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| Project | Investment Entities / Investment Companies | | |
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| Paper topic | Definition and Factors | | |
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Purpose of this Memorandum

1. At the May 21, 2012 joint meeting, the Boards decided an entity would be required to meet a definition and also consider additional factors to determine whether it is an investment company¹. At that meeting, the Boards tentatively decided on the definition of an investment company. The definitions decided upon by each Board are provided in Appendix A.
2. At the May 2012 joint meeting, the FASB decided that ‘fair value management’ would be a factor to consider whereas the IASB decided that ‘fair value management’ would be part of the definition of an investment entity. The FASB’s fair value management factor also is included in Appendix A.
3. At the same meeting, the Boards also discussed whether an entity should consider the following factors to be an investment company:
 - (a) Number of investments and investors
 - (b) Whether the investors are related parties

¹ For the purpose of these agenda papers, the terms *investment entity* and *investment company* are used interchangeably.

(c) Unit ownership.

The Boards asked the staff to further explore how those factors would interact with the definitions decided by each Board. This memo analyzes the factors above and how the factors interact with the definition.

4. The approach to investment company guidance decided on by the Boards at the May 2012 joint meeting will be referred to as the ‘definition and factors’ approach in this paper.

Summary of staff recommendations

Unit ownership

5. The staff does not think that the guidance about ownership interests should be removed completely. The staff continues to believe that unit ownership should be a factor to be considered rather than part of the definition.
6. However, if the Boards believe that some securitization vehicles should not qualify as investment companies, the staff has the following recommendations:
 - (a) Some staff members would require ownership interests to be in the form of equity or partnership interests
 - (b) Other staff members would permit debt ownership but require that a proportionate share of net assets be attributed to each ownership interest.
7. The staff also recommends that the wording be changed from ‘ownership units’ to ‘ownership interests.’

Remaining factors

8. Some staff members recommend that an entity should not be required to meet one or more of the factors to be an investment company (the approach recommended by the staff at the May 2012 joint meeting).

9. Other staff members believe that an entity should be required to meet at least one factor in addition to the definition to be an investment company. Those staff members would not specify which factor should be required to be met. In addition, those staff members believe that:
- (a) if an entity meets only the ‘number of investments’ factor, it should be required to have multiple substantive investments;
 - (b) if an entity only meets the ‘number of investors’ factor, it should be required to have multiple substantive investors.
10. Staff members also recommend that application guidance as described in paragraphs 68 and 69 should be provided to clarify the relationship between the definition and factors.

Introduction

11. In Agenda Paper 8B/FASB Memo No. 46B for the May joint meeting, the staff recommended that an entity should be required to consider particular factors in addition to a definition when assessing investment company status. That is, an entity would not be required to *meet* all of the factors to be an investment company. However, an entity would be required to *assess* those factors when the definition is met to determine whether an entity is an investment company. The factors would indicate typical characteristics of an investment company and the entity would consider its purpose and design to determine whether it meets the definition and factors.
12. In that memo, the staff also recommended that when an entity does not meet a factor, it must demonstrate or justify how it meets the definition. Not meeting a factor could be an indication that the entity is not an investment company and the entity must provide sufficient justification to overcome that negative indicator.

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13. In Agenda Paper 8B/FASB Memo No. 46B for the May 2012 joint meeting, the staff described the factors to consider as follows:

- (a) *Number of investments and investors*: Investment companies typically have multiple investors and hold multiple investments. However, an entity is not precluded from being an investment company because it has a single investor or holds a single investment, provided it demonstrates how it meets the definition of an investment company. It would be rare for an investment company to have both a single investor and hold a single investment because it would be very difficult but not necessarily impossible for such an entity to meet the definition of an investment company.
- (b) *Related investors*: Typically, investment companies have multiple investors with a significant ownership interest held by an investor or investors that are not related to the parent (if there is a parent). However, an entity is not precluded from being an investment company because it has multiple related investors provided it demonstrates how it meets the definition of an investment company. For this assessment, investors related to the parent should be combined and treated as a single investor, along with the parent.
- (c) *Ownership interests*: Ownership interests in an investment company are typically in the form of equity or partnership interests to which a specifically identifiable portion of the net assets are attributed. However, an entity that has significant debt ownership may still qualify as an investment company provided that it demonstrates that its ownership interests represent a specifically identifiable portion of the net assets.

14. The May 2012 joint meeting memo described why the staff believes that the components above should be factors rather than part of the definition. In brief, the staff believes that there are structures in practice in which one or more of those factors are not met and yet those structures should still be investment companies, provided the structures meet the definition of an investment company. Constituents provided various examples of such structures in their feedback on the criteria proposed in the Exposure Draft (ED). The feedback received on the proposed criteria relevant to the factors above was summarized in the May 2012 joint meeting memo and is included as Appendix B to this memo.

