### **Bret Dooley**

Managing Director Corporate Accounting Policies

February 15, 2012

Ms. Susan M. Cosper Technical Director Financial Accounting Standards Board 401 Merritt 7, P.O. Box 5116 Norwalk, CT 06856-5116

File Reference: No. 2011-200 "Financial Services—Investment Companies (Topic 946)"

Dear Ms. Cosper,

JPMorgan Chase & Co ("JPMorgan Chase" or "the Firm") appreciates the opportunity to comment on the proposed Accounting Standards Update, *Financial Services—Investment Companies (Topic 360)* (the "proposed ASU") issued by the Financial Accounting Standards Board ("FASB" or the "Board").

## Executive Summary

We believe that fair value provides the most relevant information for users of financial statements for entities that make non-strategic investments for capital appreciation and investment income purposes, because it best incorporates the timing and amount of the future cash flows that will result from the sale of the investments.

We are concerned that the proposed ASU would prohibit fair value accounting (and instead require consolidation) in certain circumstances where fair value is the most relevant information for users. For example, by focusing on the nature of the *parent* of the investment company rather than the *activities* of the investment company, the ASU's criteria for applying investment company accounting could inappropriately prevent merchant banking activities from qualifying for investment company accounting. As discussed further below, we believe that the pooling of funds criterion is unnecessary to achieve the Board's objectives and that eliminating fair value accounting in such circumstances would only complicate communication with investors and analysts of the parent company regarding these merchant banking activities.

A more effective approach would be to retain certain proposed criteria (such as the nature of investment activities, express business purpose, and fair value management) that relate directly to the activities of the entity, and to remove the proposed criteria that relate to the nature of the owners of the entity (such as the pooling of funds criterion). Removing the ownership-based criteria (or changing them to considerations rather than requirements) would still achieve the Board's objective to appropriately scope the use of investment company accounting (i.e. to exclude entities that make potentially strategic investments), and would also eliminate the need for a special exemption for certain types of entities (e.g. single investor pension plans).

Merchant banking activities are aligned with investment company criteria

Financial holding companies are authorized to make certain investments in portfolio companies in accordance with the merchant banking rules and regulations established under the Bank Holding Company Act of 1956 (as amended, the "BHC Act") by the Board of Governors of the Federal Reserve System (the "Federal Reserve"). Merchant banking activities provide several benefits to the economy at large. The authorization of merchant banking activities under the BHC Act (as provided for in the Gramm-Leach-Bliley Act of 1999 (as amended, the "GLB Act")) was designed to recognize the essential role that these activities play in modern finance and provided financial holding companies with the ability to participate in the market for providing equity financing to commercial companies.

The regulatory restrictions for merchant banking activities are similar to many of the proposed ASU's requirements to qualify as an investment company. The BHC Act permits financial holding companies to make controlling and non-controlling privately negotiated investments under certain conditions, which include: (i) that investees be nonfinancial in nature, (ii) that the investments may not be held for more than 10 years unless specific approval from the Federal Reserve is sought and obtained, (iii) that the financial holding company not be involved in running the day-to-day business activities of the investment, and (iv) a prohibition on cross-marketing products and services by any depository institution owned by the financial holding company. Not only are these companies expected to be owned for a limited period, but by regulation, their business operations are not, and cannot be integrated with the respective financial holding company. Therefore, no merchant banking portfolio company could be considered a strategic investment for the financial holding company. Thus, the merchant banking criteria are closely aligned with the proposed ASU's criteria to be an investment company, in particular the nature of investment activities, and express business purpose criteria.

#### Fair value is the most relevant measurement attribute

Under the BHC Act, financial holding companies that provide merchant banking services may make controlling or non-controlling investments in non-financial companies with the purpose of capital appreciation to be realized upon sale of the investment. These investments are typically managed on a fair value basis, consistent with the nature of the investment returns that will be realized upon sale. Since financial holding companies engaged in merchant banking activities are not involved in the day-to-day operations and management of the investees, and the investments are limited in their duration, we do not see the benefit provided to users of financial statements by consolidating these entities. We do not believe that there should be a difference in the accounting treatment between a substantial minority stake and a majority stake for merchant banking investments, given the restrictions on being involved in the day-to-day management and the limited duration of the investments. Consolidating assets and liabilities of these majority owned investees would be misleading to users of the parent's financial statements because consolidation emphasizes the financial position, operations and cash flows of the investee rather than the cash flows to be realized upon the sale of the investee. Also, because the assets of the investees that would be consolidated are related to entities that are not financial in nature it may be confusing to users in their analysis of the operations of the financial holding company. Including these assets and liabilities in the financial statements of the financial holding company is not representative of the nature of the investments and could distort important financial and capital ratios that are based on balance sheet or income statement information.

