AICPA Investment Companies Expert Panel

May 16-17, 2022, meeting highlights

I. **Accounting/Reporting Issues:**

1. The Expert Panel (EP) members continued discussing the appropriate accounting model for a scenario previously discussed during the November 2021 and January 2022 meetings. In this scenario, an investment company buys carbon credits and plans to retire the credits to offset the emissions of its portfolio companies but does not plan to sell the credits or contribute them to its underlying portfolio companies. During the May 2022 meeting, the EP members acknowledged that while no prescribed GAAP currently exists, if the investment company holds these carbon credits for capital appreciation or investment income purposes and ultimately plans to sell them in the future, the carbon credits would likely meet the definition of an "other investment," which would be accounted for at fair value. One EP member noted that non-investment companies would expense any cost associated with the acquisitions in the period the carbon credits are retired. Others that recognize carbon credits as assets generally classify them as intangible assets or inventory. These approaches could be appropriate if an investment company is not holding the credits as investments for capital appreciation or investment income purposes. The EP members noted that if credits are recognized as assets, using inventory model accounting may be inconsistent with the notion that the carbon credits are not investments, as it could imply that the fund is intending to sell them; yet, they also noted that the inventory model may be less complicated to implement than the intangible asset model, although both models have complexities. An EP member observed that the FASB has an agenda topic on accounting for environmental credits.
   The EP also discussed how the accounting for carbon credits may impact the unit of account of the underlying portfolio company. One EP member observed that if purchasing and holding these credits is considered a non-investing activity to the entity and later becomes significant to the purpose and design of the entity, it may affect the investment company determination.
   Regardless of the accounting model applied to acquired carbon credits in the entity's circumstance, the entity should properly document its accounting conclusions and apply the accounting model consistently. The EP may revisit this topic at a future meeting.
2. The EP discussed the FASB's project on fair value measurement of equity securities subject to contractual sale restrictions. Subsequent to the meeting, the FASB issued

[ASU 2022-03, *Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*], which clarifies that a contractual restriction on the sale of an equity security is not considered part of the unit of account of the equity security and, therefore, is not considered in measuring fair value.

3. The Vietnamese stock market is subject to restrictions on the level of foreign ownership in a particular company. Shares of Vietnamese companies purchased by foreign investors typically trade at a 7% premium when the foreign investor limit has been reached. During the May 2022 meeting, the EP considered the valuation implications for a fund that acquires securities at a price that includes the purchase premium. The discussion focused on the definitions of principal vs. most advantageous market. The EP members discussed that the entity would first determine which exchange would qualify as the principal market. This would include considerations whether the fund has access to that market and consider the relative volume of that market. FASB ASC 820 *Fair Value Measurement* states that the fair value measurement should represent the price in the principal market, even if the price in a different market is potentially more advantageous at the measurement date.
4. The EP continued its discussion from the January 2022 meeting when a change in status from a noninvestment company to an investment company results in the deconsolidation of previously consolidated portfolio companies upon the change in status. In particular, at the May meeting, the EP members observed that this deconsolidation would likely result in a cumulative-effect adjustment to net assets due to the change in the reporting entity in accordance with FASB ASC 946-10-25-3, but would not result in a gain or loss from deconsolidation.
5. Some funds have been structuring their agreements where certain fees or expenses are not paid at the fund level but are instead paid directly to the adviser by the investors. The EP members shared their views on the accounting and presentation of such arrangements. Several EP members have seen disclosures in the notes to the financial statements of the fund that certain fund expenses have been paid by the adviser but no gross up of the effects of such agreement on the fund's financial statements. One EP member also noted that registered funds would not include such arrangement in a fee table. The EP discussed that if the fund was the primary obligor of the expense (i.e. the fund entered into the contract directly with the third party), it may be appropriate to gross up the expense with a corresponding reimbursement/waiver by the adviser. In contrast, if the adviser was the primary obligor, it could be appropriate to exclude the expenses from the financial statements of the fund.
6. A private portfolio company held by a private equity fund was sold to a public company for both cash and shares in the public company. The public company shares are not issued as of the transaction date, but instead will be released in tranches following the scheduled quarterly public filings. There are no substantial contingency provisions for the release of the shares other than the passage of time. The EP considered 1) derecognition of the private portfolio company and recognition of realized gains; 2) accounting for the receivable for the shares to be delivered; and 3) recording the cost basis of the shares as they are received. The EP expressed a view that the sale would likely be a realization event to the private equity fund, and that a

promise of receiving shares of a public company at certain dates in the future would likely be a financial instrument that would be accounted for at fair value.

SEC Staff Update

Disclaimer

The following comments and observations were compiled by the AICPA Investment Companies Expert Panel and AICPA staff and are not authoritative positions or interpretations issued by the SEC or its staff. The comments and observations were not transcribed by the SEC or its staff and have not been considered or acted upon by the SEC or its staff. Accordingly, these comments and observations do not constitute a statement of the views of the SEC or its staff.

