

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 84718 / December 4, 2018

INVESTMENT COMPANY ACT OF 1940
Release No. 33314 / December 4, 2018

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3995 / December 4, 2018

ADMINISTRATIVE PROCEEDING
File No. 3-18912

In the Matter of

KCAP Financial, Inc.

Respondent.

ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 9(f) OF THE INVESTMENT COMPANY ACT OF 1940, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 (“Exchange Act”) and Section 9(f) of the Investment Company Act of 1940 (“Investment Company Act”), against KCAP Financial, Inc. (“KCAP” or “Respondent”).

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (“Offer”) that the Commission has determined to accept. Respondent admits the facts set forth in Paragraphs 1 through 38 below, acknowledges that its conduct violated the federal securities laws, admits the Commission’s jurisdiction over it and the subject matter of these proceedings, and consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934 and Section 9(f) of the Investment Company Act of 1940, Making Findings, and Imposing a Cease-and-Desist Order (“Order”), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

SUMMARY

1. From at least 2010 through the third quarter of 2014 (the "relevant period") KCAP, a New York based company that elected to be regulated as a business development company ("BDC") under the Investment Company Act, received approximately \$35.8 million from its wholly-owned Asset Manager Affiliates ("AMAs") and improperly recorded and distributed the entire amount as taxable dividends when, in fact, approximately \$22.3 million (62.3%) of the funds received were actually return of capital.

2. Generally Accepted Accounting Principles ("GAAP") allow distributions by investment companies to be recorded as dividends only when they are paid from current or accumulated tax basis earnings and profits. KCAP recorded the entirety of the distributions as dividends despite the fact that it prepared quarterly tax accrual worksheets demonstrating that certain AMAs lacked current or accumulated tax basis earnings and profits from which to pay dividends in certain reporting periods.

3. In short, KCAP failed to: (i) analyze the distributions it received from the AMAs to determine whether the funds it received were paid from current or accumulated tax basis earnings and profits, or another source; and (ii) record the distributions in conformity with GAAP.

4. In order to maintain its status as a Regulated Investment Company ("RIC") for U.S. federal income tax purposes, and to avoid paying an excise tax on undistributed income, KCAP distributed approximately 98% of its investment income to shareholders each year, including income received from the AMAs, through quarterly distribution payments.

5. By failing to record the distributions it received from the AMAs in conformity with GAAP, however, a significant portion of the quarterly distributions KCAP paid to its shareholders also were a return of capital and not dividends. The quarterly distribution payments were not, however, accompanied by a contemporaneous written statement disclosing the source of the funds distributed. Instead, KCAP issued tax Forms 1099 to its shareholders at year end, but those Forms 1099 inaccurately described the distributions as dividends because KCAP had recorded the distributions it received from the AMAs incorrectly.

6. Although this accounting error was not quantitatively large as a percentage of net asset value or net income, KCAP determined that the erroneous recording and recognition of the distributions it received from the AMAs was material because it impacted tax-basis distributable

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

income, which KCAP identified as one of two main metrics used by analysts and investors to evaluate BDCs.

7. Accordingly, in March 2015, KCAP restated its financial statements for the years 2010 through 2013 and the first three quarters of 2014. In doing so, KCAP disclosed that the AMA distribution accounting error was material and that the company had identified a material weakness in the internal control over financial reporting regarding the way it recorded those distributions.

8. More specifically, KCAP disclosed in the restatement that its management had assessed the effectiveness of the company's internal control over financial reporting and determined that it "did not maintain effective internal control over financial reporting as of December 31, 2014."

9. Accordingly, as explained further below, KCAP violated the reporting, books and records, and internal accounting controls provisions of the Exchange Act and Investment Company Act as well as the payment and distribution provisions of the Investment Company Act.

