs in the sweep cases had failed to provide and maintain such a bond.[88]

120 Day Limit on Warrants or Rights to Subscribe

All nine of the sweep cases included a finding that the BDC had violated the 1940 Act's limitation on the time a warrant or right to subscribe or purchase the BDC's shares could be in effect. Investment Company Act Section 18(d),[89] which is made applicable to BDCs by Section 61(a),[90] states: it shall be unlawful "to issue any warrant or right to subscribe to or purchase a security of which such company is the issuer, except in the form of warrants or rights to subscribe expiring not later than one hundred and twenty days after their issuance…" All of the BDCs in the sweep had issued warrants or convertible securities without the mandated expiration date.[91] Moreover, while the 1940 Act provides BDCs with an opportunity to extend the deadline, so long as the BDC's shareholders authorize and a majority of the disinterested directors approve issuing such

Energy Resources, 5G Wireless Communication*s*, *supra* note 82; as well as in the order issued by default. Rudy 45, *supra* note 83. Their small size and exempt disclosure status distinguishes these firms from the larger and better known BDCs. Nonetheless, the 1940 Act compliance issues identified in the sweep, and discussed in the text, are applicable to all BDCs.

[85] 15 U.S.C. § 80a-17(g).

[86] 17 C.F.R. § 270.17g-1.

[87] 15 U.S.C. § 80a-58.

[88] *See* CLX Medical, Green Globe International, S3 Investment Company, Starinvest Group, *supra* note 80; American Energy Production, Atlantis Technology Group, Global Beverage Solutions, *supra* note 81; Renew Energy Resources, 5G Wireless Communications, *supra* note 82.

[89] 15 U.S.C. § 80a-18(d).

[90] 15 U.S.C. § 80a-60(a).

[91] *See* CLX Medical, Green Globe International, S3 Investment Company, Starinvest Group, *supra* note 80; American Energy Production, Atlantis Technology Group, Global Beverage Solutions, *supra* note 81; Renew Energy Resources, 5G Wireless Communications, *supra* note 82.

securities,[92] none of the BDCs in the sweep cases had availed themselves of this opportunity.[93]

Equal Voting Rights for Issued Stock

Seven of the sweep cases included a finding that the BDC had violated the 1940 Act's requirement that every share issued by a BDC must be a voting stock with equal voting rights. Section 18(i) of the 1940 Act,[94] which is made applicable to BDCs by Section 61(a),[95] states: "every share of stock hereafter issued…" by a BDC, "shall be a voting stock and have equal voting rights with every other outstanding voting stock."[96] The seven BDCs named for this violation had issued preferred stock that either had no voting rights, less voting rights than the common, or in a few cases, more voting rights than the common.[97]

Issuing Securities for Services

Six of the sweep cases included a finding that the BDC had violated the 1940 Act's prohibition on issuing securities for services. Section 23(a) of the 1940 Act,[98] which is made applicable to BDCs by Section 63,[99] states: no BDC "shall issue any of its securities (1) for services; or (2) for property other than cash or securities."[100] The six BDCs named for this violation had issued securities for services, including to officers, directors, employees, consultants, and lawyers.[101]

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[92] 15 U.S.C. § 80a-60(a)(3). If a BDC obtains shareholder authorization, and the independent directors' approval, and complies with other restrictions set out in the provision, it may extend the deadline to ten years. *Id*.
[93] *Id*.
[94] 15 U.S.C. § 80a-18(i).
[95] 15 U.S.C. § 80a-60(a).
[96] This provision also contains a 'grandmother clause' applicable to shares and contracts that predate 1940.
[97] *See* CLX Medical, Green Globe International, S3 Investment Company, Starinvest Grou*p*, *supra* note 80; American Energy Production, Atlantis Technology Group, Global Beverage Solutions, *supra* note 81; Renew Energy Resources, 5G Wireless Communications, *supra* note 82.
[98] 15 U.S.C. § 80a-23(a).
[99] 15 U.S.C. § 80a-62.
[100] Certain exceptions are set out in the provision. *Id*.
[101] *See* Starinvest Group, *supra* note 80; American Energy Production, Atlantis Technology Group, Global Beverage Solution*s*, *supra* note 81; Renew Energy Resources, 5G Wireless Communications, *supra* note 82.

Compliance

Six of the sweep cases included a finding that the BDC had violated the Compliance Rule—Rule 38a-1.[102] This rule was issued pursuant to 1940 Act Section 38(a),[103] which is made applicable to BDCs by Section 59,[104] and requires BDCs to appoint a Chief Compliance Officer, establish compliance policies and procedures, and engage in certain other compliance practices, such as conducting an annual compliance review. Six of the BDCs named for this violation failed to appoint a Chief Compliance Officer,[105] and five also failed to adopt compliance policies and procedures.[106]

Disinterested Directors

Four of the sweep cases included a finding that the BDC failed to have a majority of disinterested directors. Section 56(a) of the 1940 Act[107] states that a majority of a BDC's directors or general partners shall be persons "who are not interested persons of such company." The four BDCs named for this violation failed to have a majority of disinterested directors for varying lengths of time, ranging from eleven and a half months, to sixteen months.[108]

Asset Coverage for Senior Securities

Two of the sweep cases included a finding that the BDC had insufficient asset coverage for its senior securities. Section 18(a) of the 1940 Act,[109] which is made applicable to BDCs by Section 61(a),[110] states that it shall be unlawful for any BDC to issue or sell any senior security, unless it has an asset coverage[111] of at least 200%.[112] The two BDCs named

[102] 17 C.F.R. § 270.38a-1.
[103] 15 U.S.C. § 80a-37(a).
[104] 15 U.S.C. § 80a-58.
[105] *See* CLX Medical, S3 Investment Company, Starinvest Group, *supra* note 80; American Energy Production, Atlantis Technology Grou*p*, *supra* note 81; 5G Wireless Communications, *supra* note 82.
[106] *See C*LX Medical, Starinvest Grou*p*, *supra* note 80; American Energy Production, Atlantis Technology Group, *supra* note 81; 5G Wireless Communications, *supra* note 81.
[107] 15 U.S.C. § 80a-55(a).
[108] *See* CLX Medical, Starinvest Group, *supra* note 80; American Energy Production, Atlantis Technology Group, *supra* note 81.
[109] 15 U.S.C. § 80a-18(a).
[110] 15 U.S.C. § 80a-60(a).
[111] The asset coverage calculation is set out in Section 18(h). 15 U.S.C. § 80a-18(h).
[112] 15 U.S.C. § 80a-60(a)(1).

for this violation had issued debentures[113] without meeting the asset coverage test.[114]

Issuing Shares Below Net Asset Value

One of the sweep cases included a finding that the BDC had issued shares below net asset value. Section 23(b) of the 1940 Act,[115] which is made applicable to BDCs by Section 63,[116] states: no BDC "shall sell any common stock of which it is the issuer at a price below the current net asset value of such stock."[117] The BDC named for this violation had issued shares of stock at prices as low as one third of net asset value.[118]

