

AN ALERT FROM THE BDO FINANCIAL SERVICES PRACTICE

ASSET MANAGEMENT INSIGHTS

The BDO Asset Management Group is pleased to send you a round-up of the latest accounting, auditing and regulatory developments affecting the U.S. asset management industry.

ACCOUNTING AND REPORTING

ASU 2015-07: Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)

[ASU 2015-07](#), issued in May 2015, amends ASC 820, Fair Value Measurement, disclosures by eliminating the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient (NAV practical expedient). Prior to ASU 2015-07, investments that were measured at fair value using the NAV practical expedient were categorized within the fair value hierarchy based on liquidity, i.e., the ability and the length of time before which the reporting entity could redeem its investment at NAV. Although classification within the fair value hierarchy is no longer required, an entity must disclose the amount of investments measured using the NAV practical expedient in order to permit reconciliation of the fair value of investments in the hierarchy to the corresponding line items in the balance sheet.

ASU 2015-07 also reduces disclosures that were required for investments that are eligible for the use of, but for which the reporting entity opts not to use, the NAV practical expedient. These investments are no longer subject to the disclosures described in paragraph 820-10-50-6A. Since the fair value for these investments is determined using observable and/or unobservable inputs, the fair value measurements for these investments continue to be subject to the fair value

disclosures required by paragraph 820-10-50-2, which includes "leveling" disclosures.

Since investments that are measured at fair value using the NAV practical expedient will no longer be included in the fair value hierarchy, ASU 2015-07 also amended ASC 230, Statement of Cash Flows, to expand the exemption for investment companies from providing a cash flow statement. That is, the cash flow statement is not required for an investment company if, among other conditions, substantially all of its investments are carried at fair value and classified within Level 1 or Level 2 of the fair value hierarchy, or are measured using the NAV practical expedient and are redeemable in the near term at all times.

The amendments are effective retrospectively as follows:

- public business entities for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years
- all other entities for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years.

Early adoption is permitted

Related Party Disclosures in the Notes to the Financial Statements

The [SEC recently charged](#) an investment adviser for not satisfying the Custody Rule because the financial statements of the funds it managed did not comply fully with U.S. GAAP. The departure cited that the audited financial statements failed to disclose related party relationships and transactions of almost



For more financial services-related information, please visit BDO's [Asset Management](#) page. If you are interested in learning more about these matters, BDO has a team of advisors available to help. Contact information for our advisors is listed below.

Keith McGowan, New York
212-885-8037
kmcgowan@bdo.com

David Casavecchia, New York
212-885-8198
dcasavecchia@bdo.com

Dale Thompson, Boston
617-239-4145
dthompson@bdo.com

\$3 million in expenses tied to transactions involving entities controlled by the investment adviser's principal. The SEC also charged the audit partner associated with those financial statements for, among other things, issuing inaccurate audit reports, i.e., unqualified opinion on the funds' financial statements for fiscal years 2009 through 2012 even though the related party relationships and transactions were not adequately disclosed in conformity with U.S. GAAP.

REGULATORY

Business Development Companies' (BDCs) Unfunded Commitments are an Area of Concern for the SEC

BDCs may make commitments to provide additional funding to its private company investees in the future (unfunded commitments). Such unfunded commitments typically represent an obligation to purchase additional securities of the private companies either at a specified date or upon issuance of a call notice by such private companies, at a predetermined price. During the comment letter process, the SEC staff has questioned whether such unfunded commitments are similar in substance to standby commitment agreements, as described in Release 10666 – therefore, falling within the scope of Section 18(a) of the Investment Company Act of 1940 as senior securities. If unfunded commitments are deemed to be senior securities, BDCs would be required to either: (a) segregate liquid assets in the amount of the unfunded commitments and exclude such unfunded commitments from senior securities in the asset coverage calculation; or (b) include the unfunded commitments as senior securities in the asset coverage calculation. Auditors also are required to audit a BDC's disclosures of asset coverage per unit in accordance with Item 4.3 of Form N-2.

At this time, the SEC has no formal response as to whether unfunded commitments are senior securities. However, the SEC will continue to comment on positions taken by a BDC that such commitments are *not* senior securities in order to understand management's rationale and basis.

Long and short of it: *The determination of whether such commitments are senior securities is a matter of law—BDCs are advised to seek legal interpretation on this matter.*

2015 Examination Focus Areas

Earlier this year, the SEC [announced](#) its examination priorities for 2015, which cover a wide range of issues at financial institutions, including investment advisors and investment companies. The examination priorities include, but not are limited to:

- "Alternative" investment companies
- Fixed income investment companies
- Cybersecurity
- Potential equity order routing conflicts
- Never-before-examined investment companies
- Fees and expenses in private equity funds

The priorities listed for 2015 are not exhaustive and may be adjusted throughout the year in light of ongoing risk assessment activities. The priorities were selected by senior exam staff and managers and other SEC divisions and offices in consultation with the chair and other commissioners.

