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Technical Director
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Financial Accounting Standard Board
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BY EMAIL

RE: National Venture Capital Association Response to Proposed ASU – Fair Value
Measurement of Equity Securities Subject to Contractual Sale Restrictions.

Introduction

As the voice of the venture capital industry, the National Venture Capital Association (NVCA)¹ appreciates the opportunity to respond to this Proposed ASU and provide the perspective of venture capital funds (VCFs), which invest across the spectrum of company development stages, typically from an early-stage startup through IPO or acquisition. The impact that this Proposal would have on VCF post-IPO asset valuations is the principal focus of this letter.

Our comments on all financial reporting matters are informed by the active involvement of NVCA's CFO Task Force, a working group comprised of member firms' Chief Financial Officers, Chief Operating Officers, and Administrative Partners. Most CFO Task Force members are CPAs, and many have practiced accounting with leading national firms and have had significant operating experience as CFOs of both private and public companies. CFOs of venture funds are collectively responsible for the financial reporting within the venture industry and thus determine VCF net asset values reported to limited partner investors (LPs). In this capacity they have primary responsibility for policies on valuation of securities of portfolio companies (PCs), including those with a public market price that are also subject to ironclad IPO lockup restrictions on sale.

¹Venture capitalists are committed to funding America's most innovative entrepreneurs, working closely with them to transform breakthrough ideas into emerging growth companies that drive U.S. job creation and economic growth. As the voice of the U.S. venture capital community, the National Venture Capital Association (NVCA) empowers its members and the entrepreneurs they fund by advocating for policies that encourage innovation and reward long-term investment. As the venture community's preeminent trade association, NVCA serves as the definitive resource for venture capital data and unites members through a full range of professional services. For more information about the NVCA, please visit www.nvca.org.

Background

The Proposed ASU implicates two important principles. NVCA has consistently urged the FASB to ensure that its standards help preparers deliver GAAP financials with practical, economically accurate information to investors. We have also consistently urged the Board to take a hard look at cost and benefit in developing its standards, especially regarding fair value accounting. Our comments below reflect the views on these two topics we have received from our CFO Task Force members on this Proposal.

Responses to Questions

Question 1—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.

Since our experience, and thus our comments apply only to contractual restrictions arising from IPO underwriters, i.e., “lockups” which are discussed in the Proposal, we will not comment on whether the scope of the Proposal should extend to any other contractual restrictions. As to IPO lockups, it seems apparent that application of the Proposed ASU to VCFs would result, at least temporarily, in inaccurate valuation information in GAAP reports to investors.

As the Board is certainly aware, VCFs are investment companies whose net asset values (NAVs) are often driven by the value of a single successful portfolio company that completes an IPO. Therefore, in considering limitations to the scope of this Proposed ASU, the Board should heavily weigh the impact the proposed change could have on the accuracy of the NAVs that VCFs and similar investment companies report to their investors.

Question 2 (first question)—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?

The statement in the Proposal that a “contractual sale restriction only affects the behavior of the holder of the equity security and does not affect the security itself and, therefore, is an entity-specific characteristic” (Para BC10) is axiomatic. We leave it to accounting experts to say whether technical wording in Topic 820 regarding Unit of Account should be read to require a concomitant distinction in valuation determinations based on the legal-versus-contractual distinction that the Proposal makes. The important question is whether the distinction is meaningful in practice.

In that vein, we firmly believe, that the “marketplace participant” perspective required by Topic 820 should be that of a hypothetical buyer or seller, who is subject to the economic realities of the actual marketplace in which a transaction would occur. Most responses we have received from our members support the view that “for an equity security the distinction of whether a legal or contractual restriction on a sale is asset specific or entity specific is arbitrary from an economic point of view because the value of an equity security can typically only be fully realized through sale.” (Para BC18). For securities in a VCF where the holder is subject to an IPO lockup, this seems a simple truth.

Question 2 (second question)—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?

CFO Task Force members are somewhat divided on this question. However, based on the totality of responses we have received, we see a strong case for the FASB’s guidance to allow contract-based restrictions to be considered in setting fair value for securities held by venture capital funds. We address two important aspects of the Proposal below.

