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### VIA Email

Technical Director
File Reference No. 2011-200
FASB
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116
director@fasb.org

Re: Proposed ASU: Financial Services -- Investment Companies (Topic 946). Amendments to the

#### Introduction

The National Venture Capital Association ("NVCA") represents the vast majority of American venture capital under management. Venture capital funds provide start-up and development funding for innovative entrepreneurial businesses. NVCA's member firms, the funds they manage and the vast majority of the companies in which they invest are private entities.

NVCA appreciates the opportunity to comment on the Exposure Draft of the Proposed ASU on Investment Companies, ("the Proposal" or "the ED"). Our comments are informed by the expertise of NVCA's CFO Task Force. This group is made up of the Chief Financial

<sup>&</sup>lt;sup>1</sup> Venture capitalists are committed to funding America's most innovative entrepreneurs, working closely with them to transform breakthrough ideas into emerging growth companies that drive U.S. job creation and economic growth. According to a 2011 IHS Global Insight study, venture-backed companies accounted for nearly 12 million jobs and \$3.1 trillion in revenues in the United States in 2010. As the voice of the U.S. venture capital community, the National Venture Capital Association (NVCA) empowers its members and the entrepreneurs they fund by advocating for policies that encourage innovation and reward long-term investment. As the venture community's preeminent trade association, NVCA serves as the definitive resource for venture capital data and unites its 400 plus members through a full range of professional services. For more information about the NVCA, please visit <a href="https://www.nvca.org">www.nvca.org</a>.

Officers and Administrative Partners of more than 100 of our member firms. Members of our Task Force have been engaged in efforts to improve investment company accounting and financial reporting to venture investors for many years. Many of them had significant experience in public accounting and other professional fields prior to their careers in venture capital.

# **Background**

With guidance from the CFO Task Force, NVCA has worked with the FASB on every consolidation standard since FIN 46. Our consistent message throughout this process has emphasized investment company accounting as the proper means of reporting to venture capital investors. We applaud the FASB's success in bringing investment company accounting into the global arena and thus preserving this valuable tool for investors in US based funds. The key piece of information for users of venture capital fund financial statements, primarily institutional investors, is the fair value of their proportional interest in the fund. Therefore, it is critical to these investors that the GAAP financial reports of venture capital funds are prepared under Topic 946 using investment company accounting.

#### **General Comment**

In general, the six criteria for evaluating whether an entity is an investment company in proposed 946-10-15-2 are appropriate indicators of entities that should use investment company accounting. We understand that the FASB and the IASB intend that some of the restrictive language will deny the opportunity to "game" investment company accounting.

However, the Proposed ASU ("the Proposal" or "the ED") would cause the six criteria to be applied in an overly rigid manner. If each venture capital fund is subjected to a strict test of whether it trips any of a number of "sub-criteria" for each of the six criteria in the ASU, significant cost and reporting volatility could result. Therefore, we have two important interpretive recommendations regarding application of the six criteria.

The first is that the ASU explicitly state that the Topic 946 criteria are intended to state principles rather than rules. The second is that the ASU make it clear that the six criteria are to be used holistically to assess whether an entity qualifies for investment company accounting. Therefore, an entity should be able to use investment company accounting even if it does not fully meet every aspect of each criterion. Judgments on the proper use of investment company accounting should be based on the preponderance of the elements that make up the six criteria, the needs of fund investors and the fund's overall alignment with the underlying principles upon which investment company accounting is based. This general overlay to the new standard would serve to address many of the concerns that we have identified in the language of the ASU.

In addition, we believe that the rationale for the proposed *per se* investment company qualification for SEC-registered investment companies also supports a *per se* qualification for investment funds whose investors require reporting at fair value. Whether the requirement to prepare two separate types of financial report -- consolidated and investment company -- results

from regulation or investor demand, the resulting excessive burden of preparing reports based on two separate measurement bases is the same.

In addition, we do not see value in the proposals for funds-of-funds to consolidate other investment companies or the new disclosures regarding financial support and dividend restrictions for venture capital investors.

