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Proposed Accounting Standards Update, *Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*

Dear Ms. Salo:

We appreciate the opportunity to comment on the Proposed Accounting Standards Update (ASU), *Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*, issued by the Financial Accounting Standards Board (Board).

We commend the Board's effort to reduce the diversity in practice observed by stakeholders in measuring the fair value of equity securities that are subject to contractual sale restrictions and agree that the proposal would accomplish this objective. However, we believe it would result in a fair value measurement that does not faithfully reflect the economic effect of the contractual sale restriction on the holder, who derives value from the equity security by monetizing it. For investment companies in the scope of Accounting Standards Codification (ASC) 946, *Financial Services — Investment Companies*, the effect would likely be a higher net asset value (NAV) per share, which may negatively impact investors in open-ended funds who transact with those entities at NAV.

To reflect the true economics of an equity security subject to a contractual sale restriction, we believe the unit of account for all entities should include both the equity security and the related contractual sale restriction. Therefore, we recommend that the Board consider amending the guidance in ASC 820, *Fair Value Measurement*, to define a contractual sale restriction on an equity security as a characteristic of the asset that would be considered by a market participant at the measurement date and, therefore, should be considered when the holder of the equity security measures its fair value.

In addition to our recommendation above, we would also support a practical expedient that would permit entities that are not in the scope of ASC 946 to exclude a contractual sale restriction from an equity security's unit of account for the purpose of measuring its fair value under ASC 820 if the restriction is for a short duration (e.g., 180 days) at contract inception.

We believe our recommendations would achieve the Board's objective of reducing diversity in practice while also faithfully presenting the economic effects of a contractual sale restriction on an equity security. We believe our recommendations would also provide relief to certain entities that hold equity securities subject to short-duration contractual sale restrictions without affecting the quality of information presented in their financial statements.

Our responses to certain questions in the proposal are in the attached Appendix.

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We would be pleased to discuss our comments with the Board or its staff at your convenience.

Very truly yours,

Ernst + Young LLP

Appendix — Responses to Questions to Respondents in the Board's proposal and other comments

Question 1 — Restriction Type: Do you agree with the Board's decision on scope to include all contractual restrictions that prohibit the sale of an equity security? Please explain why or why not.

We support the Board's decision to include all contractual restrictions that prohibit the sale of an equity security in the scope of the proposal. This is because we believe that an underwriter lock-up agreement that restricts the sale of an equity security has the same effect as any other restriction on the sale of an equity security — preventing the holder from monetizing the security — and, therefore, should be accounted for the same way.

Question 2 — Measurement: Do you agree with the Board's decision that a contractual restriction prohibiting the sale of an equity security is not considered part of the unit of account of the equity security and, therefore, should not be considered in measuring fair value? Alternatively, should the Board amend the guidance in Topic 820 (or elsewhere in GAAP) such that contractual sale restrictions would be required to be considered in determining fair value?

While we agree that the proposal would reduce diversity in practice, we believe the proposal would not faithfully reflect the economic effect of the contractual sale restriction on the holder of the equity security. The holder derives value by selling the equity security to another market participant. Therefore, we believe any restriction on the holder's ability to sell the equity security would have an economic consequence on the equity security's value. The proposal would require the recognition of an equity security that is subject to a contractual sale restriction at its unadjusted share price without regard to the holder's inability to realize the equity security's value. As such, we believe the proposal would overstate the value of an equity security subject to a contractual sale restriction and, therefore, reduce the overall quality and usefulness of the information provided to financial statement users.

We note that the proposal defines a contractual sale restriction as a restriction on the holder of the equity security and assumes that the restriction would not transfer with the equity security in a hypothetical transaction to sell the security. We also note that the guidance in ASC 820 requires the entity to assume a hypothetical sale at the measurement date. However, for a hypothetical sale of the contractually restricted equity security to occur before the restriction lapses, we believe the restriction would have to be transferred to the market participant that purchases the equity security.

We also believe that the unit of account for a security subject to a contractual sale restriction should be consistent with that of a restricted security (as defined in the proposal). We believe that both types of restrictions limit the holder's ability to monetize the underlying equity security. We also believe that the holder of an equity security subject to a contractual sale restriction is often more limited in its ability to derive value from the asset than a holder of a restricted security. This is because what the proposal defines as a restricted security may be sold to a specific class of investors (e.g., an accredited investor) while an equity security subject to a contractual sale restriction often cannot be sold to any party until the restriction lapses. We believe that using a consistent unit of account would reflect the limitations resulting from both restrictions and remove the judgment that may be required in certain circumstances to differentiate between a restricted security and an equity security subject to a contractual sale restriction.

