



March 31, 2003

Mr. Joel Tanenbaum
Technical Manager, Accounting Standards
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**Re: Comments on the exposure draft of the proposed statement of position,
*Clarification of the Scope of the Audit and Accounting Guide Audits of Investment
Companies and Accounting by Parent Companies and Equity Method Investors for
Investments in Investment Companies* (File 3170.Scope)**

Dear Mr. Tanenbaum:

On behalf of the Securities Industry Association's¹ Dealer Accounting Committee, I wish to express our views on the Exposure Draft of the proposed statement of position, *Clarification of the Scope of the Audit and Accounting Guide Audits of Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* (the "proposed SOP" or the "Guide"), that has been prepared by the Accounting Standards Executive Committee ("AcSEC") of the American Institute of Certified Public Accountants, dated December 17, 2002.

Our letter consists of our overall comments on the proposed SOP along with our suggestions for improvement. We do not provide a response to each question raised in the exposure draft but, instead, have incorporated our comments in the five main sections below.

¹ The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. Collectively they employ more than 495,000 individuals, representing 97 percent of total employment in securities brokers and dealers. The U.S. securities industry manages the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2001, the industry generated \$280 billion in U.S. revenue and \$383 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

Introduction

It is our understanding that one of AcSEC's objectives for clarifying the scope of the Guide was to capture non-regulated investment companies. We do not believe the proposed SOP accomplishes this goal. We believe that the criteria contained in the proposed SOP are complex, punitive, and arbitrary and do not see how they improve financial reporting. While we agree with a broad principle that the definition of an investment company is an entity whose business purpose is based on the nature of the entity's activities and the relationships with investees, we do not agree with the stringent, rule-based criteria specified in the Guide as necessary for entities to apply the Guide. Our comments below discuss our view further.

Unintended Consequences to Private Equity Investors

Financial Strategy vs. Strategic Investment

We believe the complex ruled-based approach outlined in the proposed SOP may inadvertently cause many private equity entities to fail the definition of an investment company. To that end, we suggest that the final SOP recognize the differences between a *financial* strategy undertaken by a private equity investor from a *strategic* investment undertaken by an entity whose objective is to benefit from a strategic integration of the investee's operations with the investor rather than maximizing its realized return through a planned exit strategy resulting in capital appreciation.

While we understand AcSEC's concern for "abuse" by entities who include investments in an investment company for the sole purpose of achieving fair value accounting under the Guide (and, therefore, avoid consolidation of an entity it truly controls), our view is that the facts and circumstances of each individual situation must be evaluated. For example, we recognize that there are situations when a company may attempt to make use of the Guide for "incubator investments" whereby a small company investee may be developing a new technology that could enhance the investor company's own business. Since the "parent" company generally controls and oversees this R&D function, we believe the investee should be consolidated, as it is not an activity indicative of investment but rather an "outsourcing" of an R&D function. We do not believe that this type of investment is eligible for the "safe harbor" from consolidation that is provided for in the Guide.

In contrast, private equity investing entails engaging in high-risk, high-return strategies such as leveraged buy-outs, restructurings, merchant banking, venture capital and real estate with the aim of achieving superior returns on the assets allocated to this investment class. Private equity investing typically is accomplished either through a pooled private equity fund², which pools capital from a number of investors, or through a captive fund, which is typically a wholly owned subsidiary of a private equity investor. In

² Typical investors include corporate pension plans, public pension plans, university and foundation endowments, bank holding companies, insurance companies and high net worth individuals.

either case, the purpose of the investments is to generate current income, capital appreciation, or both.

