# THE CARLYLE GROUP

1001 Pennsylvania Avenue, NW • Washington, DC 20004-2505 Tel (202) 347-2626 • Fax (202) 347-1818

February 13, 2012

Ms. Susan M. Cosper Technical Director File Reference No. 2011-200 Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Re: Proposed Accounting Standards Update, Financial Services - Investment Companies (Topic 946)

Dear Ms. Cosper:

On behalf of The Carlyle Group (referred to herein as "Carlyle" or "we"), we appreciate the opportunity to comment on the Financial Accounting Standards Board's Proposed Accounting Standards Update, Financial Services – Investment Companies (Topic 946) ("the Proposed ASU").

Carlyle is a global alternative asset manager with more than \$148 billion in assets under management across 89 funds and 52 fund of funds vehicles, serving over 1,400 investors. Our funds invest across a range of investment strategies, including corporate buyout, growth capital, real estate, infrastructure, energy and renewable resources, distressed debt, corporate mezzanine, energy mezzanine, hedge funds, and structured credit. Our fund of funds vehicles make investments into buyout, growth capital, venture, and other alternative asset funds advised by other general partners, make co-investments alongside other private equity and mezzanine funds, and acquire interests in portfolio funds in secondary market transactions.

Our funds' historical financial reporting has been in accordance with the investment company accounting and reporting guidance. Based on the revised definition of an investment company in the Proposed ASU, we believe that certain of our funds would no longer qualify as investment companies. Some of these funds would be classified as investment property entities ("IPE") based on the definition provided in the proposed Accounting Standards Update on investment property entities, and others would no longer qualify as investment companies nor would be classified as IPEs, and would therefore apply non-investment company U.S. GAAP.

We support the Board's efforts to develop a common, high-quality standard on investment company accounting and to promote financial reporting that provides information that is useful and relevant to financial statement users. We acknowledge that there is some diversity in practice in the application of the investment company criteria and the principles of consolidation by an investment company. However, we have concerns that certain of the proposed changes would not promote high quality financial reporting because (1) certain

investment vehicles that have substantially the same design and purpose as investment companies would lose investment company accounting under the proposed definition and (2) the proposed consolidation guidance would reduce the clarity and transparency of financial information to investors.

The accounting and reporting framework for investment companies is a longstanding, proven framework that promotes clear, transparent, and meaningful financial information to investors. The consequences of not applying investment company accounting (i.e., consolidation of controlled investees, amortized cost-basis measurements) would result in financial statements that are neither relevant nor useful to investors. Therefore, we believe that any changes to the definition of an investment company must be cautiously considered and thoroughly examined. The inappropriate loss of investment company accounting for true investment vehicles would be a step backwards from current practice.

The Proposed ASU would introduce "bright-line" requirements to the definition of an investment company, replacing what is currently primarily a principles-based definition that promotes the use of reasonable judgment. We believe that certain of these new requirements will result in the inconsistent application of investment company accounting, or the loss of investment company accounting for vehicles that historically qualified. If the Board believes that additional clarification is necessary, we recommend providing factors to consider – rather than creating a set of determinative criteria – to determine whether an entity is an investment company.

The potential loss of transparent, comparable financial information is a concern for us and our investors. We have received increasing feedback from a broad base of our investors, as well as their industry representatives, such as the Institutional Limited Partners Association ("ILPA"), that they want additional clarity and comparability from the fund financial statements, so that those statements can be easily reconciled to their individual investor capital account statements.

The potential for inconsistent application of investment company accounting or the loss of investment company accounting, as well as the consolidation requirements of the Proposed ASU, would result in fund financial statements that are less clear and comparable to investors and will make it impossible for them to reconcile the fund financial statements to their individual capital account statements.

We have also noted that investors are increasingly asking for combined financial reports for the funds in which they have invested. Many of our investors invest in multiple Carlyle funds; currently, their capital account information is provided on a fund-by-fund basis. Investors have requested that we enhance our reporting capabilities to combine all their various fund holdings into a single capital account statement across all funds. They also want this combined capital account statement to be reconciled to the related fund financial statements. To the extent that the Proposed ASU results in certain investment vehicles not qualifying as investment

companies, it will be impossible to aggregate our investors' holdings across all funds in a meaningful presentation and provide them with a meaningful reconciliation of their holdings to the funds' financial statements.