RESPONDENT

10. KCAP is an internally managed, non-diversified closed-end investment company that elected to be regulated as a BDC under the Investment Company Act. KCAP is incorporated in the State of Delaware and is headquartered in New York City. KCAP's common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act and trades on the NASDAQ Global Select Market under the symbol "KCAP." Because KCAP has elected to be treated as an RIC for U.S. federal income tax purposes, and to avoid paying an additional excise tax, KCAP distributes to its shareholders each year approximately 98% of its net ordinary income.

FACTS

A. KCAP's AMAs

11. During the relevant period, KCAP invested in as many as four wholly-owned asset management companies. Even though the AMAs are wholly-owned subsidiaries of KCAP, in accordance with Article 6 of Regulation S-X, KCAP does not consolidate the AMAs' investments.

12. Instead, KCAP's AMA investments are reported at fair value in KCAP's financial statements. While the AMAs, unlike KCAP, are not public companies, they are required to have consolidated audited financial statements included in KCAP's annual reports on Forms 10-K pursuant to Rule 3-09 of Regulation S-X.

13. While the AMAs' financial statements can be filed on a consolidated basis, each AMA must separately file its own federal tax return. Both KCAP and the AMAs typically filed their tax returns in September of the following tax year (*i.e.*, KCAP and the AMAs filed their tax returns for tax year 2011 in September 2012), or several months after the filing of the financial statements for that corresponding year.

14. Although KCAP had the ultimate responsibility for complying with GAAP and the federal tax rules, because they lacked in-house tax expertise, KCAP and the AMAs engaged external tax advisers throughout the relevant period. The services provided by the external tax advisers included review of quarterly AMA tax accruals prepared by KCAP, tax return preparation for both KCAP and the AMAs, review of KCAP's Form-1099-DIV information, and review of the tax-related notes to the financial statements in KCAP's SEC filings.

15. KCAP financial executives served in those same capacities for the AMAs and were responsible for managing and reviewing the work of the external tax advisers.

B. Relevant Accounting and Tax Rules

16. FASB Accounting Standards Codification Topic 946 ("ASC 946") states that "[d]istributions that represent returns of capital shall be credited to investment cost rather than investment income." ASC 946-320-35-5. Returns of capital are "distributions by investment companies in excess of tax-basis earnings and profits." ASC 946-320-20-Glossary.

17. In addition, ASC 946-20-50-8 states that "[d]ividends paid to investors shall be disclosed as a single line item in the statement of changes in net assets except return of capital distributions, which shall be disclosed separately. The notes shall disclose the tax basis components of the dividends paid (that is, either from ordinary income, capital gains, or tax return of capital)."

18. Similarly, the relevant tax rule expressly states that dividends can only be paid out of current year earnings and profits (E&P) and/or accumulated E&P. IRS Rule, Topic 404 – Dividends. "[Dividends are] paid out of the earnings and profits of the corporation." *Id.*

C. KCAP's Distributions from the AMAs

i. Determining the Distribution Amount from the AMAs to KCAP

19. Each quarter, KCAP determined that the total amount of the distributions the AMAs paid it were "dividends" without regard to whether the AMAs had current or accumulated tax-basis earnings and profits from which to make the distribution. KCAP subsequently reported the AMA distributions as dividends in its current, quarterly, and annual SEC filings, the latter two of which were reviewed by its auditor.

20. During the first quarter of each year, KCAP prepared a consolidated AMA dividend budget based on actual results for the first quarter and estimates for the next three quarters. As the year progressed, KCAP updated the budget on a rolling quarter basis to reflect actual results by quarter.

21. The "dividend" budget for the AMAs did not take into consideration whether the AMAs had tax-basis earnings and profits as defined by GAAP and IRS rules. The AMAs determined how much cash was available for each to distribute by reviewing their bank statements and deducting the funds needed to pay their outstanding bills.

22. Essentially, KCAP and the AMAs 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 for tax and financial reporting purposes as dividends. KCAP did not, however, analyze the distributions from the AMAs for compliance with GAAP or the federal tax rules governing dividends.

ii. Information Indicating the Improper Classification of Distributions

23. Although KCAP recorded the AMA distributions as dividends, KCAP had certain information that should have prompted it to record significant portions of the AMAs' distributions as return of capital.

