

INVESTMENT COMPANY CONSOLIDATION

To further the Division's mission to protect investors and facilitate informed investment decisions, the Division's Chief Accountant's Office periodically issues Guidance Updates to assist registrants.¹ This Guidance Update provides the views of the Division's Chief Accountant's Office regarding the presentation of consolidated financial statements for certain investment companies ("RICs") registered under the Investment Company Act of 1940 ("1940 Act") and investment companies that have elected to be treated as business development companies under the 1940 Act ("BDCs") that have wholly owned subsidiaries.²

Regulation S-X

Regulation S-X governs the form and content of, and sets forth the requirements for, financial statements filed pursuant to, among other statutes, the Securities Act of 1933 ("1933 Act") and the 1940 Act. As such, the provisions of Regulation S-X apply to financial statements filed by, among others, RICs and BDCs.

One of the topics addressed by Regulation S-X is the presentation of consolidated financial statements. Regulation S-X provides, in relevant part, as follows:

In deciding upon consolidation policy, the registrant must consider what financial presentation is most meaningful in the circumstances and should follow in the consolidated financial statements principles of inclusion or exclusion which will clearly exhibit the financial position and results of operations of the registrant. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one entity directly or indirectly has a controlling financial interest in another entity.³

The provisions of Regulation S-X that set forth additional, special rules for RICs and BDCs state that "[c]onsolidated . . . statements filed for [RICs and BDCs] shall be prepared in accordance with . . . [Article 3A quoted above] except that (i) statements of the registrant may be consolidated only with the statements of subsidiaries which are investment companies . . ."⁴



In reviewing the financial statements of RICs and BDCs, periodically the staff has discussed these provisions with registrants and their counsel and independent auditors. This guidance highlights examples of the variety of situations that might arise and result in questions concerning consolidation based on comments the staff has provided, and invites registrants and their counsel and independent auditors to contact the staff if they have further questions about the application of these requirements to their particular situations.

RICs that are Feeder Funds or Funds of Funds

The staff has observed that a RIC that is a feeder fund in a master-feeder structure, or a RIC that is a fund of funds in the same group of investment companies, may have “a controlling financial interest in another entity” for purposes of Regulation S-X. In a master-feeder arrangement, the securities issued by the master fund are the only investment securities held by the RIC feeder fund⁵ and may constitute a controlling financial interest in the master fund. A RIC that is a fund of funds may have a controlling financial interest in one or more of the underlying funds in the same group of investment companies as the fund of funds.

In the circumstances of a feeder fund, generally, the staff has taken the position that the financial presentation that is most meaningful is unconsolidated,⁶ provided that, among other things: (i) the feeder fund attaches the financial statements of the master fund to its financial statements;⁷ (ii) if the master fund is organized as a partnership,⁸ the feeder fund separately discloses on its statement of operations the net investment income, the net realized gain or loss, and the net change in unrealized gain or loss allocated from the master fund;⁹ and (iii) if the master fund is organized as a partnership,¹⁰ the feeder fund includes the net investment income and expenses allocated from the master fund in its net investment income and expense ratios in its financial highlights.¹¹ In the staff’s view, because a feeder fund typically is one of several investors in the master fund, such disclosure provides a meaningful and appropriately transparent presentation of the financial position and results of operations of the feeder fund.

In the circumstances of a fund of funds, generally, the staff has taken the position that the financial presentation that is most meaningful also is unconsolidated. A fund of funds typically invests in multiple underlying funds, may hold controlling financial interests in some underlying funds and non-controlling interests in other underlying funds, and the level of its interest in any particular underlying fund might fluctuate between controlling and non-controlling. In such circumstances, in the staff’s view, if the fund of funds were to consolidate the financial statements of certain of its underlying funds for certain periods, the resulting financial presentation may not be meaningful

and may be confusing to the fund of funds' investors. The staff notes, a fund of funds also should consider whether its investment in a single underlying fund is so significant to the fund of funds that its presentation of financial statements should be made in a manner similar to a master-feeder fund.¹²

BDCs with Wholly Owned Subsidiaries¹³

In reviewing registration statements and financial statements, the staff has observed¹⁴ a number of BDCs that have wholly owned subsidiaries, for example, in order to facilitate investment in a portfolio company. Certain of these BDCs do not consolidate such subsidiaries, even though the design and purpose of the subsidiary (e.g., a holding company) may be to act as an extension of the BDC's investment operations and to facilitate the execution of the BDC's investment strategy. As part of the registration statement and financial statement review process, the staff has generally suggested BDCs consolidate such subsidiaries, because the staff believes that consolidation provides investors with the most meaningful financial presentation in those statements.¹⁵ If a BDC has questions about preparation of its financial statements in this regard, the BDC may contact the Division's Chief Accountant's Office at 202-551-6918 or IMOCA@sec.gov.