For example, if an investor has investments in one of our investment funds (that qualifies as an investment company) and then also establishes a managed account with us (that would not qualify as an investment company), we would not be able to reconcile the investor's combined capital account statement to the financial statements. As described previously, this reconciliation is important to investors.

We have summarized below for the Board's consideration our comments on the aspects of the Proposed ASU that we believe will result in inconsistent application of investment company accounting, including the criteria related to (i) "nature of the investment activities", (ii) "unit ownership", and (iii) "pooling of funds". We also provide below our comments on the proposed requirement for an investment company to consolidate another investment company when it holds a controlling financial interest.

#### Nature of the Investment Activities Criteria

Pursuant to the proposed amendments to section 946-10-55-4, an investment company would be required to hold multiple investments. Section 946-10-55-6 of the Proposed ASU would clarify that an investment company may hold a single investment if it is formed in conjunction with another investment company that holds multiple investments. In its basis for conclusion, the Board noted that "…investing in multiple investees is an important characteristic of an investment company" (BC 19).

We believe this requirement in the Proposed ASU would inappropriately result in the loss of investment company accounting for certain investment vehicles that we manage. There are circumstances where an investment vehicle is formed solely for the purpose of making a single investment. This typically occurs, for example, when a private equity fund has identified a potential investment, but the amount of capital required to acquire the investment exceeds the fund's limitations (most funds have limitations on the amount of capital to invest in a single investment to reduce the risk of investment concentration).

In these circumstances, we may create a separate investment vehicle to raise the additional capital necessary to complete the investment. These investment vehicles, commonly referred to as "external coinvestment vehicles" or "side-cars", exist only for the purpose of the single investment. The investors in this vehicle may also be investors in the related fund that is also making the investment, or the investors may be unique investors that are not investors in the related fund.

While at the onset of a fund, we anticipate that external coinvestment vehicles may be formed, we do not know the investments the fund will make, the amount of capital that those investments will require, and therefore whether an external coinvestment vehicle will in fact be necessary. Even when a fund has identified a potential investment, it is not necessarily known whether an external coinvestment vehicle will be needed or desired. At times, such vehicles are raised subsequent to the fund completing the investment (with the external coinvestment vehicle acquiring a portion of the fund's investment).

Additionally, there are times when we identify a potential investment and raise investor capital specifically for that one investment. This may occur when we are planning to enter a new investment category or geography with a new investment fund. Prior to soliciting investors for the new fund, we may do one or more individual investments in this new category/geography (typically referred to as "pre-fund" investments) to demonstrate the investment opportunities in the sector. For these investments, we create an investment vehicle to hold the single investment and raise investor capital to acquire the investment. The investment vehicle is not intended to hold any other investments and will have no relationship to the new fund that subsequently be raised.

Also, less frequently, we may identify a potential investment in an existing industry segment or geography, but that investment does not fit the criteria of any of our existing funds. In these circumstances, we will create an investment vehicle solely for the purpose of acquiring this investment and will solicit investors to invest into this vehicle.

We believe that the application of investment company accounting – which is current practice – is appropriate for external coinvestment vehicles, pre-fund investments, and other single-investment vehicles, as it provides those investors with fair value measurements of the investment, which is the most relevant information to them. An investor in a fund that also makes an incremental investment through an external coinvestment vehicle should be provided with information that is relevant and comparable for their total investment; this is achieved only if external coinvestment vehicles also qualify as investment companies.

We believe that investment vehicles should not be required to hold multiple investments to meet the "nature of the business activities" criteria of the Proposed ASU. While the Board could clarify in ASC 946-10-55-6 to indicate that the additional vehicle need not be formed at the same time as the other investment company that holds multiple investments in order to meet this criterion for external coinvestment vehicles, the requirement to hold multiple investments would be a significant change in practice and would not resolve this issue for pre-fund investments or single-investment vehicles. The Board should perform additional outreach to understand the potential impact of the change and whether users would benefit with historical cost-basis financial statements before concluding on this issue.

### **Unit Ownership**

Pursuant to section 946-10-55-11 of the Proposed ASU, an entity must issue ownership units in the form of equity or partnership interests to investors for the entity to be classified as an investment company. This requirement would prohibit investment company accounting for investment vehicles where investors' interests are made primarily through debt securities, not equity.

In a structured credit fund (e.g., a collateralized loan obligation, or "CLO"), investors' interests are primarily in the form of debt securities, not equity or partnership interests. We believe that these vehicles should follow investment company accounting. Our investment management strategies for these funds is similar to our other funds (where investors invest through equity interests), and debt is simply a different form of capital. Given the fundamental similarities of structured credit funds to other investment funds, we believe that they should also be considered investment companies.