Repurchasing the BDC's Own Shares

One of the sweep cases included a finding that the BDC had repurchased its own shares. Section 23(c) of the 1940 Act,[119] which is made applicable to BDCs by Section 63,[120] states: no BDC "shall purchase any security of any class of which it is the issuer" except pursuant to certain defined transactions. The BDC named for this violation had issued preferred stock to an officer in return for common stock, which the SEC alleged, constituted a repurchase.[121]

Books and Records

One of the sweep cases included a finding that the BDC had failed to create and maintain appropriate books and records. Section 31 of the 1940 Act,[122] which is made applicable to BDCs by Section 64,[123] requires BDCs to make and keep certain books and records as the SEC requires by rule or regulation. Rule 31a-1 sets out the required records.[124] The BDC named for this violation had failed to keep certain required records, specifically, daily journals of all debits and credits, ledgers of all assets,

[113] The Act defines senior security to include debentures having priority over any other class. 15 U.S.C. § 80a-18(g).
[114] *See* CLX Medical, *supra* note 102; American Energy Production, *supra* note 103.
[115] 15 U.S.C. § 80a-23(b).
[116] 15 U.S.C. § 80a-62.
[117] Certain additional terms and exceptions are also set forth in the provision, including that a BDC may issue below net asset value shares with the consent of a majority of shareholders. *Id*.
[118] *See* S3 Investment Company, *supra* note 80.
[119] 15 U.S.C. § 80a-23(c).
[120] 15 U.S.C. § 80a-62.
[121] *See* Green Globe International, *supra* note 80.
[122] 15 U.S.C. § 80a-30.
[123] 15 U.S.C. § 80a-63.
[124] 17 C.F.R. § 270.31a-1.

liabilities, reserve capital, income and expense accounts reflecting account balances on each day, and journals reflecting an itemized daily record reflecting sales and redemptions or repurchases of its securities.[125]

It is unfortunate that the BDC enforcement sweep became public at a moment when the financial crisis absorbed all attention. The sweep cases deserved greater notice. They illustrate the myriad compliance risks a BDC faces, in addition to the valuation and disclosure issues that dominated the CCRS and Rockies Fund cases.

II. RECENT CASES INVOLVING BDCs

The SEC's oversight program involving BDCs continues to reflect the primary concerns identified in its formative cases. Recent cases continue to focus on valuation and disclosure.[126] They also continue to enforce full compliance with the applicable requirements of the 1940 Act.[127] Finally, BDCs are not immune to fraudsters seeking victims. Recent enforcement cases have highlighted two areas where fraudsters have attempted to exploit BDCs: insider trading and traditional frauds.[128]

A. BDC VALUATION AND DISCLOSURE

In the last few years the SEC has bought several enforcement actions involving BDCs that raise valuation and disclosure issues similar to those raised in the CCRS and Rockies Fund cases. The recent cases show the SEC's continuing concern over the issues identified in the formative cases, and further illustrate its prosecutorial decision-making.

1. Brantley Capital

In 2009 the SEC filed a civil injunctive action involving Brantley Capital, a BDC. The action named the BDC's investment adviser, CEO, and CFO.[129] The SEC alleged that the adviser, CEO and CFO had overvalued two of the BDC's portfolio investments. In one instance, the

[125] American Energy Production, *supra* note 81.
[126] *See infra* Section III.A.
[127] *See infra* Section III.B.
[128] *See infra* Section III.C.
[129] SEC v. Brantley Capital Management, LLC, Complaint, 1:09-cv-01906-JG (N.D. Ohio E. Div. Aug. 13, 2009).

portfolio company had consistently suffered losses, primarily due to operational losses in a private airline in which the portfolio company held an ownership interest.[130] The SEC alleged that the airline was able to remain in business only because a major corporation with an ownership interest repeatedly lent it money.[131] In the other instance, the portfolio company was suffering losses, and remained in business only because the BDC continued to lend it money.[132]

The crux of the SEC's action focused on the valuation process for these securities. In particular, the SEC detailed warning signs that the CEO and CFO received about the portfolio companies' declining fortunes.[133] For example, the private airline continued to miss the financial targets that had been factored into its valuation. Indeed, it reached a point where its auditors' questioned whether it could continue as a going concern,[134] and the corporation that was lending it money proposed a financial resolution that would have had the effect of eliminating the portfolio company's – and hence the BDC's – ownership interest without compensation.[135] Nonetheless, the SEC alleged, the CEO and CFO continued to value the portfolio company at the same, increasingly stale price, based on disproven assumptions.[136] They also failed to inform the BDC's board of the negative developments, and provided the board with incorrect information.[137] The stale prices were also reported in the BDC's periodic reports filed with the SEC.

The board learned of these problems when the BDC's auditor brought them to its attention. The CEO had told the auditor that no independent valuations of the private airline's securities existed or were planned.[138] In fact, such a valuation had been conducted, and had indicated that the fair market value of the stock was *de minimis*.[139] When the auditor received the valuation, the audit partner contacted the BDC's board to express reservations about the veracity of management's representations.[140] In the event, despite maintaining a valuation in the tens of millions of dollars, the BDC realized only approximately eight-four thousand dollars upon resolution of its interest.[141]

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[130] *Id*. at ¶ 2.
[131] *Id*.
[132] *Id*. at ¶ 4.
[133] *Id*. at ¶ 20-192.
[134] *Id*. at ¶ 94.
[135] *Id*. at ¶ 101.
[136] *See e.g*., *id*. at ¶ 102-106.
[137] *Id*.
[138] *Id*. at ¶ 112.
[139] *Id*.
[140] *Id*.
[141] *Id*. at ¶ 115-119.

The SEC charged the adviser, CEO and CFO with fraud, disclosure violations, and other claims.[142] The CFO settled immediately,[143] and the CEO eventually did so as well.[144]

Perhaps the most noteworthy allegations in the Brantley Capital case—which was charged and ultimately settled as a fraud—were the false statements made by the defendants to the BDC's board of directors and auditor. It is important to note that the SEC did not simply allege that the valuations were wrong: it alleged that the CEO and CFO actively misled others about them. This distinction—between making less than accurate valuations and making false and misleading statements—would be further developed in the next case.

2. iWorld Projects & Systems, Inc.

In 2009 the SEC instituted administrative proceedings involving iWorld Projects and Systems, Inc. ("iWorld"), a BDC. The proceedings included iWorld,[145] which defaulted,[146] its CEO,[147] who settled,[148] and its President,[149] who also settled.[150] Comparing the culpability of the CEO and the President is revealing.

