STAFF PAPER

REG FASB | IASB Meeting

Project	Investment Entities / Investment Companies		
Paper topic	FASB Exposure Draft Feedback Summary		

CONTACT(S)	Kathryn Anderson	ksanderson@fasb.org	1-203-956-5264
	Marguerite Ward	mfward@fasb.org	1-203-956-5279
	Upaasna Laungani	ulaungani@fasb.org	1-203-956-5325

Purpose of This Memorandum

1. On October 21, 2011, the Financial Accounting Standards Board (FASB) issued proposed Accounting Standards Update, *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements* (FASB ED). The Boards and staff received feedback through comment letters, public roundtable meetings, and in-person meetings or conference calls with constituent groups, including preparers, auditors, users, valuation specialists, and regulators.

2. The comment period for the FASB ED ended on February 15, 2012. As of April 4, 2012, 93 comment letters were received and posted to the FASB website. The following table provides demographic statistics on the comment letters received:

Type of Respondent	Number
Preparers	49
Accounting firms and associations	16
Users	8
Industry associations	16
Others	4
Total	93

3. The Boards held five joint public roundtable meetings to discuss the FASB ED and the IASB Exposure Draft, *Investment Entities* (IASB ED). Those roundtables included more than 87 participants and were held in Toronto, London, Norwalk, and Kuala Lumpur.
4. Board members and staff participated in numerous in-person meetings or conference calls, on a confidential basis, to discuss the FASB ED and the IASB ED. The Board members and staff received feedback from approximately 55 users, including pension funds, endowment funds, and analysts, through these discussions.
5. The purpose of this memorandum is to provide the Boards with a summary of significant feedback received on the FASB ED. The staff plans to provide detailed feedback and recommendations received as it discusses each topic during the redeliberations process. The summary is organized as follows:
   (a) Overall Comments
   (b) Scope and Criteria to Be an Investment Company
   (c) Interests in Other Entities
   (d) Accounting by a Noninvestment Company Parent of Its Investment Company Subsidiary

(e) Presentation and Disclosure

(f) Reassessment of Investment Company Status

(g) Transition and Effective Date.

6. Generally, user views were consistent with views expressed by other constituents. The feedback is disaggregated by feedback received from users and feedback received from other constituents in areas in which user views differed from views expressed by all other constituents, including preparers, auditors, and regulators.

7. A summary of feedback received on the IASB ED is provided as Agenda paper 11/FASB Memo no. 45A for this meeting.

Overall Comments

8. Most constituents supported the FASB's position to retain and clarify its existing investment company guidance noting that fair value measurement of investments provides the most decision-useful information to users of investment company financial statements. Those constituents also supported the FASB's and the IASB's efforts to develop converged guidance for determining whether an entity is an investment company. Those constituents urged the Boards to arrive at a converged solution on areas in which the FASB ED and the IASB ED differ.

9. Some constituents stated that the proposals are one step toward convergence; however, the FASB and the IASB should work together to develop a complete converged standard for investment companies. In contrast, some constituents questioned the need for amendments to the current investment company guidance in U.S. generally accepted accounting principles (GAAP) because they stated that current U.S. GAAP for investment companies continues to provide meaningful information to its financial statement users and significant practice issues have not been identified by the industry.

10. Almost all constituents agreed that the proposed amendments should apply to both public as well as nonpublic entities. As such, feedback received from nonpublic entities was generally consistent with feedback received from public entities. Those constituents stated that there are very few differences between public and nonpublic investment companies in terms of the nature of their investment activities and express business purpose to warrant different accounting and reporting guidance for nonpublic entities. Those constituents also stated that users of nonpublic investment company financial statements have the same needs as users of public investment company financial statements and different guidance for nonpublic investment companies would result in a loss of comparability.

Scope and Criteria to Be an Investment Company

11. The guidance in the FASB ED would require an entity to meet the following six criteria to be an investment company:

    (a) *Nature of investment activities:* The investment company's only substantive activities are investing in multiple investments for returns from capital appreciation, investment income (such as dividends or interest), or both.

    (b) *Express business purpose:* The express business purpose of the investment company is investing to provide returns from capital appreciation, investment income (such as dividends or interest), or both.

    (c) *Unit ownership:* Ownership in the investment company is represented by units of investments, in the form of equity or partnership interests, to which a portion of the net assets are attributed.

    (d) *Pooling of funds:* The funds of the investment company's investors are pooled to avail investors of professional investment management. The entity has investors that are not related to the parent (if there is a parent) and those investors, in aggregate, hold a significant ownership interest in the entity.

(e) *Fair value management:* Substantially all of the investment company's investments are managed, and their performance evaluated, on a fair value basis.

(f) *Reporting entity:* The investment company provides financial results about its investment activities to its investors. The entity can be but does not need to be a legal entity.

