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The IASB's Exposure Draft *Investment Entities*

The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as by enhancing investor protection.

ESMA has considered through its Standing Committee on Corporate Reporting the IASB's Exposure Draft (ED) *Investment Entities*. ESMA thanks you for this opportunity to contribute to the IASB's due process. ESMA is pleased to provide you with the following comments aimed at improving the decision-usefulness of financial statements and the transparency and enforceability of IFRSs.

ESMA supports the proposed requirement for investment entities to measure investments in entities that it controls at fair value through profit or loss in accordance with IFRS 9 – *Financial Instruments: Classification and Measurement* rather than consolidating such investments. ESMA however believes that the Board should further deliberate on how to achieve that objective. In particular, ESMA believes that the Board should:

- Introduce a main principle that the general business model of the parent investment company is to invest for capital appreciation, investment income (such as dividends or interest) or both. For an entity to meet this principle ESMA believes that its business model must meet all the criteria identified in paragraph 2 of the ED (except criterion 2f for the reasons set out in this letter) as well as the additional criteria proposed in this letter;
- Identify the exit strategy as an additional criterion: an exit strategy is specific to the business of investment entities and should be in place as part of the business model. ESMA believes that all criteria should be fulfilled to qualify for the exclusion of consolidation (with the exception of criterion 2f). ESMA feels that a high prominence of all criteria would contribute to better financial reporting, better information to users of the financial information and a better enforcement process.



- Whilst ESMA would not be supportive of an overly prescriptive requirement for the format of disclosures, it may be helpful to users of the information to include the proposed schedules (of investments and financial highlights) as a disclosure requirement.
- Regarding the scope exclusion in IAS 28 – *Investment in Associates*, ESMA considers that the Board should clarify the impact (if any) of the amendment of the scope exception.

Our detailed comments on the ED are set out in the Appendix to this letter. I would be happy to discuss all or any of these issues further with you.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'J. Galbo', written over a faint blue line.

Julie Galbo

Chair of ESMA's Corporate Reporting Standing Committee

APPENDIX – ESMA’s detailed answers to the questions in the IASB’s *Exposure draft Investments Entities*

Question 1 – Exclusion of investment entities from consolidation

Do you agree that there is a class of entities, commonly thought of as an investment entity in nature, that should not consolidate controlled entities and instead measure them at fair value through profit or loss? Why or why not?

1. ESMA supports the proposed requirement for investment entities to measure investments in entities that they control at fair value through profit or loss in accordance with IFRS 9 – *Financial Instruments: Classification and Measurement* rather than consolidating such investments. Fair value measurement and disclosures provides more decision-useful information to investors.
2. To achieve comparability of investment companies’ financial statements it is important that the proposed amendments be mandatory. ESMA agrees that all investment entities that meet the criteria should apply the consolidation-exclusion and value its controlled interests at fair value through profit or loss instead of consolidation of the subsidiaries.
3. ESMA suggests that the Board should add a main principle that the general business model of the investment company is to invest for capital appreciation, investment income (such as dividends or interests) or both. For an entity to meet this principle ESMA believes that its business model must meet all the criteria identified in paragraph 2 of the ED. That said, ESMA would like to refer to our response to question 2 where ESMA has set out some concerns to the suggested criteria in paragraph 2.
4. Importantly, ESMA believes that the Board should perform a post-implementation review to assess whether the principle of the general business model and the criteria identified in paragraph 2 are robust and do not lead to inappropriate use of the consolidation exemption in practice.

Question 2 – Criteria for determining when an entity is an investment entity (paragraphs 2 and B1 – B17)

Do you agree that the criteria in this exposure draft are appropriate to identify entities that should be required to measure their investments in controlled entities at fair value through profit or loss? If not, what alternative criteria would you propose, and why are those criteria more appropriate?

5. To achieve comparability of investment companies' financial statements it is important that the proposed amendments become mandatory. All investment entities that meet the criteria should apply the consolidation-exclusion and value its controlled interests at fair value through profit or loss instead of consolidation of the subsidiaries.
6. ESMA is generally supportive of the criteria the IASB puts forward in paragraph 2 for an entity to qualify as an investment entity. ESMA however believes that the Board should further deliberate on the different criteria and particularly on how those criteria as a whole interact with the business model:
 - (a) The business processes, which also includes management intent and management strategy, are the main criteria for ESMA. ESMA believes that the management strategy should also include an exit strategy. ESMA suggests identifying the exit strategy as a separate criterion. ESMA feels that a higher prominence of the exit strategy would contribute to better financial reporting, better information to users of the financial information and a better enforcement process.
 - (b) ESMA suggests to replace the word 'substantially' in criteria 2(e) with 'all'. The word 'substantially' is not in line with the application guidance in B17 which describes that 'all controlled investments of an investment entity must be managed and evaluated on a fair value basis'. ESMA agrees with the guidance provided in paragraph B17.
 - (c) ESMA suggests moving the last sentence in criterion 2(f) to the application guidance. Whether the entity is a legal entity or not could be perceived as being an additional criterion. ESMA believes that the other criteria apply and qualify an investment entity irrespective of the status of the entity.
7. In addition, ESMA notes that the application guidance in B13 regarding the multiple classes of equity instruments that supports criterion (c) could be perceived as contradicting the Board's intention explained in BC 13, which indicates that one investor should not obtain benefits from its investees that would be unavailable to other investors. All benefits should be available to all investors.

