



February 14, 2012  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

File Reference No. 2011-200

Dear Ms. Cosper:

The Financial Reporting Executive Committee (FinREC) of the American Institute of Certified Public Accountants is pleased to offer comments on the proposed FASB Accounting Standards Update (ASU), “Financial Services—Investment Companies (Topic 946): *Amendments to the Scope, Measurement, and Disclosure Requirements*”.

We support the proposed ASU’s objective to develop, as part of a joint consolidation project, consistent criteria for determining whether a company is an investment company. We understand that in preparing this proposed ASU for issuance, the Board considered guidance from previously issued AICPA Statement of Position 07–1, *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*, which was deferred to allow the Board time to consider certain implementation issues arising from application of the SOP.

We are concerned that the proposed ASU does not provide an appropriate scope for Topic 946 and that the consolidation requirement for funds-of-funds may result in financial statements that are less meaningful for investors in a fund-of-funds. We would like to offer the following observations in connection with this proposed ASU:

### **1. Application of criteria**

The proposed ASU would require entities (other than those registered under the Investment Company Act of 1940) to meet all six criteria in paragraph 946-10-15-2 in order to be investment companies within the scope of Topic 946. There are numerous examples of entities that function as investment companies, and that have historically been considered investment companies, for which we believe the investment company accounting and financial reporting guidance contained in Topic 946 provides the most meaningful financial statement presentation for users, but which may fail to meet certain of the six criteria contained in the proposed ASU. For example:

- An entity formed by several individual investors to pool their money to invest in an entity for which the minimum investment is too great for each individual investor, or which would result in too great a concentration of risk for an individual investor to make the investment on his or her own, would fail the criterion to invest in multiple investments.
- Although paragraph BC29 indicates that the FASB concluded that money market funds would be considered to be managing their investments on a fair value basis since they attempt to minimize the difference between amortized cost and fair value, it could be argued that yield rather than fair value is the “primary measurement attribute” for many cash management funds, including money market funds.
- It is common for an entity that invests in fixed income securities to have a primary investment objective of income and a secondary objective of capital appreciation. If such an entity acquires short-term fixed income securities with the intent to hold them to maturity, the entity may not meet the requirement contained in the proposed ASU which states that “...an investment company whose express business purpose includes realizing capital appreciation should have an exit strategy for how it plans to realize the capital appreciation of its investments.”
- Examples of entities that may not meet the pooling-of-funds criteria, but which we believe should apply Topic 946, are provided in the “Pooling of funds criterion” section below.

To address the concern expressed above, that entities that should utilize investment company accounting and reporting but may not meet the scope criteria contained in the proposed ASU, we recommend a more subjective approach to determining whether an entity is an investment company within the scope of Topic 946, similar to the approach provided in AICPA Statement of Position 07-1. Under a more principles-based approach, certain criteria may be required, such as:

- The entity’s only substantive activities are investing for capital appreciation, income, or both; however, multiple investments would not be required to meet this criterion.
- The entity’s express business purpose (how it holds itself out to investors/potential investors) is to provide returns from capital appreciation, investment income, or both; however, exit strategies would not be required to meet this criterion.
- Fair value is an important measurement attribute in evaluating the performance of the entity’s investments; however, fair value should not be required to be the primary attribute by which performance is measured (as required by paragraph 946-10-55-16).
- The entity is a reporting entity.

Other criteria, such as pooling of funds, multiple investments, and exit strategies, should be indicators in determining whether an entity is an investment company.

As an alternative, if the Board decides to retain the proposed approach, we believe the criteria should be modified to remove certain requirements and provide exceptions to other criteria as outlined below:

- *Nature of investment activities* – Remove the requirement to invest in multiple investments. We believe there are many situations in which an investment company may hold one investment where application of Topic 946 is the appropriate financial reporting model. Holding a single

investment may be a factor to consider in determining whether an entity is investing for purposes other than capital appreciation or income and, therefore, whether it otherwise meets the “nature of investment activities” criterion, but should not preclude the determination that an entity is an investment company.

- *Express business purpose* – Revise the requirement that an investment company have exit strategies for its investments when its business purpose includes realizing capital appreciation to clarify that this requirement only applies to the investments that are acquired for capital appreciation. As such, investments acquired solely for investment income (by an investment company whose business purpose includes realizing capital appreciation) would not require exit strategies.
- *Unit ownership* – Revise the criterion to include debt issued by the entity that participates significantly in the entity’s economic risks and rewards. We don’t believe that expanding the unit ownership criterion to include this type of debt interest would result in typical mortgage-backed/asset-backed securitization structures being considered investment companies as the express business purpose criterion (the fact that these entities typically do not hold themselves out as investment companies) will generally preclude these structures from being investment companies.
- *Pooling of funds* – Revise the criterion to provide an exception when the parent entity is required or permitted to measure its investments at fair value through earnings (or changes in net assets where the entity presents a statement of changes in net assets rather than an income statement). Note that a parent entity generally would not be permitted to measure a controlling financial interest at fair value through earnings.
- *Fair value management* – Revise the criteria/guidance to indicate that if an investment is purchased primarily for investment income (for example, a short-term fixed income investment) that fair value is not required to be the primary attribute by which performance is measured (as required by paragraph 946-10-55-16). In this case, fair value must be a measurement attribute considered by management of the entity, but yield (income) may be the primary measurement attribute.

