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Project	**Investment Entities / Investment Companies**
Paper topic	Accounting by an Investment Company Parent for an Investment Company Subsidiary

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Purpose of this Memorandum

1. The FASB's proposed Accounting Standards Update, *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements*, (FASB ED) and the IASB's Exposure Draft, *Investment Entities*, (IASB ED) proposed different measurement requirements for accounting by an investment company[1] parent for an investment company subsidiary.

2. This memo discusses the accounting by an investment company parent of an investment company subsidiary in light of feedback received on the FASB ED and the IASB ED. This memo, however, does not discuss the accounting by an investment company parent of an investment property entity subsidiary. The FASB will discuss that issue at a later date at a FASB only meeting.

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

3. This memo is organized as follows:

   (a) Summary of staff recommendations

   (b) Background

   (c) Proposed requirements and the basis for the guidance

   (d) Feedback received

   (e) Staff analysis and recommendations

      (i) Issue 1: Master-feeder structures

      (ii) Issue 2: Fund-of-fund structures.

Summary of staff recommendations

4. The staff recommends that:

   (a) Along with its financial statements, each feeder fund in a master-feeder structure should be required to present its master fund's financial statements.

   (b) An investment company should be required to measure all controlling financial interests in another investment company at fair value (in both master-feeder and fund-of-funds structures), rather than consolidating those subsidiaries[2].

Background

5. There are two common structures in which an investment company invests in another investment company: (1) Master-feeder funds and (2) Fund-of-funds. Fund-of-fund managers focus on providing investors with greater diversification of assets

[2] This would make the accounting for investment company subsidiaries consistent with the accounting for other controlled investments held by investment companies (except investments in operating entities that provide services to the investment company parent, which are required to be consolidated.)

whereas master-feeder fund managers focus on providing trading and tax benefits by separating investment-related activities in the master fund from investor servicing activities in the feeder fund.

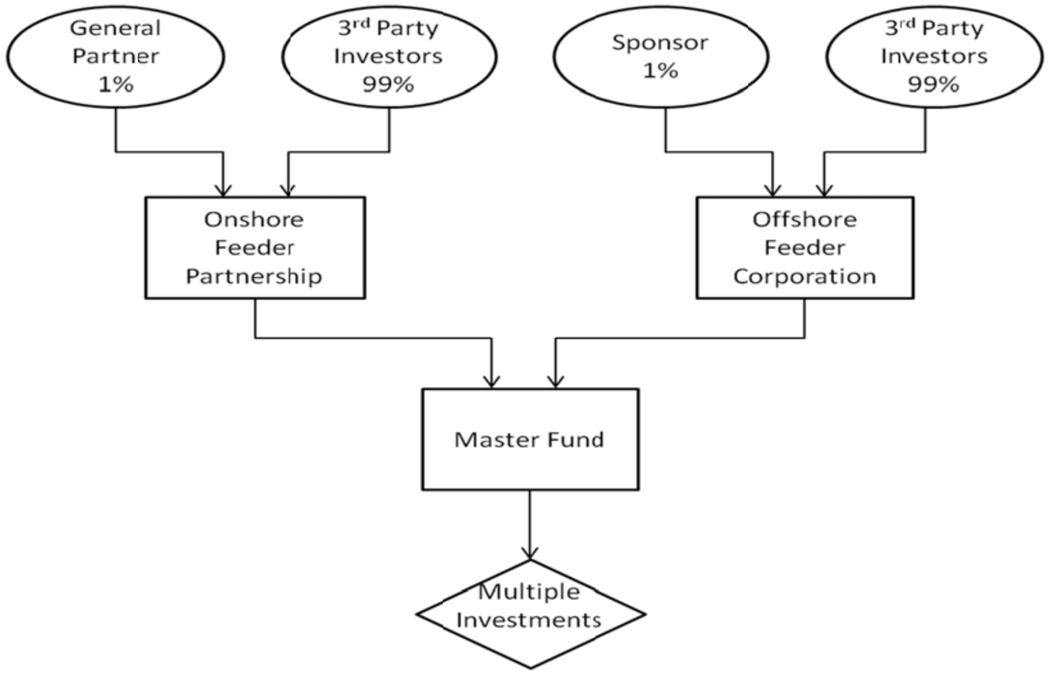
Master-feeder funds

6. In a master-feeder structure, investors invest in the feeder funds, which in turn invest in the master fund. The master fund performs all the investment-related activities, while subscription/redemption activity and management/performance fees handled at the feeder fund level.