The BDC's assets consisted of two operating companies with limited histories. One had no operations when acquired, and the other had limited revenues from the sale of its sole product, a piece of project management software.[151] Both were acquired for approximately $285,000 in cash and $200,000 in assumed liabilities.[152] Nonetheless, the BDC valued the acquisitions at $10 million, and this value was reported in various filings with the SEC. [153] Moreover, over a period of months, as the condition of the operating companies deteriorated until all meaningful

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[142] *Id*. at ¶ 197-221

[143] SEC v. Brantley Capital Management, LLC, Litigation Release No. 21178 (August 13, 2009), *available at* http://www.sec.gov/litigation/litreleases/2009/lr21178.htm. *See also In re* Tab Keplinger, CPA, Release No. 34-60898, 97 SEC Docket 82 (Oct. 28, 2009).

[144] *See In re* Robert Pinkas, Release No. IA-3097, 97 SEC Docket 1779, 2010 WL 3896566 (Oct. 5, 2010).

[145] *See In re* iWorld Projects & Systems, Inc., Release No. 34-60502, 96 SEC Docket 1834, 2009 WL 2488065 (Aug. 14, 2009).

[146] *Id*.

[147] *See In re* Robert Hipple, Release No. 34-61688, 97 SEC Docket 3381, 2010 WL 883936 (Mar.11, 2010) (hereinafter cited as "Hipple").

[148] *Id*.

[149] *See In re* David Lloyd Pells, Release No. 34-60238, 96 SEC Docket 724, 2009 WL 1916538 (July 2, 2009) (hereinafter cited as "Pells").

[150] *Id*.

[151] Hipple, *supra* note 147148.

[152] *Id*.

[153] The BDC acquired another company, also controlled by Hipple, that held the positions in two operating companies. *Id*. For ease of reference, we will refer to them as the BDC's holdings.

operations had ceased with no prospect of revival, the BDC held to this initial valuation.[154]

In its proceeding against the President, the SEC noted the BDC's obligation to determine in good faith the fair value of the portfolio securities for which market quotations were not readily available.[155] Under generally accepted accounting principles, the SEC continued, the fair value of such securities is "the amount at which they could be exchanged in a current transaction between willing parties, other than a forced or liquidation sale."[156] Because there were no market quotations for its two portfolio companies, the BDC was required to determine their fair value in good faith. However, it did not do so. Instead, even though they had been purchased for much less, they continued to lose money, and they repeatedly fell short of projected revenues or earnings, the BDC held to its valuation of $10 million. The SEC concluded this was materially misleading.[157]

On the basis of these findings, the SEC charged the President with causing the BDC to violate its disclosure obligations under the Exchange Act,[158] and its books and records obligations under both the Exchange Act[159] and the Investment Company Act.[160] The President was not charged with fraud. The only action taken against him was an order to cease and desist from causing any future violations of these provisions.[161]

In the proceeding against the CEO, the SEC noted the same violative conduct—that the BDC had never made a good faith determination of the fair value of the portfolio securities—and charged him with the same disclosure violations.[162] However, the SEC also charged the CEO with fraud,[163] making false statements to the SEC,[164] falsifying books and records,[165] and more.[166] This could appear inconsistent, with much more serious charges brought against the CEO. But the proceeding against the CEO cites to an additional fact that may explain the difference. The CEO had also told the BDC's auditor, in connection with the auditor's

[154] *Id*.
[155] Pells (citing to Investment Company Act § 2(a)(41)), *supra* note 149150.
[156] *Id*.
[157] *Id*.
[158] *Id*. (charging violations of Securities Exchange Act § 13(a) and Rules 13a-1, 13a-13 and 12b-20).
[159] *Id*. (charging violations of Securities Exchange Act § 13(b)(2)(A) and 13(b)(2)(B)).
[160] *Id*. (charging violations of Investment Company Act § 31(a), made applicable to BDCs by § 64, and Rule 31a-1).
[161] *Id*.
[162] Hipple, *supra* note 147148.
[163] *Id*. (charging violations of Securities Exchange Act § 10(b) and Rules 10b-5).
[164] *Id*. (charging violations of Investment Company Act § 34(b)).
[165] *Id*. (charging violations of Securities Exchange Act Sections 13(b)(5) and Rules 13a-14, 13b2-1 and Rule 13b2-2(a)).
[166] Other violations are set out in the SEC's order. *See id*.

review of one of the BDC's periodic reports, that an independent investment board had approved the $10 million valuation.[167] The SEC stated that the CEO "knew – or was reckless in not knowing, that this statement was false."[168] The CEO was ordered to cease and desist from future violations, subjected to a five year bar as an officer and director of a public company, prohibited from affiliation with an investment company, and denied the privilege of appearing or practicing before the SEC as an accountant.[169]

The contrast between the culpability of iWorld's President and CEO illustrates an important point that had been suggested in the Brantley Capital case. A defective valuation is not fraud, in and of itself. As the SEC noted in the action against iWorld's President, the BDC never made a good faith determination of the portfolio securities' fair value, and the President had caused that violation. He was charged with disclosure violations. On the other hand, above and beyond the disclosure problems, iWorld's CEO materially misled the BDC's auditor. He was charged with fraud and false statements, and administered much stronger remedies.[170] This careful parsing of culpability is a credit to the SEC and its oversight program. Valuations can be imperfect, even to the point of warranting enforcement, without rising to the level of fraud. On the other hand, knowingly false statements can give rise to a higher level of culpability.

3. Equus Total Return, Inc.

In 2010 the SEC brought administrative proceedings involving Equus Total Return, Inc. ("Equus"), a BDC. The proceedings were based on the sale of the BDC's investment adviser,[171] and named Equus's CFO, who settled the proceeding,[172] its selling CEO and Chairman, who eventually settled,[173] and its buying CEO and Chairman, who also eventually settled.[174]

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[167] *Id*.
[168] *Id*.
[169] *Id*.
[170] Indeed, even in regard to the disclosure violations, the CEO was charged with both causing and aiding and abetting the violations, Hipple, *supra* note 147145, while the President was charged only with causing the violations. Pells, *supra* note 149150.
[171] *See In re* Sam P. Douglas, Release No. 34-62261, 98 SEC Docket 2181, 2010 WL 2343228 (June 10, 2010).
[172] *See In re* Harry O. Nicodemus IV, CPA, Release No. 34-62260, 98 SEC Docket 2180, 2010 WL 2343227 (June 10, 2010).
[173] *See In re* Sam P. Douglas, Release No. 34-63953, 2011 WL 674080 (Feb. 24, 2011) (hereinafter cited as "Douglass Settlement").
[174] *See In re* Sam P. Douglas, Release No. 34-64029, 2011 WL 761778 (Mar. 3, 2011) (hereinafter cited as "Moore Settlement").