24. First, each quarter, and at year end, KCAP prepared, and the external tax advisers reviewed, spreadsheets tracking the AMAs' tax accruals. Throughout the relevant period, these AMA tax accrual spreadsheets reflected that certain of the AMAs had taxable losses, as well as accumulated Net Operating Losses ("NOLs"). Accordingly, it was not possible that all of the cash distributions from the AMAs to KCAP were made from tax-basis earnings and profits (current or accumulated) and, thus, could not properly have been recorded as dividends in conformity with GAAP.

25. Second, for virtually all the tax years during the relevant period, the AMAs filed tax returns correctly identifying that certain of the distributions to KCAP had not come from current or accumulated tax-basis earnings and profits.

26. More specifically, many of the AMAs' tax returns included tax Form 5452 ("Corporate Report of Non-Dividend Distributions"), which indicated that certain distributions were paid from sources "other than earnings and profits." Although the returns were prepared by the external tax advisers, KCAP received and reviewed copies of the AMAs' tax returns.

27. Because KCAP recorded the AMA distributions incorrectly in its books and records, however, the tax returns prepared for KCAP by the external tax advisers incorrectly treated the distributions as dividends instead of return of capital. KCAP also received and reviewed these tax returns and authorized their filing with the IRS.

D. KCAP's Earnings and Profits Analysis and Discovery of Error

28. One way to ensure that distributions are properly classified in conformity with ASC 946 as either a dividend or return of capital is to perform an Earnings and Profits Analysis ("E&P Analysis"). In an E&P Analysis, a company calculates its current year tax-basis earnings and profits as well as its historical tax basis earnings and profits to determine whether distributions are being made out of current or accumulated tax-basis earnings and profits.

29. Despite its practice of distributing approximately 98% of investment income each year and its external tax advisers' suggestion that it conduct such an analysis for the AMAs in the fall of 2013, KCAP did not perform its first E&P Analysis until early 2015 when its new auditor requested that KCAP complete one. KCAP subsequently hired new external tax advisers to

conduct an E&P Analysis, which identified the scope of the accounting error described above in March 2015 (before KCAP filed its 2014 Form 10-K).

E. The Restatement

30. On March 31, 2015, KCAP filed its 2014 Form 10-K, restating certain financial statements to correct the material error related to its accounting for the AMA distributions. Specifically, KCAP restated its financial statements for fiscal years 2010 through 2013, all quarters in 2013, and the first three quarters of 2014.

31. KCAP determined that the accounting error was material because it impacted the tax-basis distributable income, which KCAP identified as one of the two main metrics used by analysts and investors to evaluate BDCs.

32. In its restatement, KCAP disclosed that management had “identified that there was a material weakness in [its] internal control over financial reporting relating to the Company’s recording of distributions from its wholly-owned Asset Management Affiliates” and that “the Company did not maintain effective internal control over financial reporting as of December 31, 2014.” In an internal review memo assessing the company’s internal control over financial reporting, KCAP also noted that management had identified that there was a design deficiency in its system of internal control over financial reporting such that there was no control in place to ensure that the amounts received from its AMAs were properly recorded as dividends or return of capital. In short, regarding the way it recorded distributions it received from the AMAs, KCAP failed to adopt and implement policies and procedures that were reasonably designed to prevent violation of the federal securities laws.

33. As reflected in the following table, and pursuant to Item 301 of Regulation S-K, KCAP restated its selected financial data for the prior five years:²

| Year | Total AMA Dividend/Distribution | Amount Comprising Return of Shareholder Capital | Error % |
|-------------|--|--|----------------|
| 2010 | \$4,500,000 | \$4,500,000 | 100% |
| 2011 | \$1,910,000 | \$850,000 | 45% |
| 2012 | \$4,700,000 | \$3,485,002 | 74% |
| 2013 | \$12,750,000 | \$7,014,955 | 55% |
| 2014 | \$11,900,000 | \$6,432,086 | 54% |

F. Notices to Shareholders Accompanying Investment Company Distributions

34. As noted, in order to maintain its status as an RIC for federal income tax purposes, and to avoid paying an excise tax on undistributed income, KCAP distributed approximately 98%

² KCAP made the same accounting error with respect to the AMA distributions it received in 2008, recording all of the approximately \$1.3 million paid as dividends when the entire amount was actually a return of capital. KCAP received no AMA distributions in 2009.

of its investment income to shareholders each year, including income received from the AMAs, through quarterly distribution payments.