Endnotes

- 1 In September 2013, the Division's Chief Accountant's Office issued a Guidance Update concerning certain subsidiaries of business development companies, available at <http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-07.pdf>.
- 2 Rule 1-02(aa) of Regulation S-X defines a wholly owned subsidiary as a subsidiary substantially all of whose outstanding voting shares are owned by its parent and/or the parent's other wholly owned subsidiaries.
- 3 Rule 3A-02 of Regulation S-X. See also Financial Accounting Standards Board Accounting Standards Codification (FASB ASC) paragraph 810-10-10-1.
- 4 Rule 6-03(c) of Regulation S-X. Article 6 of Regulation S-X applies to RICs. BDCs are not registered under the 1940 Act, but they register their securities under the 1933 Act on Form N-2. For purposes of Form N-2, "[a BDC] should comply with the provisions of Regulation S-X generally applicable to registered management investment companies. (See . . . Sections 210.6-01 through 210.6-10 of Regulation S-X . . .)." See Instruction 1.a to Item 8.6.c of Form N-2.

- 5 See section 12(d)(1)(E) of the 1940 Act (providing an exemption from the limitations in section 12(d)(1) on, among other things, a RIC investing more than 5% of its total assets in securities issued by another investment company, provided that, among other requirements, such securities are the only investment securities held by the RIC).
- 6 However, if the design and purpose of the master-feeder structure is for the master fund to be wholly owned by a sole feeder fund, the staff encourages registrants to consult with the staff on whether consolidated financial presentation would be the most meaningful.
- 7 See *also* SEC Staff Generic Comment Letter for Investment Company CFOs (Dec. 30, 1998), available at <http://www.sec.gov/divisions/investment/imlr1230.htm> (indicating that: (1) a feeder fund's shareholder report contains two sets of financial statements, one for the master fund and another for the feeder fund; and (2) in instances where the feeder fund and the master fund have different fiscal year-ends, the staff would not object if, at each feeder fund's year-end, the audited shareholder report of the feeder fund is accompanied by the latest audited shareholder report of the master fund and by an unaudited balance sheet of the master fund and schedule of investments of the master fund as of the date of the feeder fund's financial statements).
- 8 It is the staff's position that if the master fund is organized as a corporation, classification of the master fund's income in the feeder fund's financial statements depends upon the distribution policies of the master fund. Until it is distributed, income received by the master fund is recorded by a feeder fund as unrealized appreciation. See SEC Staff Generic Comment Letter for Investment Company CFOs (Nov. 2, 1995), available at <http://www.sec.gov/divisions/investment/noaction/1995/accountingcomment110295.pdf>.
- 9 See *generally* FASB ASC paragraphs 946-225-45-11 and 946-225-45-12. In accordance with FASB ASC paragraph 946-225-45-11, a feeder fund should separately disclose its allocated interest, dividends, and expenses when disclosing on its statement of operations its net investment income allocated from the master fund.
- 10 See *supra* note 8.
- 11 See *generally* FASB ASC paragraph 946-205-50-28.

- 12 See generally FASB ASC paragraph 946-210-45-7, and SEC Staff Generic Comment Letter for Investment Company CFOs (Nov. 7, 1997), available at <http://www.sec.gov/divisions/investment/noaction/1997/cfo110797.pdf>. The staff notes that this consideration should be made regardless of whether the fund of funds has a controlling financial interest or a non-controlling interest in the underlying fund.
- 13 See *supra* note 2.
- 14 The staff has also observed that some BDCs do not include in their financial statements disclosures required by FASB ASC paragraph 850-10-50-1 about certain transactions with investees that meet the definition of related parties in FASB ASC paragraph 850-10-20 (e.g., certain directly or indirectly held portfolio companies, including holding companies). BDCs are reminded of their obligations to comply with FASB ASC Topic 850, *Related Party Disclosures*, because disclosures about related party transactions are important for shareholders to understand the financial statements and make informed investment decisions.
- 15 In the staff's view, RICs in similar circumstances also should consolidate wholly owned subsidiaries (e.g., a RIC that uses a wholly owned subsidiary as a 'blocker').

This *IM Guidance Update* summarizes the views of the Division of Investment Management regarding various requirements of the federal securities laws. Future changes in laws or regulations may supersede some of the discussion or issues raised herein. This *IM Guidance Update* is not a rule, regulation or statement of the Commission, and the Commission has neither approved nor disapproved of this *IM Guidance Update*.

The Investment Management Division works to:

- ▲ protect investors
- ▲ promote informed investment decisions and
- ▲ facilitate appropriate innovation in investment products and services through regulating the asset management industry.

If you have any questions about this IM Guidance Update, please contact:

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