12. In addition, under the guidance in the FASB ED, an entity that is regulated under the Securities and Exchange Commission's (SEC) Investment Company Act of 1940 (1940 Act) would be an investment company for accounting purposes.

13. Many constituents (mostly nonusers) expressed concern that requiring an entity to meet all six criteria to be an investment company is too prescriptive and would cause entities that currently follow investment company accounting to lose investment company status. Those constituents added that a more flexible approach to assessing the criteria would result in more consistent reporting by entities with similar business activities. Those constituents emphasized the application of judgment and presented the following two broad alternative approaches:

(a) A qualitative assessment of the proposed criteria in which an entity would not be required to meet all six criteria. Under this approach, an entity would consider the criteria in totality to determine if it meets the majority of the criteria.

(b) A principle to define an investment company with certain proposed criteria that would be required to be met and the remainder of the proposed criteria to be used as additional indicators that the entity is an investment company. Most of those constituents suggested that the principle should incorporate the nature of investment activities criterion and the express business purpose criterion. Some suggested that the pooling of funds criterion or the fair value management criterion should also be part of the principle.

14. Some constituents commented that the proposed criteria would capture the appropriate population of investment companies. Other constituents have raised concerns about aspects of the proposed criteria, because they stated that the criteria may inappropriately include or exclude certain entities from being investment companies. The remainder of this section summarizes feedback received on specific proposed criteria or other scope concerns raised by constituents.

Nature of Investment Activities

15. Most constituents agreed with the fundamental concept of the nature of investment activities criterion and stated that it is operational and could be consistently applied.

16. Most constituents agreed with the proposals that an investment company should be permitted to provide (or hold an entity that provides) services if the services relate to the investment company's investment activities and that an investment company also should be permitted to provide services to other entities only if those activities are not substantive. Some constituents suggested that the FASB provide additional implementation guidance to clarify the types of activities that would be considered more than supporting the investment company's investment activities and to define *substantive activities*.

Investment company returns: paragraph 946-10-55-7

17. Paragraph 946-10-55-7 of the FASB ED provides examples of relationships and activities between (a) the entity or its affiliates and (b) an investee or its affiliates (other than an investment company or an investment property entity) that would demonstrate that an investment company is investing for other than capital appreciation or investment income. Most constituents agreed with the examples but emphasized that the examples should not be a checklist but, rather, should be used as indicators that an entity would consider to determine whether or not it meets the

nature of investment activities criterion. A few constituents requested clarification of specific examples included in the paragraph.

18. Some constituents stated that the concept in paragraph 946-10-55-7 is essential to defining the business activities of an investment company and should be more prominent. Those constituents added that the principle for an investment company or the nature of investment activities criterion should state that an investment company should not obtain, or have the objective of obtaining, returns from its investment activities other than investment income or capital appreciation.

Multiple investments

19. The proposed amendments in the FASB ED would require an investment company to hold multiple investments, directly or indirectly through another investment company. However, at certain times during the investment company's life, such as during the initial offering period and during liquidation, the guidance in the FASB ED would permit an investment company to hold a single investment. The guidance in the FASB ED also permits an investment company to hold a single investment when the investment company is formed in conjunction with another investment company that holds multiple investments.

20. Many constituents stated that an investment company should be permitted to hold a single investment throughout the life of the entity. Those constituents explained that it is common for a single investment fund to be formed to pool money to invest in a single entity for which the minimum investment is too great for each individual investor, the investment is unobtainable by single investors, or the investment could result in too great a concentration of risk for an individual investor.

21. Many constituents stated that the requirement to hold multiple investments should not be a determinative factor but, rather, should be considered an indicator when assessing whether an entity is an investment company. Some constituents also noted that it is common for a real estate fund to hold one single investment

property. Those constituents highlighted that an investment property entity would not be required to hold multiple investments under the guidance in the proposed FASB Accounting Standards Update, *Real Estate—Investment Property Entities (Topic 973)* (FASB IPE ED). Additionally, some constituents were unclear whether the phrase *in conjunction* required the investment companies to be set up at the same time and stated that it is common for feeder fund or a co-investment fund to be set up at a much later date compared to the set up of the main fund.

Express Business Purpose

22. Almost all constituents agreed that the express business purpose criterion is fundamental to defining an investment company. In addition to the criterion itself, the proposed implementation guidance would require an investment company whose express business purpose includes realizing capital appreciation to have an exit strategy for its investments.

23. Some constituents noted that requiring an exit strategy would inappropriately exclude certain investment companies and may create structuring opportunities in which an entity could opt in and out of investment company status. Those constituents added that the exit strategy notion should be an indicator that an entity is an investment company rather than a determinative requirement.