It is also our understanding that many investment companies that hold equity securities subject to contractual sale restrictions consider the restriction to be part of the equity security's unit of account when they measure fair value. In addition, many investment companies (e.g., open-ended mutual funds and hedge funds) transact with investors at NAV per share. If an investment company holds equity securities subject to contractual sale restrictions, and all other factors are held constant, we believe the proposal would result in an investment company recording a higher NAV per share. As a result, investors in open-ended funds would be required to transact at a higher NAV per share due to the unit of account as defined in ASC 820 and not the underlying economic performance of the fund.

Further, in many instances, a fund's management and/or performance fees are based on the value of the net assets under management, which would also increase if investment companies did not consider the contractual sale restriction when calculating fair value. Therefore, we believe the proposal would result in higher compensation to fund managers that is not necessarily aligned with the fund's underlying performance.

Therefore, when an entity measures the fair value of an equity security that is subject to a contractual sale restriction, we believe the unit of account to which the entity applies the principles of ASC 820 should include both the equity security and the related sale restriction. We recommend that the Board consider amending ASC 820 to define a contractual sale restriction on an equity security as a characteristic of the asset that would be considered by a market participant when pricing the equity security at the measurement date. We believe our recommendation would achieve the Board's objective of reducing diversity in practice while also faithfully representing the economic impact of the contractual sale restriction on the equity security's fair value measurement.

We would also support a practical expedient that would permit entities not in the scope of ASC 946 to exclude a contractual sale restriction from an equity security's unit of account under ASC 820 if the restriction was for a short duration (e.g., 180 days) at contract inception. We believe this practical expedient could reduce the potential burden on preparers that hold securities subject to contractual sale restrictions where the value of the security may not be significantly affected by the presence of a contractual sale restriction due to its short duration.

Question 3 — Entity Type: Should all types of entities use the same unit of account when measuring the fair value of an equity security subject to a contractual sale restriction, or should certain types of entities (for example, investment companies, broker dealers, and pension plan financial statements) have a different unit of account? Please explain your responses.

We believe all entities should use the same unit of account when measuring the fair value of an equity security subject to a contractual sale restriction. As described in our response to Question 2, we recommend that the Board amend ASC 820 to define a contractual sale restriction of an equity security as a characteristic of the asset; therefore, both the equity security and the related contractual sale restriction would be considered part of the same unit of account for all entities. However, to provide relief for entities that are not in the scope of ASC 946 that hold equity securities subject to short-duration contractual sale restrictions, we would also support a practical expedient that would allow them not to consider a contractual sale restriction as part of an equity security's unit of account.

Question 4 — Disclosures: Would qualitative or quantitative disclosures (for example, describing the nature of a contractual sale restriction on an equity security and the related amount recognized on the balance sheet) help users in understanding the effects of a contractual restriction on the sale of an equity security held by a reporting entity? Please explain why or why not. For reporting entities, what costs would be incurred to disclose that information?

Based on the recommendations outlined in our response to Question 2, we believe the existing disclosure requirements for Level 3 inputs would be sufficient to help users understand the effect of contractual restrictions on the sale of equity securities held by a reporting entity. However, if an eligible entity were to elect the practical expedient described in our response to Question 2, we believe the entity should disclose that fact as well as the aggregate value of equity securities measured using the practical expedient.

Alternatively, if the Board finalizes the proposal as it is currently drafted, we believe additional disclosures would be necessary to help users understand the effects of a contractual restriction on the sale of an equity security held by a reporting entity. For example, we would recommend that the Board consider a requirement to disclose the aggregate fair value of equity securities subject to contractual sale restrictions as well as information about when and/or the circumstances under which the contractual sale restrictions lapse.

Question 5 — Transition: Do you agree with the transition guidance in this proposed Update? Please explain why or why not.

We support the Board's proposed transition guidance. For entities in the scope of ASC 946, we believe the proposed transition guidance would minimize any immediate volatility to investors in open-ended funds who transact at NAV. For all other entities, we believe prospective adoption is appropriate.

Question 7 — Clarity and Operability: Do you agree that the proposed amendments and, in particular, the definition of a restricted security provide the necessary clarity to resolve existing diversity in practice? Please explain why or why not. Are the proposed amendments operable and auditable? If not, which proposed amendment or amendments pose operability or auditability issues and why?

We believe the proposed amendments are both operable and auditable because entities would not be required to estimate the effect of a contractual sale restriction when determining the fair value of the related equity security. However, as discussed in our response to Question 2, we believe judgment may be required in certain circumstances to differentiate between a restricted security and an equity security subject to a contractual sale restriction.