7. In a typical master-feeder structure, there are two feeder funds, one on-shore fund and one off-shore fund. A master-feeder structure is a common way for both foreign and domestic investors to invest in one central portfolio of investments with different tax benefits depending on whether an investor is invested in an on-shore or off-shore feeder fund. The master fund and the feeder funds together could be viewed economically as one investment company.

8. In the United States, a feeder fund is required to separately present its allocated share of the master fund's net investment income, and realized and unrealized gains and losses in its financial statements. Also, for investment companies regulated under the 1940 Act, each feeder fund is required to present a complete set of the master fund's financial statements along with its financial statements. Presenting a complete set of the master fund's financial statements is optional for unregulated investment companies.

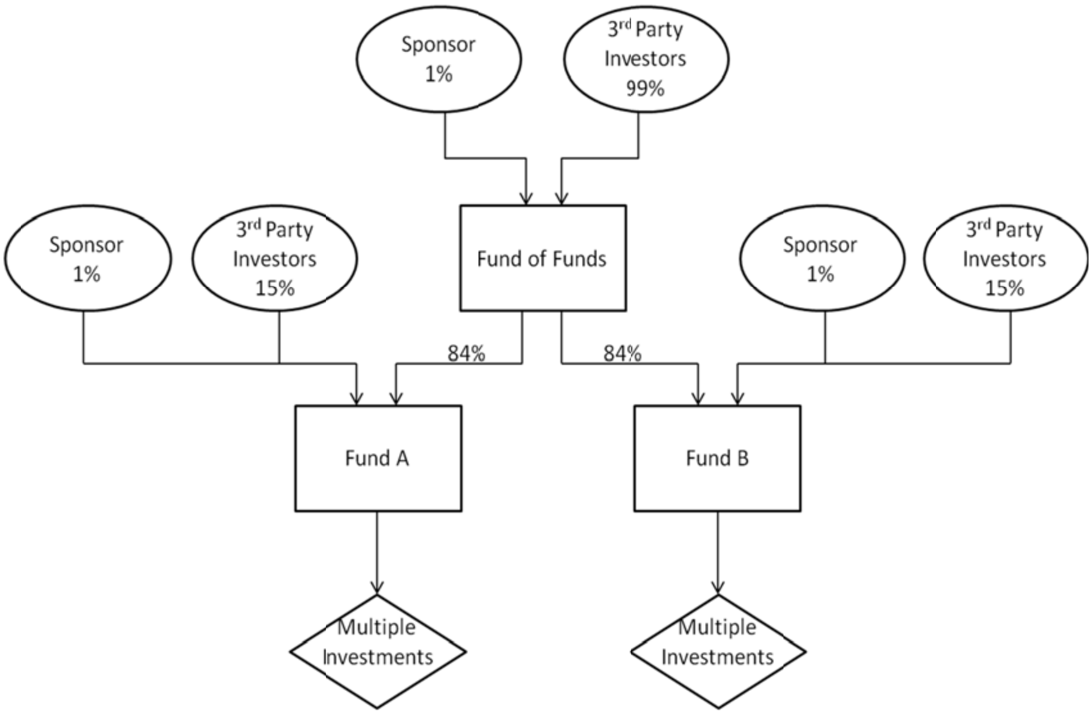
9. The diagram below illustrates a master-feeder structure:



Fund-of-funds

10. Fund-of-funds are investment companies that invest in other investment companies rather than investing directly in securities. Master-feeder funds can be viewed as fund-of-funds but their investment portfolio is only one level. Fund-of-funds typically have multiple layers of funds. Fund-of-funds are common in the alternative fund industry. Many hedge funds and private equity funds are structured as fund-of-funds providing investors with broad diversification strategies. In the United States, investment companies regulated under the 1940 Act generally may invest in other investment companies only if the investee funds are part of the same group of investment companies (affiliated funds).