24. Other constituents agreed with the exit strategy requirement in the FASB ED but requested that the Boards clarify the following related to the exit strategy requirement:

    (a) Whether an exit strategy would be required for each individual investment held for capital appreciation in circumstances when the entity intends to hold investments for capital appreciation and investment income purposes.

    (b) The application of the exit strategy requirement to certain entities such as the following:

(1) Index funds and exchange-traded funds that would sell an investment only to reflect changes in asset allocation strategies or the composition of the index.

(2) Tax-managed funds that pursue capital appreciation with the intent of minimizing taxable capital gains distributions to shareholders.

(3) Limited life entities in which investments are disposed of only when the entity is liquidated.

Unit Ownership

25. Many constituents questioned the requirement that ownership in an investment company be in the form of equity or partnership interests and stated that this requirement introduces complexity, including determining whether units in the legal form of equity are considered debt for accounting purposes. Those constituents added that the relevant factor to consider is whether the units issued by the entity represent a specifically identifiable portion of the net assets of the entity rather than the form of the units. In addition, several constituents expressed concern that the unit ownership criterion would inappropriately exclude separate accounts of an insurance company because the accounts are not in the form of equity or partnership interests but are a contractual relationship between the insurer and the policyholder.

26. Some constituents agreed with the FASB ED and stated that debt interests should not be considered when determining whether an entity is an investment company. Many constituents, however, stated that the unit ownership criterion should focus on whether ownership interests participate in the risks and rewards of the entity rather than the form of the interests. The main examples provided by those constituents were securitization vehicles such as collateralized debt obligations and collateralized loan obligations, which do not have substantive equity interests. Those constituents stated that many collateralized debt obligations and collateralized loan obligations currently follow investment company accounting

and reporting guidance and are concerned that the proposed unit ownership criterion would inappropriately exclude such structures from investment company guidance. Further, some constituents stated that in certain jurisdictions, investment funds with ownership interests in the legal form of debt receive tax advantages and such interests should be considered as part of the unit ownership criterion.

27. If the Boards decide that the unit ownership criterion should not consider debt interests, some constituents requested that the Boards clarify the amount of equity necessary to meet the criterion in an entity with a mixed capital structure. For example, an investment company may employ leverage strategies to provide higher returns to equity holders.

28. Some constituents stated that the unit ownership criterion should not be required. Others stated that the criterion should be an indicator rather a determinative factor. Those constituents added that the other criteria such as the nature of investment activities, express business purpose, and fair value measurement would appropriately identify investment companies.

Pooling of Funds

29. Most constituents expressed concerns with the pooling of funds criterion. Some constituents stated that this criterion should be eliminated. Some constituents stated that this criterion should be an indicator rather than a determinative factor. Other constituents stated that the criterion should not focus on the number, structure, or nature (passive vs. active) of the investors even though they agreed that the fundamental business of an investment company is to pool investor funds and provide professional investment management services. Those constituents stated that the nature of investment activities and express business purpose criteria along with paragraph 946-10-55-7, which provides examples of relationships and activities that would not be consistent with those criteria, adequately address the FASB’s concerns expressed in paragraph BC24 regarding the potential for an

investment company to be inserted into a larger corporate structure to achieve a particular accounting outcome.

30. Some constituents stated that the nature of investors should be considered as part of the pooling of funds criterion because the nature of investors may provide support that the entity's activities are for investment purposes as well as insight into the needs of the financial statement users. However, those constituents added that the nature of the investors should not be a determining factor by itself and judgment should be permitted when assessing the nature of investors.

Single investor funds

31. Many constituents expressed concern that the pooling of funds criterion would inappropriately exclude single investor funds that are established for the specific investment needs of an investor, for example, separately managed accounts, sovereign wealth funds, and investment funds wholly owned by pension plans and endowment funds. Those constituents stated that although these funds have a single investor, they represent the interests of multiple underlying investors.

32. Several constituents noted that the proposed amendments in the FASB IPE ED provide an exemption from the pooling of funds and unit ownership criteria if the parent entity is required to measure its investments at fair value under U.S. GAAP or is a not-for-profit entity under Topic 958, Not-for-Profit Entities, that measures its investments at fair value. Those constituents stated that a similar exemption should be provided for investment companies, but noted that the exemption as worded in the FASB IPE ED would not address all single investor fund concerns. For example, the exemption would not address concerns regarding sovereign wealth funds and separate accounts of insurance companies.

33. Many constituents also highlighted the fact that single investor funds could be formed to invest in the same investments as a main fund (commonly referred to as co-investment funds) to meet the investment needs of that investor, such as additional exposure to particular investments. Those constituents stated that such

funds have the same investment activities and business purpose as the main fund and should, therefore, be investment companies. In addition, those constituents noted that the guidance in the FASB ED does permit a single investor when the entity is formed in conjunction with its parent. However, those constituents are unsure whether the *in conjunction* guidance would apply in circumstances in which the co-investment fund is not set up at the same time as the main fund and the fund has one investor, such as a high net worth individual who also invests in the main fund.