We recommend the final ASU include a more judgmental application of the scope criteria for determining whether an entity is an investment company within the scope of Topic 946. This approach would achieve an objective of more consistent reporting among entities for which investment company accounting and reporting is most relevant for financial statement users, but would not otherwise meet more stringent scope criteria contained in the proposed ASU.

## 2. Pooling of funds criterion

While we understand and share the Board’s desire to prevent abuses by limiting the application of investment company accounting when substantially all capital is contributed by related parties, we believe there are also situations where such accounting is appropriate – in particular, where the related parties would also be required or permitted to present the fund’s investments at fair value, with changes in fair value reported through earnings, if they held them directly. The most common example of this is the establishment of certain hedge, private equity, and venture capital funds as “co-invest” vehicles (managed in a manner parallel to funds that would clearly qualify as investment companies under the ASU), whose investors are limited to advisory personnel and their families, in order to allow them to participate in fund investment strategies without fees. Because these funds would have no substantive investment from other than related parties, they would not qualify as investment companies under the ASU. Financial statement presentation of co-invest vehicles commonly has been at fair value in practice, using investment company presentation, and we believe that this is appropriate for the following reasons:

- a. GAAP requires the use of fair value measurement in presenting investments in the financial statements of individuals.
- b. If the proposed ASU were adopted as drafted, financial statements for co-invest vehicles would not be comparable to financial statements for the funds they intend to parallel, even though they are managed for the same purpose and have substantially the same investments.
- c. Further, the prohibition on the use of investment company presentation in this instance presumes that investment company presentation is “decision useful” in managing capital provided by external investors but not for management of the employees’ *own* capital.

We do not believe opportunities for abuse exist when investments may be accounted for at fair value with changes in fair value reported in current earnings regardless of whether they were held directly or indirectly (through an investment company), and we believe that investment company presentation (including a schedule of investments and financial highlights) results in greater transparency and is a preferable alternative when substantially all related parties would otherwise employ fair value accounting for investment holdings.

It is also common for bank collective funds, limited partnerships, and similar vehicles to be established with only one substantive investor (or one group of related investors) and, in fact, some investors require advisers to establish such vehicles, parallel to existing multi-investor vehicles, to protect their interests, both legally and economically (that is, to not be subject to large cash inflows and outflows from other investors which may affect overall returns). In many instances, these single investors are pension plans (both private and government), sovereign wealth funds, endowments, or individuals (including family offices) which are required to present investment holdings at fair value under their specialized GAAP and recognize changes in fair value through earnings. Long-standing practice has been to account for these entities as investment companies and, for bank collective funds, the use of fair value accounting (and a reporting format similar to investment company presentation) is generally required under banking

regulations<sup>1</sup>. It is not uncommon for pension plans and other applicable entities to have multiple investments in these single investor vehicles. If these vehicles are not considered investment companies, we believe they would be disregarded or consolidated for financial reporting purposes. Requiring pension plans to record potentially hundreds or thousands of underlying investments in their financial statements may create a significant burden for these entities in obtaining the information needed to prepare their financial statements.

Where an entity holds itself out as an investment company and its investor is otherwise permitted or required to record investments at fair value through earnings, we do not believe the entity should be precluded from applying Topic 946 simply because it does not have multiple investors. Making “pooling of funds” an indicator or factor to consider would resolve our concern relative to this criterion. Alternatively, we recommend providing an exception for a single investor that is otherwise permitted or required to record investments at fair value through earnings.

### 3. Unit of ownership criterion

We believe that certain collateralized loan obligations (CLOs) or collateralized debt obligations (CDOs) that otherwise meet the criteria to be investment companies should not be excluded from the scope of Topic 946 as a result of the unit of ownership criterion. Illustration 13 in AICPA SOP 07-1 provided that a CLO would be considered an investment company even though it did not have a significant equity investment. The reasons given included that the CLO had pooled funds from numerous investors (debtholders of various classes, including classes that bore significant risks and rewards from the management of the investment portfolio), managed the portfolio for income and capital appreciation; made multiple investments with appropriate exit strategies; and was a separate entity. We understand the Board’s concern that the absence of a significant ownership (that is, equity) interest could result in the determination that many common securitization vehicles are investment companies. However, we believe the express business purpose criterion (and the fact that many such entities do not hold themselves out as investment companies) will prohibit such entities from being considered investment companies where they are not held out as such. We are concerned that situations could easily arise where one of the external investors in a CLO or similar vehicle may be required to consolidate it under ASC 810 as it has exposure to significant risks and rewards of the vehicle – clearly meeting the “return” criterion stated in the proposed ASU – but yet, the CLO itself is unable to be considered an investment company. We believe the substance of the interests issued by the entity should be considered rather than the legal form. Making “unit ownership” an indicator or factor to consider would resolve our concern relative to this criterion. Alternatively, we recommend permitting debt interests issued by an entity that participate in the significant economic risks and rewards of the entity to meet this criterion.

In addition, many equity interests in nonpublic investment companies were affected by FASB Staff Position FAS 150-3 (now codified in ASC 480-10-65) which deferred indefinitely the effective date of Statement 150 for certain entities and interests. Depending on the outcome of that deferral, it is possible that many redeemable equity interests of investors in private investment companies may be classified as liabilities and, as a result, they would no longer meet the definition of an investment company in the proposed ASU.

