# February 15, 2012

### VIA Email

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File Reference No. 2011-200
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Re: Proposed ASU: Financial Services -- Investment Companies (Topic 946)

### Introduction

Independence Capital Partners, LLC (ICP) is the finance and accounting group for several closed end private equity funds with more than \$9 Billion of equity raised in more than 34 investment partnerships. These funds invest in real estate, growth capital to private companies, start-up and development funding for innovative entrepreneurial businesses, and community banking companies. I participated in several conversations on this topic with the NVCA and included some of their points in this letter. However, our comments reflect our view for all of our funds (including real estate, growth equity and buy-outs), the users of our financial statements (LPs and banks) and our joint venture partners. Given the limited time, we will not be able to comment separately on Investment Property Entities (Topic 973) or Consolidations (Topic 810).

## **Background**

Our firms have submitted comment letters in the past to the FASB on consolidation standards since the issuance of FIN 46R-d. Our consistent message throughout this process has emphasized investment company (IC) accounting as the proper means of reporting to private equity investors. We applied 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 private equity 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 most if not all of private equity funds be prepared under Topic 946 using investment company accounting. This is also our position on the ASU on Investment Property Entities – Topic 973.

#### **General Comments**

Our funds are owned by hundreds of Endowments, Foundations, State Retirement Plans, Corporate Retirement Plans, Fund of Funds and High Net Worth individuals. Our real estate funds typically hold hundreds of positions (just like a mutual fund). Some of these investments are in hotels, condo development projects and resort residential. Most are in multi-family and office. The use of fair value is the only relevant reporting standard to apply. Our investors want to know what we paid for something and what it is worth (even for IPE's). In general, we believe 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.

However, the Proposed ASU should explicitly state that the Topic 946 criteria are intended as principles rather than rules. If each private equity 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. The ASU should make it that the six criteria are to be used from a comprehensive perspective 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. If these rules cannot be viewed as principles, there should be some mechanism to permit reporting entity to retain investment company accounting even though a portion of the reporting entity's investments are otherwise not qualifying (20% has been used in the regulatory arena). These general principles could be augmented with anti-abuse rules to prevent "gaming" by entities that

would not otherwise be viewed as investment companies (as seems to be of major concern to the Board).

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.

## **Specific Comments**

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

For private equity fund investors (including those in real estate) the requirement to receive financial statements based on fair value reporting is not negotiable. The Proposed ASU's requirement to meet all six criteria at all times appears too restrictive a basis for assessing whether an entity is an investment company. Given the dynamic nature of private equity funds and fund structures, we fear that some entities that have the same investment characteristics and ownership structure as typical funds might fail to meet one of the criteria in their design or might fail to meet one of the criteria for a brief period of time.

Both the requirement in criterion "a" for multiple investments and in criterion "c" for multiple non-related investors will not be met by certain private equity fund structures that have the same investment goals and same non-related investors as typical funds. For a variety of reasons private equity fund managers create "side funds" that have a single investor or that limit their assets to a single investment in order to accommodate particular tax, regulatory or legal needs of investors. 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.

We feel that 946-10-55-6 and 946-10-55-13 items a-c are clear examples that these rules should be principle based rather than rule based.

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 ...."

While we are not aware of criteria that may not be met by RICs, the rational for this *per se* inclusion of regulated investment companies in the ASU's definition of an "investment company" should be equally applicable to private equity funds. SEC- regulated investment companies are required to use investment company accounting when reporting to the SEC and 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." Private equity funds ("PEFs") are generally exempt from regulation under the Investment Company Act ("ICA") under the 3(c)(1) and 3(c)(7) exemptions. However, like SEC-regulated funds PEFs are required to present asset and liabilities on a fair value (FV) 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 investor demands for fair value reporting are driven by their regulatory requirements under ERISA, for example.

Under the proposed ASU, a PEF 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," *id.*, 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

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the exemptions stated in Section 3(c)(1) and 3(c)(7) of the Act. This approach would ensure that PEF investors would receive the fair value reporting they require and avoid the duplicative cost of two measurement bases in fund reporting.