Typical private equity pooled funds (“Pooled Funds”) are characterized by the following structure: (1) two or more unaffiliated investors pooling funds for the purpose of generating capital appreciation; (2) such pooling of funds is typically accomplished through the formation of a limited partnership, a limited liability company or through a co-investment arrangement; (3) the majority of the equity interests of such a Pooled Fund are typically held by investors who do not control the day-to-day activities of the Pooled Fund, but may have certain rights to remove the manager in certain circumstances; (4) the sponsor or manager of the Pooled Fund typically receives incentives to generate capital appreciation, such as a carried interest, and usually receives a management fee to cover the costs of day-to-day management of the Pooled Fund. Private equity investing may also be structured through “Captive Funds.” These are typically subsidiaries of investors who either (1) sponsor Pooled Funds, and in connection with such sponsorship, either invest in or alongside such Pooled Funds or (2) find it more economically efficient to make their own private equity investments rather than join or form a Pooled Fund.

Pooled and Captive Funds (collectively “Private Equity Funds”) typically have as a stated objective the generation of capital gains from their investments over an expected holding period and have planned exit strategies at the time the investments are made. The investments of Private Equity Funds operate separately and independently of the Private Equity Fund and its parent or manager and from each other. The expected economic return on the investment does not come from the operations of the investee company, but rather from the capital gain expected upon realization.

Day-to-day management

We do not believe the guidance contained in paragraph 1.6d of the proposed SOP is operational. Our view is that management assistance is necessary in certain types of investment companies (e.g., when providing seed capital, investing in real estate) and should be assessed from the substance of the management arrangement rather than the length of time that the assistance is provided. The day-to-day management in these situations is not provided in order to obtain strategic benefits from an integration of the investee’s operations with the investor, but instead to enhance the return to investors by, for example, servicing (e.g., collecting rents and maintenance) the real estate properties in order to maximize its realized return through a planned exit strategy.

In a broader sense, an investment company may provide temporary management assistance when deemed necessary due to the loss of senior management of the investee or to avoid a significant operating loss at the investee, which would cause a significant deterioration in the value of its investment. In these cases, the investment company may appoint a representative, who may be an employee of the investment company, as an executive officer of the investee, or may parachute in staff to assist in turning around the deteriorating situation. Since these situations requiring day-to-day management are generally complex, our experience is that it will most likely take longer than six months

to sort out all of the issues that need to be solved before a new management team can take over.

In summary, we strongly urge AcSEC to abandon any reference to a time period, as the six-month bright line is an arbitrary cut that does not accurately depict the typical activities of investment companies.

Impact of a failure to achieve investment company status on consolidation

We are concerned that the “separate autonomous” guidance in paragraphs 1.7 and 1.10 would be applied in a literal manner and result in the consolidation of many investments by Captive Funds and their parent or equity method investors. Consolidated financial statements present the financial position and results of operations of a group of entities as if they were a single economic unit. In many cases, the consolidated entities function together by using centralized support services, consolidated funding and cash management, entering into intragroup transactions, engaging in strategic plans designed to further the interests of the group, etc. Abuse occurs where entities, which support the operations of the investor, whose operations are synergistic with the investor and which are, therefore, made for strategic reasons, are **not** consolidated into the financial statements of the investor. In general, the investees of Private Equity Funds are separate and autonomous entities (i.e., they are isolated from the investor) and are held on a non-strategic or financial basis. The activities of Private Equity Funds comply with what we believe to be the spirit of the guidance in paragraphs 1.7 and 1.10 related to separate autonomous investees. Our concern is that the application of paragraphs 1.7 and 1.10 would be applied in a literal manner inconsistent with the normal activities of Private Equity Funds.

For example, assume a Private Equity Fund invests in a printing company and uses the investee entity to print its offering memorandums. Our view is that the Private Equity Fund’s use of the printing services provided by its investee should not cause the investor to fail the condition in paragraph 1.7a as long as their investments are characterized by their: (1) *temporary nature* - the investments are not permanent and have a defined exit strategy; (2) *independence* - the operations are separate and independent of the parent or manager and of each other; and (3) *purpose* - the investments are managed to achieve capital appreciation, not for strategic purposes. Additionally, we believe the investor will not fail the business activity conditions as long as the service is provided on an arms-length basis to the investor, was part of the normal service activity provided by the investee to its clients, and did not constitute a significant portion of the investee’s revenues.

