

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 55931 / June 20, 2007**

**ACCOUNTING AND AUDITING ENFORCEMENT**  
**Release No. 2618 / June 20, 2007**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-12661**

**In the Matter of**

**ALLIED CAPITAL  
CORPORATION,**

**Respondent.**

**ORDER INSTITUTING CEASE-AND-DESIST  
PROCEEDINGS, MAKING FINDINGS, AND  
IMPOSING A CEASE-AND-DESIST ORDER  
PURSUANT TO SECTION 21C OF THE  
SECURITIES EXCHANGE ACT OF 1934**

**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”), against Allied Capital Corporation (“Allied” or “Respondent”).

**II.**

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over it and over the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 (“Order”), as set forth below.

**III.**

On the basis of this Order and Respondent’s Offer, the Commission finds that:

## Respondent

1. **Allied Capital Corporation**, incorporated in Maryland and headquartered in Washington, D.C., is a closed-end management investment company that has elected to be regulated as a business development company (“BDC”) pursuant to Section 54 of the Investment Company Act of 1940 (“Investment Company Act”). Allied provides privately negotiated debt and equity financing to middle market companies, with a primary focus on private finance. Allied’s securities are registered pursuant to Section 12(g) of the Exchange Act. Allied makes periodic filings with the Commission pursuant to Section 13(a) of the Exchange Act.

## Summary

2. From the quarter ended June 30, 2001 through the quarter ended March 31, 2003, Allied violated recordkeeping and internal controls provisions of the federal securities laws relating to the valuation of certain securities in its private finance portfolio for which market quotations were not readily available. During the relevant period, Allied failed to make and keep books, records, and accounts which, in reasonable detail, supported or accurately and fairly reflected certain valuations it recorded on a quarterly basis for some of its securities. In addition, Allied’s internal controls failed to provide reasonable assurances that Allied would value these securities in accordance with generally accepted accounting principles. Further, from the quarter ended June 30, 2001 through the quarter ended March 31, 2002, Allied failed to provide reasonable assurances that the recorded accountability for certain securities in its private finance portfolio was compared with existing fair value of those same securities at reasonable intervals by failing to: (a) provide its board of directors (“Board”) with sufficient contemporaneous valuation documentation during Allied’s March and September quarterly valuation processes; and (b) maintain, in reasonable detail, written documentation to support some of its valuations of certain portfolio companies that had gone into bankruptcy.

3. Allied has implemented new valuation processes, more detailed recordkeeping, and a series of additional controls and procedures over its valuation processes.

## Background

4. As a BDC, Allied is required to value its private finance security portfolio pursuant to the requirements in Section 2(a)(41) of the Investment Company Act. Because the large majority of Allied’s investments in its private finance portfolio are securities for which market quotations are not readily available, Section 2(a)(41)(B)(ii) of the Investment Company Act requires that Allied’s Board determine the fair value of its portfolio securities in good faith. The fair value of securities for which market quotations are not readily available is the price Allied would reasonably expect to receive on a current sale of the security.<sup>1</sup> By the end of the relevant

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<sup>1</sup> See AICPA Audit and Accounting Guide - Investment Companies (Sect. 2.35-2.39), which incorporates Accounting Series Release No. 118 (“ASR 118”). The Commission has provided interpretative guidance related to financial reporting in the Accounting Series Releases, which is included in the Codification of Financial Reporting Policies. Thus, conformity with the ASR 118 is required by Commission rules and is consistent with GAAP. See also Articles 1-01(a) and 6.03 of Regulation S-X.

period, Allied's private finance portfolio recorded at fair value grew to over \$1.7 billion, which represented approximately 65% of Allied's total assets, and included investments in approximately 152 portfolio companies.

5. From the quarter ended June 30, 2001 through the quarter ended March 31, 2003, however, Allied failed to make and keep books, records, and accounts which, in reasonable detail, supported the valuations of certain of its securities for which market quotations are not readily available ("private finance investments"). With respect to 15 private finance investments reviewed by staff, Allied could not produce sufficient contemporaneous documentation to support, or which accurately and fairly reflected, its Board's determination of fair value. Instead, in some instances, the written valuation documentation Allied presented to its Board for these investments failed to include certain relevant indications of value available to it (as further discussed below) and sometimes introduced changes to key inputs used to calculate fair value from quarter to quarter without sufficient written explanation of the rationale for the changes (*e.g.*, changes from EBITDA to revenue-based valuations and in some instances, changes in multiples used to derive enterprise value). The written valuation documentation retained by Allied for these private finance investments does not reflect reasonable detail to support the private finance investment valuations recorded by Allied in its periodic filings during the relevant period.