Related parties

34. In addition, many constituents stated that the requirement that an investment company have investors that are not related to the parent (if there is a parent) would inappropriately exclude related party funds such as employee funds. A common example provided by many was of side-by-side or co-investment funds that are managed parallel to funds that would clearly qualify as investment companies under the proposed amendments in the FASB ED but whose investors are limited to employees and their families to allow them to participate in fund investment strategies without fees. Those constituents stated that related party funds should be investment companies because although capital is not provided by external investors, the funds are managed for the same purpose and have substantially the same investments as the parallel funds. Some of those constituents suggested excluding employees from the related party group used to evaluate this criterion or amending the criterion to refer to affiliates of the parent rather than related parties.

Fair Value Management

35. Many constituents stated that the fair value management criterion is essential to the business activities and purpose of an investment company. Those constituents stated that the criterion is operational and can be consistently applied. Other

constituents stated that the criterion should not be required but, rather, should be considered an indicator when determining whether an entity is an investment company. Further, some constituents stated that a criterion that would require an entity to consider whether its investors require fair value reporting should be added to determine whether the entity is an investment company.

36. Some constituents are concerned that the fair value management criterion is not operational and would not be consistently applied as currently drafted. Those constituents requested additional guidance to determine whether the following scenarios would meet the criterion:

    (a) Investments managed and their performance evaluated primarily on a yield (income) basis such as investments held in money market funds and fixed-income funds. Constituents stated that for those investments, fair value may be a measurement attribute considered by management, but yield (income) may be the primary measurement attribute used to make decisions about the financial performance of the investment. However, because yield affects the fair value of the investment and is a key component used in determining fair value, it is unclear whether the entity would meet the fair value management criterion.

    (b) Investments managed and evaluated based on another metric (such as internal rate of return), which constituents noted is common in the private equity industry.

    (c) Stable value funds that currently measure investments at fair value but transact with investors at contract value.

37. Some constituents noted that the guidance in the FASB ED is inconsistent with the IASB ED in describing how to assess whether an entity meets the fair value management criterion. In addition to fair value being the primary measurement attribute used to make a decision about the financial performance of investments, the Basis for Conclusions of the FASB ED would require an entity to consider

(a) how it transacts with its investors and (b) how asset-based fees are calculated to determine whether the entity meets the fair value management criterion. Those constituents urged the Boards to develop similar implementation guidance for this criterion to ensure that the criterion is consistently applied.

Investment Companies Regulated under the 1940 Act

38. Almost all constituents agreed that investment companies regulated under the 1940 Act also should be investment companies for accounting purposes to avoid keeping two sets of accounting records: one for regulatory purposes and one for accounting purposes. Many constituents support the approach in the FASB ED and stated that an investment company regulated under the 1940 Act should not be required to assess whether it meets the criteria to be an investment company. Those constituents are concerned that certain 1940 Act entities such as business development companies, equity index funds, money market funds, certain bond funds, and registered separate accounts of insurance companies may not meet all of the six proposed criteria.

39. Some constituents stated that all entities should assess the criteria to be an investment company regardless of whether they are regulated under the 1940 Act. That is because they think that it is inappropriate for accounting principles to link to regulatory requirements and highlight that the IASB ED does not link to regulatory requirements.

40. Several constituents recommended that rather than referencing a particular regulatory framework such as the 1940 Act, all entities subject to regulations that require fair value reporting should be investment companies. Those constituents stated that small business investment companies and bank common (collective) trust funds currently follow investment company accounting and are subject to regulations that require fair value reporting similar to investment company reporting under the 1940 Act. Those constituents stated that if these entities are required to meet all six criteria, they would not meet the pooling of funds criterion because they

are generally wholly owned by the sponsoring bank or related parties of the sponsoring bank. A few of those constituents stated that if regulated entities similar to those regulated under the 1940 Act are not automatically considered investment companies for accounting purposes, more flexibility in assessing the criteria rather than strict criteria also would allow those entities to continue to use investment company accounting.

Real Estate Investment Trust Scope Exception

41. Under current U.S. GAAP, real estate investment trusts (REITs) are specifically excluded from being investment companies. The guidance in the FASB ED would remove the REIT scope exception. Therefore, a REIT that meets the criteria to be an investment company would be required to apply investment company accounting, unless it meets the criteria to be an investment property entity under the FASB IPE ED.