SEC Issues Guidance on Cybersecurity

Both registered investment companies ("funds"), i.e., funds registered under the Investment Company Act of 1940, and registered investment advisers ("advisers") increasingly use technology to conduct their business activities and need to protect confidential and sensitive information related to these activities from third parties, including information concerning fund investors and advisory clients. The SEC's Division of Investment Management has identified cybersecurity of funds and advisers as an important issue. Therefore, funds and advisers should identify their respective compliance obligations under the federal securities laws and take into account these obligations when assessing their ability to prevent, detect and respond to cyber-attacks. For example, the compliance program of a fund or an adviser could address cybersecurity risk as it relates to identity theft and data protection, fraud and business continuity, as well as other disruptions in service that could

affect, for instance, a fund's ability to process shareholder transactions.

The SEC formally provided its thoughts and guidance to funds and advisers in April 2015 through [IM Guidance Update 2015-02, Cybersecurity Guidance](#).

Despite Some Progress, SEC Pushing Private Equity Funds for More Compliance Improvements

At the Private Equity International Conference in May 2015, Marc Wyatt, acting Director of the SEC's Office of Compliance Inspections and Examinations (OCIE) gave a [speech](#) noting several improvements since last year, when Andrew Bowden, then Director of OCIE, presented at the same conference. Mr. Bowden described deficiencies surrounding fees and expense practices that he observed during the examination of newly registered private equity fund managers under the Presence Exam initiative—many of which are still common today.

Among the improvements that OCIE has seen with private equity (PE) fund managers:

- **Changes in Disclosure Practices:** Improvements include modifications to Form ADV, Part 2A about disclosures on fees and expense practices, as well as enhanced disclosures on certain PE fund manager websites about the role of operating partners. More robust disclosures are also being made to the LP advisory committees.
- **Changes in Fees and Expense Practices:** The practice of accelerating monitoring fees when a portfolio company is sold or taken public appears to be falling out of favor, and the use of evergreen provisions in monitoring agreements, which often enable advisors to take large monitoring agreement termination payments, appears to be declining. Additionally, the collection of revenues from portfolio companies' use of group purchasing organizations is being better disclosed and contained.
- **External Evaluations:** More funds are using consultants to evaluate fee practices, leading to a revision of practices where issues have been identified.

- **Improved Internal Controls:** Funds are dedicating greater attention to compliance programs by creating a separate chief compliance officer (CCO) role, instead of combining it with the chief financial officer or general counsel role. CCOs are also gaining greater visibility into the firms' business model.

Despite the advances noted above, Mr. Wyatt noted improvement is still needed in several areas including:

- Expenses and expense allocation
- Co-investment allocation
- Certain claims about fees made by real estate advisors

While the improvements in disclosure of fee practices in Form ADV amount to a positive change, Mr. Wyatt noted that the disclosure of material changes in terms of post-fund closing on Part 2A of Form ADV alone is usually not a

sufficient remedy for the absence of disclosure prior to fund closing.

***Long and short of it:** The SEC continues to scrutinize the private equity industry to make sure that fund managers aren't misallocating or unfairly charging fees and expenses to investors. This is an area of focus under the 2015 Examinations program. Managers of PE funds are encouraged to (i) engage with their investors to obtain whatever consents are necessary under their existing limited partnership agreements to reflect current practices and (ii) adopt and implement policies and procedures governing expense allocation as part of its compliance program.*

SEC Charges KKR With Misallocating Expenses

Recently, the SEC's investigation of Kohlberg Kravis Roberts & Co. (KKR) found that during a six-year period ending in 2011, KKR incurred

\$338 million in broken deal or diligence expenses related to unsuccessful buyout opportunities and similar expenses. Even though KKR's co-investors, including KKR executives, participated in the firm's private equity transactions and benefited from the firm's deal sourcing efforts, KKR did not allocate any portion of these broken deal expenses to any of them for years. KKR also did not expressly disclose in its fund limited partnership agreements or related offering materials that it did not allocate broken deal expenses to the co-investors. Under [the SEC's order](#), KKR agreed to pay nearly \$30 million to settle the charges, including a \$10 million penalty. The SEC's order also finds that KKR failed to implement a written compliance policy governing its fund expense allocation practices during the six-year period in 2011.

BDO'S FINANCIAL SERVICES PRACTICE

BDO's Financial Services Practice provides assurance, tax and advisory services to asset management entities, primarily Hedge Funds, Private Equity Funds, Broker Dealers and Mutual Funds. The practice services over 600 advisors nationwide with funds ranging from start-up funds to those with billions under management.

ABOUT BDO USA

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, financial advisory and consulting services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through 58 offices and more than 400 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multi-national clients through a global network of 1,328 offices in 152 countries.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. For more information please visit: www.bdo.com.

Material discussed is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.

© 2015 BDO USA, LLP. All rights reserved.