35. As a result of the accounting errors described above, a significant portion of the quarterly distributions KCAP made to its shareholders were return of capital and not dividends. At the time it paid the distributions, KCAP did not provide its shareholders with a contemporaneous written statement explaining the sources from which the payments were made.

36. KCAP did not send contemporaneous written statements to its shareholders because it mistakenly believed, based at least in part on the advice of counsel, that it could comply with Section 19(a) of the Investment Company Act 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.

37. Accordingly, KCAP attempted to communicate the sources of the distributions it made to its shareholders through the tax Forms 1099 it issued to them via its transfer agent in January of the following year. In January 2014, for example, KCAP issued Forms 1099 to its shareholders attempting to describe the distributions paid in tax year 2013.

38. As a result of the accounting errors described above, however, those Forms 1099 also were inaccurate. Thus, until the time of the restatement, KCAP never accurately disclosed to its shareholders the source of the distributions it paid them during the relevant period.

VIOLATIONS

39. Section 13(a) of the Exchange Act requires issuers with securities registered under Section 12 to file such periodic and other reports as the Commission may prescribe and in conformity with such rules as the Commission may promulgate. Exchange Act Rules 13a-1, 13a-11, and 13a-13 require the filing of annual, current, and quarterly reports, respectively. In addition to the information expressly required to be included in such reports, Rule 12b-20 of the Exchange Act requires issuers to add such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading. “The reporting provisions of the Exchange Act are clear and unequivocal, and they are satisfied only by the filing of complete, accurate, and timely reports.” *SEC v. Savoy Industries*, 587 F.2d 1149, 1165 (D.C. Cir. 1978) (citing *SEC v. IMC Int’l, Inc.*, 384 F. Supp. 889, 893 (N.D. Tex. 1974)). A violation of the reporting provisions is established if a report is shown to contain materially false or misleading information. *SEC v. Kalvex, Inc.*, 425 F. Supp. 310, 316 (S.D.N.Y. 1975).

40. Section 13(b)(2)(A) of the Exchange Act requires issuers with securities registered under Section 12 to “make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer.” Section 13(b)(2)(B) of the Exchange Act requires issuers with securities registered under Section 12 to devise and maintain a system of internal accounting controls sufficient to, among other things, provide reasonable assurances that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles.

41. Investment Company Act Rule 38a-1(a)(1) requires registered investment companies to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws.

42. Section 19(a) of the Investment Company Act prohibits investment companies from paying any dividend or making any distribution in the nature of a dividend payment, wholly or partly, from any source other than current-year or accumulated net income unless the payments are accompanied by contemporaneous written statements to shareholders disclosing the sources of the distributions. Rule 19a-1 thereunder specifies that the written statement must be on a separate paper and clearly indicate what portion of the payment is from: 1) net income (not including capital gains); 2) capital gains; and 3) paid-in surplus or other capital source. The purpose of Section 19(a) and Rule 19a-1 is to afford shareholders adequate disclosure of the sources from which the 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 or capital gains.

43. By engaging in the conduct described above, KCAP violated Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder; and Section 19(a) of the Investment Company Act and Rules 19a-1 and 38a-1(a)(1) thereunder.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent KCAP's Offer.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act and Section 9(f) of the Investment Company Act, Respondent KCAP cease and desist from committing or causing any violations and any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder as well as Section 19(a) of the Investment Company Act and Rules 19a-1 and 38a-1(a)(1) thereunder.

By the Commission.

Brent J. Fields
Secretary