Question 3 – 'Nature of the investment activity' (paragraphs 2(a) and B1-B6)

Should an entity still be eligible to qualify as an investment entity if it provides (or holds an investment in an entity that provides) services that relate to:

- (a) its own investment activities?**
- (b) the investment activities of entities other than the reporting entity?**

Why or why not?

8. ESMA believes that an entity can still qualify as an investment entity if it provides services to its own investment group and these services relate to the management of its investment activities only. The services provided should only be limited to their own investments in order to assess all the activities of the entity as investing activities. Otherwise there might be a risk of inappropriate use of the exception.
9. ESMA suggests that the Board should improve the proposed guidance by:
 - removing the word ‘substantive’ in criterion 2(a) and B1 to prevent structuring opportunities. Furthermore, ESMA feels that the situations described in paragraph 7(a) and (b) provide the investment entity sufficient leeway to not assess the entity as an investment entity;
 - adjusting the wording in BC11 as it currently mentions ‘operating entity’ while ESMA believes that ‘an entity that provides services’ is more consistent with paragraph 7(a) and B2; *and*
 - ESMA suggests developing application guidance with respect to the support activities that are described in paragraph 10(b) and (c). ESMA believes that those support activities would not be allowed by an entity to qualify as an investment entity (see our response to question 7).
10. As a last point, ESMA encourages the Board to provide more details in application guidance on the nature of the support activities.

Question 4 ‘Pooling of funds’ (paragraphs 2(d) and B14 – B16)

(a) Should an entity with a single investor unrelated to the fund manager be eligible to qualify as an investment entity? Why or why not?

(b) If yes, please describe any structures/examples that in your view should meet this criterion and how you would propose to address the concerns raised by the Board in paragraph BC 16.

11. ESMA believes that an entity with a single investor could, in theory, qualify as an investment entity. For example, ESMA understands that State owned funds (i.e. sovereign wealth funds) typically have a single investor and thus would not have investors unrelated to the parent that in aggregate hold a significant ownership interest in the entity.
12. With a view to be able to appropriately assess criterion 2(d), ESMA would like to encourage the Board to elaborate on the following concepts:
 - a. *Unrelated* single investor; does the Board refer to the guidance provided in IAS 24 – *Related Party Transactions* and if so, does the Board think that that guidance is appropriate in this

context? It seems very unlikely to ESMA that a single investor can be unrelated to the fund manager

- b. *Pooling of fund criterion*; the investment entity should have unrelated investors that, in aggregate, hold significant ownership. The parent of the investment company in turn may also have unrelated investors that in aggregate hold significant ownership to apply the consolidation exclusion. It is not clear for ESMA how to apply this criterion to the separate levels in a group structure; *and*
- c. *Fund manager*.

Question 5 – Measurement guidance (paragraphs 6 and 7)

Do you agree that investment entities that hold investment properties should be required to apply the fair value model in IAS 40, and do you agree that the measurement guidance otherwise proposed in the exposure draft need apply only to financial assets, as defined in IFRS 9 and IAS 39 *Financial Instruments: Recognition and Measurement*? Why or why not?

- 13. ESMA agrees that investment properties held by investment entities should be required to be accounted for using the fair value model in IAS 40 – *Investment Property* to be consistent with the way those entities manage their assets, i.e. on a fair value basis (see criterion (e)).
- 14. In line with the rationale expressed in the paragraph above, ESMA questions the measurement basis for investment entities' other assets should be required to be accounted for using fair value through profit or loss. The Board should clarify if investment entities would be prevented from using the available-for-sale category under IAS 39 – *Financial Instruments: Recognition and Measurement* (or the fair value through Other Comprehensive Income option under IFRS 9 – *Financial Instruments: Classification and Measurement*) for financial instruments not directly addressed by the measurement requirements of the ED.