We strongly recommend that these concepts be incorporated into section 1.7 to avoid un-intended consequences of an investor failing the business activity conditions.

Definition of “pooled funds”

We strongly believe that the condition in paragraph 1.5 requiring that no investor can hold 20% or more of the financial interests of the fund, is an arbitrary “bright line”

that does not adequately capture the essence of a pooled fund. We understand that AcSEC used APB 18 as a basis for this threshold. We believe that a 20% limitation is appropriate for a corporation where the shareholders have the ability to exert significant influence. However, private equity funds are typically set up as limited partnerships. In a limited partnership, the managing general partner exerts control over the partnership while the limited partners are merely passive investors. Therefore, we believe this condition is not meaningful in the context of limited partnerships.

In many cases the private equity industry considers a pooled fund to be one with less than 5 investors. For example, during the initial stages of an offering period, a fund will often have only a few primary investors. We believe that a pooled fund should be defined as an arrangement where there are unaffiliated investors who have given investment discretion to a fund manager.

Therefore, when defining “pooled funds”, the nature of the arrangement should be assessed rather than prescribing the number of investors.

The parent of an investment company is prohibited from making similar investments

The reference to “similar entities” in paragraph 1.9 (b) is unclear. We suggest changing this reference from “similar” to “same.” Inconsistent application of this criterion may result if the wording in the final SOP is not changed as companies may have a different interpretation of what is meant by similar.

Rebuttable presumption for controlling financial interests

We disagree with the rebuttable presumption in paragraph 1.12 and the examples in paragraph 1.14 that obtaining control or assisting in the formation of entities is for the purpose of “*obtaining benefits through relationships with investees or affiliates of investees that are unavailable to noninvestor entities.*” Venture Capitalists often assist new start-up entities with seed capital, company formation and many administrative (such as real estate, technology and treasury) services in exchange for a substantial equity ownership stake. This form of assistance is provided to maximize the return on invested capital and not for strategic benefit. Clearly, the private equity division of a financial institution does not derive strategic benefits from investing in biotechnology related entities, yet they are often the early investors in these entities.

Changes in Status

Restatement is not appropriate

Given the complex, rule-based criteria in the proposed SOP, there will be circumstances where entities could easily “slip in and out” of qualifying to apply the Guide. Because a failure of a criterion in paragraph 1.6 may be relatively insignificant and not indicative of a change in the intent of the investment company to invest for current income, capital appreciation, or both, we believe the reader of financial statements would be misled by the restatement of financial statements.

For example, assume that on 1/1/04, an entity with two substantive investments meets all of the criteria in the proposed SOP to qualify as an investment company. On 1/1/05, consistent with its stated business purpose, the entity sells one of its investments in order to maximize a capital gain. Given that at 1/1/05 the entity only holds one investment, it is in violation of paragraph 1.6b of the proposed Guide since it no longer holds multiple substantive investments – even though all of the other criteria in the Guide are met. Therefore, the entity must restate its financial statements for all prior periods presented as if the Guide had never been applied.

On 4/1/05, to better diversify its portfolio, the entity purchases three investments. Given that paragraph 1.18 states that investment company status must be reviewed and reconsidered each period, the entity now determines that it meets the criteria to apply the Guide. As such, investment company accounting is applied on a prospective basis.

Forward to 2007. Assume that, as part of a planned liquidation, the entity sells all but one of its investments, which it holds until it can be sold in 2008. Again, according to paragraph 1.6b, the entity can no longer apply the Guide and must restate its financial statements for all prior periods presented as if the Guide had never been applied.

We fail to see how financial reporting is improved by requiring the entity in our example to apply investment company accounting on a sporadic basis. Further, readers of financial statements would be confused as to the business intent of the reporting entity. Therefore, we urge AcSEC to revise the proposed SOP to state that a change in status from an investment company to a non-investment company be applied on a prospective basis to ensure consistency in the financial statements.

