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VIA Email

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RE: Exposure Draft: *Proposed Accounting Standards Update*, Definition of a Public Business Entity, An Amendment to the Master Glossary, File Reference No. 2013-310

INTRODUCTION

The National Venture Capital Association (“NVCA”) represents the vast majority of American venture capital under management.¹ Venture capital funds provide start-up and development funding for innovative entrepreneurial businesses. We appreciate the opportunity to comment on the Exposure Draft of the Definition of a Public Business Entity.

We have supported the FASB and the FAF throughout the many efforts to adapt GAAP to private company needs. NVCA members have participated in the FASB Small Business

¹ 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 www.nvca.org.

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Advisory Committee, the Private Company Financial Reporting Committee and the FASB-AICPA-NASBA Blue Ribbon Panel, among others. We also supported the development of the Private Company Council (“PCC”). We recently commented on the Private Company Decision Making Framework in an effort to ensure that the FAF’s effort to adapt GAAP to private companies remain relevant both to venture capital funds and to the companies in which they invest.

As we have often noted in this context, venture capitalists are both users and preparers of private company financial statements. Venture capital funds are nearly all private entities that invest primarily in private companies. In addition, some NVCA members manage funds of funds and use venture capital fund financials. Therefore, our comments are based on concerns we have as:

- users of general purpose private company financial statements,
- preparers of venture capital fund (investment company) statements, and
- users of venture capital fund financial statements.

We have reviewed the Exposure Draft, *Proposed Accounting Standards Update, Definition of Public Business Entity, An Amendment to the Master Glossary*², (“the Exposure Draft” or “the ED”). Our comments respond primarily to Question Two in the Exposure Draft: “*Do you agree with the definition of a public business entity included in this proposed Update? Please explain why.*”

GENERAL COMMENTS

The proposed definition is actually a set of five broad, inclusive criteria.³ Meeting any one of these can sweep an entity in the “public” category and deny it any benefit of the work of the Private Company Council.⁴ As a general matter, we foresee significant risk and complexity arising from the dependence of the various criteria on legal and regulatory requirements. The Board’s proposal to establish detailed criteria to identify all companies that “access the public capital markets by issuing securities that are publicly traded”⁵ would create a vague and

² Exposure Draft, *Proposed Accounting Standards Update, Definition of Public Business Entity, An Amendment to the Master Glossary*, Available at http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176163150997

³ *Id.* Page 7.

⁴ *Id.* Page 1 (“The primary purpose of this proposed Update is to: . . . b. Identify the types of business entities that would be excluded from the scope of the [*Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies(guide)*].”

⁵ *Id.* Paragraph BC11, page 11.

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changeable status for many companies that have not affirmatively sought to access public capital.

Paragraph BC11 of the Exposure Draft frames the issue by setting out a “current” definition of a publicly traded company and then noting the broader principle that apparently underlies the five exclusionary criteria in the proposed definition.

“Under all of the definitions of a nonpublic entity and public entity in the Accounting Standards Codification, entities that file financial statements with a regulatory agency in preparation for the sale of securities or for the purpose of issuing securities are defined as public companies. The financial statement users of entities that issue securities that trade in a public market generally lack direct access to management to obtain material financial information, and it is common for there to be a large number of financial statement users that have broader, more diverse needs and that use financial information for different reasons than typical users of private company financial statements. The six significant differential factors between public companies and private companies described in the guide were developed primarily on the basis of entities that access the public capital markets by issuing securities that are publicly traded. Therefore, when assessing those entities and their relationship to the six significant differential factors, the Board concluded that those entities should be considered public business entities.”⁶

The Exposure Draft distills from the common elements of all current definitions of nonpublic and public entities a definition that suggests an affirmative intent to become a public company. Indeed, a company that files financial statements with a regulatory agency in order to sell or issue securities to the public has chosen to accept the regulatory obligations that come with access to public capital. Investors in these companies know that they will have to rely heavily upon filed financial information. They also know that they are not nearly as constrained in selling their shares as they would be in a private company investment. Thus investors can be clear about the company’s status, what to expect from its financial statements and what other avenues of information and liquidity are available.

