AN ALERT FROM THE BDO FINANCIAL SERVICES PRACTICE

ASSET MANAGEMENT INSIGHTS

PROPER EXPENSE ALLOCATION, VALUATION, AND INCOME RECOGNITION – REINFORCED BY RECENT SEC ENFORCEMENT ACTIONS

By Dale Thompson

In December 2018, the Enforcement Division of the U.S. Securities and Exchange Commission ("SEC") issued three enforcement actions involving a private equity fund manager and two business development companies. Below is a summary of each case highlighting the compliance issues identified in the enforcement action that can help firms evaluate their own compliance programs and better identify weaknesses and areas for improvement in their internal controls policies and procedures.

NB ALTERNATIVES ADVISERS LLC

Misallocation of an Affiliated Service Provider's Compensation Expense

On December 17, 2018, the SEC posted its fine against NB Alternative Advisers, LLC ("NBAA") related to the manner in which it allocated compensation-related expenses to certain private equity funds that it managed[1].

BACKGROUND

NBAA and its affiliates ("Neuberger") sponsored and managed three private equity funds, known as the "Dyal Funds." The investment objective of each Dyal Fund was to acquire minority stakes in alternative investment funds (i.e. hedge funds and private equity funds). Neuberger created a group of employees, referred to as the "Business Services Platform" or "BSP," to provide client development, talent management, operational advisory and other services, support and advice to managers of the underlying alternative fund investees. Pursuant to the Dyal Funds' organizational documents[2], the funds were responsible for paying the expenses relating to the utilization of the BSP up to a cap per fund, and Neuberger was responsible for all "compensation costs of [their] investment professionals" other than those related to the BSP.

FAILURE TO CONFORM TO THE EXPENSE ALLOCATION METHODOLOGY

Even though BSP and its employees provided advice and support to the underlying fund managers in which the Dyal Funds invested, which was consistent with the disclosures in

1 https://www.sec.gov/litigation/admin/2018/ia-5079.pdf
2 These include the Limited Partnership Agreement ("LPA"), Investment Management Agreement ("IMA") and Private Placement Memorandum ("PPM").

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the funds' offering documents, certain BSP employees spent a percentage of their time on tasks not related to the Dyal Funds and NBAA did not adjust the compensation expense allocated to the Dyal Funds to exclude the percentage of those employees' time that was not spent providing advice or support to the underlying fund managers.

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Every dollar an investor pays in fees and expenses is a dollar not invested. It is critically important that investors are provided with proper disclosures of the fees and expenses they pay for products and services and that advisers accurately calculate and charge fees in accordance with these disclosures. Advisers must assess their advisory fee, expense allocation and reimbursement practices and related disclosures to ensure that they are complying with the Investment Advisers Act ("Advisers Act"), the relevant rules, and their fiduciary duty, and that they review the adequacy and effectiveness of their compliance programs. The SEC will continue to review fees and expenses charged to advisory accounts, ensuring that the fees and expenses are assessed in accordance with the client agreements and firm disclosures.[3]

IMPACT OF FAILURE

By virtue of the above, of the $28.7 million in expense paid by the Dyal Funds to BSP from 2012 through 2016, approximately $2 million, or 7%, was paid for time spent on tasks not related to providing services, support and advice to managers of Dyal Funds' underlying alternative fund investees. The allocation of this amount to the Dyal Funds was inconsistent with the disclosures in the LPAs and the IMAs, which specified that the Dyal Funds would be responsible only for those expenses relating to the utilization of the BSP on their behalf, and not for any other expenses of NBAA or its affiliates. Despite this expense allocation policy, NBAA did not adopt or implement any written policies or procedures reasonably designed to prevent the misallocation of compensation-related expenses.

In addition to the SEC's order to cease and desist from any future violations under Sections 206(2) and 206(4) under the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder, the SEC also ordered NBAA to pay disgorgement of ≈ $2.1 million and prejudgment interest of $284,620. The full amount of ≈ $2.4 million will be distributed to the limited partners in the Dyal Funds based on the percentage of the BSP fee paid by each fund that was improperly allocated to the fund for each year during the relevant period.