<sup>1</sup> See, for example, Office of the Comptroller of the Currency (OCC) Regulation 9.18(b)(6)(ii).

Lastly, we believe the Board should consider clarifying whether the unit ownership of an entity is required to represent a substantive or significant portion of the entity's capital structure. Since in the discussion of the pooling of funds criterion the proposed ASU indicates that investors unrelated to the parent must hold a significant ownership interest in the entity, we assume unit ownership must therefore be significant. However, guidance around what is meant by significant, possibly by analogy to other literature such as that related to variable interest entities, would be beneficial for preparers and practitioners.

#### **4. Consolidation of an investment company by an investment company parent—FinREC majority view**

The proposed ASU would require an investment company entity to consolidate other investment companies in which it holds a controlling financial interest in a fund-of-funds structure and to consolidate all investment property entities in which it holds a controlling financial interest. Investment companies often make investments in other investment companies to obtain the expertise of a third-party investment manager in a specific sector or asset class that cannot be easily replicated by the investing fund's manager. An investment adviser may also sponsor a proprietary fund-of-funds structure in order to provide an efficient mechanism to create an asset allocation strategy for investors. Likewise, an investment company may invest in a real estate fund meeting the proposed definition of an investment property entity in order to gain exposure to real estate that the fund itself could not easily access. In each of these examples, investment companies do not invest in the other investment vehicles in order to control them; rather, they seek an efficient mechanism to gain exposure to expertise within a specific sector or asset class or as a mechanism to efficiently develop an asset allocation strategy. The Board has already acknowledged that an investment company entity is different from a commercial entity by retaining the exception that an investment company should not consolidate a non-investment company investee. We believe a similar rationale for not consolidating a non-investment company investee is applicable for investments in other investment companies in most instances.

Additionally, while we believe that investors must have transparency into the types of investments and strategies used by the investment manager to achieve the fund's objectives, we question whether consolidation would provide meaningful transparency in many cases. For example, in a fund-of-funds structure, the "investor fund" may invest in five underlying investment companies (investee funds). Assume four of the investee funds represent 95% of the investor fund's net assets (with concentrations ranging from 20-30% of net assets and no control), while the fifth fund represents 5% of the investor fund's net assets and is controlled by the investor fund. In this example, we question whether users of the financial statements would receive the most relevant information about the investor fund's investment strategies and investments if the controlled investee fund were consolidated, as financial statement users would receive greater transparency and more information about an insignificant investment than they would about investments that are more significant to the net assets and performance of the investor fund. Additionally, we question more basically whether users would understand why a fund that has described itself in all its offering documents as a "fund-of-funds" is reporting a number of direct investments in securities in its financial statements.

While we understand that the investor's intent with respect to control is not considered under current GAAP as it relates to consolidation, we believe that it is an important consideration when determining the consolidation of another investment company. This is because transparency into investments that are significant to the investor fund's assets and performance is the most important objective in the context of an investment company's investment in another investment company. We believe that consolidation based solely on control does not achieve, and often may hinder, this objective. When control is the only consideration, it may easily result in a presentation that places emphasis on the wrong attributes and obfuscates, rather than enhances, users' understanding of the investment strategies and objectives of the investor fund.

Additionally, we have concerns about how the Board's proposal will impact insurance company separate accounts that issue variable annuity contracts and variable life insurance policies. It is common for an insurance separate account to invest its assets in underlying investment companies (mutual funds) that are chosen by the contract/policy holder. In many cases, the separate account may be the sole investor in certain proprietary investee funds and, therefore, would have a controlling financial interest in such funds. Again, we believe that this may not provide the most meaningful financial reporting to contract/policy holders, as they generally select the underlying fund (investment option) to which their assets are allocated. We believe a user of separate account financial statements would be confused to see many individual equity and debt investments rather than an investment in the investment company they selected.

We also question whether consolidation is necessary in circumstances where investee funds' financial statements are publicly available and investors can easily access the information (through websites of a regulator, the fund group and/or investment adviser). In these cases, investors have full transparency into the underlying investments and obligations of the investee funds. We believe this is similar to the master-feeder financial reporting model which the Board decided continues to be an appropriate presentation.

While we don't believe consolidation of an investee fund is warranted based solely on control, we do not believe that consolidation should necessarily be prohibited. We would encourage the Board to develop a framework to assist preparers when greater transparency (via consolidation or disclosure) is warranted. We suggest the following criteria could be used to assess whether greater transparency is needed:

- **Concentration of Net Assets:** Consideration should be given as to whether the investment in the investee fund represents a significant concentration to the investor fund's net assets. We believe that when a significant concentration exists, investors generally desire greater transparency to better understand the types of investments and obligations impacting performance.
- **Availability of Financial Statements:** In many cases, financial statements prepared in accordance with GAAP are prepared for investee funds and these financial statements are publicly available and easily accessible through websites of a regulator, the fund group, and/or the investment adviser. In addition, the investor fund often provides disclosure indicating the investment objectives of the

investee fund, the types of investments made by the investee fund, and where investors can obtain the investee fund's financial statements. We believe that when this information is publicly available, investors have the transparency needed to obtain information regarding the investments and obligations of the investee fund. Conversely, when investee funds represent a significant concentration of the investor fund's net assets and the financial statements are not publicly available, we believe that consolidation of the investee fund would be warranted in order to provide the level of transparency desired by an investor. In lieu of consolidation, we suggest the Board consider permitting that, if investee funds' financial statements are not publicly available, when significant, such investee funds' financial statements may be attached to the investor fund's financial statements, similar to a master-feeder presentation.