11. The diagram below illustrates a fund-of-funds structure:



12. Another common type of structure that also would be considered a fund-of-funds structure is when an investment company invests in a "blocker entity." Some investment companies insert a blocker or stopper fund to change the character of the underlying income or assets, or both, primarily to address entity qualification criteria under tax, regulatory, or legal guidelines. One common example is when a 1940 Act regulated investment company organizes a foreign subsidiary (the blocker fund) to invest in commodities. For a regulated investment company to maintain its status under the 1940 Act, a substantial portion of its portfolio must be invested in securities. Therefore, a 1940 Act regulated fund would not be able to make significant commodity investments directly. By inserting a blocker fund, "bad" assets and income are converted into "good" assets (shares of the foreign subsidiary) and income (dividends), allowing the investment company to maintain its status as a regulated investment company under the 1940 Act. The staff understands that blocker funds held by 1940 Act regulated funds are generally

wholly-owned. However, multiple funds could invest in one blocker entity, particularly in the alternative funds market. Also, an entity that initially registers to be regulated under the 1940 Act is currently required to consolidate wholly owned investment company subsidiaries for regulatory purposes. The staff understands that there are mixed practices by existing 1940 Act regulated investment companies with some consolidating wholly owned investment company subsidiaries and others attaching the financial statements of those subsidiaries.

13. Current U.S. GAAP prohibits an investment company from consolidating a noninvestment company, except an operating entity that provides services to the investment company. However, current U.S. GAAP is silent on whether an investment company is required to consolidate a controlled investment company. Practice is mixed with some entities consolidating wholly-owned investment company subsidiaries and others reflecting those subsidiaries as investments but presenting the financial statements of wholly-owned subsidiaries along with the parent entity's financial statements. Generally, in practice, investment companies do not consolidate less-than-wholly-owned investment company subsidiaries because of concerns that the usefulness of the financial statements is reduced by the inclusion of amounts attributable to noncontrolling interest holders.

Proposed Requirements and the Basis for the Guidance in the FASB ED

14. The guidance 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, including a feeder fund's interest in its master fund in a master-feeder structure.

15. The IASB ED would require an investment company to measure controlled investees at fair value, regardless of whether the controlled investee is an operating entity or another investment company (with the exception of consolidating an operating entity that provides services to the investment entity).

16. Initially, the FASB and IASB agreed that an investment company would measure all controlled investees at fair value, unless the investee is an operating entity that provides services to the investment company. The FASB later decided that an investment company should consolidate controlling financial interests in another investment company in a fund-of-funds structure because of concerns raised that an investment company should consolidate wholly owned investment company subsidiaries that are set up for specific tax, legal, or regulatory purposes, such as blocker entities. The FASB believed that a wholly-owned investment company is different from a wholly-owned operating entity because the operations of a wholly-owned investment company would be an extension of the operations of the parent investment company.

17. As explained in paragraph BC36 through BC38 of the FASB ED, the FASB was concerned that by not requiring an investment company to consolidate its wholly-owned subsidiaries in a fund-of-fund structure, transparency into the subsidiary's underlying investments and obligations to which the parent investment company has economic exposure would be reduced[3]. Conceptually, a distinction could not be made between a wholly owned and a majority-owned subsidiary and the FASB

[3] If an investment company subsidiary is measured at fair value then, the financial statements of the investment company parent would reflect the net investment in that subsidiary. In contrast, if the investment company subsidiary is consolidated then, the underlying investments and funding of the investment company subsidiary would be reflected in the investment company parent's consolidated financial statements.

decided that all controlling financial interests in another investment company should be consolidated in a fund-of-funds structure.

18. The FASB considered whether the proposed consolidation requirements for fund-of-fund structures should also apply to master-feeder structures. They decided that consolidation was not required in a master-feeder structure because the current presentation and disclosure requirements for master-feeder structures, such as including the mater fund's financial statements as part of the feeder fund's financial statements provide transparency into the underlying investments and obligations of the master fund.