In the transaction that gave rise to this proceeding, the BDC's CEO offered to sell his shares in the BDC's adviser. After preparation of the sale agreement, and filing of a definitive proxy statement to obtain shareholders' approval, the financial press ran an article noting that certain fund shares would be purchased in privately arranged transactions with individual shareholders.[175] This raised concerns among shareholders that not all would be given an opportunity to sell at a favorable price.[176] In response, the BDC issued a press release stating that the price paid for shares held by officers and directors would not exceed the market price.[177] Then, to ensure a senior Vice President's retention, he was paid a premium for his shares, and the cost was absorbed by the fund in a one-time special administrative expense attributed to the change in control.[178] Importantly, during a review by the BDC's board, the buying CEO "admitted that some of the expenses included retention bonuses for the senior vice president and others, but did not enumerate the specific amounts."[179]

The SEC alleged that the press release was misleading, in light of the retention bonus paid the senior Vice President. It charged both the selling and the buying CEOs with disclosure and proxy violations.[180] Interestingly enough, however, while the SEC charged the two CEOs with falsifying books and record, and with a false proxy solicitation, the SEC was careful to note that the violations did not require a showing of scienter,[181] that is, an intent to deceive, manipulate or defraud.[182] The order does not draw an explicit connection between the two, but one must wonder if the lesser, non-scienter charges were selected because of the disclosure made to the BDC's board members who were reviewing the administrative charge.[183]

The SEC's handling of the retention bonus in Equus illustrates a continuing concern in its BDC oversight program: undisclosed use of fund assets to resolve personal issues. As noted above, this had been one of the claims in the Rockies Fund case, until it was vacated by the Court of Appeals on the ground the SEC had not established that the alleged benefit received by the BDC insider had any value.[184] It was a claim in the Brantley Capital case, where the SEC alleged that the BDC's CEO had required a portfolio company to place certain shares in escrow to cover any shortfall

[175] Douglas Settlement, *supra* note 173174, at *1-2.
[176] *Id*.
[177] *Id*.
[178] *Id*.
[179] *Id*.
[180] *Id*.; Moore Settlement, *supra* note 174175, at *1-2.
[181] *Id*.
[182] *Id*. (*citing to* Aaron v. SEC, 446 U.S. 680, 686 n.5 (1980)).
[183] *See supra* text accompanying note 180.
[184] *See supra* text accompanying notes 41, 51 and 62-63.

in his personal investments, which ultimately reduced the BDC's share of the portfolio company's liquidation value by $1.7 million.[185] Finally, it arose in the Equus case, where the seller and buyer used fund assets to resolve a stumbling block in their transaction.

4. Allied Capital Corporation

In 2007 the SEC brought a settled administrative proceeding against Allied Capital Corporation ("Allied"), a BDC.[186] This case illustrates an important concern of the SEC's oversight program: the effectiveness of a BDC's internal controls.

The SEC's enforcement order against Allied indicated that it had a private finance portfolio of over $1.7 billion invested in approximately 152 portfolio companies.[187] As a result of its inquiry, the SEC indicated that it had identified 15 investments where Allied could not produce sufficient contemporaneous documentation to support, or accurately and fairly reflect, the board's determination of fair value.[188] The order cited several problems: Allied did not retain the valuation documentation presented to the board for two quarters regarding one investment; in other instances the documentation was incomplete or inadequate such as by listing enterprise values without any explanation, by missing necessary inputs and/or calculations, or by failing to provide an adequate explanation of the various inputs; finally there were insufficient checks and balances in the valuation process to provide a sufficient assessment of its objectivity.[189] The SEC noted that while Allied maintained that its board members and employees engaged in discussions before and during board meetings, to satisfy themselves with the recorded valuations, the written documentation did not reflect reasonable detail to support the valuations.[190]

Beyond these flaws in Allied's valuation process, the SEC offered three specific examples of insufficient recordkeeping: the valuation for one investment included revenue from discontinued lines of business, another was based in large part on a potential future buy-out event that remained preliminary in nature, and a third valuation failed to take account of the portfolio company's loss of one of its major customers due to the terrorist attack on the World Trade Center.[191]

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[185] Brantley Capital Management, LLC, *supra* note 129130, at ¶ 72.
[186] *In re* Allied Capital Corporation, Release No. 34-55931, 90 SEC Docket 2389, 2007 WL 1773811 (June 20, 2007) (hereinafter cited as "Allied").
[187] *Id*. at *3.
[188] *Id*.
[189] *Id*. at *3-4.
[190] *Id*.
[191] *Id*. at *4.

As a result of these problems, the SEC charged Allied with violation of the books and records requirements applicable to companies whose securities are registered with the SEC, pursuant to the Exchange Act.[192] Specifically, Allied had violated the provisions that require public reporting companies to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect their transactions and dispositions of their assets,[193] to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, or other criteria applicable to its financial statements,[194] and to provide reasonable assurances that the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.[195] The SEC ordered Allied to cease and desist from these violations in the future.[196] It also ordered Allied to comply with its undertakings to continue to employee a Chief Valuation Officer to oversee its quarterly valuation process, and to continue to employ third-party valuation consultants to assist in its quarterly valuation process for private finance investments.[197]

The SEC's action against Allied was consistent with its handling of other cases where it did not charge fraud. For example, in a case discussed above, the SEC found that iWorld's President, who was not charged with fraud, had violated the same provisions that were charged against Allied.[198] In other words, at least in reviewing the SEC's public cases, it appears to distinguish carefully between fraud and other types of problems, such as non-fraudulent disclosure and internal control failures.[199]

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[192] *Id*. at *4-5 (charging Section 13(b)(2)(A), 13(b)(2)(B)(ii) and 13(b)(2)(B)(iv) which are applicable to issuers with securities registered with the SEC pursuant to Section 12).
[193] 15 U.S.C. § 78m(b)(2)(A).
[194] 15 U.S.C. § 78m(b)(2)(B)(ii).
[195] 15 U.S.C. § 78m(b)(2)(B)(iv).
[196] *Id*.
[197] *Id*.
[198] David Lloyd Pells (citing to Securities Exchange Act § 13(b)(2)(A) & (B)), *supra* note 149150.
[199] Around the time of the case discussed in the text, Allied was involved in a bitter public dispute with a well-known short seller. One magazine described it as a "blood feud." Elizabeth MacDonald, "Allied Capital's Blood Feud," Forbes Magazine (Feb. 8, 2007) (stating: "sometimes a fight gets so down and dirty you can't tell the good guys from the bad"), *available at* http://www.forbes.com/2007/02/08/allied-capital-loans-biz_cz_em_0208allied.html. The author of this article states no view on the substance of the dispute. However, in 2010 the SEC's then Inspector General conducted an investigation based on the short seller's published allegations. *See* SEC Office of Inspector General, "Allegations of Conflict of Interest, Improper Use of Non-Public Information and Failure to take Sufficient Action Against Fraudulent Company," Case OIG-496 (Jan. 8, 2010). The report shows that the SEC staff investigated both parties to the dispute—the short seller and Allied—and ultimately decided to bring the non-fraud action against Allied described in the text. The Inspector General's report goes into great detail on a number of

5. KCAP Financial, Inc.

In 2012 the SEC brought a settled administrative proceeding against KCAP Financial, Inc. ("KCAP"), a BDC.[200] This case illustrates yet again the importance of valuation in the SEC's oversight program.

