

Susan Cospier
Technical Director
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FASB
401 Merritt 7
PO Box 5116
Norwalk
CT 06856-5116

Dear Susan

I am writing on behalf of the British Private Equity and Venture Capital Association ('BVCA') in response to the proposed Accounting Standards Update of Topic 946.

The BVCA is the industry body for the UK private equity and venture capital industry. With a membership of over 450 firms, the BVCA represents the vast majority of all UK based private equity firms and their advisers. This submission has been prepared by the BVCA's Legal & Technical committee, which represents the interests of BVCA members in legal, accounting and technical matters relevant to the private equity and venture capital industry.

As major investors in private companies, and some public companies, our members have an interest in financial reporting matters relating to those companies, and the burdens placed on the management of such companies.

We have only responded to the questions that we consider to be most relevant to our members, and we, have referred to "Investment Entities", which includes all types of investment vehicles, rather than "Investment Companies" as many of our members are partnerships.

General

We welcome the initiative to conform both International Accounting Standards and US GAAP to fair value accounting for investments by investment entities. Our experience is that fair value accounting of investments is what investors and other stakeholders require and expect and is consistent with the way private equity funds manage their investments. On the other hand, consolidation of financial statement line items is of no practical use to investors. Indeed, it may even be counterproductive as investors seek to make comparisons between periods when the investment entity may have bought or sold investments which, instead of being shown at fair value, would be presented as a consolidation of those different entities. In many cases consolidated accounts would also be extremely hard to produce.

Our view is that the whole private equity community should be able to use fair value accounting, including fund of funds, infrastructure funds, sovereign wealth funds and organisations owning private equity funds. If users of financial statements are analysing similar organisations with similar business models which are accounting for their businesses in two completely different ways, much

of the benefit being sought by the Boards will be lost, particularly if it is the way the investment entity is structured that leads to the different treatment, rather than the underlying business model.

While the majority of private equity fund structures are organised such that the investment management activity is conducted separately to the investment entity itself, in some cases these activities may be contained within the same entity. This would result in a different accounting presentation caused solely by the structure. We approve of the allowance that an entity may manage its own investments but consider that this should be extended to managing those of a third party.

We would have preferred a principles based approach rather than a list of mandatory criteria. We understand the Board's aim to exclude the ability to structure operating businesses to meet the definition. Nevertheless, we believe that the Board's aim could be achieved by having a number of mandatory attributes, together with a number or rebuttable indicators, recognising that there should be substantive reasons for any rebuttal.

With respect to the criteria, we believe that Investment Entities should be entities that have, within their organization, investments which are owned for capital appreciation, investment income (such as dividends or interest), or both and that, for those businesses, the entity makes an explicit commitment to its investors concerning the above business purpose and has an exit strategy or a strategy of gradual realisation of its investments over a finite period of time, by way of receipt of income or capital gain or both.

We believe that it is essential that an investment entity should be able to carry out other related business which would not be fair valued, such as investment management, investment trusteeship, and also to have investments which are not fair valued, such as corporate debt to be held to maturity.

We would expect such investment entities predominant or primary activity to be investment activity or for those other businesses to be consistent with being an investor (such as external investment management activity).

We would consider the other 'criteria' listed by the Board more as indicators. A blended model such as this should lead to private equity funds being treated consistently using fair value accounting for their equity investment activity and line by line consolidation for other businesses.

We would welcome an opportunity to discuss this response with you. We attach a copy of our response to the IASB exposure draft for your information purposes.

Questions asked by the Board

Scope

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 entities? If not, what changes or additional criteria would you propose and why?

We believe that there should be a number of mandatory criteria with a number of rebuttable indicators recognising that there should be substantive reasons for recognising any rebuttal.

Investment activities

This should be mandatory. However, by making this requirement relate to substantially all activities, investment entities that have other related activities such as external investment management and trusteeship businesses could be excluded. We think that it is entirely consistent for an investment entity that makes its own investments, to manage those investments and use its skills to manage other's investments.

Express business purpose

This should be mandatory

Unit of investment/Pooling of funds

These should be rebuttable indicators as we consider single ownership funds such as sovereign wealth funds which governments have established for the purpose of acting as investment entities, to be investment entities as long as they met the mandatory criteria

Fair value management

This should be mandatory for any equity investments of the entity. However, the definition should take into account that Investment entities might invest in non-equity investments that are held to maturity such as corporate debt. We do not see holding a non-equity investment as being inconsistent with being an Investment Entity

Reporting entity

We would consider this to be implicit but it is helpful to clarify that the investment entity does not need to be a legal entity.

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. Are you aware of any entities that are investment entities under U.S. regulatory requirements that would not meet all of the proposed criteria in paragraph 946-10-15-2? If so, please identify those types of entities and which of the criteria they would not meet.

No comment.

3. The proposed amendments would remove the scope exception in Topic 946 for real estate investment trusts. Instead, a real estate investment trust that meets the criteria to be an investment property entity under the proposed Update on investment property entities would be excluded from

the scope of Topic 946. Do you agree that the scope exception in Topic 946 for real estate investment trusts should be removed? In addition, do the amendments in the proposed Updates on investment entities and investment property entities appropriately identify the population of real estate entities that should be investment entities and investment property entities?

No comment.