- **Amount of Investee Fund Debt/Leverage:** The greater the amount of leverage created by both debt and derivative transactions, the greater the need for transparency, as this activity could significantly impact the performance of the investor fund. Additionally, when the creditors of the investee fund have recourse against the investor fund with respect to the investee fund's obligations, consolidation may be warranted in order to provide investors the appropriate information to understand the extent of the obligations of the investor fund. Conversely, consolidation of an investee, which has issued debt without recourse to the parent's assets, may give an unwarranted impression that the parent's assets may be available for settlement of the debt. This may be particularly true if the parent's and investee's assets are combined in the investment portfolio without any ready means to distinguish which assets are and are not available for recourse.
- **Liquidity of Investments Held by Investee Fund:** It may be appropriate to assess the liquidity of the investee fund's investments to determine the length of time it may take the investee fund to monetize its investments. When the investee fund holds a material amount of illiquid investments, greater transparency may be warranted.
- **Nature of the Investment in the Investee Fund:** In most fund-of-funds structures, the investor fund invests in the investee fund to obtain returns from current income and capital appreciation. The investee fund is selected to obtain professional management with respect to a certain sector or asset class or, in a proprietary fund-of-funds structure, to create an efficient asset allocation strategy. At the time of investment, it is possible there are few investors in the investee fund and, as noted in our above example, this could lead to the investor fund having a controlling financial interest. However, in most cases this control will be diluted over time as new investors invest in the investee fund. While we acknowledge that temporary control is not a concept that GAAP considers in assessing consolidation, we believe that, in the case of an investment company consolidating another investment company, it is easy to foresee numerous instances of consolidation and deconsolidation from one period to another due to investor flows at the investee fund, which may result in financial statement presentation which is not meaningful to users.
- **Structure of Investment Company Complex:** It is important to consider whether the investment company was involved in the design or creation of the investee fund or whether the investee fund is in the same investment company complex when determining whether consolidation is appropriate.



When the activities of an investee fund represent an extension of the investor fund and the investee fund merely provides a mechanism for the investor fund to accomplish an objective indirectly that it cannot achieve directly, consolidation is appropriate. For example, investment companies may establish blocker entities which themselves meet the requirements to be investment companies, in order to “block” a certain tax or legal consequence. Commonly, registered investment companies create tax blockers through which they gain exposure to commodities. Without the blocker entity, the registered investment company may fail to meet the tax requirements to qualify as a Regulated Investment Company (“RIC”) established by the Internal Revenue Service, thereby losing the favorable tax status offered by the Internal Revenue Code. If it were not for this tax consequence, the Fund would have invested directly in commodities rather than investing through a blocker entity. General practice related to this issue is to consolidate the blocker entity.<sup>2</sup>

### **Consolidation of an investment company by an investment company parent—FinREC minority view**

While a majority of FinREC members hold the preceding views on consolidation, a minority of our members agree that the Board’s proposed consolidation requirement will enhance transparency. Those members believe the existing presumption in US GAAP that consolidated financial statements are usually necessary for a fair presentation when one of the entities in the consolidated group directly or indirectly has a controlling financial interest in the other entities<sup>3</sup> applies equally to investment companies. Those members also note the purpose and design of entities in a fund-of-funds structure are homogenous, compared to an investment company’s interest in a commercial operating entity. Lastly, those members believe a separate consolidation framework for investment companies as described above would add unnecessary complexity to US GAAP, i.e., a third model in addition to the models for voting and variable interest entities.

### **Consolidation of an investment company by an investment company parent – further comments**

The proposed ASU uses the terms “fund-of-funds” and “master-feeder funds.” However, these terms are not adequately defined and currently have varying meanings in practice. As such, the Board’s intent with respect to how the measurement criterion applies to these types of structures is unclear in certain situations. Traditionally, the investment funds industry has used the term “fund-of-funds” when the strategy consists of solely investing in other funds. In the traditional sense, the investing fund does not hold directly any individual investment of a commercial entity (non-investment company). We are unclear whether the Board intends for the measurement criteria to extend to situations where the reporting entity’s primary objective is to invest directly in investments of non-investment companies, however, may invest a portion of its assets in other investment companies. For example, many funds will sweep excess cash into a money market fund for cash management purposes or gain exposure to a particular asset class by investing in another investment company. It is possible that the investing fund

<sup>2</sup> See Securities and Exchange Commission (SEC) Division of Investment Management no-action letter to Fidelity on April 29, 2008, available at <http://www.sec.gov/divisions/investment/noaction/2008/fidelity042908.htm>.

<sup>3</sup> See ASC 810-10-10-1.

could take a controlling interest in the investee fund; however, it is currently unclear whether this constitutes a “fund-of-funds” structure as used in the guidance. If the Board intends that this type of investment be consolidated when the investing fund has a controlling financial interest, we suggest the Board clarify the guidance to indicate that an investment company shall consolidate any controlling interest in another investment company, except in a master-feeder structure.

