

February 13, 2012

Financial Accounting Standards Board *Delivered Via E-mail: director@fasb.org* 

Re: File Reference No. 2011-200

Proposed Accounting Standards Update: Financial Services – Investment Companies (Topic 946)

The Small Business Investor Alliance appreciates the opportunity to comment on the Proposed Accounting Standards Update entitled Financial Services - Investment Companies (Topic 946). Small Business Investment Companies (SBICs) are small, highly regulated private investment funds, licensed and overseen by the U.S. Small Business Administration (SBA), that invest capital exclusively in domestic small businesses. We are the Small Business Investor Alliance (the Alliance), the trade association that represents the SBIC community. Our membership consists of over 130 private equity and mezzanine funds, funds in formation and limited partners. The Alliance also has accounting and law firms as its members. Among the 130 members, 96 members are fully operational mezzanine or private equity funds, most of which focus on lower middle market and small business, making debt and equity investments in the \$2 to \$25 million range. The majority of such members of the Alliance manage at least one active SBIC. The total assets under management by such firms is \$30 billion and the average (per firm) for assets under management is \$303 million in assets. The Alliance's membership is geographically diverse with approximately 40% in the Northeast, 32% in the Southeast, 23% in the Midwest, and the remaining amount elsewhere in the U.S.

By way of background, the purpose of the SBIC program is to increase the amount of capital available to small businesses. Since the passage of the Small Business Investment Act of 1958 (15 U.S.C. §681, et. seq.), SBICs have bridged the gap between entrepreneurs' need for capital and traditional financing sources and have provided more than \$60 billion to over 109,000 job-creating small businesses that would otherwise lack

the access to capital. SBICs sometimes invest in companies "off the beaten path" and usually invest in companies that do not qualify for financing from large financial entities.

SBICs have provided capital to many small businesses at critical moments in their early development, assisting in their growth and enabling them to become major employers. Such businesses include: Intel, Apple Computer, Callaway Golf, Whole Foods Market, Staples, Federal Express, Costco, and Quiznos.

SBICs are licensed and regulated investment entities that i) are required to invest in a diverse portfolio of small businesses for investment income and capital gains; ii) are independently and professionally managed by persons approved and licensed by SBA; iii) are strictly prohibited from investing in entities affiliated with their investors or associates; iv) must divest of their investment assets within a seven year time horizon; and v) are required to value and report their investments on a fair value basis. SBICs, through their licensing and regulatory structure, are investment companies with strict prohibitions on Affiliate transactions that protect against the accounting consequences that the Board is attempting to address.

Addressing the Board's criteria to qualify as an investment company, SBICs have no substantive activities other than investing activities; are required to hold multiple investments; have the objective of obtaining returns from investments from capital appreciation and investment income; have the sole express business purpose of making investments for capital appreciation and investment income; and require unit ownership representing an identifiable portion of the net assets of the company. Clearly, SBICs meet five of the six proposed criteria for recognition as an investment company with the possible exception being the "pooling of funds" requirement.

SBA regulations allow for single limited partner ("LP") SBICs provided that they do not utilize SBA guaranteed leverage. These non-leveraged SBICs are often bank-owned or bank-sponsored as they serve the dual purpose of promoting investment in small business, while also allowing banks to meet their Community Reinvestment Act ("CRA") objectives through capital commitments made to SBICs. Because SBICs are highly regulated by SBA, meet the public policy objectives of Congress by providing investment capital to small business, and do so through the commitments of private capital, SBICs are specifically permitted to receive bank investment under the Dodd-Frank Wall Street Reform and Consumer Protection Act's "Volcker Rule." This exemption from the Volcker Rule is expected to promote bank investment in SBICs as a consistent and effective method of providing jobs to America's job creators. As of Fiscal Year 2011 approximately 25% of SBICs licensed and regulated by SBA were bank-sponsored SBICs.

As a condition of licensing SBICs must adopt SBA's Valuation Guidelines, which require that investments be held, valued, and reported by the entity on a fair value basis. All SBIC funds are also required to provide its investors with Audited Financial

<sup>&</sup>lt;sup>1</sup> United States Small Business Administration (2011). Data Management Branch, Investment Division. SBIC Program Overview, Washington 2011. <a href="http://www.nasbic.org/?page=SBIC\_Statistics">http://www.nasbic.org/?page=SBIC\_Statistics</a>.

Statements with investments valued on a fair value basis. Should the proposed language be adopted, the investor in a single-LP SBIC, typically an SEC Registrant, would be required to utilize a different method of accounting, either through consolidation or the equity method, for each of the underlying investees of the SBIC. We don't believe that this is consistent with the objectives of the Board. The underlying investees of an SBIC are small privately-owned companies that may not have the financial systems that allow for timely and adequate reporting to ensure the proper consolidation by an SEC Registrant. We also believe that fair value reporting provides a more accurate depiction of the SBIC's investments.

SBIA strongly requests that the Board consider specifically recognizing Small Business Investment Companies as entities qualifying as investment companies or, alternatively, broadening the scope of entities defined as investment companies to those entities that are subject to both regulatory oversight and financial reporting that requires fair value reporting.

