

BDC ROUNDTABLE

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SEC ENFORCEMENT AND REGULATORY ISSUES RELATED TO FAIR VALUE

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WHAT YOU DON'T WANT

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"It's the S.E.C. How do you plead?"

Brantley Capital Management:

- Injunctive action against investment adviser to BDC, CEO and CFO charging direct and indirect violations of anti-fraud provisions of federal securities laws.
- SEC claims two concentrated holdings were overvalued in order to generate higher advisory fees and implies that the Board was misled as to the value of those holdings by the CEO and CFO.
- Board members not named.
- One investment (Flight Options) was nearly 50% of portfolio;
- Appraisal used to support valuation based on revenue and financing assumptions that did not come to pass early on;
- Valuation not reduced in light of subsequent negative information (missing targets);
- Valuation maintained despite subsequent deteriorating third party valuations/information;
- CEO on board of portfolio company affiliate, had business dealings with portfolio company, know of loans to portfolio companies, so in the flow of information that was not provided to the Board.

WHAT THE SEC DOESN'T LIKE

- Valuations not tied to external, verifiable information
- Valuations performed internally
- Valuation that affects compensation
- Static or sticky valuations
- Lack of documentation
- Lack of objective oversight
- Concentrated positions not subject to increased testing
- Valuation practice “drift”
- Valuations in a vacuum (without regard to declining market conditions)

WHAT THE SEC PREFERS.....

- Board member knowledge of the valuation process and actual and meaningful board member involvement in the valuation process
 - Documented process
 - Understanding of modeling tools as well as internal processes
 - Documentation that all relevant information presented to Board and discussed
- Sufficient resources and staff
- Independence in valuation-a first step
- External criteria
- Examination and control of conflicts (internal/external)
 - Elimination or reduction of conflicts in valuation process (e.g., uncoupling compensation from valuations)
- Testing and validation
- Checks and balances
- Documented consideration of negative or contrary information or relevant assumptions
- Documentation of consideration of factors influencing valuation
- Refreshed inputs
- Dynamic procedures
- Auditability

WHAT TO KEEP IN MIND

- Identification of assumptions, revisiting assumptions
- Kick the tires approach-valuation is dynamic
- Documentation
- Email etiquette:
always eventually speaking to Board, auditors and regulators