With respect to “master-feeder funds,” we suggest the Board provide a definition of a master-feeder fund. The SEC literature<sup>4</sup> (Form N-1A) defines a master-feeder fund as a two-tiered arrangement in which one or more Funds (each a “Feeder Fund”) hold shares of a single Fund (the “Master Fund”) in accordance with section 12(d)(1)(E) of the Investment Company Act of 1940. We suggest the Board clarify the definition of a master-feeder fund under GAAP as a fund (the feeder fund) that invests substantially all of its assets in one other fund (the master fund). Additionally, we suggest that the Board explicitly require that the financial statements of the master fund be included with the feeder fund’s financial statements. Current SEC staff guidance<sup>5</sup> requires such presentation; however, existing GAAP is silent, and diversity of practice currently exists, in the case of non-registered funds. If a feeder fund is unable to provide the financial statements of the master fund, we suggest the Board require the feeder fund to consolidate its controlling financial interest in a master fund.

Lastly, the Board’s proposal to require a fund-of-funds to consolidate its controlling financial interest in an investee fund may result in operational difficulties and challenges for both reporting entities and their auditors. With respect to reporting entities, there may be challenges in obtaining the information required to consolidate controlled investees in a timely manner, particularly when investor flows at the investee fund level cause the magnitude of the fund-of-fund’s interest to fluctuate from period to period. Availability of timely information may be further complicated due to the proprietary nature of investment strategies of certain investment managers and the desire not to share information that could divulge such strategies. Consolidation also creates obstacles for auditors of fund-of-funds financial statements that may inhibit or preclude the audit of certain fund-of-funds financial statements. Auditors may also be challenged in connection with principal auditor considerations, particularly when the investee fund is part of a broader fund family that is audited by a different auditor than the reporting entity. This may result in undue costs and burdens to reporting entities, which ultimately get passed on to the investors.

## 5. Interaction with Investment Property Entity Proposal

There are currently similarities between this proposed ASU and the proposed ASU on Investment Property Entities (IPEs) both in terms of scope and in the framework for accounting and financial statement presentation that might be viewed as a reason to combine the two proposals into one standard. However, based on the various comments we have provided both in this letter and our comment letter on the IPE proposal, we believe there are significant issues remaining to be addressed as to appropriate

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<sup>4</sup> See Form N-1a, Section A, “Definitions.”

<sup>5</sup> See the December 30, 1998, “Dear CFO Letter” issued by the Chief Accountant of the Securities and Exchange Commission Division of Investment Management.



scope criteria, the issue of consolidation of investments, and other financial statement presentation issues that may cause these two projects to diverge in ways that warrant separate standards. FinREC's comment letter on the IPE proposal identifies several instances where we believe application of Topic 946 may not meet the needs of investors in certain types of real estate entities.

We recommend the Basis for Conclusions of both the IPE and investment company ASUs clearly explain why the Board created separate ASC Topics, if the Board proceeds in that direction, or alternatively, why one ASC Topic is appropriate. In addition, we believe it is critical for the FASB to describe the significant differences in the accounting and financial reporting by IPEs versus investment companies and its rationale for those differences (i.e., the primary financial statement user considerations, investor needs and other objectives that prompted the need for the different accounting and financial reporting models). In addition, as previously discussed, we believe the FASB should develop a more comprehensive financial reporting framework specific to IPEs. For example, the final IPE ASU should clearly indicate whether an IPE would be required to present a schedule of investments and financial highlights.

Lastly, given the uncertainty surrounding how the IPE proposal will progress, the types of investments that may ultimately be held by an IPE, and the accounting and financial reporting guidance that will be provided relative to investment properties, we are unable to form a view as to whether we agree or disagree with the aspect of this proposed ASU that would require application of Topic 973 to take precedence over Topic 946 for an entity that meets the criteria to be both an IPE and an investment company.

The Appendix to this letter includes our responses to the questions raised in the proposed ASU, our additional observations and suggested wording changes.

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We appreciate the opportunity to comment on the proposed ASU. Representatives of FinREC and Topic 946 comment letter task force are available to discuss our comments with Board members or staff at their convenience.

Sincerely,

Richard Paul  
Chairman  
Financial Reporting Executive Committee

Brent Oswald  
Chairman  
Topic 946 Comment Letter Task Force



## Appendix

### I. Questions for Respondents

#### Scope

**Question 1:** The proposed amendments would require an entity to meet all six of the criteria in paragraph 946-10-15-2 to qualify as an investment company. Should an entity be required to meet all six criteria, and do the criteria appropriately identify those entities that should be within the scope of Topic 946 for investment companies? If not, what changes or additional criteria would you propose and why?

**Not necessarily. As described above, we believe that the criteria are generally appropriate but that a principles-based approach to application should be utilized to ensure that entities are properly included in or excluded from scope.**

**Question 2:** The definition of an investment company in the proposed amendments includes entities that are regulated under the SEC's Investment Company Act of 1940. Are you aware of any entities that are investment companies under U.S. regulatory requirements that would not meet all of the proposed criteria in paragraph 946-10-15-2? If so, please identify those types of entities and which of the criteria they would not meet.