Below please find additional information which addresses specific questions posed in the Board's Questions for Respondents:

## **Scope**

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

We would agree that five of the six criteria appropriately identify entities as investment companies with the exception being the "pooling of funds" criteria. SBICs are, by regulation, investment companies, yet may be structured as single-LP entities, which would therefore not meet the "pooling of funds" criteria. SBICs are required to have a General Partner licensed by SBA, which is professional, independent and unaffiliated with its LP(s), and are prohibited from making investments in companies that are Affiliates or Associates of either the management GP or the investor LP(s), therefore "pooling of funds" is not a requirement. LPs are also legally and regulatorily prohibited from participating in the investment decision process or the management of an SBIC.

As currently proposed in the exposure draft the "pooling of funds" criteria for a single LP SBIC would result in the SBIC not being considered an investment company and therefore would require that the single LP of the SBIC use the applicable accounting methodology deemed necessary for consolidated financial reporting purposes, while the SBIC itself is required to use fair value reporting per its license and regulatory structure. We believe it is the Board's intent to avoid situations in which an entity would present assets and liabilities under two different measurement bases because it is considered an investment company for regulatory purposes but not for U.S. GAAP financial reporting purposes.

Either not requiring an entity to meet all six criteria, excluding the "pooling of funds" criteria, or broadening the scope of entities recognized as investment companies to include SBICs and/or those entities which are both regulated and required to report on a fair value basis would resolve this conflict.

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

As discussed above, SBICs are entities that are regulated investment companies licensed under the regulatory requirements of the U.S Small Business Administration. The regulatory framework governing the licensing and operation of SBICs insures that they meet the public policy objectives of Congress of stimulating the national economy by promoting private investment in U.S. small businesses, while also meeting the investment company structural and operational requirements of SBA. All of SBA's regulatory requirements are consistent with the criteria proposed by the Board for determining whether an entity is an investment company except the "pooling of funds" criteria, which is not necessarily required by SBA.

## **Unit Ownership and Pooling of Funds**

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

Under SBA regulations governing SBICs, the GP must be independent and unrelated to its investors, yet the entity may have a single LP holding a 99% interest and the GP holding 1% interest, the latter of which we presume would not be deemed a "significant ownership interest" under the proposed draft. Other SBA licensing and operating regulations are imposed on SBICs to prevent the consequences which we believe are the focus of the Boards exposure draft.

Specifically, to prevent an investment company from being inserted into a larger corporate structure to achieve certain corporate or accounting objectives, regulations governing SBICs include i) the requirement to invest in a diverse portfolio of multiple investments in small businesses with limitations on how much capital can be committed to any single investment; ii) the strict prohibition on investments in entities affiliated with its investors or Associates of either the GP or its LP(s); and iii) the requirement to divest of its investments within seven years. Additionally, SBICs report quarterly and are examined annually by SBA to ensure compliance with its regulations regarding operations, investments and conflicts of interest.

All of these SBA regulations serve to protect against the consequences the Board is attempting to address. Requiring the "pooling of funds" criteria with unrelated parties holding a "significant ownership interest" would result in a single LP SBIC not being considered an investment company and would result in the use of two different measurement bases of accounting for the same assets and liabilities by the SBIC and its investor. SBA regulations require that SBICs report on the basis of fair value accounting, yet the single LP would be required to either consolidate the underlying investees of the SBIC, or apply the equity method of accounting, or both, for the individual investees of the SBIC.

## Fair Value Management

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

We do agree with the criteria that all of an investment company's investments be managed, evaluated and reported on a fair value basis. This is the basis of management and reporting required by SBA regulations for SBICs. We believe the unintended consequence of the proposed draft is that the "pooling of funds" criteria would require that a single LP SBIC report on fair value basis for regulatory purposes and the applicable accounting methodology as deemed necessary for consolidated financial reporting purposes for its investor. We do not believe that requiring an LP to consolidate the underlying investments of an SBIC is operational or could be consistently applied given the financial reporting systems of the underlying small privately-owned business investees of an SBIC have not been designed to comply with public reporting requirements and therefore the timeliness and adequacy of the information may not meet the requirements of the proposed draft. For an LP to consolidate the underlying investees of an SBIC would in all likelihood require reporting on a lag basis and at substantial additional expense, while improving neither the timeliness nor usefulness of the information.

We thank the Board for the opportunity to submit these comments on the proposed ASU for *Financial Services – Investment Companies (Topic 946)*. While we understand the Board's objective of insuring that investment company structures are not utilized to achieve a particular accounting outcome, we do believe that the requirement proposed in the exposure draft that investment companies either be registered under the Investment Company Act of 1940 or meet all six of the proposed criteria will result in unintended negative consequences. We believe that either adding Small Business Investment Companies as a recognized investment company or broadening the scope of entities defined as investment companies to those entities that are subject to both regulatory oversight and financial reporting that requires fair value reporting will allow the Board to achieve its objectives without creating the unintended consequences identified in our letter. We would be pleased to discuss our comments with the Board or its staff.