15. The staff believes that the ‘definition and factors’ approach would accommodate legitimate exceptions to how typical investment companies operate. The staff believes that requiring an entity to demonstrate or justify why it still meets the definition of an investment entity when one of the factors is not met would ensure that the nature of the entity is consistent with the scope of investment companies as intended by the Boards.
16. Further, many constituents commented that the application guidance in the Exposure Drafts provided some exceptions to the strict criteria. Those constituents stated that the exceptions should be better integrated into the standard or that the Boards should develop a principle for an investment company that would not require many exceptions. The staff believes that the ‘definition and factors’ approach would address those concerns. The ‘definition and factors’ approach would allow the guidance to stand on its own with application guidance providing clarification rather than exceptions to the guidance.
17. At the May joint meeting, some Board members were confused about the relationship between the definition and factors and requested that the staff clarify that relationship. Additionally, some Board members were concerned that an entity could be an investment company while not meeting any of the factors. Those Board members questioned whether the factors are needed if none of the factors are required to be met.
18. Also at the May joint meeting, Board members had mixed views regarding the unit ownership factor. Some Board members raised concerns about entities with significant debt ownership, such as securitization vehicles, meeting the criteria to be investment companies and therefore qualifying for an exception from consolidation. Some Board members stated that they do not believe unit ownership should be retained (as a factor or part of the definition) when assessing investment company status. Because of those concerns, this memo discusses unit ownership separately from the other factors in paragraphs 20–41.
19. The remainder of this memo is organized as follows:

- (a) Issue 1: Unit Ownership
- (b) Issue 2: Remaining Factors.

Issue 1: Unit Ownership

20. The unit ownership criterion is phrased in the FASB ED as follows:

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.

21. The unit ownership criterion is phrased in the IASB ED as follows:

Ownership in the entity is represented by units of investments, such as shares or partnership interests, to which proportionate shares of net assets are attributed.

22. The staff notes that the unit ownership criterion was expressed slightly differently in the FASB ED and the IASB ED. The FASB ED would have required ownership units in an investment company to be in the form of equity or partnership interests. The IASB ED used the less prescriptive phrase ‘such as’, which the staff believes implies that ownership need not always be in the form of equity or partnership interests.

23. Also, the IASB ED would have required a ‘proportionate’ share of the net assets of the investment entity to be attributed to each unit of ownership, while the FASB ED would have required a ‘portion’ of the net assets to be attributed.

24. The language for the unit ownership criterion in the IASB ED is the language in current U.S. GAAP. However, the criteria in current U.S. GAAP are not strict criteria that are required to be met. Rather, an entity assesses the criteria qualitatively as a whole to determine whether it is an investment company. The staff believes that the FASB ED would require ownership interests to be in the form of equity or partnership interests because the Boards intended to exclude entities with only debt ownership from the scope of investment company guidance. The FASB ED included

a question for constituents asking whether debt interests should be considered for both the proposed unit ownership and pooling of funds criteria.

25. In addition, the FASB ED proposed that a ‘portion’ rather than a ‘proportionate share’ of the net assets to be attributed to units of ownership to include common investment company structures that have multiple classes of ownership with different terms, such as different management and incentive fee rates, or a separate class to invest in specific investment assets.
26. Feedback received on the proposed unit ownership criterion in the EDs is included in Appendix B.

Staff Analysis

Retention of unit ownership

27. The staff does not think that the guidance about unit ownership should be removed completely. The staff continues to think that the concept that the net assets of an investment entity are divided into ownership interests that are held by investors is an important one that justifies why fair value information is more relevant for investors in investment companies. Investors evaluate the performance of an interest in an investment company by evaluating how changes to the net assets (which are based on fair value) affect their ownership interests.
28. The staff originally recommended that unit ownership should be a factor that an entity would consider to be an investment company in order to address constituents’ concerns that the strict unit ownership criterion proposed in the EDs would inappropriately exclude certain structures. The staff continues to believe that unit ownership should be a factor rather than part of the definition because of the operational concerns identified by constituents and the concerns identified in the analysis below. However, because of Board member concerns about securitization vehicles, such as CDOs and SPVs, qualifying as investment companies, this paper

discusses two alternatives that the Boards could consider to exclude those entities from the scope of investment company guidance.

Form of ownership interests

29. As described in Appendix B, constituents raised concerns with the ‘unit ownership’ criterion proposed in the EDs, highlighting instances in which the form of an ownership interest in an entity would disqualify it from investment company status. Staff members have mixed views on the concerns raised by constituents and have identified two ways of including unit ownership in the definition of an investment company:

Alternative 1: Require ownership interests to be in the form of equity or partnership interests

Alternative 2: Permit debt ownership but require that a proportionate share of net assets be attributed to each ownership interest.