19. Although consolidating less-than-wholly owned investment company subsidiaries would result in the parent investment company including noncontrolling interests in its financial statements, the FASB believed that the presentation and disclosure requirements in Subtopic 810-10, along with the proposed changes to the financial highlights requirements would provide users with the appropriate information. The FASB ED would require financial highlights to be calculated excluding amounts attributable to noncontrolling interests.

Feedback received

20. The IASB ED did not ask a specific question on the subject of investment company accounting for investment company subsidiaries, and relatively few IASB respondents commented on this issue. However, of those constituents that did comment, the majority were supportive of the IASB approach of measuring an investment company subsidiary at fair value (that is, not consolidating controlled investment companies). Those constituents provided feedback that was consistent with the feedback received by the FASB. The feedback received by the FASB is summarized below.

21. Most constituents 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 to be attached to each feeder fund's financial statements.

22. A few constituents (nonusers) supported consolidation of controlling financial interests in a fund-of-funds structure as proposed in the FASB 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.

23. 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. Some of those constituents stated that consolidation should be required only for certain controlling financial interests in another investment company (described in paragraphs 28 and 29).

User feedback

24. 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 highlights information that provides details about changes to net asset value.

25. 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 in an intermediary investment fund.

Feedback from nonuser constituents

26. 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 on 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*. A few constituents requested the FASB clarify whether consolidation guidance would apply only to formal fund-of-funds structures. Several constituents also questioned how the consolidation guidance would apply to separate accounts of insurance companies.

27. 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, therefore, consolidation could result in more non-GAAP measures for investor reporting purposes.

28. 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.

29. 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.

30. In lieu of consolidation, some constituents suggested that an investment company parent's financial statements should be required to present the financial statements of an investment company subsidiary along with its financial statements 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.

Disclosures in lieu of consolidation

31. Many nonuser constituents stated that concerns regarding transparency into the underlying assets, liabilities, income, and expenses of an investment company subsidiary could be addressed through expanded disclosures in the notes to the financial statements rather than through consolidation of the investment company subsidiary. Those constituents suggested various methods of providing information about investment company subsidiaries. However, users had mixed views about including disclosures in the notes to the financial statements about the activities of an investment company subsidiary.

32. 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. Some users stated that information about underlying investments provided outside the financial statements is more timely and therefore more useful in performing risk analysis.

33. 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.

34. The staff plans to discuss disclosures in a fund-of-funds structure at a future meeting.

Staff Analysis and Recommendations

Issue 1: Master-feeder structures

35. The staff recommends that a feeder fund should not consolidate a controlling financial interest in its master fund in a master-feeder structure. Most FASB constituents agreed with that proposed requirement in the FASB ED. In addition, the majority of constituents who commented on the IASB's proposals supported the IASB's approach of measuring all controlled investees of an investment company at fair value, unless the investee is an operating entity that provides services to the investment company.

36. The staff believes that financial statements for a master fund that are separate from the financial statements of each feeder fund would provide the most useful information to investors because of the nature of a master-feeder structure. The staff is unsure how the consolidation analysis would be applied to determine which feeder fund is the parent entity. Furthermore, consolidation by only one feeder fund

could create confusion and would not provide sufficient information to investors in other feeder funds.

37. However, the staff believes that a feeder fund should be required to present master fund financial statements along with its financial statements because the investment management activities performed by the master fund are integral for an investor's analysis of the feeder fund. The staff believes that the inclusion of the master fund financial statements should be required rather than optional because of comparability.

38. Currently, this presentation is required for 1940 Act investment companies under U.S. GAAP but optional for other investment companies. The staff understands that currently private feeder funds generally do provide master fund financial statements along with their financial statements. Accordingly, the staff believes that this requirement would not be a change to practice in the United States.

39. This requirement, however, would be new for investment entities under IFRS. The staff notes that while the IASB ED stated that appending an investment entity subsidiary's financial statements to an investment entity parent's financial statements would be a way of meeting the disclosure requirements, it did not require investment entity subsidiary financial statements to be appended in any specific circumstances. The IASB staff has talked to some IASB constituents who have specifically requested that master fund financial statements be required to be appended to feeder fund financial statements, stating that this will result in the most relevant information for financial statement users and should not be too onerous as feeder funds will have ready access to master fund financial statements. The staff agrees with their comments.