## **Specific Comments**

# ED Question 1: "The proposed amendments would require an entity to meet <u>all six of the criteria</u>...." [emphasis supplied]

For venture capital fund investors, the requirement to receive financial statements based on fair value reporting is not negotiable. These investors must use fair value reporting for their own financial statements. The Proposed ASU's requirement to meet all six criteria at all times is too restrictive a basis for assessing whether an entity is an investment company. Given the dynamic nature of venture capital funds and fund structures, we fear that some entities that have the same investment characteristics and ownership structure as typical venture funds might fail to meet one or more of the criteria in their design or might fail to meet one of the criteria for a brief period of time. Therefore, in addition to the holistic, principles-based approach recommended above, we strongly recommend modification of criteria a, c, and d in 946-10-15-2 as follows:

- a. Nature of the investment activities. The investment company's <del>only</del> substantive activities are investing <del>in multiple investments</del> for returns from capital appreciation, investment income (such as dividends or interest), or both.
- c. Pooling of funds. The funds of the investment company's <u>investor or</u> investors are pooled to avail the <u>investor or</u> investors of the benefit of professional investment management. The entity has <u>an investor that is or</u> investors that are not related to the parent (if there is a parent), and those investors, in aggregate, hold a significant ownership interest in the entity. representing a majority of the funds available for investment.
- d. Reporting entity. The investment company provides financial results about its investment activities to its <u>investor or</u> investors. The entity can be, but does not need to be a legal entity.

Both the requirement in criterion "a" for multiple investments and in criterion "c" for multiple non-related investors will not be met by certain venture capital fund structures that have the same investment goals and same non-related investors as typical venture funds. For a variety of reasons venture fund managers create "side funds" that have a single investor or that limit their assets to a single investment in order to accommodate a particular venture investor. Often, but not always, these limitations are driven by external requirements applicable to the particular investor. In each of these cases, all of the other criteria are clearly met and the investors would be ill-served by financial reports other than investment company reports at fair value. Therefore, either the criterion should be modified or the standard must be clear that no single criterion

should disqualify a fund from investment company status when the overall facts and circumstances of the fund and its investor or investors indicate that investment company accounting is the appropriate method of reporting.

ED 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 ...."

The rationale for this *per se* inclusion of regulated investment companies in the ASU's definition of an "investment company" is set out in BC9, pages 50-51 of the ED. It notes that SEC-regulated investment companies are required to use investment company accounting when reporting to the SEC. It states that their *per se* inclusion in the ASU definition is intended to "avoid situations in which an entity would be required to present assets and liabilities under two measurement bases because it is considered an investment company for regulatory purposes but not for U.S. GAAP financial reporting purposes."

Venture capital funds ("VCFs") fit the general definition of an "investment company" in the Investment Company Act ("ICA"); however, as "private funds" they are generally not regulated under the ICA by the SEC.<sup>2</sup> Nonetheless, like SEC-regulated funds VCFs are required to present asset and liabilities on a fair value basis. The only distinction is that the reporting requirement is driven by the requirements of investors, not by SEC regulation. Furthermore, in many cases, these investors' demands for fair value reporting are driven by their regulatory requirements under, for example, the ERISA law.<sup>3</sup>

Under the proposed ASU, a VCF that fails to meet a single criteria of the six-part definition would be required under GAAP to consolidate fund assets but would "be required to present assets and liabilities under two measurement bases," (BC9, ED p. 50), and incur the cost associated with such dual reporting. In light of the similarity of this situation to the one upon which the ASU bases the *per se* status of SEC-regulated investment companies, the same sort of *per se* status should apply to funds that would be regulated investment companies under the ICA but for the private fund exceptions stated in Section 3(c)(1) and 3(c)(7) of the Act. This approach would ensure that VCF investors would receive the fair value reporting they require and avoid the duplicative cost of two measurement bases in fund reporting.

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<sup>&</sup>lt;sup>2</sup> Section 3(a)(1)(c) of the Investment Company Act of 1940 says that "any issuer which is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis" is an investment company. However, Section 3 goes on to create the so-called "private funds exemptions" from SEC regulation through Subsections 3(c)(1) and 3(c)(7).

<sup>&</sup>lt;sup>3</sup> See e.g., BNA Pension & Benefits Blog (August 16, 2011 "What Does the New Accounting Standard on 'Fair Value' Mean to ERISA Fiduciaries?" ("ERISA requires that investments be reported at 'current value.' ERISA Section 3(26) defines 'current value' as follows: The term 'current value' means fair market value where available and otherwise the fair value as determined in good faith by a trustee or a named fiduciary (as defined in section 402(a)(2)) pursuant to the terms of the plan and in accordance with regulations of the Secretary, assuming an orderly liquidation at the time of such determination. ") Available at http://pblog.bna.com/penben/2011/08/what-does-the-new-accounting-standard-on-fair-value-mean-to-erisa-fiduciaries.html

ED Question 12: "The proposed amendments would ... require an investment company to consolidate controlling financial interests in another investment company in a fund-of-funds structure. An investment company would not consolidate controlling financial interests in a master-feeder structure. Do you agree with this proposed requirement for fund-of-funds structures?"