KCAP FINANCIAL, INC.

Improper Characterization of Income and Distribution

On December 4, 2018, the SEC took formal action against KCAP Financial, Inc. ("KCAP")[4], an internally managed[5] business development company ("BDC"), related to its improper accounting and reporting of distributions that it received from its wholly-owned unconsolidated Asset Management Affiliates ("AMAs").

ACCOUNTING FAILURES

In short, KCAP failed to:

1. analyze the distributions it received from the AMAs to determine whether the distributions it received from the AMAs were paid from current or accumulated tax earnings and profit ("Tax E&P"), or another source; and
2. record those distributions—*with respect to both the income recognition and the nature of the distribution payments made to investors*—in conformity with Generally Accepted Accounting Principles ("GAAP").

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The SEC order noted that KCAP essentially used cash as a proxy for taxable income, and KCAP determined that, since the distributions from the AMAs came from cash, the distributions could be treated as dividends for tax and financial reporting purposes. It is therefore imperative that management of funds (i) make good-faith efforts in analyzing the distributions received by the funds from their underlying investments (or portfolio companies) to determine whether the distributions received were paid from current or accumulated Tax E&P, or another source; and (ii) record the distributions accordingly in conformity with GAAP. Management should seek out information (including tax returns, e.g. K-1 from an investee, and other periodic information) from the funds' investees making distributions to ascertain the source of such distributions from a Tax E&P perspective.

Income Recognition

GAAP allows distributions by investment companies to be recorded as dividends only when they are paid from current or accumulated Tax E&P. As it relates to distributions received from investees, ASC 946-320-35-5 states that "… distributions that represent returns of capital shall be credited to investment cost rather than investment income." Returns of capital, as defined in

3 See also the SEC's Risk Alert, *Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers*, issued in April 2018: https://www.sec.gov/ocie/announcement/ocie-risk-alert-advisory-fee-expense-compliance.pdf

4 https://www.sec.gov/litigation/admin/2018/34-84718.pdf

5 On December 17, 2018, KCAP announced it would convert to an externally managed BDC.

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ASC 946-320-20 Glossary, are "distributions by investment companies in excess of tax-basis earnings and profits."

Reporting of Distributions Made to Investors

Dividends paid to investors should be disclosed as a single line item on the statement of changes in net assets except return of capital distributions, which should be disclosed separately (ASC 946-20-50-8). The [foot]notes to the financial statements shall also disclose the tax basis components of [distributions] paid (that is, either from ordinary income, capital gains, or return of capital (tax-basis). Further, according to ASC 946-20-50-10, if management of a fund determines that a return of capital (tax basis) is likely to occur for the fund's fiscal year, although the exact amount may not be estimable, that fact shall be disclosed in a note to the interim financial statements.

INVESTMENT COMPANY ACT ("ICA") FAILURES

In order to maintain its status as a Regulated Investment Company ("RIC") for Federal income tax purposes, and to avoid paying an excise tax on undistributed income, KCAP distributed approximately 98% of its investment [taxable] income to shareholders each year, including the distributions it received from the AMAs that were improperly recorded as dividend income, through quarterly distribution payments. By failing to record the distributions it received from the AMAs in conformity with GAAP, a significant portion of the quarterly distributions KCAP paid to its shareholders also were a return of capital and not dividends. The SEC noted that the quarterly distribution payments were not accompanied by a contemporaneous written statement disclosing the source of the fund's distributions. Further, KCAP mistakenly believed that it could comply with requirements of the ICA at year end in connection with the preparation of its tax returns when it was able to determine its taxable income for the full year. Even when KCAP issued the 1099 Forms to its shareholders at year end, those 1099 also inaccurately described the characterization of the distributions as being entirely dividends because KCAP had recorded the distributions it received from the AMAs incorrectly.