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 consider this to be appropriate and operational, although unlikely for most private equity organizations because of the agreements with investors existing throughout the life of the fund

Nature of the Investment Activities

5. An entity may be an investment company when it performs activities that support its investing activities. As a result, a real estate fund or real estate investment trust (that is not an investment property entity) could be an investment company if the entity (directly or indirectly through an agent) manages only its own properties. 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, and could it be consistently applied?

We agree with the Board that their example of having a construction subsidiary supporting a property investor would preclude the investment entity being considered as an investment entity if the activity was substantive, but we would not agree if the example was changed to external investment or property management or investment trusteeship activities which we consider to be consistent with being an investment entity making use of its investment expertise. We therefore do not agree that the investment entity may only provide investment management services to others if they are not substantive. We agree that such activities should be consolidated, but it is consistent with being an investment company to carry out such external investment management activities, together with internal investment activities. We also consider that there are other investment related activities which are consistent with being an investment company.

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?

We consider that investees having business relationships, joint ventures, or trading with each other on an arm's length basis is consistent with investing for capital appreciation or investment income so that if investee 1 entered into a relationship with investee 2 to exploit the technology of investee 2 on

an arm's length basis, then although that would be accounted for by the investees according to the relevant standards, it would not preclude the investor from fair valuing both investees. We therefore consider criteria c, e, and f as being inconsistent with being an investment entity but would not necessarily conclude that a, b, and d are if they are negotiated between the entities on an arm's length basis.

Unit Ownership and Pooling of Funds

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?

We consider this to be a rebuttable indicator for those entities that meet other criteria. For instance, we consider that a sovereign wealth fund should be an investment entity if it has been established by a government for the purpose of making investments which meet the three key criteria.

8. The proposed unit-ownership criterion would require an entity to have ownership interests in the form of equity or partnership interests to be an investment company. The entity would consider only those interests in determining whether it meets the proposed pooling-of-funds criterion. Therefore, a securitization vehicle, such as a collateralized debt obligation, may not qualify as an investment company under the proposed amendments because it may not meet the unit-ownership or the pooling-of-funds criterion. The entity would not consider interests held by its debt holders when evaluating these criteria to be an investment company. For entities that do not have substantive equity interests (for example, those considered variable interest entities under Subtopic 810-10), should the unit-ownership and pooling-of-funds criteria to be an investment company consider interests held by debt holders? Please explain.

We agree.

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 measures 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?

No comment.

10. The unit-ownership and pooling-of-funds criteria in the proposed amendments do not consider the nature of the entity's investors for evaluating if an entity is an investment company. That is, the criteria do not differentiate between passive investors and other types of investors. Do you agree that the nature of the investors should not be considered in evaluating the unit-ownership and pooling-of-funds criteria?

We agree.

Fair Value Measurement

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?

In principle we agree but are concerned that the word 'substantially' might preclude investors who invest in both equity and debt, where the debt tends to be held to maturity but the investment is still made to obtain income. We consider that a requirement to fair value all investments or to consolidate all investments in these circumstances would be wrong.

Interests in Other Entities

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 do not consider there to be any difference between indirect and direct ownership of investments if the key criteria are met with respect to those investments.

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 above for question 12.

14. The proposed amendments would prohibit an investment company from applying the equity method of accounting in Topic 323 to interests in other investment entities and investment property entities. Rather, such interests would be measured at fair value. Do you agree with this proposal? If not, why?

We agree. We would like there to be consistent treatment for controlled investments and minority investments if the key criteria are met.

Presentation and Disclosure

15. An investment company with a controlling financial interest in a less-than-wholly-owned investment company subsidiary or an investment property entity subsidiary would exclude in its financial highlights amounts attributable to the non-controlling interest. Do you agree that the amounts attributable to the non-controlling interest should be excluded from the calculation of the financial highlights? If not, why?

We agree.

16. If an investment company consolidates an investment property entity, the proposed amendments require the investment company to disclose an additional expense ratio that excludes the effects of consolidating its investment property entity subsidiaries from the calculation. Do you agree? If not, why?

No comment.

17. Do you agree with the additional proposed disclosures for an investment company? If not, which disclosures do you disagree with, and why? Would you require any additional disclosures, and why?

In response to the IASB exposure draft, we wrote that we agree with the objective that disclosure should provide information to enable users of financial statements to evaluate the nature and financial effect of the investment activities in which it engages but we do not see the need for additional detailed disclosure requirements, and would prefer to rely on existing requirements together with the objective. We consider that the Board should take a consistent approach and that the requirements should be the same in both pronouncements.

Retention of Specialized Accounting

18. The proposed amendments would retain the current requirement in U.S. GAAP that a non-investment 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 consider that the accounting should be retained because investors in a non investment entity would get a greater understanding of the performance of its investment business if fair values were used and that to mix consolidation with fair value accounting is preferable to full consolidation which could be misleading and unhelpful to investors.

Effective Date and Transition

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?

We agree.

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

Many investment entities will already be providing their investors with fair value information so the effort of implementation into financial statements should be relatively minor. However, any change requiring consolidation would be significant and would take a considerable time and cost to implement for a private equity entity. (See our response to the IASB)

21. The proposed amendments would prohibit early adoption. Should early adoption be permitted? If yes, why?

We would expect the adopted update to be an improvement over the current practice, so therefore early adoption should be encourage.

Nonpublic Entities

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

We consider consistency of approach to be important.

Yours sincerely

A handwritten signature in black ink, appearing to read 'S. Witney', with a large, stylized flourish at the end.

Simon Witney

Chairman, BVCA Legal and Technical Committee