42. Many constituents do not support the FASB IPE ED. Many of those constituents stated that a separate investment property entity concept should not be developed but, rather, an entity that focuses on investing in real estate properties should be assessed under the criteria to be an investment company. They also commented that entities that would otherwise meet the criteria to be an investment company should not be precluded from investment company accounting because they primarily hold real estate investments. (Additional feedback received on the FASB IPE ED will be summarized separately at a later date.)

43. Most constituents agree that the REIT scope exception should be removed whether or not they support the FASB IPE ED. Many of those constituents agree with the Basis for Conclusions in the FASB ED that it would be inappropriate to consider an entity's tax election when determining accounting requirements. Several of these constituents also noted that the IASB ED does not include a similar scope exception and, therefore, the scope exception should not be retained for convergence reasons.

44. Some constituents, primarily REITs, disagree with the removal of the REIT scope exception. Those constituents stated that if the FASB retains the reference to investment companies regulated under the 1940 Act, the REIT scope exception also should be retained because both scope considerations are linked to external rules. REITs stated that equity REITs would not meet the proposed criteria to be an investment company, but are concerned about the application of the criteria to mortgage REITs. REITs stated that the business model of a mortgage REIT is fundamentally different from the business model of an investment company because of the following significant reasons:

    (a) Mortgage REITs are not regulated under the 1940 Act.

    (b) Mortgage REITs are restricted in the types of securities in which they may invest, including restrictions on turnover of those securities.

    (c) Mortgage REITs can originate loans and are not restricted in their use of leverage.

    (d) Mortgage REITs do not manage on a fair value basis; rather, they manage their investments on a yield basis for the purpose of collecting contractual cash flows. Typically, securities held by mortgage REITs are classified as available for sale or held to maturity under current U.S. GAAP.

    (e) Investors in mortgage REITs do not have the same financial reporting needs as investors in investment companies because they do not evaluate their interests in mortgage REITs on the same basis

    (f) Investors do not transact with publicly traded mortgage REITs based on net asset value.

    (g) Management fees are not based on the fair value of assets held.

45. If the REIT scope exception is removed, mortgage REIT constituents suggested the following alternatives to address their concerns:

    (a) Add a criterion that would consider how the entity transacts with its investors. For example, an entity would be required to transact with its investors at current net asset value rather than a quoted share price to be an investment company.

    (b) Clarify the fair value management criterion to indicate that entities that manage and evaluate the performance of their investments primarily on a yield (income) basis would not meet the fair value management criterion.

    (c) Retain the current measurement, presentation, and disclosure framework followed by mortgage REITs, including the use of other comprehensive income for unrealized gains and losses.

    (d) Change the terminology from *investment companies* to *investment entities* to avoid confusion with the different definitions of investment companies under regulatory requirements and accounting requirements.

46. Users of mortgage REIT financial statements explained that the business activities of those trusts fall along a spectrum ranging from mortgage REITs mostly investing in agency mortgage-backed securities for returns from capital appreciation and investment income to commercial mortgage REITs that function similar to a bank that may originate small commercial loans. Those users stated that when analyzing their interests in mortgage REITs, information about net interest income and cash flows is more relevant than fair value. Users of mortgage REIT financial statements stated that investment company accounting would not provide incremental useful information. Some users stated that other-than-temporary impairment information currently provided would be lost if the assets held by mortgage REITs are required to be measured at fair value with all changes in fair value recognized in net income.

Interests in Other Entities

Controlling Financial Interests

47. The proposed amendments in the FASB ED would require an investment company to consolidate controlling financial interests in the following entities:

    (a) Another investment company in a fund-of-funds structure

    (b) An investment property entity

    (c) An operating entity that provides services to the investment company.

    All other controlling financial interests held by an investment company would be measured at fair value. The guidance in the FASB ED would not require a feeder fund to consolidate a controlling financial interest in its master fund in a master-feeder structure.

48. Almost all constituents agreed that an investment company should not consolidate controlling financial interests in an operating entity, unless that entity provides services to the investment company. Most constituents also agreed that a feeder fund should not consolidate a controlling financial interest in its master fund in a master-feeder structure. However, some requested that the FASB explicitly require master fund financial statements with each feeder fund's financial statements.

49. Most constituents disagreed with the development of a separate investment property entity concept and, therefore, did not support consolidation of controlling financial interests in an investment property entity.

50. A few constituents (nonusers) supported consolidation of controlling financial interests in a fund-of-funds structure as proposed in the FASD ED. Those constituents stated that consolidation would be consistent with the conceptual reasons for consolidation under current U.S. GAAP. Those constituents also agree with the Basis for Conclusions that consolidation of controlling financial interests in a fund-of-funds structure provides better transparency into the assets, liabilities, income, and expenses of the investment company subsidiary.