## Pooling of funds criterion has unintended consequences

The FASB's proposal that an investment company meet all the criteria of section 946-10-15-2 of the Proposed ASU will prevent financial holding companies engaged in merchant banking activities that make controlling investments from continuing to apply fair value accounting. Such entities will thus be required to either consolidate their limited duration controlling interest investments (complicating

investor communications as discussed above) or significantly change their business activities in order to meet the pooling of funds criterion that requires significant third party investors in the investment company.

In order to apply investment company accounting under the proposed ASU, financial holding companies using fund structures to engage in merchant banking activities would be required to attract third party investors. However, pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), a banking entity's investments in funds that have third party investors would be limited to 3% of the total capital in the fund. In order to comply with both the Proposed ASU and the Dodd-Frank Act, a financial holding company would have to increase the third party investments in its investment company fund structure to 97%—clearly a level of "significance" for third-party interests that was not intended by the FASB. Additionally, with only 3% ownership in the fund, merchant banking is unlikely to be a viable business.

## Consolidation has other important unintended consequences

The impact of consolidation of controlling investments made solely for short-term capital appreciation purposes is not limited to preparers and users of their financial statements. Those investee firms not already subject to the Sarbanes-Oxley Act of 2002 ("SOX") if consolidated by an entity subject to SOX would be required to implement and document SOX controls that may be cost prohibitive for growing private companies. The cost of such control and documentation processes could influence investment decisions for investors and capital sources for investees. One important benefit of merchant banking activities is that they provide small businesses with an attractive alternative source of capital. Middle market private companies are often overlooked by venture capital firms as a result of their size and also by later stage private equity firms as a result of a number of milestones that may need to be achieved before such companies are in a position to raise equity in public markets. Banks serve as a valuable source of capital for such businesses. Companies with merchant banking partners often have the strong financial support to enter the public market as innovative competitors. In this way, merchant banking activities fill a niche as a valuable source of capital for certain small- and medium-sized companies that would be hindered by the proposed ASU, when considered in context of the Dodd-Frank restrictions.

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We have additional comments about other specific aspects of the proposed ASU that can be found in our responses to certain of the Questions for Respondents in Appendix I of this letter. We appreciate the opportunity to submit our views and would be pleased to discuss our comments with you at your convenience. If you have any questions, please contact me at 212.648.0404.

Sincerely yours,

**Bret Dooley** 

Appendix I

## **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 do not believe that all six of the criteria should be required to be met in order to qualify as an investment company. As discussed in the body of our comment letter, there are valid applications of investment company accounting, in particular for merchant banking activities, when an entity may not meet the pooling of funds criterion, and recommend the FASB remove it from the Investment Company criteria.

We understand that the Board is concerned that without the pooling of funds criterion the model may inappropriately provide an entity with the ability to use investment company accounting for majority owned investments that are part of its business operations. However, by emphasizing the other investment company criteria, in particular the nature of investment activities and express business purpose criteria, any such situations would be prevented. These criteria focus on whether or not an investment is strategic and meant to be part of an entity's overall operations. Additionally, this approach would still achieve the Board's objective to clarify the scope of Topic 946 and to prevent certain entities the Board has identified in the proposed ASU from qualifying as investment companies because those entities would not meet the express business purpose criterion. In addition, such an approach would eliminate the need for an express scope exception for certain single investor entities, such as pension funds. We believe that because investment company accounting is applied on a reporting entity level that it can easily be monitored by management, auditors and regulators to ensure it is being appropriately applied. The entity's history can be evaluated to identify whether investments are made for capital appreciation and investment income or are part of the entity's operations. Auditors and regulators can also monitor if the entity is meeting the express business purpose criterion by exiting investments according to its documentation.

### Question 4:

The proposed amendments would require an entity to reassess whether it is as an investment company if there is a change in the purpose and design of the entity. Is this proposed requirement appropriate and operational? If not, why?

We support the requirement to reassess whether an entity meets the investment company criteria if there is a change in the purpose and design of the entity. A significant change in the purpose and design of the entity that is inconsistent with investment company accounting should be reflected by a change in the accounting for its investments. Based on our experience with FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities, and FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R) we believe reassessments based on design/purpose changes would be operational.