ED Question 3: In addition, do the amendments in the proposed Updates on investment companies and investment property entities appropriately identify the population of real estate entities that should be investment companies and investment property entities (IPEs)?

No. We believe that closed end private equity real estate funds (REFs) should remain under investment company accounting. Whether there are controlling or non-controlling investments does not change the focus on fair value. Consolidation, a difficult and changing term under accounting literature, often distorts the financial information for an investment fund by giving it undue influence on the balance sheet and income statement. For a fund with 100 or more joint ventures (JVs) - with operating partners across the country in most all real estate asset types - in a single reporting entity, having a hand full of JVs subject to consolidation and included in the fund's assets and liabilities (while the vast majority remain unconsolidated) is likely to significantly distort the financial statement presentation. (Again, the reader should note that our investors would require an adjustment to FV for their reporting purposes and have it audited so that they could use it in their GAAP reporting.) The debt we use in the JVs is virtually always non-recourse to the fund. We believe that any guarantees or carve-outs are adequately handled through FIN 45 and/or FAS 5.

We take issue with the consolidation of investment properties as well. Combining the operating results of a property in New York with a property operating in the Southeast (for example) - likely at different stages of redevelopment or repositioning, likely in different types of real estate - is unlikely to produce meaningful results in an opportunity fund looking for capital appreciation. Consolidation also presumes that we will always have access to sufficient information from our operating partners. Of course, this is not always the case, especially when the investment is in distress or when the operations are not going according to plan.

Furthermore, many JVs currently use Other Comprehensive Basis of Accounting for their financial statements. Predominantly, this other basis is the income tax basis. Where we can, we require income tax basis audits at the JV level as a critical component of managing our tax reporting risk to our investors. We believe that prohibiting REFs from IC accounting or requiring consolidation would have a significant adverse effect on our operating partners, our investors' performance (i.e. due to additional costs), our tax reporting, and the smaller and mid-tier CPA firms that many smaller property JVs use.

Most investment funds produce quarterly or semi-annual reports to investors in tremendous detail. For our larger funds, these reports can reach hundreds of pages. The audited financial statements can never reach this level of detail – nor should it. The proposal on IPEs seemingly is the worst of both worlds – combining a requirement to consolidate with the requirement to fair value the assets.

ED Question 5: An entity......However, the entity would be precluded from being an investment company if the other activities were considered more than supporting the entity's investment activities (for example, construction). Is this requirement operational?

No – we do not feel that this is operational nor appropriate under investment company accounting for real estate funds. 946-10-15-2 (a) does not define substantive. Real estate opportunity funds can invest in hundreds of JVs. For a fund with 100 JVs in office, retail, multifamily, etc., making investments in JVs in condo development, hotels or homebuilding should not prohibit investment company accounting. We are not convinced that mere investment in these types of businesses should be "outside" the IC scope, even if the interest rises to the level of "controlling" (temporary or otherwise). If a RIC invests in the common stock of a homebuilder or a PEF invests in a controlling interest in a homebuilder (or a manufacturer of widgets), it appears there is no requirement to look through to the underlying business of investment and IC accounting would be appropriate. We question why this would be different for a "real estate" investment fund. Of course, an entity almost entirely in the integrated trade or business of construction, etc. should not be reporting under the IC guide. However we feel that

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the six criteria if expressed as principles, or the addition of anti-abuse rules, would be the more appropriate means of addressing this problem.

ED Question 9: should the criteria in this proposed Update be amended to address situations in which the entity has a single investor?

Yes – as discussed above.

ED 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 generally agree with this statement. However, the fact that managers are often focused on key metrics that translate into FV should not be viewed as not managing on a FV basis. For example - on most investments monitoring revenues, NOI, EBITDA, etc. is a manner of managing on a FV basis. In most valuation models, these attributes are key inputs.