51. Most constituents, however, stated that controlling financial interests in another investment company should be measured at fair value and did not support consolidation of controlling financial interests in a fund-of-fund structure as proposed in the FASB ED. Those constituents also noted that the IASB ED does not require consolidation of controlling financial interests in a fund-of-funds structure. Some of those constituents stated that consolidation should be required for certain controlling financial interests in another investment company. The remainder of this section summarizes concerns raised and alternatives provided by constituents that did not support consolidation of controlling financial interests in a fund-of-funds structure as proposed in the FASB ED.

User feedback

52. All users generally disagreed with consolidation of controlling financial interests in a fund-of-funds structure. Those users stated that consolidation would clutter and distort the financial statements. Those users also stated that they are most interested in fair value information in the financial statements, including liquidity and valuation information provided through fair value disclosures, and financial highlight information that provides details about changes to net asset value. Some users stated that they use fair value information in the financial statements, particularly in the schedule of investments, to perform trend analysis and consolidation would complicate such analysis. Some also stated that consolidation of controlling interests in a fund-of-funds structure would not provide important leverage information because many alternative funds hold borrowings within an operating entity rather than an intermediary investment fund.

53. Although user views on consolidation of controlling financial interests in a fund-of-funds structure were generally consistent, views about disclosures in the notes to the financial statements about underlying assets, liabilities, income, and expenses were mixed.

54. Most users stated that they currently receive or can request from the asset manager detailed information about underlying investments such as leverage, expenses, and risk concentrations. Depending on the sophistication of the user, some users perform detailed analysis on the information provided outside the financial statements while other users rely on the asset manager to perform due diligence when making investment decisions.

55. Some users stated that information about underlying investments provided outside the financial statements is timelier and therefore more useful in performing risk analysis. Other users suggested that the financial statements include disclosures about underlying investment information. One user stressed the importance of the expense ratio and stated that the expense ratio should include expenses incurred by underlying funds. Some users stated that disclosures are especially necessary when underlying funds are nonpublic entities for which information is not readily available.

Feedback from nonuser constituents

56. Nonuser constituents requested clarification regarding various aspects of the proposed fund-of-funds consolidation requirement. Many constituents requested that a fund-of-funds structure and a master-feeder structure be defined. Many constituents also commented that the guidance in Topic 810, Consolidation, is generally not from an investment company perspective and, therefore, requested clarification on how to assess control in a fund-of-funds structure under that Topic, including amendments in proposed FASB Accounting Standards Update, *Consolidation (Topic 810): Principal versus Agent Analysis*. Several constituents also questioned how the consolidation guidance would apply to separate accounts of insurance companies.

57. Nonuser constituents raised both conceptual and operational concerns with the proposed consolidation requirement in a fund-of-funds structure. Significant concerns raised include the following:

   (a) Investment companies invest in another investment company to access an asset class or investment strategy and do not intend to control the investee or dictate how the investee's assets will be invested.

   (b) It is common for an investment company to have temporary control of another investment company due to subscription and redemption activity of other investors. Constituents stated that it would be operationally complex and not useful to consolidate an investment company subsidiary in one reporting period and to measure the same investee at fair value in another reporting period.

   (c) It may be difficult to obtain the information necessary to consolidate an investment company subsidiary because of different reporting period ends and unavailability of detailed information for nonpublic investment companies.

   (d) The proposed requirement would result in audit concerns, such as assessing which audit firm is the principal auditor and auditor independence issues. In addition, consolidation would increase audit costs because underlying investments of consolidated investee funds may need to be audited by both the auditor of the investee fund as well as the auditor of the investing fund. In addition, if the investee and investor funds have different year ends, the investee funds may need to be audited multiple times.

   (e) Consolidation would decrease the usefulness of investment company financial statements. Consolidation would give prominence to controlled investees regardless of their significance to the investment company's net assets and would result in mixed presentation of similar investments in which some investments would be measured at fair value and other investments would be consolidated. Constituents stated that investors in investment companies are most interested in fair value information and the effects on net asset value from fund performance.

58. Some constituents stated that controlling financial interests in a fund-of-funds structure should be consolidated in certain circumstances. Some of those constituents stated that investment company subsidiaries that are formed and controlled by the investment company for specific legal, tax, or regulatory reasons (such as a blocker entity) and are integral to the investment company's business purpose should be consolidated. Those constituents added that in these circumstances, the blocker entity is similar to an operating entity that provides services to the investment company and is not held as a passive investment to gain exposure to a particular asset class and to recognize investment income and capital appreciation. A few constituents stated that consolidation is appropriate when the investment company subsidiary is wholly owned because concerns with presentation of amounts attributable to noncontrolling interests and temporary control would not be relevant for wholly owned investment company subsidiaries.

59. In lieu of consolidation, some constituents suggested that an investment company parent's financial statements should be required to include the financial statements of an investment company subsidiary or, at minimum, provide information about where to obtain the financial statements. If financial statements are not publicly available, these constituents suggested that disclosures about investment strategies and activities of underlying funds should be required in the notes to the financial statements.