This type of definition brings the benefits of simplicity and certainty while aligning the company’s accounting status with its practical status as affirmatively and clearly public. As investors in private companies that range from early-stage start-ups to pre-IPO companies, our members see these two elements -- an affirmative filing in order to issue securities to the public - - as practical and appropriate means of distinguishing between private and public companies.

⁶ *Id.* (emphasis supplied).

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The new “definition” set out in BC11, “entities that access the public capital markets by issuing securities that are publicly traded” is vague and expansive. We understand the Board’s concern that securities markets are constantly changing. However, the criteria the ED sets forth to capture that principle introduce significant complexity and uncertainty. Furthermore, the criteria introduce many factors over which a private company has little or no control – factors that could change with regulatory priorities or a single shareholder’s actions. These five criteria also introduce key terms that will require interpretation by the auditor for each individual firm. Clarity and certainty will be lost along with the opportunity for many private companies to take advantage of appropriate accounting alternatives.

Legal and regulatory requirements to file or furnish GAAP financial statements vary among regulatory agencies and can change frequently. These changes can be the result of policy issues that are unrelated to the different needs of private company financial statement users. Therefore, we see the proposed definition as fundamentally flawed by its reliance on legal and regulatory triggers that create trap doors through which private companies can fall.

Basing accounting on any single set of regulatory standards introduces real risk of unintended consequences as noted in our comments on Criterion Number 1 below. However, these proposed criteria introduce still more risk of consequences arising from the actions of any one of dozens of regulatory agencies, including foreign agencies. If regulatory criteria are to be the basis for this definition, the scope of the regulation should be specific and limited.

Even if the regulations to which the criteria refer are limited to a single jurisdiction, some key terms used in the five criteria are vague and will require substantial interpretation. It will be necessary for each private company and its auditor to determine on an ongoing basis whether any of these criteria exclude the company from private company alternatives. There is a strong likelihood that these terms will be interpreted differently by different auditors, creating diversity in practice. There is also a significant risk that these terms could be interpreted in an over-broad manner, which would result in private companies being required to use public company accounting. Depending on the degree of uncertainty, companies might simply concede the point and ignore the work of the PCC.

SPECIFIC COMMENTS ON THE FIVE EXCLUSIONARY CRITERIA

Criterion Number 1:

“It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements, with the SEC (including other

entities whose financial statements or financial information are required to be or are included in a filing).”

This criterion illustrates why it is not advisable to use the changeable and sometimes random requirements of even a single regulatory agency as criteria for accounting rules. In this criterion, the term “or does ... furnish financial statements” raises the risk that a privately organized investment adviser and/or a private investment fund could fall through this trap door during a routine SEC examination. For example, some NVCA member firms are SEC-registered investment advisers (“RIAs”) and, as such, are subject to periodic examination by the SEC. The SEC has authority to (and often does) request the financial statements of both the RIA and its private investment funds during these routine examinations.

Moreover, because of certain rules regarding prepayment of client fees, certain RIAs are required to provide or “furnish” a GAAP balance sheet of the RIA to the SEC pursuant to Form ADV Part 2A (a required SEC filing). Would this not be furnishing a financial statement?

Again, these situations are but examples. There are myriad unanticipated triggers that may arise from regulatory requirements. Such requirements are varied and unpredictable and are not a sound basis for accounting differentials.

The Criterion Number 1 parenthetical is apparently clarified by Paragraph BC12.⁷ Otherwise, it is confusing. The requirement set out in BC12 would apply to the financial statements of companies that receive major investment funds from a publicly-traded strategic investor but are private in every other aspect. Under this reading of the requirement, a company that receives funding from a strategic investor would be adversely affected.⁸ If the investor is required to include the investee company’s financials with its own SEC filing, the portfolio company investee not only faces the added burden of meeting SEC deadlines for producing audited financials but also loses the opportunity to use private company alternatives in its financial statements. The supposed concession of being permitted to use such alternatives in their stand-alone financial statements outlined in BC12 seems an illusory benefit.