**We believe there are investment companies under U.S. regulatory requirements that may not meet all of the proposed criteria in paragraph 946-10-15-2. Certain business development companies (BDCs) may not meet the nature of investment activities in that substantially all of the entity's activities may not be investing for capital appreciation or income. For example, some BDCs have substantive loan origination activities. As described above, despite the fact that paragraph BC29 indicates that the FASB concluded that money market funds would be considered to be managing their investments on a fair value basis since they manage their investments to minimize the difference between carrying value and fair value, we believe it could be argued that fair value is not the "primary measurement attribute used to make a decision about the financial performance" of the investments as required by paragraph 946-10-55-16. Rather, yield may be the primary measurement attribute used to make decisions about the performance of investments and the fair value comparison to amortized cost may be a secondary factor. This may be particularly true in cases where credit quality of the investments is less of a concern; for example, U.S. Treasury securities. Questions have also been raised as to whether index funds would meet the express business purpose criterion of the exposure draft as their exit strategy is essentially a removal of a security from the related index, which may be very rare. For example, General Electric has been in the Dow Jones Industrial Average for more than 100 years (since 1907).**

**Question 3:** The proposed amendments would remove the scope exception in Topic 946 for real estate investment trusts. Instead, a real estate investment trust that meets the criteria to be an investment property entity under the proposed Update on investment property entities would be excluded from the scope of Topic 946. Do you agree that the scope exception in Topic 946 for real estate investment trusts should be removed? In addition, do the amendments in the proposed Updates on investment companies and investment property

entities appropriately identify the population of real estate entities that should be investment companies and investment property entities?

**We agree the scope exception for real estate investment trusts (REITs) should be removed from Topic 946. Our suggested principles-based approach and/or changes to the proposed criteria address our concerns regarding the scope of entities that should be considered investment companies.**

**Question 4:** The proposed amendments would require an entity to reassess whether it is as an investment company if there is a change in the purpose and design of the entity. Is this proposed requirement appropriate and operational? If not, why?

**We agree that an entity should reassess whether it is an investment company in certain instances; however, we are not certain what would constitute “a change in the purpose and design” of an entity. For example, a change in circumstances of an entity that is currently an investment company may result in the entity having a single investor or holding a single investment. We believe changes in circumstances of this nature should result in a reassessment of whether the entity is an investment company, but believe that some may not consider these changes to be changes in the purpose and design of the entity. We recommend that an entity reassess whether it is an investment company if there are changes in the entity’s purpose, design, or circumstances that could significantly affect the application of the criteria contained in paragraph 946-10-15-2.**

### **Nature of the Investment Activities**

**Question 5:** An entity may be an investment company when it performs activities that support its investing activities. As a result, a real estate fund or real estate investment trust (that is not an investment property entity) could be an investment company if the entity (directly or indirectly through an agent) manages only its own properties. However, the entity would be precluded from being an investment company if the other activities were considered more than supporting the entity’s investment activities (for example, construction). Is this requirement operational, and could it be consistently applied?

**We believe the guidance in the exposure draft that allows an investment company to perform activities that support its investing activities is operational, and will not result in significant inconsistencies in application.**

**Question 6:** The proposed implementation guidance includes examples of relationships or activities that would indicate that an entity obtains or has the objective of obtaining returns from its investments that are not capital appreciation or investment income. Do you agree with these examples? If not, how would you modify the examples while still addressing the Board’s concerns identified in paragraphs BC15 and BC16? 7

**We agree with the example relationships and activities that would indicate that an entity obtains returns from its investments that are not capital appreciation or investment income.**

## Unit Ownership and Pooling of Funds

**Question 7:** To be an investment company, the proposed amendments would require an entity to have investors that are not related to the entity's parent (if there is a parent) and those investors, in aggregate, must hold a significant ownership interest in the entity. Is this criterion appropriate? If not, why?

**As described above, we believe that in most cases this criterion is appropriate, but there are situations where we believe lack of meeting this criterion should not preclude an entity from being considered an investment company. As described above, we recommend a subjective approach to the application of certain proposed criteria, including unit ownership and pooling of funds.**

**Question 8:** The proposed unit-ownership criterion would require an entity to have ownership interests in the form of equity or partnership interests to be an investment company. The entity would consider only those interests in determining whether it meets the proposed pooling-of-funds criterion. Therefore, a securitization vehicle, such as a collateralized debt obligation, may not qualify as an investment company under the proposed amendments because it may not meet the unit-ownership or the pooling-of-funds criterion. The entity would not consider interests held by its debt holders when evaluating these criteria to be an investment company. For entities that do not have substantive equity interests (for example, those considered variable interest entities under Subtopic 810-10), should the unit-ownership and pooling-of-funds criteria to be an investment company consider interests held by debt holders? Please explain.

**As described above, we believe that debt interests that significantly participate in the risks and rewards of the entity should be considered when determining whether an entity meets the unit ownership criterion, regardless of whether the entity has substantive equity interests. We don't believe that the typical asset-backed/mortgage-backed security structures should generally be considered investment companies; however, we believe the express business purpose criteria (the fact that these entities typically do not hold themselves out as investment companies) is responsive to this concern.**

**Question 9:** Certain entities may meet all of the other criteria to be an investment company but have only a single investor (for example, a pension plan). The amendments in FASB's proposed Update on investment property entities provides that if the parent of an entity is required to measure its investments at fair value under U.S. GAAP or the parent entity is a not-for-profit entity under Topic 958 that measures its investments at fair value, the entity would not need to meet the unit-ownership and pooling-of-funds criteria to be an investment property entity. Considering the Board's concerns identified in paragraph BC24, should the criteria in this proposed Update be amended to address situations in which the entity has a single investor?