The SEC's enforcement order against KCAP indicated that it had a portfolio of over $500 million invested in debt securities issued by middle market companies, as well as the equity tranches of collateralized loan obligations ("CLO").[201] The SEC alleged that during the financial crisis of 2008 and 2009 KCAP management made the decision that, due to market conditions, the quotes of third party pricing services did not represent fair value, and market trades reflected distressed transactions. Therefore, they decided not to use trade data when valuing the portfolio, and instead used an enterprise value methodology. This was, the SEC alleged, inconsistent with controlling statements of the Financial Accounting Standards Board.[202] Specifically, the SEC alleged, KCAP management was aware of and disregarded market quotations and actual trades in its portfolio securities at lower values. In 2010, KCAP restated its financial statements for 2008 and two quarters of 2009, reporting that the values of both its debt and CLO investments had been overstated. In the restatement, KCAP also acknowledged weaknesses with respect to its internal controls for valuing its asset portfolio.

As a result of these problems, the SEC charged KCAP with violation of the disclosure and internal control provisions of the Exchange Act. The SEC did not charge fraud. Instead, it charged that KCAP violated its disclosure obligations under the Exchange Act,[203] and its books and records obligations under the same Act.[204] The SEC also charged certain of

issues, including the short seller's opinion of Allied and how some members of the SEC staff were apparently disappointed their investigation did not lead to charges of fraud. Unfortunately though, the report does not address the key issue for this article: what the Commission's enforcement activity reveals about its BDC oversight program. As discussed in the text, based on its disposition of cases, the Commission appears to distinguish carefully between fraud and other types of problems, such as non-fraudulent failures in disclosures and internal controls. The Inspector General's report, or at least the redacted version that has been made available to the public, does not add to our understanding of that analysis.

[200] *In re* KCAP Financial Inc., et al., Release No. 34-68307, 105 SEC Docket 207, 2012 WL 5940890 (November 28, 2012) (hereinafter cited as "KCAP Financial").

[201] *Id*.

[202] *Id*. (citing to FASB 157 and FASB 157-3).

[203] *Id*. (charging violations of Securities Exchange Act § 13(a) and Rules 13a-1, 13a-11, 13a-13 and 12b-20).

[204] *Id*. (charging violations of Securities Exchange Act § 13(b)(2)(A) and 13(b)(2)(B)).

the managers with causing the BDC's violations, and with directly violating certain related rules.[205]

The SEC's action against KCAP was consistent with its handling of other cases where it did not charge fraud. It shows that, in late 2012, the Commission continued to distinguish carefully between fraudulent and non-fraudulent disclosure problems.

Recent cases involving BDCs include a wide range of problems: from fraud, to disclosure problems, to books and records and internal control problems. Similarly, the SEC's charges have reflected this range. Not every problem is a fraud. Having this range of charging options gives the SEC depth and flexibility in its oversight program. Using its prosecutorial discretion, the Commission can carefully choose the charges and remedies that best fit the conduct. This flexibility was further demonstrated in March 2012, when the SEC returned to the enforcement sweep approach, to prosecute compliance problems at BDCs.

B. THE 2012 BDC SWEEP

On March 29, 2012, the SEC filed eight cases involving BDCs.[206] All eight were administrative proceedings - none of which were settled. Moreover, as with the enforcement sweep of 2008, none of the 2012 cases

[205] *Id*. (charging violations of Rules 13b2-1 and 13a-14).

[206] *In re* Superior Community Capital Corporation, Release No. IC- 30021, 2012 WL 1066126 (Mar. 29, 2012), *proceeding discontinued because respondent could not be found*, Admin. Proceedings Release No. 723, 2012 WL 8718374 (Sept. 12, 2012) (hereinafter cited as "Superior Community Capital Corporation"); *In re* Olm Ventures, Inc., Release No. 33-9306, 2012 WL 1066118 (Mar. 29, 2012), *order making findings and imposing sanctions by default*, Release No. 33-9328, 2012 WL 1998055 (June 5, 2012) (hereinafter cited as "Olm Ventures"); *In re* International Asset Group, Inc., Release No. IC-30018, 2012 WL 1066125 (Mar. 29, 2012), *order making findings and imposing sanctions by default,* Release No. IC-30088, 2012 WL 1951384 (May 30, 2012)(hereinafter cited as "International Asset Group"); *In re* American Capital Partners Limited, Inc., Release No. IC-30015, 2012 WL 1066124 (Mar. 29, 2012), *proceeding discontinued because respondent could not be found*, Admin. Proceedings Release No. 711, 2012 WL 8704502 (July 11, 2012) (hereinafter cited as "American Capital Partners Limited"); *In re* Interim Capital Corp., Release No. 34-66687, 2012 WL 1066123 (Mar. 29, 2012), *order making findings and imposing sanctions by default,* Release No. 34-67081, 2012 WL 1951382 (May 31, 2012)(hereinafter cited as "Interim Capital"); *In re* Central Capital Venture Corporation, Release No. 34-66685, 2012 WL 1066122 (Mar. 29, 2012), *order making findings and imposing sanctions by default*, Release No. 34-67089, 2012 WL 1980664 (June 4, 2012) (hereinafter cited as "Central Capital Venture"); *In re* of Principal Mortgage Fund, Inc., Release No. IC-30022, 2012 WL 1066127 (Mar. 29, 2012), *order making findings and imposing sanctions by default*, Release No. IC-30097, 2012 WL 2024647 (June 5, 2012)(hereinafter cited as "Principal Mortgage Fund"); *In re* Entertainment Capital Corp., Release No. 33-9305, 2012 WL 1066117 (Mar. 29, 2012), *order making findings and imposing sanctions by default*, Release No. 33-9327, 2012 WL 1951376 (May 31, 2012) (hereinafter cited as "Entertainment Capital").

were alleged fraud.[207] Instead, all were concerned with the BDCs' compliance obligations.[208]

Status as a BDC

All eight of the 2012 Enforcement Sweep cases included an allegation that the BDC had ceased to engage in business. Investment Company Act Section 54(a)[209] provides that whenever the SEC finds that a BDC has ceased to engage in business, the SEC may revoke the BDC's election to that status. In all of the cases in the 2012 Enforcement Sweep, the SEC alleged that the BDC was no longer in business, in most cases because its state registration was delinquent, inactive, in default, or had been revoked.[210]