Practical Economic Impact

The points raised in the Additional Views section regarding “economic” fair value raise a key issue for VCFs. As the Board is aware, this Proposal would have a significant impact on discounts applicable to securities in VCFs that are subject to contract-based sale restrictions from IPO lockup agreements. Indeed, it would eliminate them in GAAP reporting and may require an additional means of communicating economic or “real world” value to Limited Partners (LPs). The points raised in the Additional Views section in this regard are well-developed and capture the importance of this issue to VCFs.

It seems beyond dispute that lockup sales restrictions, as described in Paragraph BC19, “clearly have a differential impact from an economic point of view on the owners of restricted shares who are precluded from realizing value for the shares during the restricted period.” *Id.* Specifically, for venture funds, securities under an underwriters’ lockup carry liquidity-based volatility risks which would invariably cause a “marketplace participant” to require a discount to the price of the same securities that are freely tradable. In practice, the illiquidity of these shares is part of the fund’s position in the securities and impacts the measurement date fair value of that position in the same way as a legal restriction would.

In this respect we note that the Proposal lacks a response to the criticism in the Additional Views that the Proposal would create “a clear disconnect between economic fair value and accounting fair value when an equity security is subject to [a contractual] restriction . . .” (Para BC20). Absent an answer to this point, we see the Proposal as flawed, and a step in the wrong direction in terms of providing investors with decision useful VCF valuations.

One member firm that is also a manager of fund of funds, and thus is an LP user of VCF financial statements strongly agrees on this economic point. In addition, they say that diversity in practice as to discounting does not justify eliminating lockup discounts, since there are methods for establishing discounts that are “auditable and repeatable.” We hope that the FASB hears from other LPs on this question.

Cost Benefit

NVCA has consistently urged the FASB to place great emphasis on cost-benefit analysis in all its activities. We applaud the Board for the significant progress it has made in that area over the past twenty years. Like the Board, our members are not of one mind on the question of whether this Proposal will

reduce the cost of compliance for GP preparers – a cost-benefit question. Therefore, on that question our comments are somewhat nuanced.

Some NVCA members expect that there will be cost impact from this proposal. Indeed, some members enthusiastically support the Proposal on this basis. They cite various problems that arise under the current practice of applying discounts to fund assets subject to IPO lockups. These problems arise from differences in valuations among VCFs holding the same securities subject to the same lockups. One member also describes the additional systems needed to track declining discounts as lockup periods mature. In addition, funds that purchase a portfolio company's IPO shares on the public market value those shares at the public market price but also discount the value of the fund's position in the same shares that are subject to a lockup. In this respect these members agree with the Proposal's conclusion that "initial costs would be offset by a reduction in the recurring cost and complexity incurred in preparing and auditing the discount incorporated into the fair value measurement." (Para BC7, emphasis supplied). However, this is a minority view among members who have responded to us regarding the Proposal.

In addition, other members have indicated that they do not expect a large impact from a preparer point of view or have not responded. However, most of the detailed member responses we've received are consistent with the Additional Views in Paragraph BC21:

"While recognizing the challenge of estimating the appropriate discount, and the ease of applying the current market price, Messrs. Cannon, Jones, and Kroeker do not believe that difficulty in measurement is a compelling reason to ignore the economics of the contractual restrictions on sale." *Id.*

Indeed, some of our members have characterized the methods for setting appropriate discounts as "standardized" and "pretty simple." One member also alluded to cost and complexity that would arise from the need to communicate separately with LPs because the GAAP valuation would clearly be overstated, and LPs would want to know by how much. Therefore, our members are mixed in their responses on the issue of whether the Proposal would save cost and reduce complexity for GP preparers.

Conclusion

Thank you for the opportunity to submit these comments and for your consideration of our views. On behalf of the venture capital industry, NVCA looks forward to working with the FASB on this Proposal and on future initiatives. If you have questions or wish to discuss our comments, please feel free to contact Charlotte Savercool, Senior Director of Government Affairs, at (202) 864-5928.

Sincerely,



Bobby Franklin
President and CEO