**We believe the principles-based approach described above would address this question. If a principles-based approach to the criteria is not taken, as described above, we believe there should be an exception to the pooling-of-funds criterion when the parent entity is required or permitted to measure its investments at fair value through earnings (or changes in net assets where the entity presents a statement of changes in net assets rather than an income statement). Note that a parent entity generally would not be permitted to measure a controlling financial interest at fair value through earnings.**



We believe another issue may arise with Small Business Investment Companies (SBICs) that are wholly owned by financial institutions. Small Business Administration (SBA) regulations require SBICs to present their investments for financial reporting purposes at fair value, and SBA accounting guidance specifically refers to the AICPA Audit and Accounting Guide *Investment Companies* (as well as GAAP promulgated by FASB) as sources of guidance in the preparation of SBIC financial statements.<sup>6</sup> Because these SBICs have only a single investor and are not registered as investment companies with the SEC, they too would no longer qualify for investment company presentation under the proposed ASU, although there has been a clear, long-standing regulatory expectation of this presentation. We believe that these entities should be given an explicit exemption to permit the use of investment company financial statement presentation, similar to that provided in the ED for those entities registered with the SEC under the Investment Company Act of 1940.

**Question 10:** The unit-ownership and pooling-of-funds criteria in the proposed amendments do not consider the nature of the entity's investors for evaluating if an entity is an investment company. That is, the criteria do not differentiate between passive investors and other types of investors. Do you agree that the nature of the investors should not be considered in evaluating the unit-ownership and pooling-of-funds criteria?

**In a principles-based approach described above, the nature of the investor may be a consideration in determining the application of the criteria that are indicators/factors to consider, including the pooling-of-funds criterion.**

See our general observations and response to Question 9 above. More generally, we believe that other criteria – particularly those relating to investment for other than income and capital appreciation – will adequately identify those investors whose presence would make the use of investment company financial statement presentation inappropriate. Thus, we do not believe there is a need for a separate requirement to consider the nature of the investors in determining whether an entity qualifies as an investment company.

### **Fair Value Management**

**Question 11:** The proposed amendments would require that substantially all of an investment company's investments are managed, and their performance evaluated, on a fair value basis. Do you agree with this proposal? If not, why? Is this proposed amendment operational and could it be consistently applied? If not, why?

**We agree that fair value should be an important measurement attribute in managing and evaluating the performance of investments held by an investment company. However, we do not believe it should be required to be the primary attribute by which performance is measured (as required by paragraph 946-**

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<sup>6</sup> See Appendix 14: *Accounting Standards and Financial Reporting Requirements for Small Business Investment Companies*, available at [http://archive.sba.gov/idc/groups/public/documents/sba\\_program\\_office/inv\\_standards.pdf](http://archive.sba.gov/idc/groups/public/documents/sba_program_office/inv_standards.pdf).



**10-55-16), particularly for short-term fixed income investments (whether held by an equity fund, fixed income fund, cash management fund, etc.).**

## **Interests in Other Entities**

**Question 12:** The proposed amendments would retain the requirement that an investment company should not consolidate or apply the equity method for an interest in an operating company unless the operating entity provides services to the investment company. However, the proposed amendments would require an investment company to consolidate controlling financial interests in another investment company in a fund-of-funds structure. An investment company would not consolidate controlling financial interests in a master-feeder structure. Do you agree with this proposed requirement for fund-of-funds structures? If not, what method of accounting should be applied and why? Should a feeder fund also consolidate a controlling financial interest in a master fund? Please explain.

**As described above, the majority of our members believe that transparency and not consolidation based solely on control is the most important objective relative to fund-of-funds financial reporting, although a minority of FinREC agrees with the Board’s proposal.**

**Additionally, we note that ASC 946 codified the AICPA Audit and Accounting Guide *Investment Companies* guidance that, if a fund-of-funds places a substantial amount of its assets in a single underlying fund, it should consider whether master/feeder presentation is more appropriate. Currently, there is no proposal to change this guidance in the proposed ASU. This could result in a fund-of-funds consolidating a controlling interest in an investee fund that represents a small portion of the fund-of-funds’ assets and attaching the financial statements of an investee fund that represents a significant portion of the fund-of-funds’ assets. We believe this “conflict” between consolidating a controlling interest in an investee fund and providing transparency into a significant investment in an investee fund is an important issue that needs to be addressed in the final ASU.**

**Question 13:** The proposed amendments would require an investment company to consolidate a controlling financial interest in an investment property entity. Should an investment company be subject to the consolidation requirements for controlling financial interests in an investment property entity? If not, what method of accounting should be applied and why?

**Given the uncertainty surrounding how the IPE proposal will progress, the types of investments that may ultimately be held by an IPE, and the accounting and financial reporting guidance that will be provided relative to investment properties, we are unable to form a view as to whether we agree or disagree with the aspect of this proposed ASU that would require application of Topic 973 to take precedence over Topic 946 for an entity that meets the criteria to be both an IPE and an investment company. Additionally, we address above our view regarding whether an investment company should consolidate another investment company, including an investment property entity.**





**Question 14:** The proposed amendments would prohibit an investment company from applying the equity method of accounting in Topic 323 to interests in other investment companies and investment property entities. Rather, such interests would be measured at fair value. Do you agree with this proposal? If not, why?