Question 6 – Accounting in the consolidated financial statements of a non-investment entity parent (paragraph 8)

Do you agree that the parent of an investment entity that is not itself an investment entity should be required to consolidate all of its controlled entities including those it holds through subsidiaries that are investment entities? If not, why not and how would you propose to address the Board's concerns?

15. ESMA supports the consolidation requirements for the parent of an investment entity that in itself is not an investment entity. Requiring that consolidation methods should apply to those entities is appropriate because:
- (a) It will minimise possible inappropriate use of the provisions in the proposed standard; *and*
 - (b) For a parent entity that consists substantially of operating entities (and the investment entity), management’s strategy for the whole group is unlikely to be one of earning all of its profit through capital appreciation and investment income. As such, application of the ED to such entities is unlikely to provide decision-useful information for investors. Consequently, the investment entity should be consolidated.

Question 7 – Disclosure (paragraphs 9 and 10)

- (a) Do you agree that it is appropriate to use this disclosure objective for investment entities rather than including additional specific disclosure requirements?**
 - (b) Do you agree with the proposed application guidance on information that could satisfy the disclosure objective? If not, why not and what would you propose instead?**
16. ESMA in general supports the disclosure principle described in paragraph 9. ESMA however believes that information about management’s risk assessment is relevant information for investors. ESMA therefore would like to propose to insert ‘*and risks*’ after financial effects in that paragraph.
10. ESMA believes that the disclosure requirements should be more explicit than the examples in B19. ESMA notes that BC 25 explains that users are of the opinion that a schedule of investments and a financial highlights schedule are useful, to which the boards agreed. BC25 also indicates that these disclosures are not required in the ED due to their descriptive nature. Whilst ESMA would not be supportive of an overly prescriptive requirement for the format of disclosures, it may be helpful to users of the information to include the requested schedules as a disclosure requirement, or at least as illustrative examples of good practice disclosures.
17. ESMA believes that the requirement in paragraph 10(b) to disclose whether the investment entity has provided financial or other support, that is not contractual, to one of its controlled investees should be clarified or eliminated. ESMA is concerned that providing support to an investee may be incompatible with the activities of an investment entity. When an investment entity provides support to an investee, this may change the nature of the relationship from one of investment to more of a strategic relationship where the parent is involved in the operating and financing activities of its subsidiary. In this context ESMA believes that the concept of “support” is not well defined (see our response to question 3).

18. ESMA believes that application guidance B20 should be more explicit. The IASB should identify the overlap in disclosure requirements with other IFRSs. ESMA believes the IASB is the best placed authority to ensure an efficient identification of overlap in disclosure requirements. Furthermore, identification of the overlap by the IASB enhances comparability and consistent application of the disclosure requirements regarding investment entities.
19. Finally, ESMA would like to mention as a drafting point that application guidance B19 refers to paragraph 10 instead of paragraph 9.

Question 8 – Transition (paragraphs C2)

Do you agree with applying the proposals prospectively and the related proposed transition requirements? If not, why not? What transition requirements would you propose instead and why?

20. ESMA believes that retrospective application would improve the comparability, and consequently the quality of the information provided to investors. ESMA also believes that the information should be readily available at the entities as management intention already aims to create value through capital appreciation and investment income. The accounting systems should include fair value information, as this is one of the requirements to qualify as an investment entity.
21. ESMA also believes that retrospective application should be in line with the transitional requirements in IFRS 10 – *Consolidated Financial Statements*.

Question 9 – Scope exclusion in IAS 28 (as amended in 2011)

- (a) **Do you agree that IAS 28 should be amended so that the mandatory measurement exemption would apply only to investment entities as defined in the exposure draft? If not, why not?**
 - (b) **As an alternative, would you agree with an amendment to IAS 28 that would make the measurement exemption mandatory for investment entities as defined in the exposure draft and voluntary for other venture capital organisations, mutual funds, unit trusts and similar entities? Why or why not?**
22. ESMA believes that entities that meet the requirements of an investment entity should also apply fair value through profit or loss for the measurement of their interests in associates. The consistent application of fair value is in line with management strategies to realise capital appreciation and investment income.

23. ESMA believes that the IASB should further explain and assess what is the impact (if any) of replacing venture capital organisations/mutual funds/units trusts/similar entities by investment entities in IAS 28.

24. Lastly, ESMA would like to mention that Appendix D in the ED refers to IAS 28 (as amended in 2011). It reads: 'In the introduction of IAS 28 and in paragraph 13B, replace the measurement option'. ESMA notes that in IAS 28 as published in May 2011 on the IASB's website under the section: 'Revised and amended standards and other documents', paragraph 13B does not exist. ESMA believes that the reference should be rather to paragraph 18 of IAS 28.