Restatement in the financial statements of a parent or equity method investor imposes compliance burdens

The restatement provisions in the proposed SOP would be difficult for a parent or equity method investor of an investment company entity to comply with as the complexity of the criteria is likely to create significant administrative compliance analysis each time that an entity changes status. Often times, historical information needed for accurate restatement will simply not be available. For equity method investors, confidential, proprietary information necessary to properly reflect income, loss, assets and liabilities might not be accessible from its autonomous investee. Without such access, meaningful reporting would not be possible.

One strike and you're out

Paragraphs 1.20 and A-40 state that if a parent or equity method investor no longer qualifies to retain investment company accounting for **at least one** of its investment company subsidiaries or equity method investments, it cannot retain investment company accounting for **any** of its investment company subsidiaries or equity method investments – even if the retention criteria in paragraphs 1.9- 1.16 are met for those other investment companies.

We see a likely scenario whereby an entire private equity operation with investment company activities would no longer qualify to apply the Guide in a parent's consolidated financial statements because one of its entities may have failed a criterion which may not be material to the investment company subsidiary. Using our example above, the parent or equity method investor in that entity would not be able to apply investment company accounting for any of its investment company entities from 1/1/05 – 4/1/05, but would be able to apply this accounting for its investment company entities from 4/1/05 – 2007. However, they would be precluded from using investment company accounting until the entity has been fully liquidated in 2008.

We fail to see why a private equity operation should be “penalized” for what could be an immaterial violation. We strongly believe clarification needs to be provided in the proposed SOP in order to avoid less meaningful consolidation or equity method information being provided to investors of the parent or manager. As the parent or manager does not manage the investments by utilizing consolidated or equity method financial information and metrics, but instead evaluates performance of the investment in terms of fair value, providing consolidated or equity method information to a parent/manager's investors would not be meaningful and would actually be less useful in assessing the performance of the parent/manager and its management.

Therefore, we urge AcSEC to reconsider the guidance in paragraphs 1.20 and A-40 and delete any reference to the “one strike and you're out” bright line that it entails. We would also suggest that a revised paragraph 1.20 introduce the concept of materiality (similar to the “substantive and significant” guidance in paragraph 1.6c) for these temporary criterion failures.

Nullification of EITF 85-12

We believe it is counterintuitive to require the parent or equity method investor in a Registered Investment Company (“RIC”) to be concerned with the criteria in paragraphs 1.9 to 1.16 in order to retain investment company accounting in the consolidated financial statements. A RIC is typically a mutual fund with over 100 investors. We cannot think of instances where a parent company or equity method investor would be able to use investees of the fund for strategic purposes given the fiduciary responsibility the fund has to its shareholders. A RIC is clearly investing for current income, capital appreciation, or both. As such, investment company accounting should survive in the consolidated financial statements of the parent or in the financial statements of the equity method investor.

Interaction with FIN 46

We believe that AcSEC should address how the proposed SOP interacts with the requirements of FIN 46. Specifically, FIN 46 only explicitly excludes investment companies registered under SEC Regulation S-X Rule 6-03(c)(1). This implies that all other investment companies would have to apply FIN 46 to variable interest entities

(“VIEs”). We strongly believe this is inappropriate and recommend that once an entity is deemed to be an investment company under the Guide, the accounting for all of its investments should be fair value. We do not see the merit in distinguishing the accounting for investments merely based on the accounting classification of the investee. For certain investment companies, an entity that is technically a VIE under FIN 46 could fit within the parameters of the fund’s financial strategies, and we see no reason to prescribe different accounting for those investments.

Further, we note that while FIN 46 is an interpretation of control-based consolidation rules, for VIEs it is actually a risks and rewards approach. This means that it is possible that an entity can consolidate a VIE for reasons other than control. For example, a majority owner of the equity in a VIE may consolidate the VIE, but since the equity holder does not make significant decisions the equity holder has no real control. If an affiliated investment company happens to hold some investments in the same VIE, the fact that the VIE is consolidated implies there is control over the investee and would, therefore, disqualify the entity from being an investment company. We do not think this is an appropriate result for financial reporting.