We question the need for this exclusion when it would apply to many small private companies. The SEC has the authority to require that financial statements of subsidiaries and equity method investments follow the same accounting rules as the publicly-traded parent. We

⁷ *Id.* Page 11.

⁸ There is a growing trend for corporate venture capital groups such as Google Ventures, IBM Ventures, or Pfizer Venture Capital to invest in a startup company alongside traditional venture capital funds. They also make solo venture investments. These corporate venture groups are an important and growing source of venture capital for both IT and life science companies.

question the necessity of preemptively depriving a private company of its private company accounting status in this circumstance.

Criterion Number 3:

“It is required to file or furnish financial statements with a regulatory agency in preparation for the sale of securities or for purposes of issuing securities.”

Many venture capital funds make “private offerings” pursuant to Rule 506 under the Regulation D “safe harbor” of the Securities Act, which exempts the offering from state regulation; therefore, no financials are filed or furnished with the SEC or a state regulator in connection with those offerings. Still, to the extent that venture capital funds cannot or choose not to rely on Rule 506 -- for example, offerings under Section 4(a)(2)) -- state regulators may require the filing of a fund’s financial statements in connection with state “blue sky” private placement rules. Moreover, uncertainty looms in the future should the SEC or another regulator of securities offerings introduce new requirements.

For example, if “regulatory agency” were interpreted to include foreign regulators, the European Union’s new Alternative Investment Fund Managers Directive (“AIFMD”)⁹ could trigger Criterion Number 3 and exclude many venture capital funds from private company accounting. The Directive’s Chapter IV, “Transparency Requirements” (which applies to U.S. investment firms that market to investors located within the EU) requires that an auditor’s report should accompany financial statements, which are required to be filed with the “competent authority of the home member state.” Article 23 further specifies that an annual report must be provided to regulatory authorities “upon request.”¹⁰ These requirements could well trigger Criterion 3. Again, the EU is but an example of a regulatory agency and the AIFMD is but an example of a new requirement to “file or furnish.” Private venture capital funds invest in companies on many continents and they seek limited partners among sophisticated investors around the world.

Therefore, if this criterion is retained the term “regulatory agency” should be used in a narrow and clear sense. While regulatory uncertainty would still exist, at least the origin of the uncertainty would be finite if it were revised to eliminate agencies other than those whose regulatory authority derives from U.S. securities laws.

⁹ See European Commission, *Alternative Investments*, http://ec.europa.eu/internal_market/investment/alternative_investments/index_en.htm.

¹⁰ Deloitte, *AIFMD Technical Survey, An overview*, (2010) @ 10-11 available at https://www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/Industries/Financial%20Services/UK_FS_AIFMD_Tech.pdf

Even if the criterion was narrowed as suggested above, the U.S. securities laws create their own uncertainty. The SEC's recent proposal to permit "general solicitation"¹¹ is another example of the potential for regulatory changes to impact a private company's accounting status. While offerings made under this new regime will be unregistered offerings sold exclusively to sophisticated investors, the fact that information about the offering would be available to the general public has led to calls for more regulatory oversight and transparency in these offerings.¹² Should the SEC decide at some time in the future that any fund which was formed through a general solicitation must furnish GAAP financials to the agency as part of its Form D filing, any fund that even accidentally fell into the general solicitation regime would lose its private accounting status.

Perhaps more than any other, Criterion Number 3 shows the complexity and uncertainty that basing private company accounting status on ever-changing regulatory requirements.

Criterion Number 4:

"It has (or is a conduit bond obligor for) unrestricted securities that are traded or can be traded on an exchange or an over-the-counter market."

This criterion would exclude a company if it "has unrestricted securities that ... can be traded on ... an over-the-counter market." This criterion could sweep in the type of small private companies in which venture capital funds invest. First, the verb "has" suggests that the character of a company's stock at any given time is the relevant factor as opposed to the character of the security when issued. Portfolio companies raise some capital by privately issuing shares with restrictions that expire after a certain period of time. While Rule 144 under the Securities Act would continue to define these shares as "restricted securities", the shares would be "unrestricted" in the sense that they could potentially be sold without any conditions. As a result, under this criterion a private company that issues restricted securities risks losing private company status when the holding period on their shares expires.