Fidelity Bond

As in 2008, the failure to provide and maintain a fidelity bond against larceny and embezzlement by officers and employees, as required by Investment Company Act Section 17(g),[211] and Rule 17g-1 thereunder,[212] figured prominently in this sweep. Seven of the eight BDCs in the 2012 Enforcement Sweep had allegedly violated this requirement.[213]

Delinquent Filings

Several of the BDCs in the 2012 Enforcement Sweep were allegedly delinquent in their filings with the SEC. Most of the delinquencies arose from the BDCs' registration of their securities with the

[207] *See* Superior Community Capital Corporation, Olm Ventures, International Asset Group, American Capital Partners Limited, Interim Capital, Central Capital Venture, Principal Mortgage Fund, Entertainment Capital, *supra* note 207.
[208] In addition, as with the 2008 sweep, the BDCs caught in this sweep were generally small firms that claimed the exemption from 1933 Act disclosure requirements provided by Regulation E. *See* 17 C.F.R. §§ 230.601-610. Moreover, as in 2008, in some of the cases the SEC was concerned by the BDCs' failure to comply with the terms of the exemption. *See* Olm Ventures, Entertainment Capital, *supra* note 207.
[209] 15 U.S.C. § 80a-54(a).
[210] *See* Superior Community Capital Corporation, Olm Ventures, International Asset Group, American Capital Partners Limited, Interim Capital, Central Capital Venture, Principal Mortgage Fund, Entertainment Capital, *supra* note 207.
[211] 15 U.S.C. § 80a-17(g).
[212] 17 C.F.R. § 270.17g-1. As noted above, Section 17(g) and Rule 17g- are made applicable to BDCs by Section 59 of the Act. 15 U.S.C. 80a-58.
[213] *See* Olm Ventures, International Asset Group, American Capital Partners Limited, Interim Capital, Central Capital Venture, Principal Mortgage Fund, Entertainment Capital, *supra* note 219.
[213] 15 U.S.C. § 80a-17(g).

SEC pursuant to Exchange Act Section 12(g).[214] As a result, the BDCs were subject to Section 13(a) of the Act, and required to make annual filings on Form 10-K pursuant to Rule 13a-1[215] and quarterly filings on Form 10-Q pursuant to Rule 13a-13.[216] Four of the BDCs named in the sweep allegedly failed to keep current with their filings.[217]

Equal Voting Rights for Issued Stock

Another issue in the 2008 sweep was issuing shares of stock with unequal voting rights in violation of Investment Company Act Section 18(i),[218] which also reappeared in the 2012 Enforcement Sweep. In this instance, however, only one BDC was charged in this regard. The BDC named for this violation in 2012 had allegedly issued preferred stock with no voting rights.[219]

Compliance

Finally, as in 2008, the failure to implement Rule 38a-1[220] reappeared in 2012. One of the BDCs named in the sweep had allegedly failed to appoint a Chief Compliance Officer and to adopt compliance policies and procedures.[221]

The 2012 Enforcement Sweep brought home several fundamental compliance issues: 1) keeping the BDC's state corporate registration current, 2) providing and maintaining a fidelity bond, 3) keeping current in filings due to the SEC, and 4) remaining mindful of issues such as equality of voting for issued shares and compliance. Since all of these cases were

[214] 15 U.S.C. § 78l(g).
[215] 17 C.F.R. § 240.13a-1.
[216] 17 C.F.R. § 240.13a-13.
[217] *See* Olm Ventures, Interim Capital, Central Capital Venture, Entertainment Capital, *supra* note 207. In addition, pursuant to Investment Company Act § 30(b), 15 U.S.C. § 80a-30(b), and Rule 30b-1 thereunder, 17 C.F.R. § 270.30b-1, registered investment companies must periodically file Form N-SAR with the SEC. One of the BDCs in the 2012 sweep had registered with the SEC and allegedly failed to keep current with its periodic filings on Form N-SAR. International Asset Group, *supra* note 207. In this context it is worth noting a 2009 case where a company indicated its intent to operate as a BDC, but did not qualify because it had not registered any of its securities pursuant to Securities Exchange Act § 12. *See* Investment Company Act § 54(a). The SEC found that since it had failed in its election as a BDC, and failed to register as an investment company, it was operating an unregistered investment company, and held the President of the entity personally responsible. In re Ryan Douglas Smith, Release No. IC-2884196, SEC Docket 1695, 2009 WL 2366042 (Aug. 3, 2009).
[218] 15 U.S.C. § 80a-18(i). As noted above, this provision is made applicable to BDCs by Section 61(a) of the Act. 15 U.S.C. § 80a-60(a).
[219] Central Capital Venture, *supra* note 207.
[220] 17 C.F.R. § 270.38a-1.
[221] Central Capital Venture, *supra* note 207.

resolved by default, the SEC's allegations were never tested in litigation. Nonetheless, as an indication of the SEC's continuing oversight interest in this area, the 2012 Enforcement Sweep is an important statement.

C. BDCs AS VICTIMS

While this article has focused on the SEC's oversight program involving BDCs, it is worthwhile noting that BDCs are not immune from the attacks fraudsters constantly launch against the financial community. These threatening issues should not be ignored. One of the BDCs named in the 2008 BDC Enforcement Sweep illustrates this concern. At about the same time the BDC was named in the sweep for various compliance problems, it was itself victimized in a serious fraud because manipulators attacked its securities as a "Target Stock."[222] Two areas in particular warrant careful attention in this regard: insider trading and traditional frauds.

1. Insider Trading

One of the critical concerns of the modern SEC enforcement program is insider trading. In 2011, the then-Director of the Division of Enforcement testified that the Division continues to focus on this issue, and that the number of insider trading cases has grown.[223] In 2008, the SEC announced a settled insider trading case against a BDC director.[224]

[222] SEC v. George David Gordon, 09-CV-061 CVE TLW, Complaint (N. D. Okla. Feb. 10, 2009) (Global Beverage Solutions, Inc., targeted by manipulators, along with other small companies); SEC v. Mark Byron Lindberg, 08-402 CVE SAJ, Complaint (N.D. Okla. Filed July 14, 2008) (same).

[223] Robert Khuzami, Director, Division of Enforcement, Meredith Cross, Director, Division of Corporation Finance, Robert Cook, Director, Division of Trading and Markets, Carlo di Florio, Director, Office of Compliance Inspections and Examinations, Eileen Rominger, Director, Division of Investment Management, Craig Lewis, Chief Economist and Director, Division of Risk, Strategy, and Financial Innovation, U.S. Securities and Exchange Commission, Testimony on "Management and Structural Reforms at the SEC: A Progress Report," Before the United States Senate Committee on Banking, Housing and Urban Affairs Subcommittee on Securities, Insurance, and Investment (Nov. 16, 2011), *available at* http://www.sec.gov/news/testimony/2011/ts111611rk.htm. Director Khuzami testified that the number of insider trading cases had grown 8% in one year. *Id*.