We understand that AcSEC is not expressly addressing FIN 46 in the proposed SOP, but we believe given the potential issues, including operational questions, this merits consideration and a discussion of the interaction between the two documents.

Transition

As discussed further below, many companies will not have sufficient information to accurately restate financial statements. Also, restatement of financial statements for companies that no longer qualify to apply the Guide is not practical since historical information necessary to accurately report those numbers may, in many instances, be unavailable. In addition, a six-month transition period would impose tremendous compliance and operational burdens on investment companies created before the issuance date of the proposed SOP. Each investment company as well as its parent company and equity method investor would need to:

- Determine if it is subject to the guidance;
- Consolidate investees where the Guide can no longer be applied;
- Gather historical information necessary to accurately report those numbers which may, in many instances, be unavailable; and
- Transfer/sell investments out of entities that now fail classification as an investment company.

Overall, we believe the implementation effort will prove to be extensive in light of the large number of existing investment companies that must be analyzed. There are numerous factors that contribute to the difficulties of gathering information required to

consolidate a private equity investment, more than one might initially expect, which include:

- A significant number of investees employ an accounting framework different from the investor (i.e., the investee may be on some local accounting framework other than U.S. GAAP).
- Many investees have a different fiscal year-end than the investor. Further, the year-end may be outside of any acceptable "window" for use in consolidation with the investor, requiring a second "hard" annual closing.
- Even if the year-end is consistent with that of the investor, the closing process will take longer than the time available to permit the investor to file timely reports with regulators and/or securities exchanges. This could be especially true if the private equity investee itself has to prepare consolidated financial statements first, based on specialized industry accounting, before submitting the information to the investor for purposes of preparing the investor's consolidated financial statements.
- Even if the investee applies U.S. GAAP, differences in the application of U.S. GAAP, or in the use of estimates or estimating procedures could differ. Examples include depreciable lives of assets, fair values of financial instruments (note that even if the private equity investee is not a financial services organization, it will still be a user of financial instruments), allowance for loan losses, and numerous other matters.
- This could result in a large number of modifications to existing agreements prior to the initial application in order to retain investment company status. In practice, this is no trivial matter as there are many legal and tax implications associated with transferring or selling investments. Further, in the context of a Pooled Fund, all partners must approve any transfer or sale of an investment, which is by no means an "automatic" event.

Consequently, our suggestion is to apply the Guide prospectively, with any adjustment of the change in status recorded as a cumulative effect of an accounting change given it will not be feasible to obtain the necessary information to record a restatement adjustment. Also, considering the complexity of the analysis that market participants will be required to undertake, we request that AcSEC extend the transition period one year.

Grandfathering approach for existing investments

Paragraph A-42 of the proposed SOP states that entities should be given the opportunity to "modify existing arrangements prior to the initial application of the SOP to meet or not meet the definition of an investment company and continue their current accounting method." In most instances, this would entail transferring or selling investments out of the investment company entity in order to retain investment company status. This is not practical as there are many legal and tax implications associated with transferring or selling investments.

Therefore, we suggest that AcSEC revise the transition guidance to state that a formerly qualifying investment (that causes an investment company to fail the definition of an investment company upon adoption of the final SOP) should continue to be considered a qualifying investment as long as the relationship between the investment company entity and the investee has not changed (e.g., no additional investment, no substantive activity that was not contemplated when the investment was first made). This “grandfathering” guidance would only be extended to investments in existence as of the effective date of the Guide.

Given the limited time period remaining prior to the proposed effective date of a final SOP, we would appreciate the opportunity for representatives of our Committee to meet with you to further discuss our comments. Accordingly, we will contact you to assess the feasibility of a joint meeting on this topic. If you have any questions on this letter, please feel free to call our staff adviser at the SIA, Jerry Quinn (212) 618-0507.

Sincerely,

Joanne Pace
Chair,
Dealer Accounting Committee