Alternative 1: Require ownership interests to be in the form of equity or partnership interests

30. Although some staff members recognize constituent concerns regarding the form of an ownership interest in an investment company, they believe that the form of ownership interests is a distinguishing factor of investment companies and that ownership interests should be in the form of equity or partnership interests. Those staff members believe that debt interests are economically different from typical equity or partnership interests because, generally, a debt interest holder does not participate in all the risks and rewards of the entity because the holder’s return is capped by the interest rate on the instrument.
31. For example, requiring that ownership interests be in the form of equity or partnership interests would exclude SPV or CDO structures with only debt tranches from being investment companies. This is because in such structures, the beneficial interest holders are entitled to specific interest cash flows but are not subject to all

the upside and downside. That is, the holder is entitled to a stated amount of interest income and cannot earn a return more than that stated amount. Also, holders are generally guaranteed a return of their principal amount.

32. For that reason, those staff members believe that an entity that has ownership only in the form of debt interests should not be an investment company because the interest holders are most interested in the cash flows from their investment rather than the changes to the net assets of the entity as a whole. Those staff members understand operational concerns that were raised about distinguishing between debt and equity interests but believe that addressing debt/equity concerns would be outside the scope of this project.
33. Under this alternative, the staff notes that if an investment company is required to have ownership in the form of equity or partnership interests, structures with significant debt financing could still be investment companies as long as the entity also has equity and partnership interest holders. For example, constituents were unclear whether an SPV or CDO with multiple debt ownership tranches and a residual equity tranche could meet the unit ownership criterion proposed in the EDs. Some concluded that such structures would meet the proposed unit ownership criterion because some ownership interests were in the form of equity. Others concluded that such structures would not meet the unit ownership criterion because significant ownership is in the form of debt. To ensure that such SPV and CDO structures are excluded from the scope of investment company guidance, the Boards could require *significant* ownership in the form of equity or partnership interests.
34. Under this alternative, the staff believes that insurance separate accounts may not meet the definition of an investment company. Insurance company constituents commented that an insurance separate account represents a contractual relationship between the insurer and the policyholder and that the units are not in the form of equity or partnership interests. Those constituents recommended that the Boards not require a particular form of ownership interests because they believe that separate accounts are of the same nature as a typical investment company and the most useful

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information would be provided by allowing them to be included in the scope of investment company guidance.

Alternative 2: Permit debt ownership but require that a proportionate share of net assets be attributed to each ownership interest

35. Other staff members acknowledge the concerns that were raised by constituents about the difficulty in determining whether an ownership interest should be classified as debt or equity for accounting purposes and think that requiring that ownership interests be in the form of equity would be overly strict and would place too much emphasis on the debt/equity classification. Furthermore, those staff members note that such a requirement would be stricter than the proposed unit ownership criterion in the IASB ED. Those staff members are concerned that there could be investment fund structures with ownership interests that are classified as debt that would be inappropriately excluded from investment entity status only because of their ownership structure. Similarly, not all instruments that would be classified as equity for accounting purposes has an economic profile that results in investors being exposed both to upside and downside.
36. Those staff members prefer language similar to that in the IASB ED. Ownership interests would be required, but equity or partnership ownership would be suggested as a typical form of ownership interest rather than required as the only allowable forms of ownership interest. Also, the unit ownership concept would require a ‘proportionate’ share of the net assets to be attributed to ownership interests rather than a ‘portion’ of the net assets.
37. Those staff members believe that the requirement for a ‘proportionate’ share of net assets to be attributed to each ownership interest would effectively scope out securitization structures from qualifying as investment entities because, in those structures, a proportionate share of the returns from capital appreciation² and

² The staff notes that the IASB has tentatively decided an investment entity would be required to invest for capital appreciation or capital appreciation and investment income. The FASB has tentatively decided that an investment company would be required to invest for capital appreciation, investment income, or both.

investment income is not given to each investor. Those staff members think that some investment funds without equity ownership can still distribute returns that represent a proportionate share of the fund's net assets to their investees.