[224] *See* SEC v. Edward O Boshell, Litigation Release No. 20541 93 SEC Docket 414, 2008 WL 1867964 (Apr. 28, 2008), *available at* www.sec.gov/litigation/litreleases/2008/lr20541.htm.

Edward O. Boshell was an outside disinterested director of a BDC.[225] The BDC of which he was a director owned a 25% stake in a portfolio company.[226] The portfolio company was listed for trading on Nasdaq.[227] The board of the portfolio company had held a special board meeting to discuss the sale of the company,[228] began soliciting interested buyers,[229] and identified a potential acquiring firm.[230] Then, during a board meeting of the BDC, a member of the portfolio company's board informed the BDC board that the acquiring firm was currently bidding for the portfolio company.[231] Another director of the BDC warned fellow board members, including Boshell, that the information was non-public.[232] Nonetheless, Boshell acquired several thousand shares of the portfolio company,[233] and when the sale transaction was announced, sold them for a quick profit.[234]

In its complaint, the SEC said that Boshell, "as a member of the BDC board of directors, owed a fiduciary duty to the BDC to hold in confidence the information discussed at the board meeting regarding the potential acquisition of [the portfolio company]. As a result, he had a duty of trust and confidence to not trade [the portfolio company's] securities on the basis of material non-public information."[235] The SEC charged him with fraud,[236] and he agreed to disgorge his trading profits and to pay prejudgment interest in addition to a penalty equal to his profits.[237]

Insider trading is a widespread problem, not just a BDC-issue. Nonetheless, BDCs in possession of material inside information must keep this danger in mind. It is interesting to note that one of Boshell's fellow directors warned the board that the information about the portfolio company was non-public. It is unfortunate that Boshell did not heed his warning.

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[225] SEC v. Edward O Boshell, 08CV2392, Complaint, ¶ 2 (N.D. Ill. Filed Apr. 28, 2008), *available at* http://www.sec.gov/litigation/complaints/2008/comp20541.pdf.
[226] *Id*. at ¶ 18.
[227] *Id*. at ¶ 13.
[228] *Id*. at ¶ 15.
[229] *Id*.
[230] *Id*. at ¶ 16.
[231] *Id*. at ¶ 18.
[232] *Id*.
[233] *Id*. at ¶ 19.
[234] *Id*. at ¶ 20-21.
[235] *Id*. at ¶ 24.
[236] *Id*. at ¶ 27 (charging violation of Securities Exchange Act Section 10(b) and Rule 10b-5).
[237] Edward O Boshell, *supra* note 225, at *1.

2. Traditional Frauds

Traditional frauds include a multitude of violations, but are not limited to the following: offering frauds, pump and dump schemes, outright theft or misappropriation. BDCs are not immune to these schemes. Indeed, as the BDC sector grows and prospers, it is not surprising that it has been targeted. Thus, careful compliance requires attention to these schemes.

Some elements of these cases should be highlighted. First, in some cases, the BDC is used to attract investors with the possibility of investing in other promising companies.[238] This is the most dangerous fraud, because it seeks to exploit the BDC's business model. When the fraudsters use this approach to raise significant sums of money,[239] they do untold harm to the legitimate BDC sector. Second, in some cases the BDC is used to conduct improper offerings. In these cases, the fraudsters generally exploit the BDC to conduct an offering pursuant to Exemption E, to facilitate a pump and dump scheme,[240] or to line their own pockets through the resale of shares issued to insiders in undisclosed discounted transactions.[241] Finally, in some cases, the fraudsters simply loot the BDC through illegal distributions, performance fees, and expense reimbursements.[242]

It is an unfortunate characteristic of our modern economy that traditional frauds can be found almost everywhere, and BDCs are not immune. The SEC's enforcement program plays an important role in weeding out these imposters from the legitimate community.

III. PREVENTIVE COMPLIANCE

The SEC's enforcement program involving BDCs has highlighted several areas of compliance interest. As highly regulated entities subject to a complex regulatory structure, BDCs are exposed to a myriad of possible

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[238] *See* SEC v. Imperiali, Inc., Civil Action No. 9-12-cv-80021 ECF, Complaint (S.D. Fl. Jan. 9, 2012).

[239] *See, e.g.*, SEC v. Imperiali, Inc., Litigation Release No. 22227 (Jan. 12, 2012) (scheme raised $2.5 million), *available at* http://www.sec.gov/litigation/litrealses/2012/lr22224.htm.

[240] *See, e.g.*, SEC v. Greg M.S., 2:11-cv-10403-RHC-PJK Berger, Complaint ¶ 24.84-106 (E.D. Mich. Filed Feb. 1, 2011).

[241] *See e.g.*, SEC v. Compass Capital Group, Inc., Litigation Release No. 21319, SEC Docket 1149, 2009 WL 4362874 (Dec. 2, 2009).

[242] *See, e.g.*, SEC v. Charles R. Kokash, Litigation Release 21264 97, SEC Docket 123, 2009 WL 3471296 (Oct. 27, 2009). The use of performance fees in this type of fraud should be distinguished from cases where the performance fee itself was legitimate, but the calculation was not. *See, e.g.*, Renn Capital Group, Inc., Release No. IA-2454, 86 SEC Docket 1994, 2005 WL 3273385 (Dec. 1, 2005) (performance fee that adviser charged BDC complied with applicable law except in its calculation).

issues and enforcement actions, making preventive compliance a challenge. Nonetheless, review and analysis of the SEC's enforcement actions prove instructive as to how BDCs can meet this compliance challenge.

A. ENFORCEMENT ACTIONS

1. Avoid Falsehoods

Time and again in the SEC's enforcement program involving BDCs, one can see the difference between a mistake and a falsehood. BDCs – like any other human institution – make mistakes. Not every mistake is a fraud, and the cases brought by the SEC reflect this reality. On the other hand, when the SEC finds a falsehood, involving investors, directors or auditors, it has brought fraud cases on those grounds. Perhaps the most interesting cases in this regard are those where the same underlying problem – such as faulty disclosure -- led to different levels of charges, depending on whether the problem was accompanied by false statements.

The compliance lesson should be clear: avoid making false statements. As difficult as it may be to resolve a mistake, adding a falsehood will only make it worse.

2. Have a Robust Valuation Process

The SEC's enforcement program demonstrates the importance of valuation, valuation disclosure, and governance of the valuation process. These issues were featured in the cases against CCRS, the Rockies Fund, as well as more recent cases such as iWorld. A number of compliance lessons can be taken from these cases. Management should not allow one person or a few people to dominate the valuation process. Instead, valuations should be subject to checks and balances, such as by an active Valuation Committee, to ensure that they are based on the criteria set out in the BDC's disclosure documents. In addition, these checks and balances should include active engagement by Directors, such as by actively reviewing board materials and asking substantive questions. The process should be evidenced in the BDC's books and records. Most importantly, all parties to the process – staff, managers, and board -- should avoid any temptation to blindly rely on someone else's valuations.

