Valuation of Illiquid Securities Held by Business Development Companies

A White Paper

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I. Introduction

Business Development Companies ("BDCs") comprise a little known segment of the larger, and better known population of investment companies, primarily mutual funds. While not broadly known, the number of companies electing to be treated as BDCs continues to grow. There are unique accounting issues facing BDCs and neither the Securities and Exchange Commission ("SEC") nor the FASB have focused on these unique issues. The primary accounting challenge that exists is the development of an investment valuation methodology that adequately addresses a BDC's portfolio of privately negotiated investments in non-public companies. Today, valuation methodologies are developed from interpretations and analogous application from a variety of sources. The result is an industry with potential inconsistencies in valuation methodology.

The purpose of this paper is to analyze valuation methodologies and the application of fair value accounting for purposes of accounting for the investment portfolios of investment companies that have elected to be regulated as BDCs under the Investment Company Act of 1940 (the "1940 Act"). This paper will first briefly summarize the types of illiquid private securities that typically are held in a BDC portfolio. Second, this paper will address the current SEC regulations and interpretive advice for valuing a security at fair value applicable to investment companies, but not specifically applicable to BDCs. Third, this paper will summarize applicable accounting literature on the subject matter. Fourth, this paper will summarize the valuation guidance applicable to Small Business Investment Companies ("SBICs") as set forth by the Small Business Administration ("SBA"), which specifically addresses the SBA's mandated policies for the valuation of private, illiquid securities. Finally, this paper will draw a

conclusion as to the most applicable valuation methodologies for BDCs and make a recommendation as to the appropriate methods of accounting for a BDC portfolio at fair value.

II. A BDC's Portfolio Consists of Primarily Illiquid Private Securities

BDCs primarily invest in illiquid securities of private companies. This contrasts sharply with mutual funds, which generally are required to invest at least 85% of their assets in liquid investments. BDCs are required to hold 70% of their assets in illiquid securities of small and medium-sized companies. Section 2(a)(48) of the 1940 Act sets forth the definition of a BDC. In this section, the 1940 Act mandates that a BDC must be operated for the purpose of making investments in securities described in Sections 55 (a)(1)-(3) and also mandates that a BDC make significant managerial assistance available to its portfolio companies. Sections 55 (a)(1)-(3) generally specify that a BDC must invest at least 70% of their assets in securities purchased in transactions not involving any public offering, and may invest only in eligible portfolio companies, largely meaning private companies or small public companies that have no liquid public market for their securities. As a result of these mandates, most BDCs invest in private companies or small illiquid public companies and the type of investment security is generally a debt instrument with equity features or a preferred or common equity security.

For BDCs, completing a single investment generally takes many weeks, and sometimes months, due to an investment process that generally includes a lengthy diligence period, a detailed private negotiation, and a tailored investment structure for each security to meet the requirements of the prospective portfolio company. The structure of each debt security includes terms governing the interest rate, repayment terms, prepayment penalties, financial covenants, operating covenants, and remedies upon an event of default. The structure of each equity security includes terms governing the percentage ownership and dilution parameters, liquidation preferences, voting rights, and put or call rights.

The majority of the investments made by a BDC are subject to restrictions on resale or otherwise have no established trading market. Securities in a BDC's portfolio are generally not traded, but are, in the case of a debt investment, held to maturity and repayment, or in the case of an equity security, held until the entire portfolio company is sold or at least a significant partial sale has taken place. In fact, because a BDC's portfolio is highly illiquid, a BDC may be required to take a significant discount on the sale of a particular debt or equity security, should the BDC have to prematurely liquidate such a security.

III. The Current SEC Regulatory Framework

Investment companies regulated under the 1940 Act are required to account for their investment portfolio at value. Value is defined in Section 2(a)(41) of the 1940 Act is explained using two concepts: (i) for securities for which market quotations are readily available, value is determined to be quoted market value; and (ii) for all other securities and assets (*i.e.,* those without readily available market quotations), value is determined to be "fair value" as determined in good faith by the board of directors of the company.