38. The staff acknowledges that an investment entity might have different classes of investors but thinks that the application guidance can make clear that the 'proportionate' wording relates to an equal return *within each class* of investor, with each class receiving an uncapped amount of the returns from investments and participating fully in the risks and rewards of the investment entity.
39. However, by describing 'proportionate' amount as an equal return with no cap on the amount of returns, one could view this alternative as another way to describe equity ownership. Current U.S. GAAP and IFRS provide guidance to distinguish between debt and equity, and therefore, it may be simpler to require entities to follow guidance that already exists by requiring interests to be in the form of equity or partnership interests rather than addressing debt/equity concerns in this project.
40. Furthermore, the staff acknowledges that certain investment funds may be wholly owned by an intermediary entity and the investors in the intermediary entity may not be entitled to a proportionate share of the net assets. For example, an investment fund could be wholly owned by a defined benefit plan in which beneficiaries are indirectly entitled to a stated benefit amount rather than a proportionate share of the net assets. To address that concern, the staff believes that the Boards could clarify that ownership interest refers only to the direct investor's ownership in the investment company.

Other considerations

41. Regardless of the Boards' decision regarding the form of ownership interest, the staff also recommends that the wording be changed from 'ownership units' to 'ownership interest.' The staff does not think it is appropriate for investment funds to be excluded from the scope of the proposed guidance if they meet the definition but do not provide units of ownership to direct investors. For example, investment funds

wholly owned by pension plans or insurance separate accounts have beneficiaries that are entitled to the net assets of the investment fund; however, those beneficiaries are entitled to the net assets because of contracts with the pension plan or insurance company rather than the fund itself. In these examples, the pension plan or insurance company have an ownership *interest* in the entity but do not necessarily have an ownership *unit*.

Questions for the Boards

1. Which alternative do the Boards prefer regarding the form of ownership interests in an investment company?
2. Do the Boards agree that the guidance should refer to ownership interests rather than ownership units?

Issue 2: Remaining Factors

Background

42. Agenda Paper 8A/FASB Memo No. 46A for the May joint meeting described many examples of structures provided by constituents that have single investors, related investors, or single investments that the staff believes should not necessarily be excluded from being investment companies. The examples provided by constituents influenced the staff's recommendation in that May joint meeting paper for which characteristics should be factors to consider when assessing whether an entity is an investment company. Examples provided by constituents that were included in the May meeting memo are included in Appendix B of this memo.
43. As discussed in Issue 1 of this paper, if the Board decides that securitization vehicles, such as CDOs and SPVs, should not qualify as investment companies, the staff believes that ownership interest should be part of the definition of an investment company rather than a factor to consider. This section of the paper discusses whether

any of the following remaining factors recommended by the staff at the May 2012 joint meeting should be required to be met:

- (a) The number of investments
 - (b) The number of investors
 - (c) The existence of related investors
 - (d) Fair value management (FASB only).
44. In the May 2012 joint meeting paper, the staff recommended that the ‘number of investments’ and ‘number of investors’ should be a combined factor that an entity would consider. However, the staff now recommends that the ‘number of investments’ and ‘number of investors’ should be two different factors because they represent two different indications of why an entity should not qualify as an investment company.

Board member concerns

45. At the May joint meeting, some Board members were confused about the relationship between the factors and the definition of an investment company. Specifically, some Board members questioned whether an entity could be an investment entity without meeting all of the factors and therefore, whether the factors were needed. Those Board members were concerned that the proposed ‘definition and factors’ approach was not strict enough.
46. Also at the May joint meeting, Board members had concerns that allowing the number and nature of investors to be factors rather than required criteria would allow an entity that is wholly owned to qualify as an investment company, especially if the investment management function is being performed by the parent entity.

Staff analysis and alternatives to consider

47. Based on Board member concerns at the May 2012 joint meeting, the staff has identified the following three alternatives regarding the remaining factors and their relationship with the definition of an investment company:

Alternative 1: Do not require an entity to meet one or more of the factors to be an investment company (the approach recommended by the staff at the May 2012 joint meeting).

Alternative 2: Require an entity to meet at least one factor to be an investment company.

Alternative 3: Amend the definition to require an entity to have a significant ownership interest held by an investor that is not related to the investment manager or investors not related to the parent entity.

48. The staff emphasizes that under all of the above alternatives, when an entity does not meet a factor, it would be required to provide justification of how it continues to meet the definition to be an investment company.

Alternative 1: Do not require an entity to meet one or more of the factors to be an investment company

49. Alternative 1 is the approach recommended by the staff at the May 2012 joint meeting. Under this alternative, none of the factors (number of investments, number of investors, or related investors) would be required to be met for an entity to be an investment entity. For the FASB, the fair value management factor also would not be required to be met.
50. Under Alternative 1, the definition of an investment entity would represent the core characteristics of an investment entity. That is, the definition would describe the required activities that an investment company must engage in to differentiate it from other types of entities. The factors would describe ‘typical’ characteristics of an investment entity that should exist in an investment company, but may not always

exist because of specific business reasons or investor preferences. Again, an entity would need to provide justification for how it continues to meet the definition while not meeting a factor.