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A BDC, or any other investment company registered under the ICA, needs to take great care to determine whether a distribution made to the investors is from a source other than its current-year or accumulated net income[6]. If it is determined that the source is other than from net income, the BDC must comply with the requirements under the ICA by contemporaneously sending a written notice to its stockholders disclosing the portion of the distribution from such other source.

ICA Requirements – Reporting of Distributions to Investors

KCAP's actions were determined to be in violation of Section 19(a) of the ICA, and Rule 19a-1 thereunder. The purpose of Section 19(a) and Rule 19a-1 of the ICA is to afford shareholders adequate disclosure of the sources from which the distribution payments are made so shareholders will not believe that a fund portfolio is generating investment income when, in fact, distributions are paid from other sources, such as shareholder capital (i.e. return of capital) or capital gains. Specifically, Rule 19a-1 under the ICA specifies that the contemporaneous written statement accompanying the distributions must be on a separate paper and clearly indicate what portion of the payment is from:

- net income (not including capital gains);
- capital gains; and
- paid-in surplus or other capital source.

Further, according to Rule 19a-1(e) the source or sources from which a distribution is paid shall be determined (or reasonably estimated) to the close of the period as of which it is paid without giving effect to such payment. If any such estimate is subsequently ascertained to be inaccurate in a significant amount, a correction thereof shall be made by a written statement pursuant to Section 19(a) of the ICA or in the first report to stockholders following discovery of the inaccuracy.

IMPACT OF FAILURES

As a result of the improper accounting and reporting, which occurred from 2010 to 2014,

- KCAP improperly recorded and distributed the entire amount (approximately $36 million) it received as taxable dividends when, in fact, approximately $22 million (62.3%) of the funds received from the AMAs were actually return of capital.[7]

6 According to Section 19(a) of the ICA, the "net income" is "… determined in accordance with good accounting practice and not including profits or losses realized upon the sale of securities or other properties…"

7 The improper recording of the distributions received as dividend income also has the effect of increasing net investment income and the adviser's incentive fee from net investment income.

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- KCAP Restated its financial statements for 2010, 2011, 2012, 2013 and for the first three quarters of 2014[8].
- KCAP determined also that it had a material weakness ("MW") in its internal controls over financial reporting regarding the way it recorded the distributions from its AMAs. Even though the accounting error was not quantitatively large as a percentage of net asset value or net income, the MW concluded by KCAP was due to the fact that the erroneous recording and recognition of the distributions was deemed material since it impacted tax-basis distributable income, which KCAP identified as one of two main metrics used by analysts and investors to evaluate BDCs.
- KCAP was ordered to cease and desist from committing or causing any violations and any future violations from the relevant sections of the Exchange Act and the ICA, and the Rules thereunder.

FIFTH STREET MANAGEMENT, LLC

Overstated Valuations and Misallocation of Adviser's Expenses

On December 3, 2018, the SEC posted its fine against **Fifth Street Management LLC** ("FSM") related to failures in its (i) valuation for two portfolio companies held by one of its BDCs and (ii) allocation of expenses for its two BDCs[9].

BACKGROUND

FSM was an investment adviser that provided investment advisory services to two externally managed BDCs (collectively the "BDC clients")[10], two Collateralized Loan Obligation ("CLO") funds, and a private hedge fund. FSM charged the BDC clients quarterly fees based on assets under management and the performance of the funds. FSM stopped being the BDC clients' adviser in October 2017[11].

MISALLOCATION OF THE ADVISER'S EXPENSES

According to Investment Advisory Agreements between FSM and the BDC clients, FSM was responsible for paying "the compensation and routine overhead expenses" of its personnel. FSM also allocated shared expenses to its clients.

During the period for the quarters ended June 30, 2013 through the year ended September 30, 2014, the SEC order noted that while FSM allocated *compensation* expenses for only eight or nine employees (from the total of 52 and 75 employees) to the BDC clients, it allocated essentially all the rent and other overhead expenses associated with its employees to the BDC clients. This over allocation of rent and other overhead expenses to the BDC clients aggregated ≈ $1.2 million.