The SEC issued interpretive guidance on valuation procedures in 1969 and 1970 in two Accounting Series Releases.[1] These releases pertained to open-end and closed-end investment companies and their portfolios of primarily quoted public securities. These releases were not intended to address the unique profile of a BDC and its portfolio directly because BDCs were not even authorized and did not exist until 1980. ASR 113 focuses on the valuation of restricted securities while ASR 118 provides more general guidance. The guidance offered by ASRs 113 and 118 was reiterated with no further elaboration as Guide 28 to Form N-1A. Even after more

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[1] Accounting Series Release No. 113, Inv. Co. Act Rel. No. 5847 [1937-1982 Accounting Series Release Transfer Binder], Fed. Sec. l. Rep. (CCH) ¶ 72,135 (October 21, 1969) (hereinafter ASR 113). Accounting Series Release No. 118, Inv. Co. Act Rel. No. 6295, [1937-1982 Accounting Series Release Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 72,140 (December 23, 1970) (hereinafter ASR 118).

than 30 years, ASR 113 and ASR 118 remain the leading authorities on valuation of securities under the 1940 Act.[2]

A. The Concept of Market Value in ASR 118

ASR 118 generally requires investment companies to use the last quoted sales price of a security as of the time of valuation. When there is no quoted sales information for a given date, ASR 118 allows for the possibility of using bid and asked prices quoted by broker-dealers. ASR 118 also outlines circumstances in which an investment company should consider whether market quotes are actually "readily available" (*e.g.*, when the market for a security is very thin or when broker-dealer quotations appear questionable).

B. The Concept of Fair Value in ASR 118 and 113

Securities for which market quotations are not readily available must be valued in good faith by the investment company's board of directors. The application of this concept is described in ASR 118, with ASR 113 providing more specific guidance related to restricted securities. Fair value is interpreted in ASR 118 to be the amount reasonably expected to be received upon a "current sale" of the security. However, ASR 118 does not contemplate a privately negotiated, highly structured illiquid security held for investment until maturity in its explanation of what a "current sale" means. Instead, it provides guidance on the factors to be considered and methods to be used to value securities for which market quotations are not readily available. ASR 118 recommends utilizing the following methodologies to determine fair value:

1. a multiple of earnings;
2. a discount from market of a similar freely traded security;

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[2] In a publicly released letter, Douglas Scheidt, Associate Director and Chief Counsel of the SEC's Division of Investment Management, indicated that ASRs 113 and 118 "continue to represent the views of the Commission." See *Letter to Craig S. Tyle*, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management (December 8, 1999).

3. yield to maturity with respect to debt issues; or
4. a combination of the above as well as other methods.

In determining which methods to apply, ASR 118 suggests taking into account the following factors, to the extent applicable:

1. the fundamental analytical data relating to the investment;
2. the nature and duration of restrictions on disposition of the securities; and
3. an evaluation of the forces which influence the market in which these securities are purchased and sold.

More specific factors outlined in ASR 118 include the type of security involved, financial statements, cost at date of purchase, size of holding, analyst reports, transactional information or offers and public trading in similar securities of the issuer or comparable companies. ASR 118 acknowledges that there is no single standard for determining "fair value…in good faith."

Although ASRs 113 and 118 do not contemplate BDCs and their unique portfolios, in keeping with the SEC's guidance in ASRs 113 and 118, in practice BDCs typically establish valuation policies adopted by their boards of directors. However, the application of "fair value" by a BDC for its illiquid portfolio is often difficult to align with the specific requirements of ASRs 113 and 118. For instance, the concept of "current sale" for purposes of determining fair value in ASR 118 is difficult, if not impossible, to apply in the case of a BDC's portfolio. As noted in Section II above, there is no market for the illiquid investments of a BDC, and a BDC does not enter into its investments with the goal of trading such securities; instead, the BDC typically enters into an investment with the intention to nurture the investment over a long period of time (five to ten years) with a sale of the portfolio company as its preferable exit. Over the expected investment period, it is natural for a BDC to expect temporary increases and decreases

in perceived investment value, however, these temporary anomalies have little to do with the expected investment return.