### **Nature of the Investment Activities**

### Question 6:

The proposed implementation guidance includes examples of relationships or activities that would indicate that an entity obtains or has the objective of obtaining returns from its investments that are not capital appreciation or investment income. Do you agree with these examples? If not, how would you modify the examples while still addressing the Board's concerns identified in paragraphs BC15 and BC16?

The wording in paragraph 946-10-55-7 of the proposed ASU could be applied in a very broad manner to disallow activities by affiliates that we believe should be permissible. Section 946-10-55-7 states that "An entity would not meet the nature-of-the-investment-activities criterion if the entity or its affiliates obtain or have the objective of obtaining returns from its investments other than capital appreciation or investment income in entities other than an investment company or an investment property entity as defined in Topic 973." We are concerned that this language may disallow other related entities from engaging investment company investees in any transactions, including customary banking relationships such as lending arrangements, derivative transactions, etc. An investee should not be limited in its sources of funding, or other capital markets transactions, solely because such entities are related to an investor. Investees that use a related entity to the investor for financing, hedging or other transactions, that are arms-length and done in the normal course of business should be permissible because they do not change the investment companies' investment objective to invest for capital appreciation or investment income, exit strategy or in general the nature of investment activities or express business purpose of the investment company entity. Therefore, we believe that FASB should clarify that arms-length transactions done in the normal course of business between affiliates of the investment company and an investee would not cause an entity to fail the nature of business activities criterion.

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

#### *Ouestion 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?

The nature of the entity's investors should not be a primary factor in the accounting for the entity's assets, but instead, the nature of the business activities and purpose and management of the investments should be the primary considerations. As described in more detail in the main body of this letter, focusing on the nature of the parent instead of a sole focus on the nature of the business activities of the entity will result in consolidation accounting for certain investments that are not strategic to the investor and held for sale in the short term. Consolidation is not the most relevant representation in the financial statements for investments that are made for capital appreciation and investment income purposes and are managed on a fair value basis. Requiring the investment company to consolidate an investee will impede the ability of users of financial statements to assess the entity's financial position and results because it emphasizes the financial position, operations and cash flows of the investee rather than the ultimate cash flows to be realized upon the sale of that investee entity. Fair value is the most relevant information for management and investors because it best incorporates the timing and amount of the future cash flows that will result from the sale of the investments.

### Question 9:

Certain entities may meet all of the other criteria to be an investment company but have only a single investor (for example, a pension plan). The amendments in FASB's proposed Update on investment property entities provides that if the parent of an entity is required to measure its investments at fair value under U.S. GAAP or the parent entity is a not-for-profit entity under Topic 958 that measure its investments at fair value, the entity would not need to meet the unit-ownership and pooling-of-funds criteria to be an investment property entity. Considering the Board's concerns identified in paragraph BC24, should the criteria in this proposed Update be amended to address situations in which the entity has a single investor?

As expressed above, we disagree that the pooling of funds criterion should be required in order to qualify as an investment company. Accounting for investments should not be driven by the nature or number of the business owners, but by the business activities of the entity. Therefore, we recommend that the FASB remove the pooling of fund criterion as a requirement that must be met to qualify as an investment company. Additionally the Board's concern related to an entity inserting an investment company into a larger corporate structure to achieve a particular accounting outcome is already addressed by requiring entities to meet the nature of investment activities and express business purpose criteria. The pooling of funds criterion is not necessary to meet the Boards' scope limitation objectives. In addition, removing the pooling of funds criterion would relieve the FASB's need to provide a special exception from the criterion for those single investor entities (e.g. pension funds) that are required to measure its investments at fair value under U.S. GAAP, and would avoid the other important unintended consequences noted in the main body of our comment letter.

## 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 agree with the requirement that an investment company should be required to manage and evaluate the performance of its investments on a fair value basis. The accounting of the assets of the entity should be reflective of the activities of the entity. Managing assets on a fair value basis is an important indicator that the entity is managing the investments for capital appreciation because fair value is the best representation of the exit value of the investments. Additionally, we agree with the FASB's conclusion in paragraph BC29 of the proposed ASU that money market funds would meet this criterion because they are managed to minimize the difference between the carrying value and the fair value of their investments to maintain a constant net asset value.