51. The staff believes that this alternative is simpler in the sense that it would not require any exceptions to the definition of an investment company (the required components of determining whether an entity is an investment company) in order to capture the entities that the Boards believe should be considered investment companies. For example, because having related investors would be a factor to consider rather than a requirement, the Boards would not need to provide an exception to ensure that employee funds are investment companies (a common structure described by constituents).
52. Additionally, many of the Boards' concerns regarding investment companies holding a single investment or being wholly owned by a corporate entity related to scenarios in which the entity or its affiliates obtain benefits that are:
 - (a) More than returns from capital appreciation or investment income; and
 - (b) Are not available to noninvestors or are not normally attributable to ownership interests.

The staff believes that the definition of an investment company addresses those concerns.

53. The staff acknowledges that the Boards were concerned at the May 2012 joint meeting that this alternative would be more likely to lead to structuring because it involves more judgment and is more flexible than the strict criteria approach proposed in the FASB ED and IASB ED. However, the staff highlights that the 'definition and factors' approach would require an entity to justify how it meets the definition referring specifically to each factor that is not met. The staff believes that requiring that justification should promote rigor in assessing whether an entity truly meets the definition of an investment entity. The staff does understand that this would place more pressure on auditors to evaluate whether or not an entity is

attempting to inappropriately qualify as an investment company if it asserts that it meets the definition while not meeting any of the factors.

54. Because this alternative would allow for the possibility of all of the factors not being met, an investment fund with one investor also performing the asset management function investing in just one investment (and not managed on a fair value basis for the FASB) (i.e. a fund not meeting all of the factors) could qualify as an investment company if the fund could justify that it meets the definition of an investment entity. The Boards expressed concern with this fact pattern at the May 2012 joint meeting.

Alternative 2: Require an entity to meet at least one factor to be an investment company

55. Alternative 2 would require an entity to meet at least one factor in addition to the definition to be an investment entity. However, the factor that would be required to be met would not be specified.
56. Alternative 2 would help to alleviate the Boards' concern that the factors are insufficiently strict while also preserving the concepts behind the 'definition and factors' approach. That is, this approach would allow the factors to be more flexible than the definition but would ensure that an entity that does not meet all the factors is not an investment company.
57. Alternative 2 would be more complex than Alternative 1 because it would have an initial set of required characteristics along with a secondary set of characteristics of which some (but not all) are required. The staff thinks it would be more difficult to articulate the difference between the definition and factors under Alternative 2 because there would not be a clear distinction between the required activities of an investment company and the typical (but not required) characteristics of an investment company.
58. Additionally, Alternative 2 would allow an entity to only meet the multiple investments factor but still qualify as an investment entity. The staff believes that an entity could easily hold two investments by having a small investment in addition to

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the main investment, such as an investment in a money market fund or sweep account. If an entity meets the multiple investments factor, it would not be required to meet the other factors. As a consequence, an entity with one investor related to the asset manager could be an investment company, which was a concern expressed by Board members at the May 2012 joint meeting. However, the staff note that also under this alternative, such an entity would be required to justify how it continues to meet the definition of an investment company despite not meeting the other factors.

59. The staff notes that the FASB decided that managing investments on a fair value basis should be a factor rather than part of the definition of an investment company. Therefore, an entity that has one investor who is related to the parent and holding one investment could qualify as an investment company under this alternative if the entity manages the investment on a fair value basis. That is, the only factor the entity meets is the fair value management factor. This alternative would not address the concerns expressed by Board members regarding an entity meeting ‘number of investments’, ‘number of investors’ and ‘related investor’ factors and being an investment company. To address this concern, the staff believes that the FASB could require that an entity meet at least two factors in addition to the definition for an entity to be an investment company.

60. Although Alternative 2 would alleviate the Boards’ concern that an entity that does not meet all the factors could be an investment company, it is questionable whether adopting such an approach is much different from a strict criteria approach as proposed in the EDs. By requiring an entity to meet at least one of the factors, the Boards would retain many of the criteria proposed in the EDs as strict requirements to be an investment entity. The general advantages of the ‘definition and factors’ approach as described in the May joint meeting memo would be lost. The staff believes that the if the Boards prefer Alternative 2, they may want to consider reverting to the strict criteria approach proposed in the EDs for the sake of simplicity.