ED Question 13: The proposed amendments would require an investment company to consolidate a controlling financial interest in an investment property entity. Should an investment company be subject to the consolidation requirements for controlling financial interests in an investment property entity? If not, what method of accounting should be applied and why?

As discussed above, we do not agree. The Board has gone to great lengths to try to properly identify entities should report on FV and their investors that need reporting on FV. We do not see the benefit of introducing non-FV information (gross rents/gross rental expenses) directly into the financials.

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ED Question 17: Do you agree with the additional proposed disclosures for an investment company? If not, which disclosures do you disagree with, and why?

# Financial Support

The Proposed ASU would require a PEF 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].

Current disclosures in PEF financials are extensive already. We have concerns with these new proposed disclosures. The term "financial support" needs to be defined. The implementation guidance at paragraph BC42 seems to broaden the requirement with the language "explicit or implicit financial support." Attempts to apply this broad requirement to private equity would be difficult.

Without an informative and narrow definition of "financial support" we think this new disclosure would be more than redundant. It could be harmful in many cases. In the normal course of business, firms frequently provide additional financial support to their investee companies. The phrase "whether it intends to provide such support" presents two problems. As a substantive matter, future "financial support" for any investment depends on essentially whether it is a good investment. The breadth of the category "financial support … not previously contractually required" could apply to nearly everything of a financial nature done by a typical PEF. Such disclosure would not benefit investors whose interest is in long-term returns that result only from liquidity events.

<sup>&</sup>lt;sup>1</sup> These "follow-on financings" are routinely reported in each quarterly financial statement issued by the fund.

Furthermore, PEF should not disclose plans for possible future financial support for their investments because this information is highly contingent and confidential. Compelling such disclosure would place the PEF in a no-win situation *vis-à-vis* important users of the fund's financials. For example, if a fund indicated an intention to not fund the next round of financing for an investee company, it would prejudice the ability of the company to attract other investors in the next round. Therefore, while the disclosure requirement is only to indicate intent to provide further support and the reasons therefore, it could easily result in a practical requirement to also provide reasons – ones that do not reflect poorly on the investee company -- as to why the PEF is not indicating an intention to provide future support.

On the other hand, if a fund discloses its intent to provide future support, it would then be at a disadvantage in future negotiations of the terms of investment with the portfolio company management. There is also litigation risk in making such an intention known, particularly if the company files for bankruptcy. Creditors could claim "intended" funds as assets in bankruptcy. Other investors might also make legal claims regarding a failing company that a PEF's failure to provide "intended" support or the failure to indicate intent to support was a cause of the failure. Disclosure that attempted to minimize such risks would be marginally informative at best.

Therefore, we see little value, substantial cost and potential harm in the propose disclosure regarding financial support.

### **Dividend Restrictions**

It is difficult to see the relevant information coming from application of this new disclosure requirement to PEF in particular. The primary exit strategy of PEFs is to sell or otherwise dispose of an investment within the term of its life. While there are refinancings, dividend recaps, and tax distributions available from investments, it is not the typical transaction. Almost all private equity investments have restrictions on distributions, whether debt-based or otherwise. Since this would be an expected condition on most every investment, we believe that it would not be helpful to financial statement users and would cause additional reporting costs.

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

ED Question 22: The proposed amendments would apply to both public and nonpublic entities. Should the proposed amendments apply to nonpublic entities? If not, should the proposed amendments differ for nonpublic entities and why?

## **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 statement. 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.

## **Conclusion**

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

• The Six Criteria -- a comprehensive principles-based 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.

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- A *per se* exception based on the needs of investors and the general definition in the Investment Company Act including funds raised under the 3(c)(1) and (7) exemptions.
- Providing real estate investment funds the same IC accounting as other private equity investment funds and RICs
- Disclosure drastically reducing, if not eliminating the proposed disclosures regarding financial support and dividend restrictions.

We would be pleased to provide any assistance that we can make available.

Sincerely yours,

R. Eric Emrich CFO, Treasurer and Vice-President