## **Interests in Other Entities**

## Question 12:

The proposed amendments would retain the requirement that an investment company should not consolidate or apply the equity method for an interest in an operating company unless the operating entity provides services to the investment company. However, 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? If not, what method of accounting should be applied and why? Should a feeder fund also consolidate a controlling financial interest in a master fund? Please explain.

We disagree with the FASB's proposal that an investment company consolidate a controlling interest in a fund-of-funds structure. The FASB concluded that master-feeder structures should be exempt from this requirement because the current presentation and disclosure requirements of master-feeder structures includes disclosure of the master fund's financial statements as part of the feeder fund's financial statements. The same logic applies to fund of funds structures. Investment company investors are most concerned with the fair value of a fund's investments that directly drive the fund's net asset value and the investor's ownership interest, which would be misleading if consolidation of a fund-of-funds structure is required. Additionally, we do not understand the benefit of consolidation when the proposed disclosures would effectively reverse the consolidation by excluding the portion related to the noncontrolling interest. Therefore, we believe an investment company should not consolidate entities that it controls and should measure investments in such controlled entities at fair value with changes recognized in the income statement of the fund.

## **Retention of Specialized Accounting**

## Question 18:

The proposed amendments would retain the current requirement in U.S. GAAP that a noninvestment company parent should retain the specialized accounting of an investment company subsidiary in consolidation. Do you agree that this requirement should be retained? If not, why?

We strongly support the FASB's decision that the parent of an investment company retain the subsidiary's accounting for those investments. We do not understand why the accounting for an investment would change in consolidation if it is determined at the subsidiary level that fair value is the best representation of that investment. Additionally, the FASB's decision to retain investment company accounting properly reaffirms the concept that a parent should retain the subsidiary's accounting as established in Subtopic 810-10 (EITF Issue No 85-12, Retention of Specialized Accounting for Investments in Consolidation).

#### **Effective Date and Transition**

## Question 19:

An entity that no longer meets the criteria to be an investment company would apply the proposed amendments as a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption by calculating the carrying amounts of its investees as though it had always accounted for its investments in conformity with other applicable U.S. GAAP, unless it is not practicable. If not practicable, the entity would apply the proposed amendments as of the beginning of the period of adoption. Do you agree with this proposal? If not, why?

The proposed ASU would require retrospective application at initial adoption and require prospective application for entities that no longer meet the investment company criteria after the effective date (section 946-10-25-1 of the proposed ASU). We disagree with the proposal being applied on a retrospective basis to entities that no longer meet the investment company criteria at the effective date. For the reasons explained below, we believe that retrospective application will generally be impracticable, and therefore question the benefit of requiring preparers to expend the resources necessary to demonstrate that it is impracticable. Additionally, requiring all preparers to apply the guidance prospectively will lead to greater comparability for users to understand the impact of the proposed guidance at transition.

Retrospective application to investments that an entity holds at transition and those it has sold prior to the transition would be extremely difficult to apply because it would require an understanding of the detailed financial statements for investments that would need to be consolidated, which may not be readily accessible or obtainable for all the periods needed. Retrospective application would require that an entity

apply business combination guidance to these entities which it would have been required to consolidate, which would require significant assumptions about the fair value of numerous individual assets and liabilities of these entities at historical dates in order to allocate initial purchase price. In many circumstances such judgments would be very difficult to make without hindsight bias. Additionally, retrospective application would result in a significant burden on a parent to ensure the consistent application of its own accounting policies and practices in the historical financial statements of individual portfolio companies that it would be required to consolidate.

Additionally, we do not understand why the FASB would require retrospective application at initial adoption, but allow prospective application for entities that no longer meet the investment company criteria after the effective date (section 946-10-25-1 of the proposed ASU). The reasons to allow prospective application after the effective date also exist at transition. Therefore, we recommend that the FASB not require retrospective application at the effective date for those entities that no longer qualify for investment company accounting.

## Question 20:

How much time would be necessary to implement the proposed amendments?

For the reasons noted in our response to Question 19, retrospective application would generally not be practicable. Assuming that most impacted entities would need to utilize the practicability exception, we believe it would take a minimum of one year from the date of the issuance of a final standard to be able to implement the proposed ASU as drafted. Additionally, implementation of the proposed ASU should occur only after the FASB completes its project relating to classification and measurement of financial instruments because entities that no longer meet the criteria for investment company accounting will be subject to other applicable GAAP for their equity, debt and other investments. Otherwise, impacted entities would be subject to two transitions for the same investments within a short period of time.