60. Many constituents stated that the FASB's concerns regarding transparency into the underlying assets, liabilities, income, and expenses of a controlled investee could be addressed through expanded disclosures in the notes to the financial statements rather than through consolidation of the controlled investee. Constituents provided various methods of providing information about controlled investees.

61. A few constituents recommended a principle-based assessment of whether additional transparency, through disclosures or consolidation, is warranted for a controlling financial interest in another investment company. One constituent recommended that this assessment should be based on criteria such as the nature of investment, the significance of the investment to the investment company parent's net assets, the availability of the investee's financial statements, the amount of leverage held by the investee, the liquidity of investments held by the investee, and the structure of the investment company complex.

Financial highlights

62. The guidance in the FASB ED would require financial highlights of an investment company that consolidates another investment company or an investment property entity to be calculated using consolidated amounts excluding amounts attributable to noncontrolling interests. In addition, if an investment company consolidates an investment property entity, the guidance in the FASB ED would require an additional expense ratio that excludes amounts attributable to the consolidated investment property entity.

63. If the FASB decides to retain the requirement that an investment company consolidate controlling financial interests in another investment company, most constituents agree that the financial highlights should exclude amounts attributable to noncontrolling interests. Those constituents stated that users of an investment company's financial statements are most concerned about returns on their proportionate share of the investment company. Further, those constituents stated that the FASB's decision to exclude amounts attributable to noncontrolling interests in the financial highlights is an indication that consolidation may not provide the most decision-useful information for users of investment company financial statements.

64. If the FASB retains the investment property entity concept and requires consolidation of controlling financial interests in an investment property entity,

many constituents agreed that an additional expense ratio should be provided excluding amounts attributable to the consolidated investment property entity. However, those constituents generally did not support retention of the investment property entity concept.

65. A few constituents did not support the proposed amendments to financial highlights requirements when an investment company consolidates another investment company or investment property entity. Those constituents generally did not support any exceptions to consolidations guidance for investment companies.

Equity Method Investments

66. The proposed amendments in the FASB ED would require an investment company to measure interests in entities over which it can exercise significant influence at fair value rather than apply the equity method of accounting, unless the investee is an operating entity that provides services to the investment company.

67. Users did not provide feedback on this aspect of the FASB ED. Almost all other constituents agreed with the proposal regarding an investment company's accounting of interests in entities over which it can exercise significant influence because they stated that fair value measurement for those interests would provide more meaningful information to users of investment company financial statements. Further, some stated that the proposal would not cause significant change in practice because of the ability to apply the net asset value practical expedient under current U.S. GAAP. Some constituents highlighted that the proposed measurement requirements for interests that would otherwise qualify for the equity method of accounting are conceptually inconsistent with the proposed requirement to consolidate controlling financial interests in a fund-of-funds structure.

68. Two constituents commented that they currently separately present certain items such as net income from operations and changes in fair value when applying the equity method of accounting. Those constituents questioned whether similar

disaggregation of fair value changes would be permitted under the proposed requirements for investments that would otherwise qualify for the equity method of accounting.

Accounting by a Noninvestment Company Parent of Its Investment Company Subsidiary

69. Current U.S. GAAP requires a noninvestment company parent to retain the specialized accounting applied by an investment company subsidiary in its consolidated financial statements. The FASB ED would not change this guidance.

70. Almost all constituents supported the retention of specialized accounting at the noninvestment company parent level. Those constituents agree with the reasons provided in the Basis for Conclusions and added that consolidation of an investment company subsidiary by a noninvestment company parent does not change the substance of the investment company's activities and the relevance of reporting the investment company's investments at fair value. Some of those constituents also highlighted operational concerns such as the need to prepare and maintain two sets of financial records if the noninvestment company parent is not permitted to retain the specialized accounting applied by the investment company subsidiary.

71. A few constituents stated that retention of the specialized accounting applied by an investment company subsidiary may not be appropriate if the subsidiary is wholly owned more than temporarily or if the subsidiary has similar business objectives to the noninvestment company parent so that it represents an extension of the parent's operations. Those constituents are concerned about possible structuring opportunities in which a noninvestment company could avoid consolidation of controlled operating entities by inserting an investment company subsidiary.

Presentation and Disclosure

Real-Estate-Property-Specific Requirements

72. The guidance in the FASB ED would require an investment company to separately present rental revenue and rental operating expenses from real estate properties. It also would require separate presentation of the fair value of real estate properties held and any debt associated with the real estate properties. In addition, for real estate properties held either directly or through a consolidated subsidiary, an investment company would be required to disclose the following items:

    (a) Amounts recognized in net income for direct operating expenses, separately for properties that generated rental revenue and those that did not generate rental revenue

    (b) Restrictions on the ability to increase rent, collect rent, or collect proceeds on the sale of properties

    (c) Any contractual obligations related to real estate properties.