The proposed requirement for fund-of-funds consolidation of other investment companies in which it holds "a controlling financial interest" (946-810-45-3, ED p. 38) will almost certainly cause significant confusion for investors, preparers and accountants. We do not see the reason for these changes. The Proposal requires changes from current practice without providing sufficient practical rationale as to how this will improve financial reporting. Furthermore, the Proposal would create fundamental unresolved conflicts between US GAAP and IFRS treatment on this issue.

Investment structures have become particularly complex over the past 10 years. These structures provide benefits to investors and include, among others, the use of simpler blocker entities, parallel investing entities and structures that provide portfolio risk protection. Current practice in the industry for these types of entities includes consolidation of simpler blocker entities, combined financial statements of parallel investing entities with a common general partner, and master-feeder-like reporting for diversified fund of funds. It is unclear to us how the proposed changes will alter current practice. Furthermore, it is not at all certain that the resulting reporting will be an improvement for investors or if there will be negative unintended consequences.

We find the definitions of fund-of-funds and master-feeder structures unclear. For example, it is not uncommon in current practice for fund-of-funds to including copies of the underlying funds' financial statements for wholly owned funds from the same complex as attachments to their financial statements, much as a master-feeder structure would, to address concerns regarding transparency into the underlying investments and obligations of the master fund.

As with other consolidation requirements in the investment fund context, fund of funds consolidation may increase costs to investors, delay timely reporting to investors and present a number of difficult reporting issues for preparers and auditors.

We strongly urge further efforts to avoid different conclusions for US GAAP and IFRS on this issue. We urge the Board to conduct a survey of current practices and/or field testing or the proposed amendments. We would be happy to assist in any of this work. We agree that fund-of-funds reporting needs an appropriate level of detail; however, we believe that consolidated reporting would very likely reduce investors' understanding of their fund-of-funds investments, how those investments are owned and how they have performed.

### **Disclosure Requirements**

## Financial Support

The Proposed ASU would require a venture capital fund to disclose "whether it has provided <u>financial support</u> ... to any of its investments that it was not previously contractually required to provide support to or <u>whether it intends to provide such support including</u> ... the type and amount of support... [and] <u>the primary reasons for providing</u> the support." Proposed 946-20-50-15, ED p. 30 [emphasis supplied].

As a preliminary matter, we will note that current disclosures in GAAP venture capital fund financials are excessive, costly and generally not decision-useful. This is primarily because much more information is usually provided to VCF investors in quarterly and semi-annual reports. We see these new proposed disclosures as making the problem worse because of their vagueness and potential over-breadth. First, the ASU does not indicate the type of information sought or the information gap that the requirement is intended to fill. Before we can provide well-informed comments, "financial support" needs to be defined in a way that captures the type of information that Board has in mind.

Unfortunately the implementation guidance at paragraph BC43 only seems to broaden the net further with the language "explicit or implicit financial support." (ED p.58) Attempts to apply this broad requirement to venture capital would likely result in disclosures regarding ordinary course investments and other types of "financial support" that will add no useful information for investors and could be to the detriment of the venture capital fund, its investees, and, ultimately, the investors in the venture capital fund.

In the best case, the disclosure would be redundant. Paragraph BC43 states the Board's conclusion that such disclosure would help users "understand an investment company's exposure to risk." Unfortunately, it is not clear what "risk" the Board had in mind. For venture capital investors, most if not all risks fall into two major categories: loss in value of investments, and loss from contractually required future investment. These types of risks are adequately disclosed in existing financial reporting and disclosure requirements. Some examples are: cost and fair values of investments and changes in fair values are disclosed under Topic 946; the nature of information used in developing fair values is disclosed under Topic 820; and contractual contingencies come under, *inter alia*, Topic 450.

Without an informative and narrow definition of "financial support" we think this new disclosure would be more than redundant in many cases. It would be genuinely harmful. In the normal course of business, venture firms frequently provide additional financial support to their investee companies.<sup>4</sup> Venture capital funds generally have no "contractual" requirements to invest in or provide other types of financial support for their portfolio companies. Therefore, nearly every investment in a portfolio company could be described under this requirement even though they are routinely reported elsewhere in the financials.