To support compliance, valuation meetings could begin with a brief reminder of a BDC's disclosed valuation process. This could come in the form of an oral discussion at the beginning of a meeting or the distribution of valuation criteria, materials and procedures prior to or at a meeting. Committee chairs could be tasked with ensuring that the disclosed

methods are followed. To support this process, a BDC's Chief Compliance Officer could review board minutes and meeting materials during annual reviews to assess whether the process was sufficiently followed and documented. Further, in the absence of market quotes for securities, board members could be reminded of their duty to determine valuations in good faith. Finally, employing a third-party valuation firm and appointing a Chief Valuation Officer could be valuable in supporting the objectivity of valuation decisions and the rigor of board deliberations.

An allegation related to valuation that appeared in both the CCRS and Rockies Fund cases was the claim that the BDC overstated the value of its portfolio because it did not own all of its purported portfolio securities. In terms of preventive compliance, BDCs should take care to ensure that portfolio acquisitions and ownership interests are properly evidenced and supported by legally enforceable agreements.

3. Establish an Effective Corporate Governance Structure

The SEC's oversight program has highlighted the importance of effective corporate governance and full disclosure to BDC boards. This issue appeared in several cases, including Brantley Capital and Equus. In the first, failure to disclose information to the board led to harsh charges by the SEC. In the second, some level of disclosure appears to have led to lesser charges. Accordingly, it would serve BDCs well to establish effective disclosure mechanisms within the firm to ensure that all appropriate information is reaching the board. This could involve a formal process for compiling information regarding portfolio companies and ensuring its distribution to all Valuation Committee members and the board. A formal process of compilation and distribution will avoid having one or a few people in exclusive control of valuation information, and will enable the Chief Compliance Officer to test and validate the process in the annual compliance review.

4. Establish Robust Internal Controls

As discussed above, the SEC has brought several enforcement cases against BDCs charging that they failed to establish appropriate internal controls, including against iWorld and Allied. One of the overarching lessons from these cases is the importance of creating and retaining valuation documents that provide reasonable detail in support of valuation determinations. For BDCs, this can be enhanced through disciplined identification of the core documents that should be retained regarding each valuation, careful adherence to the established policy, and then compliance testing during the annual review.

5. Make Timely and Accurate Public Disclosures

In many of the enforcement actions discussed in this article, the ultimate basis for the SEC's action was a failure in disclosure. Violations ranged from inaccurate disclosures regarding valuations, valuation processes, securities held by BDCs, the financial performance of BDCs and portfolio companies, to simple tardiness in making the required filings. To avoid similar charges, BDCs should have proper procedures and structures in place to ensure SEC filings reflect their current status or facts. Establishing an effective and fully documented valuation process, as discussed above, will help establish this goal. Moreover, BDCs should remain cognizant of filing deadlines and requirements. As seen in the 2012 Enforcement Sweep, the SEC will review whether BDCs are delinquent, inactive, or in default with annual or quarterly filing requirements. Many Chief Compliance Officers address this concern by establishing a compliance calendar for tracking all filing and other compliance deadlines.

6. Distinguish Personal and Corporate Interests

Several of the cases discussed in this article alleged that BDC officials had confused personal and corporate business. These included Equus, where fund assets were allegedly used to resolve a stumbling block in the sale of the BDC's adviser; the Rockies Fund, where fund assets were allegedly used to waive an insider's personal liability; and Brantley Capital, where the CEO allegedly required a portfolio company to place certain shares in escrow to cover any shortfall in his personal investments, which reduced the BDC's share of the portfolio company's liquidation value. This is a critical area for BDC General Counsels and Chief Compliance Officers: training insiders on the appropriate separation of corporate and personal business. An apparent conflict of interest between an individual and the BDC can cast a shadow over the BDC's work, and draw suspicious scrutiny by the SEC.

7. Be Mindful of the Specific Requirements of the Investment Company Act

The SEC's two BDC enforcement sweeps, both in 2008 and 2012, demonstrate a commitment to enforcing full compliance with the applicable provisions of the 1940 Act. Among other things, this includes: (1) obtaining and maintaining a fidelity bond, (2) equal voting rights for issued stock, (3) implementing and complying with Rule 38a-1, (4) not issuing securities for services, (5) ensuring 120 day limits on warrants or rights to subscript to a BDC's securities, (6) having a sufficient number of

disinterested directors, (7) maintaining sufficient asset coverage for senior securities, and (8) not repurchasing a BDC's own securities. In the midst of the BDC's day-to-day operations, these compliance requirements must be remembered and carefully implemented. Perhaps it is not surprising that several of the BDCs caught in the enforcement sweeps suffered from defective compliance functions, several had neither a Chief Compliance Officer nor had they implemented any compliance policies or procedures. It would serve BDCs well to have adequately staffed legal and compliance departments that are well versed in the requirements of the 1940 Act.

8. Stay Current with State Corporate Obligations

The 2012 Enforcement Sweep introduced a new area of concern for the SEC: compliance with state corporate requirements. As discussed above, the SEC has shown a readiness to move against BDCs when their state filings are delinquent, inactive, or in default of registration and filing obligations.

9. Control Inside Information

Historically, the SEC's enforcement program has treated insider trading and the dissemination of material non-public information as priority concerns. As shown in the Boshell case, BDCs are not immune to this problem. While BDCs can help protect against the release of insider information by developing and enforcing effective internal controls and procedures, insider trading often is a personal choice. Thus, training for insiders should be considered, particularly by BDCs investing in publily traded securities. Moreover, every BDC should stress directors' and employees' fiduciary duties, and the culture of compliance expected of every member of the firm.

10. Conduct Due Diligence over Other Parties

Finally, BDCs should carefully assess the other parties with whom they do business. Like other successful business models, BDCs will draw fraudsters eager to exploit their reputation. Consequently, BDCs must conduct appropriate due diligence efforts to protect themselves from such fraudulent activity.

IV. CONCLUSION

As a form of business organization the BDC is now 35 years old. It is not surprising, over such a span of time, that BDCs have been subject to a certain number of enforcement actions. Indeed, considered in light of the

passage of time, the number of actions seems relatively small. More interesting than the number, however, are the continuing patterns that can be observed in the actions that have been brought. This article has sought to identify those patterns, and suggest the compliance lessons that can be drawn from them. A final point is in order.

One of the features of the BDC is the high level of regulation it receives. For example, venture capital funds remain exempt from SEC regulation and oversight.[243] As a result, BDCs continue to offer a unique combination of regulation, transparency and an opportunity to invest public funds in private equity. In short, regulation by the SEC, including through its oversight program, continues to support BDCs role as the public face of private equity investing.

[243] *See* Exemptions for Advisers to Venture Capital Funds, *supra* note 7.