Alternative 3: Amend the definition to require an entity to have a significant ownership interest held by an investor that is not related to the parent entity or the investment manager

61. The staff believes that another way the Boards could tighten the ‘definition and factors’ approach is to incorporate one of the factors into the definition of an investment company. If the Boards choose Alternative 3, the staff would recommend that they include the ‘related investors’ factor as part of the definition. The staff considered requiring an investment entity to have multiple investments or multiple investors but rejected both of those options because the staff believes that those characteristics can be easily structured around and therefore the entity would inappropriately qualify as an investment company. The FASB staff did not consider requiring an investment company to manage its investments on a fair value basis because the FASB previously decided that fair value management should be a factor rather than part of the definition for multiple reasons, as described in the May 2012 joint meeting memo.
62. Under this alternative, the staff thinks it is most appropriate to require that an investment entity must have a significant ownership interest held by an investor that is not related to the investment manager or investors not related to the parent entity. Based on the discussion at the May joint meeting, the staff believes that many Board members are concerned about an entity with a single investor qualifying as an investment company, especially if the investment manager is related to the single investor. The staff believes that requiring an investment entity to have an unrelated asset manager or significant ownership by investors unrelated to the parent entity as part of the definition of an investment entity would help to address this concern.
63. The staff believes that including the ‘related investor’ concept as part of the definition would address the Boards’ concerns that the ‘definition and factors’ approach recommended by the staff in the May 2012 joint meeting was not strict enough to prevent an investment entity to be formed to achieve a certain accounting purpose. If an investment entity would be required to have an unrelated investment manager or significant ownership by an investor unrelated to the parent entity, there

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would be a degree of independence in the formation of the entity that would help to ensure that the investor or investors are only obtaining returns from capital appreciation or investment income.

64. The staff believes that under Alternative 3, in most circumstances, the entity would also be required to have multiple investors because the alternative requires significant ownership by an investor that is not related to the parent entity. The staff believes that this is important to avoid a scenario in which the parent entity issues an insignificant ownership interest to an unrelated party just to meet the related investor concept. However, Alternative 3 would permit an investment fund that is set up for one investor's specific investment strategy to be an investment company, provided that the investment fund meets the remainder of the definition and considers the factors.
65. If the Boards decide to require an investment company to have an unrelated investment manager or significant ownership by investors that are not related to the parent entity, the Boards would need to consider addressing concerns raised regarding certain structures such as employee funds, pension funds, sovereign wealth funds and insurance separate accounts. All of those structures could have investors that are related to the investment manager or the parent entity. The staff believes that if the Boards believe that these structures should be investment entities they would need to provide specific exceptions for the above-listed structures. The staff believes that this would introduce complexity into the guidance and also would not address constituent criticisms that the criteria for determining whether an entity is an investment entity should stand on their own without exceptions.
66. For the same reasons as the structures described above, this alternative also would exclude small business investment companies (SBICs), bank common (collective) trusts³, and investment funds formed by a bank to facilitate merchant banking activities from investment company status. Some U.S. constituents commented that

³ In the United States, SBICs and bank common (collective) trusts follow investment company guidance because certain regulatory rules require those entities to report their investments at fair value.

such entities should not be excluded from investment company guidance because they are wholly-owned by a related party. The FASB would need to decide whether there should be an exception to include such entities within the scope of investment company guidance.

67. Similar to Alternative 2, it is questionable whether Alternative 3 would be very different from the strict criteria approach proposed in the EDs because the definition of an investment entity would include most of the criteria proposed in the EDs. If the Boards prefer Alternative 3, the staff believes it may be simpler to revert to the strict criteria approach proposed in the EDs.

Application guidance to supplement the ‘definition and factors’ approach

68. Regardless of which approach the Boards choose regarding the relationship of the definition and the factors to be an investment company, the staff believes that application guidance should be provided to clarify the relationship between the definition and factors. As described in paragraphs 11 and 12, the staff believes that application guidance should state that the factors represent ‘typical’ characteristics of an investment company and if an entity does not meet a factor, it is an indication that the entity may not meet the definition of an investment company.
69. The staff also recommends that application guidance state that if an entity does not meet all of the factors, it would be unlikely that the entity is an investment company. The staff believes an example should be included in application guidance to illustrate such a scenario. The staff thinks it would be unlikely that an entity would set up a wholly-owned intermediary investment fund to invest in a single investment if the parent entity did not intend to obtain benefits other than returns from capital appreciation or investment income. Further, if the asset manager for the wholly-owned investment company is related to the parent entity (and the investment is not managed on a fair value basis—FASB only), the staff thinks that there is a higher risk that the parent entity is obtaining benefits of more than capital appreciation or investment income. In this scenario the investment fund would not meet any of the

factors and that should indicate that the fund is not an investment company. The fund would need to justify how the parent entity is obtaining only capital appreciation and investment income from its investment.