6. The following are three examples of insufficient recordkeeping of Allied's private finance investments during the relevant period.

7. **Company A** - During the relevant period, Allied held a debt investment in Company A, a telecommunications company. Allied was unable to produce contemporaneous written documentation, in reasonable detail, to support its valuation of Company A during the quarters ended June 30, 2001 and September 30, 2001. Specifically, Allied's valuation of Company A for these quarters was derived, in part, by including revenues from discontinued lines of business to establish fair value. Allied maintains that it used a reduced multiple to offset any potential overstatement that would have otherwise resulted from the inclusion of those revenues, but it did not provide the Board with contemporaneous written documentation, in reasonable detail, to support this claim. In addition, Allied did not retain the valuation documentation it presented to the Board for Company A for the quarters ended December 31, 2001 and March 31, 2002. Allied valued its \$20 million subordinated debt investment in Company A at \$20 million (*i.e.*, cost) in its Forms 10-Q for the quarters ended June 30, 2001 and September 30, 2001. In its 2001 Form 10-K and its Form 10-Q for the period ended March 31, 2002, Allied valued its \$20 million subordinated debt investment in Company A at \$10.3 million. Allied subsequently wrote down its subordinated debt investment in Company A to \$245,000 in its Form 10-Q for the quarter ended June 30, 2002.

8. **Company B** - During the relevant period, Allied held a subordinated-debt investment in Company B, a direct marketing company. Allied was unable to produce contemporaneous documentation, in reasonable detail, to support the basis for its valuation of Company B for the quarter ended March 31, 2003. Specifically, Allied's valuation was based, in large part, on a potential future buyout event by Allied that was preliminary in nature. Allied maintains that – as a general practice – the Board would have discussed why this particular potential future buyout event was significant enough to form the basis of its valuation of Company

B, but it could not provide contemporaneous written documentation in reasonable detail to support this claim. Further, Allied's valuation documentation did not fully reflect Allied's consideration of competing buyout offers for Company B, which, if accepted, would have reduced the fair value of Allied's investment. Allied valued its \$16.5 million subordinated debt investment in Company B at \$14.3 million in its Form 10-Q for the quarter ended March 2003. Allied subsequently wrote down its subordinated debt investment in Company B from \$14.3 million to \$50,000 in its Form 10-Q for the quarter ended June 30, 2003.

9. **Company C** - During the relevant period, Allied held a subordinated debt investment in Company C, an office supply company. Allied was unable to produce contemporaneous documentation, in reasonable detail, to support the basis for its valuation of Company C from the quarter ended September 30, 2001 through the quarter ended March 31, 2002. For example, Allied's written valuation documentation failed to include all relevant facts available to it regarding Company C's deteriorating financial condition, including the fact that Company C had lost one of its largest customers as a result of the terrorist attack on the World Trade Center. Allied valued its subordinated debt investment in Company C at \$8 million in its Forms 10-Q and Form 10-K for the quarters ended September 30, 2001 through March 31, 2002 and subsequently wrote that investment down to \$50,000 in its Form 10-Q for the quarter ended June 30, 2002.

10. Allied also failed to implement internal accounting controls relating to its private finance investment valuations that were sufficient to provide reasonable assurances that these valuations were fairly stated in accordance with generally accepted accounting principles, or other criteria applicable to its financial statements. For example, there were certain instances where Allied did not provide its Board (or its valuation committee) with sufficient written information to support the Board's determinations of fair value.<sup>2</sup> For example, in several instances, the written valuation documentation presented to the Board was incomplete or inadequate to support the fair value recorded by Allied (*e.g.*, enterprise values were listed on worksheets without any explanation; necessary inputs and/or calculations were either missing or incomplete). In other instances, Allied's valuation documentation during the relevant period contained unexplained departures from, or changes to, key inputs from quarter to quarter. During the relevant period, Allied did not provide its Board with written valuation documentation from prior periods. At least one Board member, however, maintained prior period valuation documentation during a portion of the relevant period, but Allied did not regularly provide the Board with comparative information about prior period inputs until the quarter ended September 30, 2003.