<sup>4</sup> These "follow-on financings" are routinely reported in each quarterly financial statement issued by the fund.

The phrase "whether it intends to provide such support" presents two problems. As a substantive matter, future "financial support" for any venture capital portfolio company depends essentially on whether a company is again determined to a good investment. Again the breadth of the category "financial support … not previously contractually required" could apply to nearly everything of a financial nature done by a typical venture capital firm. Such disclosure would not benefit investors whose interest is in long-term returns that result only from liquidity events.

Furthermore, venture funds should not disclose plans for possible future financial support for their investee companies because this information is highly contingent, sensitive and arguably confidential. Compelling such disclosure would place the VCF in a no-win situation *vis-à-vis* important users of the fund's financials. A requirement to disclose such information would likely draw attention to both what the funds says and what it does not say. For example, if a fund that has invested in prior rounds failed to indicate an intention to fund an investee's next round of financing, it would probably prejudice the ability of the company to attract other investors in the next round. Therefore, while the proposed new rules appears to require a fund to only indicate intent to provide further support and the reasons therefore, it could easily result in a practical requirement to also provide an explanation when it does not indicate an intention to provide future support to an investee company. Furthermore, the economic interest of fund investors would be ill-served by any explanation that reflected poorly on the investee company.

On the other hand, if a fund disclosed its intent to provide future support, it would place itself at a disadvantage in future negotiations of the terms of investment with the portfolio company management. This also would disadvantage fund investors.

There is also litigation risk in disclosing an intention to provide financial support in the future, particularly if the investee company files for bankruptcy. Bankruptcy creditors could claim "intended" funds as assets in bankruptcy. Other interested parties might also make legal claims regarding a struggling company that a VCF's failure to provide "intended" support or the failure to indicate intent to support was a cause of the company's troubles. Therefore, this disclosure, which purports to provide information about "an investment company's exposure to risk," could actually create new risks for the fund and its investors.

Disclosure that attempted to minimize such risks would be marginally informative at best but potentially costly from both a financial and legal perspective. Therefore, we see little value, substantial cost and potential harm in the proposed disclosure regarding financial support.

# **Dividend Restrictions**

It is difficult to see any relevant information coming from application of this new disclosure requirement to venture capital in particular. For VCFs any transfer restrictions would be reflected in the fair value of assets from which the potential for such transfers arises.

It is true that venture funds invest in foreign companies in which regulatory or legal restrictions can raise doubts about the ability of an investee company to make transfers to a

foreign company such as the US venture fund. However, once again, as with other transfer restrictions, such risks are reflected in the fair value of the assets.

Therefore, we see no value in providing this new disclosure and a cost that far exceeds the benefits.

### **Non-public Entities Exemption**

We see our comments regarding the need to revise the ASU as pertinent for public as well as private investment company financial statements. However, it may be that there are benefits to some of the proposed disclosure requirements with regard to some types of complex investment funds, which may be more widely held by investors in the public securities markets.

Therefore, we will simply emphasize that for investors in *private* investment funds, neither consolidated financial reports nor these new disclosures will provide any benefit. To the contrary, these aspects of the proposed ASU will be wasteful of resources and will raise substantial risk of harmful consequences. Therefore, an exemption for non-public entities would be appropriate should the Board continue to require these disclosures for public entities.

#### **Conclusions**

We support the proposed ASU with the exceptions noted. We strongly recommend that the final ASU reflect our comments regarding:

- The Six Criteria -- a holistic approach to evaluating the qualifications of a fund for investment company accounting and elimination of the requirements for multiple investments and multiple non-related investors;
- A *per se* inclusion in the definition of "investment company" based on the needs of investors and the general definition in the Investment Company Act;
- Funds of funds consolidation substantial benefit would result from further study of current reporting on a variety of fund structures. We see much complexity and little investor benefit from a blanket requirement to consolidate funds held in a fund of funds structure.
- Disclosure drastically reducing, if not eliminating the proposed disclosures regarding financial support and dividend restrictions.

NVCA would be pleased to provide any assistance that we can make available. Please feel free to contact me or Jennifer Connell Dowling, Senior Vice President, at 703 524 2549.

Sincerely yours,

Mark G. Heesen

President