The concept of "current sale" in ASR 118 is particularly troubling if applied to a BDC's illiquid portfolio, because if such a portfolio were subject to a current sale test, the portfolio would need to carry a significant discount from the face value of its underlying securities. In the private capital markets, investors typically do not sell investments until they have reached their optimum value, and premature sales usually arise from some underlying difficulty of the investor. As a result, premature sales generally suffer a great penalty in terms of a discount imposed. The discount also often reflects the amount of effort that needs to be expended by a prospective purchaser of the investment. The SEC has recently confirmed, with little further guidance, that in fact fair value is *not* intended to be a "fire sale" price.[3] In In Re Parnassus Investments, an administrative law judge found that the fund had violated the requirement that the fund's board of directors fair value restricted securities in good faith. Respondent had argued that the "current sale" requirement was tantamount to a "fire sale." The judge responded that "[r]espondents are correct in that fire sale pricing was never the intention of the Commission." Furthermore, in a letter to Chief Financial Officers issued by the SEC staff in 2001, the staff stated that it was not appropriate to discount or mark up a readily available market price for an unrestricted security solely because an investment company holds a large quantity of the outstanding shares of an issuer or hold an amount that is a significant portion of the security's average daily trading volume.[4] This position supports the SEC's staff position that a security should not be valued at a "fire sale" price. It takes into account the fact that the investment

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[3] *See* In Re Parnassus Investments, Initial Dec. No. 131 (September 3, 1998).

[4] *See* Letter from John S. Capone, Chief Accountant, Securities and Exchange Commission, to Chief Financial Officers (Feb. 14, 2001*) available at* http://www.sec.gov/divisions/investment/im021401.htm.

company would likely sell the securities in an orderly disposition over a reasonable period of time.

Another concept in ASR 118 that is difficult to apply in the case of a BDC is the concept of using a "similar freely traded security" as a comparable measure of value for an investment in a private illiquid security. Typically, companies with freely traded securities are larger, more liquid, have greater business opportunities, and have greater access to capital, which therefore make them significantly different in terms of their relative value as compared to a smaller private company.

Yet another concept in ASR 118 that is impracticable for BDCs is the notion that yield to maturity should be considered in determining the fair value of a debt security. Clearly, since the BDC plans to hold a debt security until its repayment, fluctuations in interest rates in the capital markets are not relevant to the value of the principal amount of the note that will ultimately be collected. If the BDC were to change the value of debt securities solely because of market interest rate fluctuations, it could erroneously record appreciation or depreciation that has no chance of ever being realized when the debt security is repaid. As a result, application of this concept would mislead investors. Since BDCs investments are illiquid, it is virtually impossible to determine whether fluctuations in the highly liquid public debt markets have a relationship to the BDC investment. For a BDC to determine the impact of interest rate changes on yield, it would need to 1) find a potential buyer, 2) permit the buyer to perform due diligence on the investee company, and 3) negotiate a fair sales price.

IV. Applicable Accounting Guidance for Fair Value Accounting

The American Institute of Certified Public Accountants ("AICPA") sets forth valuation and accounting guidance for investment companies regulated under the 1940 Act in the AICPA Audit and Accounting Guide Audits of Investment Companies ("the Guide"). The Guide focuses

primarily on open-end and closed-end investment companies. With respect to investment companies, the Guide acknowledges the guidance set forth in ASRs 113 and 118, but goes on to give further definition to the concepts of fair value and current sale. Section 2.28 of the Guide defines fair value as "the amount at which the investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale." The Guide continues in Section 2.35 to state that current transaction means "realization in an orderly disposition over a reasonable period."

Accounting guidance specific to BDCs is mentioned in an appendix to the Guide, which addresses Venture Capital and Small Business Investment Companies. In Appendix A, the Guide states:

> Venture Capital Investment Companies, including most SBICs and **business development companies** differ in operating method from other types of investment companies. The usual open-end or closed-end company is a passive investor, whereas the venture capital investment company is more actively involved with its investees. In addition to providing funds, whether in the form of loans or equity, the venture capital investment company often provides technical and management assistant to its investees as needed and requested.
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> The portfolio of a venture capital investment company may be illiquid by the very nature of the investments, which are usually securities with no public market. Often, gains on those investments are realized over a relatively long holding period. The nature of the investments, therefore, requires valuation procedures that differ markedly from those used by the typical investment company with which this Guide primarily deals.