As of September 30, 2011, we consolidated into our firm's financial statements approximately \$11 billion of assets and liabilities associated with structured credit funds, and we retained their specialized investment company accounting. We believe that reporting the structured credit funds at fair value is the most appropriate and meaningful presentation of this information. The loss of investment company accounting would result in an amortized-cost basis of accounting, which we believe would be less useful to our financial statement users. Moreover, converting to this basis of presentation would require significant financial costs and a significant investment of time and personnel, which we believe would outweigh the potential benefits of changing.

#### Pooling of Funds Criteria

Pursuant to section 946-10-55-13, an investment company is required to have multiple investors who are unrelated to the entity's parent. This criteria would result in the loss of investment company accounting for an investment vehicle established for a single investor. We do not believe this is an appropriate result as such vehicles typically have the same purpose and design as other investment companies.

Over the last several years, there has been increasing demand within the alternative investment investor community to have asset managers establish individual managed accounts. In lieu of a traditional investment fund where multiple investors are pooled together, the asset manager establishes an investment vehicle solely for the benefit of a single investor. The investor provides the capital to that vehicle and the asset manager is responsible for making investments through that vehicle based on the investor's individual investment strategy and risk tolerance.

Based on the pooling of funds criteria in the Proposed ASU, these managed accounts would not qualify for investment company accounting. We believe that investment company accounting is the most relevant and consistent basis of reporting for an investor in a managed account. The overall purpose and design of the managed account is similar to any other investment fund that pools investor capital. An investor may make investments through traditional investment funds as well as have an individual managed account established; we believe that the financial reporting to that investor should be consistent and comparable.

We understand and acknowledge the Board's concern about the potential abuse of investment company classification and accounting. However, we believe that this issue would already be addressed through considering the "express business purpose" criterion of the Proposed ASU. That criterion stipulates that the express business purpose of an investment company is investing to provide returns from capital appreciation or investment income or both. Based on the factors provided in the Proposed ASU, it seems unlikely that an entity formed within a corporate structure (e.g., for the purpose of research and development) would qualify for investment company accounting.

Accordingly, we do not believe that the limitations in the "pooling of funds" criteria in the Proposed ASU are necessary to prevent potential abuse; instead, these limitations would create significant issues for legitimate investors wanting to utilize a managed account.

#### Consolidation of Entities when an Investment Company has a Controlling Financial Interest

Pursuant to section 946-810-45-3 of the Proposed ASU, an investment company should consolidate another investment company or an IPE, if the investment company has a controlling financial interest.

While we acknowledge that there is diversity in practice in the asset management industry regarding the principles of consolidation by an investment company, in general we believe that consolidation by investment companies is not prevalent, and therefore the Proposed ASU would represent a significant change in industry practice, raising more questions than answers. One of the significant challenges in implementing the consolidation requirements of the Proposed ASU would be applying the investment company criteria to each of the legal entities formed in an investment structure. Due to the variety of entity structures that can be created to execute an investment, as well as the judgment that asset managers would need to decide which entities in the structure meet the definition of an investment company, we do not believe that the Proposed ASU will provide any uniformity in investment company consolidation.

To illustrate, our funds may establish certain investment holding companies, many of which contain the acquisition debt financing for the investment. That debt is non-recourse to the fund. It is not clear that the holding company would be an investment company, based on its characteristics, potentially leading to diversity in practice. To the extent it were considered an

investment company, our funds would be required to consolidate it. Our funds would also consolidate certain investment property entities that are structured as ventures with a real estate developer who will be responsible for operating and improving the property, and who has a financial interest in the property, if the fund has a controlling financial interest.

These consolidation examples would require the funds to report debt obligations and non-controlling interests on the face of the balance sheet, which we believe would detract from high quality financial reporting. We believe that this information is not meaningful to our funds' investors. Including non-controlling interests obscures to the reader the fair value of the funds' interest in the investment, which is the information most important to the investors, and including non-recourse debt obscures the debt obligations of the fund versus the non-recourse debt of the holding companies.

We also believe that changes to the basic financial statements and the financial highlights disclosures will confuse investors. We do not believe that our investors will easily embrace these changes in presentation, as the changes would result in less clarity and comparability to their individual capital account statements.