In addition, from April 2014 until November 2014, FSM improperly allocated ≈ $119,000 to the BDC clients for the compensation of two FSM employees who assisted in preparing the registration statements for an FSM affiliate's initial public offering, the work of which is unrelated to FSM's advisory work for the BDC clients.

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Advisers must assess their advisory fee, expense allocation and reimbursement practices and related disclosures to ensure that they are complying with the Advisers Act, the relevant rules, and their fiduciary duty, and review the adequacy and effectiveness of their compliance programs. As noted earlier, the SEC will continue to review fees and expenses charged to advisory accounts, ensuring that the fees and charges assessed are not in contravention of the applicable advisory agreements, operating agreements, or other disclosures. For its examinations, the SEC will select firms with practices or business models that may create increased risks of inadequately disclosed fees, expenses, or other charges, or opportunities to shift expenses.

OVERVALUED INVESTMENTS

The investment portfolios of the BDC clients include loan investments to middle size private companies. In the portfolio for one of the two BDC clients (referred to as "BDC 1"), there were loans to two portfolio companies that were experiencing deteriorating financial performance and conditions. However, FSM's advisory personnel responsible for providing updated financial information about the portfolio companies repeatedly failed to update their revised revenue and EBITDA,[12] including growth projections for these two portfolio companies. As a result, the valuation models, which were maintained and executed by a separate group of personnel, reflected outdated and stale financial metrics. This then resulted in materially overstated valuations in BDC 1's financial statements that were included in its Forms 10-Q for periods ended March 31 and June 30, 2014, and Form 10-K for the period ended September 30, 2014.

8 KCAP had previously discovered the errors and had restated its financial statements in March 2015 for the accounting failures associated with the above.

9 https://www.sec.gov/litigation/admin/2018/33-10581.pdf. The SEC also found failures in FSM's written insider trading policy, which did not address the situation of using one client's material, nonpublic information for the benefit of another client.

10 Formal names were: Fifth Street Finance Corp. and Fifth Street Senior Floating Rate Corp.

11 In October 2017, FSM effectively sold the rights to become the investment adviser for the two BDC clients to Oaktree Capital Management, L.P. Subsequent to the closing of the sale transaction, Fifth Street Finance Corp. changed its name to Oaktree Specialty Lending Corporation and Fifth Street Senior Floating Rate Corp. changed its name to Oaktree Strategic Income Corporation.

12 EBITDA = Earnings before interest, taxes, depreciation and amortization.

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Valuation estimate of an illiquid investment generally utilizes a valuation model, the inputs of which usually contain unobservable inputs and other financial data related to the investment/investee. As part of the estimation process, data and information used should be accurate, complete, relevant, reliable and reasonably available at the time of the valuation.

The SEC order also noted that the related advisory personnel did not understand the level of review required, which may have caused their failure to flag incorrect or unreasonable valuation model inputs. In view of this, management should ensure that all personnel involved with the valuation receive adequate and frequent training so that such personnel fully understand the valuation requirements (i.e. ASC 820, *Fair Value Measurement*), and the need to ensure compliance with securities laws.

IMPACT OF FAILURES

As a result of the improper accounting and reporting, the effects, among other effects, include:

- Inaccurate books and records, including the financial statements, of the BDC clients;
- Sales and offering of BDC 1's shares during the relevant period were materially overvalued as a result of the materially misstated investment valuations[13];
- Further, because FSM received asset-based management fees, the over valuation of investments caused excess management fees paid by BDC 1 to FSM during the affected period;
- FSM being ordered ≈ $2 million in disgorgement, prejudgment interest of $334,546, and a civil money penalty in the amount of $1,650,000 to the SEC; and
- FSM was ordered to cease and desist from committing or causing any violations and any future violations.

13 When BDC 1's valuations were updated to reasonably reflect the portfolio companies' forecasted performance, BDC-1's stock price dropped 15% on February 9, 2015, when it filed its Form 10-Q for quarter-end December 31, 2014.

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