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### SEC Issues Guidance to BDCs Regarding Consolidated Financials

Client Alert

November 17, 2014

On October 31, 2014, the Securities and Exchange Commission, through the Chief Accountant's Office of its Investment Management Division, issued a Guidance Update regarding whether wholly owned subsidiaries should be consolidated in the financial statements of business development companies (BDCs). The Guidance Update also addressed certain consolidation issues with respect to master-feeder structures and fund of funds that are not addressed in this client alert.

BDCs often create wholly owned subsidiaries solely to hold certain portfolio investments. For example, subsidiaries may be formed to serve as special purpose vehicles in connection with the establishment of secured credit facilities. In other instances, subsidiaries are formed to hold portfolio investments that have pass-through tax characteristics ("blocker corporations"). Under Rule 6-03(c) of Regulation S-X, investment company issuers (including BDCs) generally may only consolidate the financial statements of subsidiaries that are also investment companies.

In the Guidance Update, the SEC notes that it believes wholly owned subsidiaries that have been created in order to facilitate investments in portfolio companies should be consolidated into an investment company's consolidated financial statements. The SEC explained that when the design and purpose of a subsidiary is to act as an extension of the BDC's investment operations and to facilitate the execution of the BDC's investment strategy, it believes that consolidation provides investors with the most meaningful financial presentation. The SEC encouraged BDCs and their counsels to consult with the Chief Accountant's Office of its Investment Management Division if they have questions about whether to consolidate wholly owned subsidiaries.

In line with the PCAOB's recently adopted new auditing standard regarding related party transactions,<sup>[1]</sup> the SEC also reminded BDCs that they should include in their financial statements disclosures required by FASB ASC paragraph 850-10-50-1 about certain transactions with directly or indirectly held portfolio companies, including holding companies, noting that "disclosures about related party transactions are important for shareholders to understand the financial statements and make informed investment decisions."

The complete Guidance Update can be viewed at  
<http://www.sec.gov/investment/im-guidance-2014-11.pdf>.

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[1] In July of 2014, the PCAOB adopted new Auditing Standard No. 18 Related Parties (AS 18), which significantly revises the standards for the audit of related party transactions by independent auditors of public companies. The standard will become effective for audits of financial statements for fiscal years beginning on or after December 15, 2014.