Staff recommendations

70. Some staff members recommend Alternative 1, which is consistent with the staff recommendation in the paper for the May 2012 joint meeting. Those staff members continue to believe that the advantages of this alternative communicated to the Boards at the May 2012 joint meeting and described in paragraphs ~~4950–5253~~ are relevant and important. This alternative draws a clear line between what is required to be met to be an investment company and the ‘typical’ characteristics of an investment company. In addition, this alternative would not require exceptions to the definition of an investment company.
71. Those staff members acknowledge the Boards’ concerns that Alternative 1 could be perceived as not strict enough to ensure that only appropriate entities are treated as investment entities. The staff thinks that requiring an entity to provide a justification of how it meets the definition of an investment entity when it does not meet a factor will ensure that preparers and auditors carefully consider the factors. In addition, the staff recommends that the application guidance provide examples as described in paragraph 69 and clearly state that it would be unlikely for an entity to be an investment entity if that entity does not meet any of the factors.
72. Those staff members also acknowledge the Boards’ concerns that Alternative 1 does not clearly describe the relationship between the definition and the factors. To address the Boards’ concern, the staff recommends that the guidance clearly state that the factors represent ‘typical’ characteristics of an investment company and if an entity does not meet a factor, it is an indication that the entity may not meet the definition of an investment company.

73. Other staff members recommend Alternative 2 which would require an entity to meet at least one factor in addition to the definition to be an investment company but would not specify the factor that must be met. Those staff members believe this alternative would address both the Boards' and constituent concerns. Alternative 2 would provide an extra level of discipline to address concerns that the 'definition and factors' approach is not strict enough. In addition, those staff members believe that Alternative 2 preserves the concepts behind the 'definition and factors' approach, which allows the factors to be more flexible than the definition but would ensure that an entity that does not meet all the factors is not an investment company.
74. Because of concerns that the 'number of investments' or 'number of investors' factors could be easily structured around, and therefore, such an entity could inappropriately qualify as an investment company, those staff members believe that:
- (a) if an entity meets only the 'number of investments' factor, it should be required to have multiple substantive investments;
 - (b) if an entity only meets the 'number of investors' factor, it should be required to have multiple substantive investors.

Questions for the Boards

3. Which alternative do the Boards prefer regarding the relationship of the definition and the factors to be an investment company?

4. Do the Boards agree with the staff recommendations regarding the application guidance that would supplement the 'definition and factors' approach?

Appendix A

A1. This appendix summarizes the FASB's and the IASB's decisions to date regarding the definition and factors to be an investment company.

FASB Decisions

A2. The FASB decided that the definition of an investment company would be as follows:

1. An investment company is an entity that does both of the following:
 - a. Obtains funds from an investor or investors and provides the investor(s) with professional investment management services
 - b. Commits to its investor(s) that its business purpose and only substantive activities are investing the funds for returns from capital appreciation, investment income, or both.
2. An investment company and its affiliates do not obtain, or have the objective of obtaining, returns or benefits from their investments that are either of the following:
 - a. Other than capital appreciation or investment income
 - b. Not available to other noninvestors or are not normally attributable to ownership interests.

A3. The FASB also decided that the concept of managing on a fair value basis as described in the FASB's ED would be a factor that an entity would consider to determine whether it is an investment company. That assessment would consider how the entity manages and evaluates the performance of its investments, how the entity transacts with its investors, and how asset-based fees are calculated to determine whether the entity manages its investments on a fair value basis.

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IASB Decisions

A4. The IASB decided that the definition of an investment entity would be as follows:

1. An investment entity does all of the following:
 - a. Obtains funds from an investor or investors and provides the investor(s) with professional investment management services
 - b. Commits to its investor(s) that its business purpose and only substantive activities are investing the funds for returns from capital appreciation or capital appreciation and investment income
 - c. Manages and evaluates the performance of substantially all of its investments on a fair value basis.

2. An investment company and its affiliates do not obtain, or have the objective of obtaining, returns or benefits from their investments that are either of the following:
 - a. Other than capital appreciation or capital appreciation and investment income
 - b. Not available to noninvestors or are not normally attributable to ownership interests.

Appendix B

B1. This appendix provides the feedback that was summarized for the following concepts in IASB Agenda Paper 8A/FASB Memo No. 46A for the May 2012 joint meeting:

- (c) Unit ownership
- (d) Multiple investments
- (e) Pooling of funds.