Issue 2: Fund-of-fund structures

40. The staff has identified the following four alternatives for consideration for an investment company's accounting of controlling financial interests in another investment company in a fund-of-fund structure.

Alternative 1: Require consolidation of investment company subsidiaries in a fund-of-funds structure (as proposed in the FASB ED)

Alternative 2: Require consolidation of only wholly-owned investment companies subsidiaries in a fund-of-funds structure

Alternative 3: Require consolidation of only those investment company subsidiaries that are set up for specific regulatory, legal, or tax purposes in a fund-of-funds structure

Alternative 4: Prohibit consolidation of investment company subsidiaries in a fund-of-fund structure (as proposed in the IASB ED)[4].

41. If the Boards select Alternatives 2 through 4, the Boards could consider disclosures to address some user concerns regarding transparency into the underlying expenses and leverage in a fund-of-funds structure for those investment company subsidiaries that are not consolidated. The staff plans to discuss such disclosures at a future meeting.

Proportionate consolidation

42. The staff understands that investors in investment companies are most interested in the changes to the value of their unit ownership (or net asset value per share). Proportionate consolidation would be consistent with that concept. However, the staff does not present proportionate consolidation as an alternative for the following reasons:

[4] The IASB ED did not specifically discuss fund-of-fund structures. However, it required that all controlled investments be measured at fair value (except operating entities that provide services to the investment entity).

(a) Current U.S. GAAP does not allow for proportionate consolidation except in the construction and extractive industries. Also, the FASB discussed and rejected this alternative prior to issuance of the FASB ED.

(b) IFRS no longer allows proportionate consolidation.

(c) Proportionate consolidation is inconsistent with general consolidation guidance, which focuses on the economic entity as a whole rather than providing a parent or proprietary view.

Attaching the financial statements of the investment company subsidiary

43. The staff also considered whether an investment company should present or attach the financial statements of controlled investment companies along with its financial statements but decided not to include it as an alternative in this paper.

44. Providing the financial statements of an investment company subsidiary would address concerns about transparency into the activities of the subsidiary and would provide users with sufficient information to allow them to choose the information they need in their analysis. However, for an investment company parent that has multiple investment company subsidiaries, requiring the parent to provide the financial statements of each of its investment company subsidiaries would significantly increase the length of the parent company's financial statements. The length of those financial statements would be further increased if any of the investment company subsidiaries also had investment company subsidiaries. The staff has heard that it is common to have multiple layers in hedge fund-of-fund structures.

45. Additionally, attaching the investment company subsidiary's financial statements would not address some of the operational concerns raised by nonuser constituents in response to the proposed fund-of-fund consolidation requirement in the FASB ED. An investment company parent may have different reporting period ends from its investment company subsidiary and the Boards would need to address how to

reconcile the differences in reporting periods. Also, an investment company subsidiary could be a nonpublic entity for which financial statements are not readily available.

46. Although attaching the financial statements of the investment company subsidiary would be similar to the presentation by feeder funds in a master-feeder structure (that is the reason why the FASB decided not to require consolidation in a master-feeder structure), the staff believes that a master-feeder structure is fundamentally different from a fund-of-fund structure. The staff believes that investors in a fund-of-fund structure do not require the same information as investors in a master-feeder structure. In a master-feeder structure, there are no other investors in a master fund aside from the feeder funds and the feeder funds do not have other investments aside from the master fund. The master fund together with each feeder fund represents the activities of the investment company. For this reason, U.S. GAAP requires a feeder fund to separately present its allocated share of the master fund's income, expenses, and gains and losses in its financial statements. On the other hand, in a typical fund-of-fund structure, the activities of an investee fund are separate from the activities of the fund-of-fund (top level fund).