Clearly, the Guide contemplates that BDCs should have a different valuation methodology for their portfolios than those methodologies employed by investment companies that make passive investments in more liquid securities.

V. Valuation Guidance Applicable to Small Business Investment Companies ("SBICs")

Arguably the most appropriate authoritative source to draw from for purposes of establishing a methodology for fair value accounting for a BDC portfolio is the SBA's valuation

policies required for SBICs. The SBA has been regulating the activity of SBICs since the late 1950s and has developed over many years valuation guidelines that specifically address the unique characteristics of an illiquid portfolio of privately negotiated securities. The SBA has adopted valuation guidelines for SBICs to use in valuing their portfolio investments (the "SBA Policy").[5] All SBICs are required to adopt this policy substantially in the form provided by the SBA. Because SBICs also invest in illiquid securities of private companies, the SBA policy provides appropriate guidance for the valuation of BDC portfolios.

The SBA Policy follows the 1940 Act model by dividing securities into two categories:

1. Marketable Securities. Securities for which market quotations are readily available and the market are not "thin." Marketable Securities are required by the SBA to be valued at (i) the average of the bid price at the close for the valuation day and the preceding two days for over-the-counter stocks or (ii) the average of the closing price for the valuation date and the preceding two days for listed securities. Marketable Securities do *not* include securities which are subject to resale restrictions.

2. Other Securities. All securities that are not Marketable Securities are Other Securities. Other Securities are valued at Asset Value, which is defined as the amount that the board of directors has established as a current value in accordance with their valuation policy.

Most securities held by SBICs are Other Securities requiring a value to be determined by the board of directors of the SBIC. The SBA Policy describes a proper valuation as being based "upon all of the relevant facts, with common sense and informed judgment influencing the process of weighing those facts and determining their significance in the aggregate," resulting in a "careful, conservative, yet realistic approach."

The SBA Policy also sets forth general considerations that SBICs should take into account not only when valuing their portfolio but also when investments are made. Negotiating

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[5] SBA Valuation Guidelines for SBICs, *available at* http://www.sba.gov/INV/valuate.html.

the terms of the investment is akin to determining the initial valuation because cost is the initial asset value until there is a basis to increase or decrease the value. Unrealized appreciation and unrealized depreciation should only be recognized when there is a sustained economic basis for doing so. Temporary fluctuations, including change in interest rates, are not a basis for adjusting the valuation of an investment.

Specific considerations regarding debt and equity securities of private companies include, among other things:

For debt securities

- Loans shall be valued in an amount not greater than cost, with unrealized depreciation being recognized when value is impaired. The valuation of loans should reflect the portfolio company's current and projected financial condition and operating results, its payment history and its ability to generate sufficient cash flow to make payments when due.

- When a valuation for an interest-bearing security relies more heavily on asset versus earnings approaches, additional criteria should include the seniority of the debt, the nature of any pledged collateral, the extent to which the security interest is perfected, the net liquidation value of tangible business assets and the personal integrity and overall financial standing of the owners of the business.

- Appropriate unrealized depreciation on loans should be recognized when collection is doubtful.

- The carrying value of interest-bearing securities shall not be adjusted for changes in interest rates.

- The valuation of convertible debt may be adjusted to reflect the value of the underlying equity security net of the conversion price.

For equity securities

- Investment cost is presumed to represent value except where indicated in the SBA Policy, and valuation should be reduced if there has been a significant deterioration in a company's performance and potential.

- Prospective equity financings of a company should only be a basis for recognizing unrealized depreciation and not unrealized appreciation.

- Subsequent significant equity financings should only be a basis for adjustments in valuations if the investor is sophisticated and unrelated.

- A company that has been self-financing and has had positive cash flow from operations for at least the past two years may be considered for an increase in its value based on a conservative measure regarding P/E ratios or cash flow multiples.

The SBA Policy for private securities is very detailed and considers the unique art of private investment. The SBA Policy, however, should be examined with respect to the requirement for a portfolio company to have positive cash flow in order to record appreciation on an equity security since today, private investors frequently place high valuations on companies that have yet to achieve positive cash flow, because of an individual company's unique technologies or operations. It is also not uncommon for investors to direct their portfolio companies to use their internally generated cash for future growth, thereby increasing investment value.