Unit ownership

Need for the criterion and form of units

- B2. Several constituents stated that this requirement introduces complexity, including determining whether units in the legal form of equity are considered debt for accounting purposes. Those constituents stated that the proposed guidance put too much pressure on the legal form of ownership units and that the analysis of whether an entity is an investment entity should focus on whether or not ownership units participate in the risks and rewards of an entity and provide an investor with a portion of the net assets of an investment entity.
- B3. Constituents described examples of investment funds in which ownership would be classified as debt rather than equity in accordance with U.S. GAAP and IFRS, such as funds formed with profit-participating loans and limited-life funds with ownership units that are mandatorily redeemable upon termination of the fund. Additionally, many U.S. constituents stated that collateralized debt obligations and collateralized loan obligations currently follow investment company accounting and reporting guidance under U.S. GAAP, but do not have substantive equity interests.
- B4. Some constituents questioned whether the unit ownership criterion was necessary, stating that the other criteria proposed in the IASB ED and the FASB ED would

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appropriately identify investment entities. Moreover, some constituents criticized the criterion for excluding certain investment funds, such as investment funds wholly owned by pension plans and sovereign wealth funds, stating that those funds should be investment entities but that they do not provide unitized ownership interests directly to their shareholders.

Proportionate shares vs. a portion of net assets

- B5. Most FASB constituents agreed with the wording proposed in the FASB ED. Many IASB constituents, however, disagreed with the proposed wording in the IASB ED. Those constituents stated that some investment funds, such as funds in which different share classes have different rights or funds where investors have discretion to invest in individual assets within the fund, would be disqualified as a result of this wording and recommended that the IASB adopt the wording in the FASB ED.

Multiple investments

- B6. In both the IASB ED and the FASB ED, the nature of the investment activity criterion would require an investment entity to hold multiple investments. However, at some times during the investment company’s life, such as during the initial offering period and liquidation, the guidance in the EDs would permit an investment company to hold a single investment. The guidance in the EDs also would permit an investment company to hold a single investment when the investment company is formed in conjunction with another investment company that holds multiple investments.

Feedback received

- B7. Some IASB constituents and many FASB constituents commented that this criterion was overly strict, stating that there are entities that hold a single investment for capital appreciation, investment income, or both that would meet the other proposed criteria to be an investment entity. Those constituents provided specific examples of

entities that they believed should be investment entities but only hold a single investment. Those examples included single investment funds set up to pool investors' funds to invest in a single entity because the required minimum investment is too high for an individual investor or the investment is unobtainable by individual investors.

- B8. Those constituents argued that the requirement to hold multiple investments should be removed or that application guidance should be added to permit an investment entity to hold a single investment in the above circumstances.

Pooling of funds

Multiple investors

- B9. The Boards proposed that an investment entity would be required to have multiple investors. The guidance in the EDs would permit an investment company to have a single investor when the investment company is formed in conjunction with another investment company that has multiple investors. In addition, the FASB ED contains implementation guidance that would allow an investment company to have a single investor at certain times during the investment company's life, such as during the initial offering and liquidation.

Feedback received

- B10. Many constituents disagreed with this requirement, arguing that investment funds with a single investor should not be excluded from being investment entities. Those constituents provided the following examples of investment funds with single investors that they thought should be investment entities:
- (a) Funds that have a single investor during start up or wind down
 - (b) Government-related entities, such as sovereign wealth funds

- (c) Funds wholly owned by pension plans⁴ and endowments⁵
- (d) Private equity funds wholly owned by corporations or financial services firms or high-net-worth individuals
- (e) Charities³ or individual trusts
- (f) Funds set up by an asset manager for an unrelated single investor with a unique investment strategy (separate accounts or managed accounts).

Related party investors

B11. The Boards proposed in their EDs that an investment entity would need to have investors that are unrelated to the investment entity's parent (if the investment entity has a parent). That proposal was made for similar reasons as the proposal that an investment entity would need to have multiple investors and was made in part to prevent entities from structuring around the requirement to have multiple investors.

Feedback received

B12. Similar to the concerns listed regarding the multiple investors requirement, many constituents did not feel that it was appropriate for an investment entity to fail to be an investment entity simply because of the types of investors an investment entity has and whether or not those investors are related to each other. The most frequently mentioned investment fund that constituents thought would inappropriately fail to be an investment entity as a result of this requirement was employee side-by-side funds. Employees and their families are offered the chance to invest in the same investments as other investment funds offered by the asset manager but those employee side-by-side funds are kept separate from the main fund.

⁴ Under U.S. GAAP, pension plans would follow the guidance in Topic 960, Plan Accounting—Defined Benefit Pension Plans, Topic 962, Plan Accounting—Defined Contribution Pension Plans, and Topic 965, Plan Accounting—Health and Welfare Benefit Plans. Under IFRS, pension plans would follow the guidance in IAS 26 *Accounting and Reporting by Retirement Benefit Plans*.

⁵ Endowments and charities would follow the guidance in Topic 958, Not-for-Profit Entities, under U.S. GAAP. There is no specific guidance for not-for-profit entities in IFRSs.