We also believe that the consolidation guidance in the Proposed ASU would be difficult to apply to a fund of funds vehicle. For example, a fund of funds may invest in a portfolio of open-ended investment vehicles (such as hedge funds). Given these underlying funds will have ongoing capital subscriptions and redemptions, it will be difficult for the fund of funds to determine when it has a controlling financial interest in the funds. There may be periods when the fund of funds has a controlling financial interest (and is required to consolidate the hedge fund) and then in subsequent periods, the fund of funds no longer has a controlling interest (and then will be required to de-consolidate the hedge fund).

We also believe that it will be difficult for a fund of funds vehicle to accumulate in a timely manner the financial information for any consolidated investment companies or IPEs, as the source of this information will be the asset managers of those respective vehicles. Such information, if consolidated, would also be subject to the fund of fund vehicle's annual audit scope, increasing audit costs.

We believe that providing additional disclosures in the financial statements in lieu of applying consolidation accounting would be an acceptable alternative that both satisfies the Board's objective of providing additional information to the financial statement users, while also preserving the current financial statement presentation that investors understand and value.

We also would note that on a quarterly basis, we currently provide all of the fund's investors with a summary of all the investments held by the fund, with specific operating financial information for each investment and the terms of the acquisition, including the amount of acquisition debt financing if applicable. This information is provided in addition to the fund's

quarterly financial statements. Given the constraints of being able to audit this information, we do not believe it would be appropriate to incorporate this information into the fund's financial statements. Based on our experience with our investors, the information we currently provide is useful to them and we believe fulfills their need to understand the operations and financial results of the investments without requiring the consolidation of investment companies.

## Accounting and Reporting for Real Estate Properties by an Investment Company

Pursuant to section 946-810-45-3 of the Proposed ASU, an investment company would be required to consolidate an IPE if the investment company holds a controlling financial interest in that entity. This consolidation requirement would result in the investment company incorporating the accounting and reporting requirements of the IPE into its financial statements. Rental revenue and rental operating expenses from IPEs would be presented in the consolidated income statement. The investment company would also include certain IPE disclosures, including the amounts of direct operating expenses recognized in the financial statements (for properties that generated rental revenue and separately for properties that did not generate rental revenue), the restrictions on the ability to increase rent and collect revenue, and contractual obligations related to an real estate investment property.

We believe these accounting and reporting requirements for an investment company related to its consolidated IPEs reduce the clarity and transparency of information in the financial statements, create operational challenges to implement, and increase compliance costs. We have prepared separately a more thorough discussion of our concerns in our response to the proposed Accounting Standards Update, *Real Estate – Investment Property Entities (Topic 973)*. We respectfully refer the Board to our response to that proposed standard for additional information related to this aspect of the Proposed ASU.

We believe that any enhancements or clarifications to financial reporting for investment companies can best be accomplished through a principles-based model that promote reasonable judgment in their application. Given the significant financial reporting impacts of many of the proposed changes, we encourage the Board to solicit input from the alternative investment investor community and their industry representatives, including the ILPA, before finalizing the proposal. We believe that the Board would receive feedback from those users that is consistent with what we have articulated in our response.

We also would encourage the Board to discuss the Proposed ASU with the staff of the Securities and Exchange Commission, as we believe that the Proposed ASU may have an impact on an asset manager's ability to satisfy the SEC's custody rules under the Investment Advisors Act of 1940. Under the custody rules, the investment advisor is required to provide monthly account statements from the qualified custodian to the investors. The custody rules provide an

exemption to this requirement for pooled investment vehicles (such as investment funds) if the vehicles provide audited financial statements to the investor.

Given the administrative burden of providing monthly account statements, most alternative asset managers operate under the exemption by providing audited financial statements of the funds to the investors. While we believe that the exemption would continue to be satisfied by completing a financial statement audit on an investment vehicle that no longer qualifies as an investment company, we question whether the overall intent of the exemption would be satisfied, as the vehicles' financial statements would no longer report investments at fair value or include a schedule of investments with share holdings.

Also, if certain investment vehicles no longer qualify as investment companies and they are currently combined with the fund for purposes of the financial statement audit (i.e., certain coinvestment vehicles), such vehicles would have to be audited separately on a stand-alone basis to comply with the custody rule exemption. This would result in additional compliance costs to the investors in those vehicles.

We appreciate the opportunity to offer our feedback on the Proposed ASU. We would be pleased to discuss our views with you at your earliest convenience.

Sincerely yours,

Curtis L. Buser

Managing Director & Chief Accounting Officer