**We agree that the equity in earnings of an investment in another investment company does not provide any more meaningful information than the change in fair value of an investment in another investment company recorded as unrealized appreciation in the statement of operations.**

### **Presentation and Disclosure**

**Question 15:** An investment company with a controlling financial interest in a less-than-wholly-owned investment company subsidiary or an investment property entity subsidiary would exclude in its financial highlights amounts attributable to the noncontrolling interest. Do you agree that the amounts attributable to the noncontrolling interest should be excluded from the calculation of the financial highlights? If not, why?

**We agree that amounts attributable to a non-controlling interest should be excluded from the financial highlights of an investment company parent.**

**Question 16:** If an investment company consolidates an investment property entity, the proposed amendments require the investment company to disclose an additional expense ratio that excludes the effects of consolidating its investment property entity subsidiaries from the calculation. Do you agree? If not, why?

**We believe that an investment company should disclose an additional expense ratio that excludes the expenses of investment companies that are not wholly owned. In addition, this view would prevent the expenses of a wholly owned investment company (for example a legal or tax blocker entity) from being excluded from the additional expense ratio.**

**Question 17:** Do you agree with the additional proposed disclosures for an investment company? If not, which disclosures do you disagree with, and why? Would you require any additional disclosures and why?

**Given the broad definition of “investee”, we disagree with the requirement to disclose restrictions on the ability of investees to transfer funds to the investment company in the case of public company investees. There is not a significant benefit to obtaining dividend restriction information on each investment. Consider, for example, financial institution investees which may have restrictions on dividends resulting from regulatory capital requirements. To disclose the nature of the restrictions for each investment would be onerous and of little value to financial statement users.**

**With respect to the proposed requirement to disclose financial support, we believe the guidance should be revised to clarify that a new investment at the discretion of the investment company and typical troubled debt restructuring are not considered “financial support”.**

### **Retention of Specialized Accounting**



**Question 18:** The proposed amendments would retain the current requirement in U.S. GAAP that a noninvestment company parent should retain the specialized accounting of an investment company subsidiary in consolidation. Do you agree that this requirement should be retained? If not, why?

**We agree that the investment company accounting should be retained in consolidation.**

### **Effective Date and Transition**

**Question 19:** An entity that no longer meets the criteria to be an investment company would apply the proposed amendments as a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption by calculating the carrying amounts of its investees as though it had always accounted for its investments in conformity with other applicable U.S. GAAP, unless it is not practicable. If not practicable, the entity would apply the proposed amendments as of the beginning of the period of adoption. Do you agree with this proposal? If not, why?

**We agree with the proposed transition guidance for an entity that no longer meets the criteria to be an investment company.**

**Question 20:** How much time would be necessary to implement the proposed amendments?

**We recommend one full calendar year following the year of issuance of the ASU is needed to implement the proposed amendments.**

**Question 21:** The proposed amendments would prohibit early adoption. Should early adoption be permitted? If yes, why?

**We do not believe that early adoption should be permitted.**

### **Nonpublic Entities**

**Question 22:** The proposed amendments would apply to both public and nonpublic entities. Should the proposed amendments apply to nonpublic entities? If not, how should the proposed amendments differ for nonpublic entities and why?

**We believe the proposed amendments should apply to both public and non-public entities.**

## **II. Additional observations and proposed wording changes**

In paragraph 946-10-05-3, we believe the sentence that has been amended to read “[m]anagement investment companies may be open-end funds and closed-end funds (commonly known as mutual funds), special purpose funds, venture capital investment companies, small business investment companies, and business development companies” should read “[m]anagement investment companies may be open-end funds (commonly known as



mutual funds), closed-end funds, special purpose funds, venture capital investment companies, small business investment companies, and business development companies”. Mutual funds are open-end investment companies that issue redeemable shares.

We believe that the circumstances described in Example 2 on page 24 suggest that the entity is investing for purposes other than capital appreciation or income. However, the only reason cited that the entity is not considered an investment company is that it does not have exit strategies for its investments. Consider adding that the entity also may not meet the nature of investment activities criterion as the facts indicate that the entity is investing for purposes other than capital appreciation or income.

Paragraph 946-10-55-28(b) indicates that the Entity LP is not an investment company, since “[e]ntity LP’s substantive activities are considered other than for capital appreciation or investment income because Entity GP (an affiliate of Entity LP) is actively involved in the development and operation of the properties” and “...the development and operations of the properties represent a significant portion of the investee’s business activities.” We are uncertain what is meant by “operation of the properties”, but it appears that it may conflict with the guidance in the proposed ASU that allows an investment company to support its investing activities by managing the properties that it owns. We suggest this paragraph be modified to focus solely on the development activities as conflicting with the nature of investment activities criterion.

The “Consolidated” and “Excluding Investment Property Entity Subsidiary” expense ratios presented in paragraph 946-810-55-6 on page 44 are reversed (1.92% should be the consolidated ratio and 1.41% should be the ratio excluding the investment property entity subsidiary). As presented in the proposed ASU, these expense ratios do not correspond with the amounts presented on page 45.