11. In addition, from the quarter ended June 30, 2001 through the quarter ended March 31, 2002, the valuation documentation presented to Allied's Board during the March and September quarterly valuation processes consisted of quantitative worksheets that failed to provide an adequate explanation of the various inputs. For example, changes in valuations from quarter to quarter were not always explained in reasonable detail in the written documentation. Moreover, Allied did not prepare a written description of the quantitative and qualitative analyses used to

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<sup>2</sup> Allied's failure to provide the Board with such information is inconsistent with the guidance in ASR 118 that a fund's board must satisfy itself that "all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered . . ." See *supra n.l.*

develop its valuations until the quarter ended June 30, 2002. During this period, Allied also failed to maintain, in reasonable detail, written documentation to support some of its valuations of certain portfolio companies that had gone into bankruptcy. While Allied maintains that its Board members and employees engaged in discussions before and during the Board meetings to satisfy themselves with the recorded valuations for Allied's private finance investments, the written valuation documentation retained by Allied for certain private finance investments does not reflect reasonable detail to support the private finance investment valuations recorded by Allied in its periodic filings during the relevant period.<sup>3</sup>

12. During the relevant period, Allied private finance department personnel typically recommended the initial valuations on the investment deals on which they worked. While there were some existing independent checks of Allied's valuation process, these checks, standing alone, did not provide a sufficient assessment of the objectivity of valuations of the private finance investments. For example, the valuation committee assigned to review each investment on a quarterly basis was comprised, in large part, of private finance managing directors and principals. Allied has since implemented new valuation processes, more detailed recordkeeping, and a series of additional controls and procedures over its valuation processes, including, but not limited to: quarterly valuation assistance from third-parties; and the establishment of a new Chief Valuation Officer position to oversee the valuation process.

13. As a result of the conduct described above, Allied violated Section 13(b)(2)(A) of the Exchange Act, which requires reporting companies to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect their transactions and dispositions of their assets. See, e.g., In the Matter of Morgan Stanley, Admin. Proc. File No. 3-11725, Exchange Act Release No. 50632, 2004 SEC Lexis 2573 (Nov. 4, 2004) (finding, in relevant part, that Morgan Stanley's failure to maintain documentation to support its bond valuations violated Section 13(b)(2)(A)).

14. As a result of the conduct described above, Allied also violated Section 13(b)(2)(B)(ii) of the Exchange Act, which requires reporting companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, or other criteria applicable to its financial statements. See, e.g., In the Matter of Morgan Stanley, Admin. Proc. File No. 3-11725, Exchange Act Release No. 50632, 2004 SEC Lexis 2573 (Nov. 4, 2004) (finding, in relevant part, that Morgan Stanley's failure to maintain internal controls sufficient to ensure that it valued its bond positions and its aircraft in accordance with GAAP violated Section 13(b)(2)(B)).

15. As a result of the conduct described above, Allied also violated Section 13(b)(2)(B)(iv) of the Exchange Act, which requires reporting companies to provide reasonable

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<sup>3</sup> Commission guidance provides that “. . . directors should take into consideration all indications of value available to them in determining the ‘fair value’ assigned to a particular security. The information so considered together with, to the extent practicable, judgment factors considered by the board of directors in reaching its decisions should be documented in the minutes of the directors’ meeting and the supporting data retained for the inspection of the company’s independent accountant.” See ASR 118.

assurances that the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

#### **IV.**

In determining to accept the Offer, the Commission considered remedial acts that were undertaken by Respondent and the cooperation that Respondent afforded the Commission staff.

#### **V.**

#### **Undertakings**

Respondent has undertaken for a period of two years from the entry of this Order to:

1. Continue to employ a Chief Valuation Officer, or a similarly structured officer-level employee, to oversee its quarterly valuation process.
2. Continue to employ third-party valuation consultants to assist in its quarterly valuation process for private finance investments in a manner consistent with the Respondent's current practices.

#### **VI.**

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

Accordingly, the Commission HEREBY ORDERS, pursuant to Section 21C of the Exchange Act, that:

- A. Respondent Allied cease and desist from committing or causing any violations and any future violations of Sections 13(b)(2)(A); 13(b)(2)(B)(ii) and 13(b)(2)(B)(iv) of the Exchange Act; and
- B. Respondent shall comply with the undertakings enumerated in Section V above.

By the Commission.

Nancy M. Morris  
Secretary