The SBA Policy also provides additional specific considerations regarding equity securities of public companies as follows:

> The valuation of public securities that are restricted should be discounted appropriately until the securities may be freely traded. Such discounts typically range from 10% to 40%, but the discounts can be more or less, depending upon the resale restrictions under securities laws or contractual agreements.

In general, the SBA Policy is far more applicable to the portfolio of a BDC than the valuation guidance set forth by the SEC in the ASRs. The SBA Policy considers the fact that privately negotiated securities increase in value over a long period of time, that the investor does not intend to trade the securities, and that no ready market exists. The SBA Policy states, "[t]his Valuation Policy is intended to provide a consistent, conservative basis for establishing the Asset

Value of the portfolio. The Policy presumes that Loans and Investments are acquired with the intent that they are to be held until maturity or disposed of in the ordinary course of business."

VI. BDCs and Fair Value Accounting

The SEC has indicated in recent months that it is seeking to have issuers provide greater transparency in their disclosures to stockholders, particularly in their financial disclosure.[6] Accounting and reporting for a BDC is obviously difficult because of the requirement to value the investment portfolio at fair value and record resulting unrealized depreciation or appreciation as appropriate. In accounting for its investment portfolio, a BDC needs to clearly communicate to its stockholders the expectation of a future realized gain or loss from a single asset. Unrealized depreciation for a BDC should be analogous to bad debt expense for a bank and should generally indicate that an asset has been impaired and full collection of a loan or realization of an equity security is doubtful. Conversely, unrealized appreciation should be a clear indication that the underlying portfolio company has appreciated in value and that the BDC's security has, as a result, also appreciated in value. Temporary changes in the capital markets with respect to interest rate movements or public equity market swings have little to do with whether or not a BDC's investment has been impaired, which may result in a loss, or whether a portfolio company has performed such that it has increased in value, which may result in a gain. In fact, from a private investor's prospective, the public markets often have little relevance as to the value of a private company.

It is appropriate for a BDC to include unrealized appreciation and unrealized depreciation as well as realized gains and losses in its net income, but a BDC must be careful to apply fair value accounting so that investors know that unrealized depreciation means a loss has most likely

[6] *See, e.g.,* Cautionary Advice Regarding Disclosure About Critical Accounting Policies, SEC Rel. Nos. 33-8040, 34-45149, FR-60 (December 12, 2001) (pointing out that investors are demanding "full transparency of accounting policies and their effects").

been incurred and unrealized appreciation means that a gain is probable. To record the impact of temporary changes in interest rates or temporary movements of the public equity markets on securities that will never be liquidated in a manner in which such market forces would be relevant would only obfuscate the transparency of a BDC's net income. The investor would never know when unrealized depreciation signaled a potential loss, instead of some temporary market decline, and the investor would never know if a gain is probable, or whether the public equity markets were temporarily irrationally exuberant.

In view of the foregoing, the SBA Policy, with minor modifications, appears to provide the best overall guidance for valuation at fair value for the portfolio of a BDC. The SBA Policy recognizes that SBICs invest in small, private companies in order to achieve long-term capital appreciation. BDCs invest with the same goal. ASRs 113 and 118 provide relevant context for determining fair value when a security is held for trading and has access to some type of trading market albeit an illiquid one. The ASRs, however, are not as easily applied to the unique characteristics of a BDC portfolio, primarily because the securities in which a BDC invests cannot be put to the test of current sale for purposes of valuation. The AICPA Guide is helpful in that it acknowledges that a BDC's valuation methodology must differ from that of a typical investment company, but it does not provide much detailed advice as to how to determine fair value when valuing a BDC portfolio.

BDCs, therefore, should adopt investment valuation policies that encompass the guidance provided by the SBA, taking into account that all private illiquid securities may have unique characteristics that impact value. This method would provide a more accurate valuation, so that stockholders would have a clearer understanding of the portfolio's performance. The SBA Policy is consistent with SEC goals of providing stockholders with current, accurate and complete information about issuers and their investments. BDCs need a valuation method that

acknowledges the illiquid nature of their investments and allows the valuations to take into account permanent changes in the value of the company underlying the security.