Alternative 1 – Require consolidation of investment company subsidiaries in a fund-of-funds structure (as proposed in the FASB ED)

47. Alternative 1 would require an investment company to consolidate all investment company subsidiaries in a fund-of-funds structure. This alternative is consistent with the entity concept in consolidation guidance and would provide transparency into the underlying assets, liabilities, income, and expenses of the subsidiary fund.

48. Investors in investment companies have stated that they are most interested in changes to the value of their ownership interest (net asset value per share). This alternative would require the parent entity to present gross assets, liabilities, income, and expenses of the subsidiary fund with the portion of net assets and net income attributable to noncontrolling interest holders separately presented. The

financial statements would not differentiate between the assets, liabilities, income, and expenses of the parent entity from those of the subsidiary. If the Boards choose this alternative, the FASB would need to discuss the proposed changes to financial highlights requirements in the FASB ED and the IASB would need to discuss any necessary changes to the disclosure objective.

49. This alternative would not address constituent concerns described in paragraphs 26 through 27 and the Boards would need to clarify how consolidation guidance would apply to investment companies, including defining fund-of-fund structures.

Alternative 2 – Require consolidation of only wholly-owned investment companies subsidiaries in a fund-of-funds structure

50. Alternative 2 would require an investment company to consolidate only wholly owned investment company subsidiaries in a fund-of-fund structure. Under Alternative 2, an investment company would measure less-than-wholly owned investment company subsidiaries at fair value. Alternative 2 would address the FASB's concerns described in paragraph 17 about transparency into the subsidiary's underlying investments and obligations to which the parent investment company has economic exposure when the subsidiary is wholly owned.

51. Alternative 2 would address constituent concerns about the presentation of amounts attributable to noncontrolling interest holders. This alternative would also reduce operational concerns raised about temporary control described in paragraph 27(b) because it would be unlikely for an entity to temporarily issue ownership interests to other investors. This alternative also would be consistent with the United States regulatory requirement to consolidate wholly owned investment company subsidiaries for initial registrations under the 1940 Act.

52. However, the staff is unable to identify a valid conceptual basis to distinguish between a wholly-owned subsidiary and a less-than-wholly owned subsidiary. Further, the staff believes that an investment company could structure the entity in

such a way that there is at least one noncontrolling interest holder in the investment company subsidiary to avoid consolidation.

Alternative 3 – Require consolidation of only those investment company subsidiaries that are set up for specific regulatory, legal, or tax purposes in a fund-of-funds structure

53. Alternative 3 would draw a different line to determine which investment company subsidiaries should be consolidated by an investment company parent. Alternative 3 would require an investment company to consolidate an investment company subsidiary only if it was formed for specific regulatory, legal, or tax purposes. These investment company subsidiaries could be wholly-owned or less-than-wholly owned.

54. This alternative would address concerns raised about blocker funds inserted by an investment company to meet specific regulatory, legal, or tax guidelines (the structure is described in paragraph 12). As described in paragraph 28, some constituents stated that consolidation of blocker fund should be required because a blocker fund is not a passive investment, rather the activities of the blocker fund are an extension of the activities of the investment company parent.

55. Alternative 3 would require investment company subsidiaries that are not formed for specific regulatory, legal or tax purposes to be measured at fair value. This alternative would require the Boards to distinguish between investment company subsidiaries that are set up for specific regulatory, legal, or tax purposes and those that are set up for other business reasons. The staff believes it would be very difficult to identify investment companies that are set up for other business reasons without consideration of specific regulatory, legal, or tax guidelines. Most investment companies are structured in a particular way because of the specific regulatory, legal, or tax strategies of their investors.

56. In the EDs, the Boards decided not to distinguish between active and passive investors because the Boards believed that an entity could be structured to meet

such a requirement without substantively changing the nature of the entity. In addition, the Boards decided that an investment company would be permitted to be involved in the day-to-day management of an investee, regardless of whether the investee is another investment company or an operating entity. Accordingly, the staff believes it is inconsistent to require consolidation of a blocker fund because the parent investment company is involved in the investing decisions of that investee.

