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National Association of Business Development Companies

Jonathan G. Katz
Secretary, Securities and Exchange Commission,
450 Fifth Street, NW,
Washington, DC 20549-0609.

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Regarding: File No. S7-03-04

Dear Mr. Katz:

We are writing to comment on the proposal set out in Release No. S7-03-04 that has as one of its proposals the requirement that an investment company have an Independent Chairman of the Board. That may be fine for regular investment companies but it would not be a good idea for investment companies that elect to be Business Development Companies ("BDCs") under section 54 of the Investment Company Act of 1940 ("40 Act").

Business Development Companies are not Investment Companies

BDCs have been recognized since they were created in 1980 as separate and apart from the normal investment companies. An investment company is a company that holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities. A BDC on the other hand is prohibited from investing in public traded securities and must instead (1) invest in "Permissible assets" which are "securities purchased, in transactions not involving any public offering or in such other transactions as the Commission may, by rule, prescribe ...," and (2) BDCs must make available managerial assistance to the companies they invest in. A BDC is a Venture Capital company investing in private businesses and the management of the BDC becomes part of the management of the company they invest in. A BDC is exempt from a large section of the 40 Act because it must perform the duties that are more like an operating company than an investment company.

Independent Chairman for BDC

The SEC has proposed to require that the chairman of the BDC fund Board be an independent director. The Investment Company Act is silent on who will fill this important role on fund boards. Today, in many cases, the Chairman is also is the chief executive officer (CEO) of the fund. This practice

**may contribute to the CEO's ability to dominate the actions of the board of directors except that the board of a Business Development Company has a majority of independent directors.**

**<u>BDC Chairman Has Less Influence</u>**

**Current regulations as well as regulations specific for BDC's prevent the chairman of a BDC's board from controlling the board's agenda. Because of recent legislation by Sarbanes Oxley and rules of NASD, *the board of a BDC* is required to consider some matters annually in connection with the renewal of the advisory contract, and other matters the board considers at its discretion, such as termination of service providers, including the adviser. For example, if the CEO Chairman of a BDC wants to hire the independent auditors of the BDC fund to perform other duties not related to the audit, the CEO must ask permission from the independent directors on the Audit Committee.**

**The chairman of the board of an Investment Company can have a substantial influence on the fund boardroom's culture but in a room full of independent directors it is not possible for the Chairman to suppress the type of meaningful dialogue between fund management and independent directors that is critical for healthy fund governance. Independent directors have ample time in their Audit Committee, Governance Committee and in the Compensation Committee (*all composed of ONLY independent directors*) to discuss (without management being present) anything they wish. And when those committees report back to the full board the Chairman (CEO) has little ability to diminish their recommendations. With the independent directors now making up all of the committees and making up a majority of directors, the role of the independent directors in the continuous, active engagement of fund management cannot be diminished by the Chairman.**

**It is highly unlikely that the boardroom culture will be more conducive to decisions favoring the long-term interest of fund shareholders when the board chairman is not the CEO because the basic decisions of control of the fund are made by the respective committees that meet without the CEO and have ultimate authority. For example, the governance committee selects new directors, the audit committee hires the auditors and the compensation *committee determines the compensation and* all these decisions are made without the oversight by the CEO or any other non-independent director. The reports of these committees that are populated only with independent directors, back to the full board of directors are not passive reports. They are the decision and there is little the CEO can do about any decision made in these committees.**

**The compensation committee that has <u>only</u> independent directors is the committee that negotiates the compensation agreements with the adviser and**

**management. The board is little more than a final recipient of the negotiated terms. The Chairman of a BDC has little power to foil the recommendation of the compensation committee on compensation since he is not part of the committee that makes the decision.**

**<u>Chairman as Management or Independent?</u>**

**Making an independent director the chairman of the funds board, especially of a BDC will effectively make the Chairman part of management. It moves the Chairman from being independent and overseeing, to becoming part of the management team of the business and removing the independence. It would be impossible for independent board chairman to be a strong leader (and thus governance would weaken) because an independent director could not effectively lead the board through a discussion of a detailed and, in some respects, complex items of a BDC. For example, in most BDC's the board must approve <u>every</u> investment. The investments of a BDC are complex and detailed because they are investments in private companies where the management of the fund of the BDC provides managerial assistance. So the CEO is with many of the investments for protracted periods of time and learns the information first hand. It is the CEO Chairman of the board of a BDC that has the capacity to lead the board through a discussion of why it is a good investment. An independent director would have to spend days studying the potential investment to be knowledgeable enough about the investment to lead the board.**

**Take a second example, each quarter the board must determine the "fair value" of each of the investments (the portfolio companies). The board must do this because the securities of a BDC are not public securities and have no market for them. This determination of fair value is a labor intensive process in which the board is presented the values and the values are debated. A majority of the directors and a majority of the independent directors must set the value of each of these private companies. There is no market for these investments so the board must find an accurate number for the value of the private business. Having an independent director lead the discussion of the values of the private business would not be feasible because the independent directors would not have the detail knowledge of the private business to help the directors determine the value.**

**<u>Independent Committees Make Major Decisions</u>**

**Currently all investment companies that are BDC's must have independent directors and only independent directors as members of the three main committees and the Chairman of those committees are independent directors. These committees are Audit, Compensation and Ethics/Nominating/Governance. The SEC should follow the lead of NASD and**

**Sarbanes Oxley and require this. This is an effective check on the power of any CEO Chairman of the BDC fund.**
**The board of a BDC is now required to meet without management and discuss management. Appointing a "lead director" to conduct these meetings would seem to be a helpful alternative.**
**Currently the board of BDC's elects the officers of the company after each annual shareholders meeting and the Chairman is appointed at that time as well. And it would be fine to make those elections be conducted by a majority of the independent directors too.**

**A BDC is not a Mutual Fund**

**Finally, every BDC is an operating company not a mutual fund or traditional investment company. It either operates as a Venture Capital fund, a LBO fund or a mezzanine lending institution. The BDC is an operating company and as such needs a leader to run the business. In a regular investment company the officers such as President, Chairman and Secretary are more administrative while the operations of the mutual fund are carried on by a team of stock or bond pickers. In a BDC the team is using its talents to find private companies to invest in, to negotiate terms and conditions of the investment, to follow the company by sitting on the board of directors of the company that the BDC has invest in, by helping the company determine marketing policies, solve production problems, select management of the company invested in and a whole host of activities that places the fund in control of the portfolio company. As the controlling investor the BDC team is supervising the operations of the company. The Chairman of the Board of a BDC must explain all this activity to the board of directors. The leadership of the board of a BDC cannot be effectively completed by an independent director that is not full time on the job with the portfolio companies. Because BDC's are such a different operating entity from regular investment companies this is why the Chairman should not be an independent board member.**

**Sincerely,**

**David Gladstone**
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