73. Only a few constituents (all nonusers) commented on the real-estate-specific presentation and disclosure requirements. Most of those constituents disagreed with the proposed requirements, questioning why real estate property investments have been specifically identified as requiring additional presentation and disclosure. Those constituents disagree that further disaggregation of fair value changes is necessary or useful for users of investment company financial statements and that it would be inconsistent with an investment company's business purpose. One constituent representing a real estate industry association suggested that both gross and net presentation of real-estate-property-specific items should be permitted depending on an assessment that considers fund strategy, structure, management, and investor needs.

Disclosure of Financial Support

74. The guidance in the FASB ED would require an investment company to disclose whether it has provided financial support to any of its investees that it was not previously contractually required to provide or whether it intends to provide such support.

75. Users did not provide feedback on this proposed disclosure requirement. Many other constituents disagreed with the requirement to provide disclosures about financial support the investment company *intends* to provide and financial support that is not contractually required. Some constituents noted operational difficulties associated with identifying and describing future plans or the intent to provide financial support. Those constituents recommended that the disclosure be limited to contractual obligations.

76. Constituents in the private equity and venture capital industry stated that plans to provide financial support are confidential and could disadvantage the fund in negotiations with investees or open the fund to litigation risk. In addition, those constituents are concerned that these disclosures may be viewed as binding commitments.

77. Some constituents requested clarification about the definition of financial support. Constituents were unclear whether capital infusions or expenditures related to restructurings by funds invested in high-yield securities or defaulted securities would be considered financial support.

Disclosure of Dividend Restrictions

78. The proposed amendments in the FASB ED would require an investment company to disclose the nature and extent of any significant restrictions on the ability of investees to transfer funds to the investment company in the form of cash dividends, interest, or repayment of loans or advances.

79. Users did not provide feedback on this proposed disclosure requirement. Many other constituents stated that this disclosure requirement would not be practical and would not increase the usefulness of information provided to users of financial statements. Those constituents are particularly concerned about investment funds that hold hundreds of investments because it would require an investment company to search financial statements, debt covenants, and other agreements issued by each investee to determine if any dividend restrictions exist.

80. Those constituents noted that investment companies regulated under the 1940 Act are currently required to provide disclosures about nonincome producing and defaulted securities and most private equity investments have restrictions on distributions. Therefore, those constituents stated that this disclosure requirement would not provide additional useful information.

Reassessment of Investment Company Status

81. The guidance in the FASB ED would require an entity to reassess whether it is an investment company if there is a change in the purpose and design of the entity. Users did not provide feedback on this aspect of the FASB ED. Almost all other constituents agreed with the proposed reassessment guidance and noted that a change in status would be rare.

82. To ensure consistent application, many constituents asked for additional guidance or examples to determine which types of changes would qualify as reconsideration events. Those constituents stressed that normal operational events such as sales of investments or redemptions by investors leading to the entity holding a single investment or having a single investor should not qualify as a change in purpose and design of the entity.

Transition and Effective Date

83. The proposed amendments in the FASB ED would be effective for an entity's interim and annual reporting periods in fiscal years that begin after the effective date. Earlier application would be prohibited.

84. An entity that no longer meets the criteria to be an investment company would recognize 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.

85. An entity that historically was not an investment company but meets the criteria of an investment company as a result of the proposed amendments, the entity would apply the proposed amendments as of the effective date and record an adjustment to opening net assets.

86. Users did not provide feedback on this aspect of the FASB ED. The feedback summarized below was received from nonuser constituents.

Transition Requirements

87. Most constituents agreed with the proposed transition requirements. Some disagreed with the transition requirements for an entity that is no longer an investment company as a result of the proposed criteria. Many of those constituents stated that most entities would apply the practicability exception because the proposed cumulative-effect adjustment to retained earnings by calculating the carrying amounts of the entity's investees as though it had always accounted for its investments under other applicable U.S. GAAP would generally not be practicable. Some disagreed with retrospective application for an entity that is no longer an investment company while requiring prospective application for an entity that

becomes an investment company because they stated that requiring all preparers to apply the guidance prospectively would result in greater comparability.

Time to Implement and Early Adoption

88. Most constituents stated that at least one year and up to two years would be necessary to implement the proposed amendments. However, some of those constituents stated that additional time would be necessary to implement the requirement to consolidate controlling financial interests in a fund-of-funds structure to allow for systems upgrades and implementation of additional control procedures.

89. Many constituents agreed that early adoption should be prohibited because of comparability concerns. Some constituents stated that early adoption should be permitted when management determines that adoption would improve the information provided to users of their financial statements.