Alternative 4 – Prohibit consolidation of investment company subsidiaries in a fund-of-fund structure

57. Alternative 4 would require an investment company to measure controlling financial interests in another investment company subsidiary at fair value. This alternative would measure investment company subsidiaries consistently with all other controlled investees held by an investment company, except operating entities that provide services to the investment company, which are consolidated. This alternative would be consistent with the guidance in the IASB ED, although the IASB did not specifically discuss fund-of-fund structures prior to issuance of its Exposure Draft.

58. Alternative 4 would be consistent with user views as described in paragraphs 24 and 25 that an investment company should not consolidate its controlled investees. This alternative also would address the operational and conceptual concerns raised by nonuser constituents described in paragraphs 26 and 27.

59. However, Alternative 4 would not provide transparency into the activities of an investment company subsidiary and therefore, would not address the concerns stated in the Basis for Conclusions of the FASB ED. For example, an investment company could avoid reflecting leverage in its financial statements by holding borrowings within an investment company subsidiary. Also, expenses incurred by a subsidiary investment company would not be reflected as expenses incurred by the

top level fund. Rather, both leverage and expenses incurred would be included as part of the fair value of the interest in the investment company subsidiary.

60. Under Alternative 4, an investment company would not be *permitted* to consolidate an investment company subsidiary because it would be *required* to measure that investment at fair value. Therefore, an investment company would not be permitted to consolidate wholly-owned investment company subsidiaries, which would be a change in practice for some entities in the United States. Also, the staff notes this alternative would be inconsistent with the regulatory requirement to consolidate wholly owned investment company subsidiaries for initial registrations under the 1940 Act because it would require fair value measurement of those subsidiaries.

Staff recommendation

61. The staff recommends that an investment company measure all investment company subsidiaries at fair value (Alternative 4). In light of feedback received from users of investment company financial statements, the staff believes that fair value measurement of an investment company's investments, including those investees that the investment company controls, provides the most decision-useful information to investors. Furthermore, the staff believes that irrespective of the nature of the controlled entity, fair value information rather than consolidation provides more useful information (except in the case of operating entities that provide services to the investment company parent).

62. Investors in an investment company are primarily concerned about total return and changes to their net asset value per share. The staff agrees with user feedback that consolidation of investment company subsidiaries could clutter the financial statements and confuse that primary analysis. The staff also believes that consolidation in a fund-of-fund structure would give undue prominence to investment company subsidiaries when those subsidiaries may not be significant to the net assets of the investment company parent and therefore not significant to the net asset value per share of an interest held by an investor.

63. The staff also acknowledges the operational concerns raised by nonuser constituents. The staff believes those operational concerns would be increased if there are multiple layers in a fund-of-fund structure.

64. To estimate the fair value of an investment in an investment company subsidiary, the investment company parent would take into account the expenses incurred and the financial liabilities held by that subsidiary. The staff believes that concerns raised about transparency into the expenses incurred and leverage throughout the fund-of-fund structure can be addressed through disclosures in the notes to the financial statements rather than by consolidation. Consolidation in a fund-of-fund structure would only provide information about expenses incurred by controlled funds. It would not provide information about expenses incurred by funds in which the top level fund-of-funds has less than a controlling financial interest. Similarly, consolidation in a fund-of-funds structure would not provide information about borrowings obtained through a controlled operating entity rather than an intermediary investment company subsidiary. As previously indicated, the staff plans to discuss disclosures in a fund-of-funds structure at a future meeting.

65. The staff believes that an investment company should not consolidate some investment company subsidiaries and measure others at fair value. The staff does not recommend Alternatives 2 and 3 for that reason. The staff believes that there is no conceptual basis to distinguish between wholly owned subsidiaries and less-than-wholly owned subsidiaries. Furthermore, it would be easy for an entity to structure around such guidance. Also, the staff believes it would be very difficult to distinguish between an investment company subsidiary that is formed for a specific regulatory, legal, or tax purpose and those that are set up only for other business reasons.

Questions for the Boards
Do the Boards agree with the staff recommendations that: a. Along with its financial statements, each feeder fund in a master-feeder structure should be required to present its master fund's financial statements? b. An investment company should be required to measure all controlling financial interests in another investment company at fair value (in both master-feeder and fund-of-funds structures), rather than consolidating those subsidiaries?