1. Public statements and speeches:
    a. "The Name's Bond:" Remarks at City Week, Chair Gary Gensler, April 26, 2022
    b. Remarks at the ICI Investment Management Conference by William Birdthistle, Director, Division of Investment Management, March 28, 2022
    c. Financial Stability Oversight Council's 2021 report
        - House testimony playback
        - Senate testimony playback
2. Policy/rulemaking:
    a. SPACs, Shell Companies and Projections rule proposal press release (comments due June 13, 2022)
    b. Re-opening of the comment period for the Private Fund Advisers rule proposal (comments due June 13, 2022)
    c. Definition of Dealer rule proposal (comments due May 27, 2022). The staff referenced Chairman Gensler's remarks at the Nov 2021 U.S. Treasury Market Conference
3. Financial statement review comments:
    a. A fund disclosed a 2020 material error within its 2021 N-CSR filing in lieu of restating its 2020 financial statements, thereby attempting to correct an error that should have resulted in a "Big R" restatement using a "little r" convention. Upon discussions with the registrant, the fund's management decided to amend and restate its 2020 N-CSR and N-CEN filings, and the auditor reissued the 2020 audit opinion and internal control report, highlighting that the error resulted in a material weakness in internal controls. In light of this, as well as conversations with other registrants regarding materiality, the SEC staff encouraged registrants to review Paul Munter's statement from March 2022 regarding materiality, which states "when an error is determined to be material to previously-issued financial statements, the error must be corrected by restating the prior-period financial statements."
    b. The SEC staff described instances where the audited financial statements of a registrant were labeled as consolidated; however, the audit report did not refer to the financial statements as such. The staff reminded registrants and

auditors that the audit report should be clear as to basis of the audit, and the title of the statements in the audit report should match the way in which the financial statements are labeled, including whether the audit report references financial statements prepared on a consolidated basis. The Staff recognized that this may arise more often when a single audit report covers multiple funds. The staff has observed that one way to resolve this is to include an appendix or table that includes the full list of financial statements that are covered by the audit report, allowing each fund's financial statements to be properly labeled in the report.

c. Seed financial statements and organization/ offering costs – the SEC staff has observed diversity in practice in how organizational and offering costs are treated in seed financial statements, largely due to differences in contracts between funds and their advisers. Generally, the staff expects that the recognition and disclosure of organization and offering costs is based on both the contract between the fund and adviser and US GAAP. However, they have seen inconsistencies between what is disclosed in the financial statements and the related footnotes, and what is disclosed in the fee table in the prospectus. They described an example where a fund presented an expense reimbursement in the statement of operations, disclosed in the notes that the adviser had a contractual obligation to pay the organizational expenses of the fund; however, there was no waiver or reimbursement included in the fee table in the prospectus. The staff reminded registrants that they should include consistent disclosures between the registration statement, financial statements, and the notes to financial statements.

d. The SEC staff offered several questions for the EP's consideration in connection with the May 2014 EP discussions on fee waiver/reimbursement paid by advisers to Fund of Funds in excess of total expenses. Specifically, situations in which investment advisers of registered fund of funds may enter into expense limitation agreements whereby they limit the total expenses of the fund of fund, inclusive of acquired fund fees and expenses (AFFE). While AFFE is not a direct component of operating expenses, the staff have seen instances where the reimbursement of AFFE is in excess of total expenses and therefore presented as a negative expense. The Staff expressed a view that the reimbursement should be included in the section of the financial statements most closely associated with the reimbursed/waived transaction and generally would not expect the reimbursement of AFFE to result in a negative expense. The EP and SEC staff will continue the conversation at a future meeting.

4. During January 2022 SEC Staff Update, the SEC staff noted an increase in new funds with strategies to invest in real estate and direct lending products, often through a subsidiary, and reminded registrants that the legal analysis to determine whether leverage at the subsidiary should be attributed to the asset coverage ratio of a fund or BDC under Section 18 of the 1940 Act is separate from the accounting analysis to determine whether the subsidiary should be consolidated in accordance with US GAAP.

During the May 2022 SEC Staff Update, the SEC staff shared they continue to review registrants' filings where a subsidiary is not consolidated for accounting purposes under US GAAP; however, under Section 18 of the 1940 Act, the Staff have questioned whether the leverage of the unconsolidated subsidiary should be attributed to the registrant, which could ultimately impact the asset coverage calculation of the registrant. The Staff provided some additional insight driving this comment:

- While the Staff recognized that registrants may use subsidiaries for a variety of reasons, the goal of the legal analysis is to ensure that the registrant is not attempting to avoid the leverage limitations of the 1940 Act through its use of a subsidiary.
- In light of this concern, the staff has taken the position that a registrant must "look through" an entity which is "primarily controlled" by the registrant and which primarily engages in investment activities in securities or other assets and determine compliance with 1940 Act requirements on an aggregate basis with the entity.
- The Staff indicated that, generally, "primarily controlled" means (1) the registrant controls the unregistered entity within the meaning of Section 2(a)(9) of the 1940 Act, and (2) the registrant's control of the unregistered entity is greater than that of any other person.
- Section 2(a)(9) defines "control" to mean the power to exercise a controlling influence over the management or policies of a company. Section 2(a)(9) creates a rebuttable presumption of control when any person owns more than 25% of the voting securities of a company (although control can be achieved even if this threshold is not breeched).
- The Staff noted that the analysis may require consideration of both economic and non-economic indicators of control. For example, while voting rights are important to consider, other decision making rights conveyed outside of such voting rights may also be relevant to the analysis.

The Staff reminded registrants of the importance of working with counsel to ensure thorough evaluation and documentation of the relevant facts and circumstances regarding whether attribution of unconsolidated subsidiary leverage is appropriate when determining compliance with Section 18 of the 1940 Act.

5. Recent 22(e) order
6. Division of Examinations 2022 priorities

7. Division of Enforcement update:

   a. Announcement related to the Crypto Assets and Cyber Unit
   b. SEC charges Archegos Capital Management market manipulation
   c. SEC charges Allianz Global Investors with Securities Fraud