In addition, venture-backed startup companies often issue stock options to their employees. After several years as a private company, employee stock options can vest and the employee can take common stock in the company. An employee can then sell shares of the private company to another private buyer without the company's knowledge or consent. In this case or in the case of expired restrictions, it could be said that the company "has" unrestricted securities though it has taken no steps to access public capital and has none of the normal

¹¹ Securities and Exchange Commission, *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Other Release No.: 34-9415, File No.: S7-07-12, Effective Date: September 23, 2013

¹² See generally, BNA, *Securities Law Daily*, *Split SEC Clears JOBS Act Advertising Rule, Issues Proposal on Enhanced Requirements*, (July 11, 2013).

attributes of a public company. Thus companies can lose the ability to use private company alternatives based on a single transaction over which it has no control.¹³

The second prong of this exclusion could provide a reasonable limitation of this risk if its meaning is limited and clear. If “can be traded ... on an over-the-counter market” means a regulated marketplace for the securities of issuers that are registered with the SEC such a criterion would be reasonable.¹⁴ However, since the ED does not define “over-the-counter market,” the more generic definition of “over-the-counter” could cause companies to lose their qualification for private company accounting based on actions by parties over which they have no control.¹⁵ It would be inappropriate for a company that has done no more than issue stock options to their employees or issue limited-term restricted securities to a private investor to cease to be a private company for financial statement purposes if a shareholder sold shares to another individual. A broad definition of “over-the-counter market” in Criterion Number 4 could cause such a result.

Therefore, if Criterion Number 4 is retained, the definition should clarify that “over-the-counter market” means a regulated marketplace for issuers that are registered with the SEC.

Criterion Number 5:

“Its securities are unrestricted, and it is required to provide U.S. GAAP financial statements to be made publicly available on a periodic basis pursuant to a legal or regulatory requirement.”

Our concerns with the fifth criterion arise from similar situations with unrestricted securities in the hands of private investors. While this criterion may not apply to venture capital it should be noted that a large portion of private capital comes from public pension funds. Each state or municipal fund is subject to a particular state’s laws, including open records laws and other rules aimed at providing transparency into the pension fund’s operations. Therefore, the term “is required to provide U.S. GAAP financial statements to be made publicly available on a periodic basis pursuant to a legal or regulatory requirement” introduces substantial uncertainty. The laws of any jurisdiction regarding pension fund investment transparency could trigger this criterion.

¹³ The assumption set out in BC18 that unrestricted securities “generally have an active market” does not apply in the case of employee-held stock. While it is true that such stock can be sold to anyone without the company’s consent, an “active market” is such stock is an extremely rare exception to the norm. While the well-documented sale of private Facebook stock is a historic fact, a policy based on such a unique set of facts could work to unfairly impact the vast majority of private companies that meet every one of the Differential Factors set out in the Private Company Decision Making Framework.

¹⁴ See generally, Securities and Exchange Commission, *Over-the-Counter Market*, <http://www.sec.gov/divisions/marketreg/mrotc.shtml>. See also, OTC Bulletin Board, <http://www.otcbb.com/>.

¹⁵ We are familiar with the view expressed at a FASB meeting that private transactions “at a Starbucks” could be a “market.”

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CONCLUSION

The definition the PCC uses should be clear, stable and principle-based rather than the proposed specific and ever-changing securities regulatory requirements in the five criteria. The proposed definition introduces significant breadth, risk and uncertainty. Given that the PCC or the Board can always exclude companies from use of certain private company alternatives, a definition based on an entity's affirmatively seeking public capital would be more appropriate. Investing in such publicly traded companies is clearly different than investing in private companies. The needs of their financial statement users are clearly different. This is an appropriate principle for distinguishing between companies that may be permitted to use private company alternatives in accounting and those that should be "excluded."

NVCA would be pleased to work with the FASB on these important matters. Please feel free to contact me or Jennifer Connell Dowling, Senior Vice President, at 703 524 2549.

Sincerely yours,



Bobby Franklin
President & CEO