November 18, 2021

Technical Director
FASB
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116

Re: File Reference No. 2021-005

Dear Technical Director,

We are pleased to provide comments on FASB's proposed Accounting Standards Update *Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions.*

Duff & Phelps, A Kroll Business, the leading independent global valuation advisory firm, helps clients make confident decisions in the areas of valuation, real estate, taxation and transfer pricing, disputes, M&A advisory and other corporate transactions. Duff & Phelps acquired Kroll in 2018 and is in the process of rebranding as Kroll by the end of 2021. Kroll is the world's premier provider of services and digital products related to valuation, governance, risk, and transparency. We work with clients across diverse sectors in the areas of valuation, expert services, investigations, cyber security, corporate finance, restructuring, legal and business solutions, data analytics, and regulatory compliance. Kroll has nearly 5,000 professionals in 30 countries and territories around the world.

Our personnel support industry efforts to enhance consistency and transparency, including participation in various AICPA and TAF (The Appraisal Foundation) task forces and committees, and other industry bodies such as the International Private Equity and Venture Capital Valuations Board, and the IVSC (International Standards Valuation Council).

We would be pleased to discuss our comments with the FASB staff. Please reach out to David Larsen at david.larsen@kroll.com, Marianna Todorova at marianna.todorova@duffandphelps.com, or Greg Franceschi at greg.franceschi@duffandphelps.com with any questions.

Sincerely,

Duff & Phelps, A Kroll Business

Office of Professional Practice

Duff & Phelps, A Kroll Business

Overall Comments

We do not agree with the proposed ASU (the Proposal) on practical, economic, and conceptual grounds, as well as potential divergence from fair value guidance in IFRS.

Practical Impacts – Investment Companies

By far, the largest potential impact of the Proposal will be on investment entities (as well as on other 'fair value entities', such as broker-dealers and pension plans). We believe that, if adopted, it will lead to greater divergence in practice and create significant potential hardship for Investors (limited partners) who used the Net Asset Value (NAV) practical expedient from ASC Topic 820 or GASB Statement 72 to measure the fair value of limited partnership interests in alternative investment funds. Further, the result would diverge from IFRS 13, compromising fair value convergence between US GAAP and IFRS by introducing non-comparability in fair value measurements within the scope of the Proposal.

Our general and specific comments on the investment company industry impact are derived from years of alternative asset valuation experience supporting Investment Managers (general partners) and Investors (limited partners) with their estimation of fair value. Annually, we perform more than 10,000 engagements for more than 5,000 clients including the majority of the largest Private Equity Funds, Hedge Funds, Fortune 100 companies, a significant number of Business Development Companies (BDCs) and more than one-third of the S&P 500. Further, we work with a number of large pension funds, sovereign wealth funds, and other institutional investors who need to measure fund interests at fair value.

Economic Considerations

We agree with the arguments expressed in the Alternative Views about the potential divergence of economic fair value and accounting fair value pursuant to the Proposal.

From a valuation perspective, a restriction on sale of a publicly traded equity security held by an entity results in additional risks compared to a freely tradeable counterpart: 1) exposure to a price decline during the restricted period, and 2) forgone ability to benefit from an appreciation of the security during the period of restriction. Furthermore, a sale restriction cannot always be circumvented in practice by hedging such risks.

Additionally, as illustrated in our comments and examples later in this letter, a prohibition on the ability to incorporate sale restrictions on equity securities in the measurement may result in valuation outcomes for financial reporting purposes that diverge from reality and disregard the perspective of rational market participant investors.

Conceptual Considerations

The Proposal emphasizes the distinction between contractual restrictions that are a **characteristic of the asset** vs. a **characteristic of the entity** (par. 820-10-35-36B). While these are two relevant endpoints, what might be overlooked is the **arrangement itself**, which could be a "market participant arrangement." A narrow approach of attributing a restriction on sale strictly to the asset (and including it in the fair value measurement) or to the entity (and excluding it from the fair value measurement) often fails to capture information that is relevant to market participants. We believe that the addition of "contractual" in ASU 2011-04 was an attempt at solving this very issue.

> For example, it is customary to have an arrangement whereby equity securities in an IPO are subject to an underwriter lock-up (a contractual restriction). A market participant entering such a transaction is subject to the restriction and would rationally factor the restriction into the price paid—and accordingly, would also not receive more for the shares in a hypothetical exit transaction (fair value) than an amount discounted for the same restriction.

In other words, while at times, a contractual restriction on the asset may not strictly be an attribute of the asset, it may be **attribute of the arrangement**. Failure to properly reflect the intent of the arrangement may result in an inaccurate picture of the economic events underlying the transaction.[1]

One way to address this is to broaden the unit of account for the measurement, consistent with the intent of the arrangement, from a market participant standpoint. Alternatively, the restriction may be presented as its own unit of account. **Either way, the restriction conveys information that is relevant to market participants**.

Separately, it is not clear on what conceptual basis a contractual restriction that prohibits sale of the equity security (such as a lockup agreement or a market standoff agreement) is differentiated from other legal documents that establish the rights and obligations of all holders of a particular class of stock (820-10-55-52A), without further analysis of the legal or commercial reasons for such restriction from a market participant perspective.

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[1] We think that the nature of an underwriter lock-up is different from the way market participants would consider the impact of a restriction on sale of equity securities pledged as collateral. The restriction in this case essentially earmarks the security for a specific use (hold as collateral), therefore from an economic point of view, it could be equivalently described as a *restriction on use* of the securities. The value of the pledged securities derives from them being held in place to support debt or other commitments, rather than from the ability to monetize them. In this sense, this type of restriction may be analogous to a restriction on use that is entity specific (refer to example in ASC 820-10-55-54 to 55-55 addressing a donor's restriction on use of land.)

Noncomparability between US GAAP and IFRS

The guidance risks introducing noncomparability with IFRS, which has identical language with respect to the consideration of contractual restrictions as current US GAAP.

IFRS 13, ***Example 8—Restriction on the sale of an equity instrument***, states:

> "IE28 An entity holds an equity instrument (a financial asset) for which sale is legally or **contractually restricted** for a specified period. (For example, such a restriction could limit sale to qualifying investors.) The restriction is a characteristic of the instrument and, therefore, would be transferred to market participants. In that case the fair value of the instrument would be measured on the basis of the quoted price for an otherwise identical unrestricted equity instrument of the same issuer that trades in a public market, adjusted to reflect the effect of the restriction. The adjustment would reflect the amount market participants would demand because of the risk relating to the inability to access a public market for the instrument for the specified period. The adjustment will vary depending on all the following:
>
> (a) the nature and duration of the restriction;
>
> (b) the extent to which buyers are limited by the restriction (eg there might be a large number of qualifying investors); and
>
> (c) qualitative and quantitative factors specific to both the instrument and the issuer." [emphasis added]

The above quote contains an identical reference to a "contractual restriction" as in ***Case A: Restriction on the Sale of an Equity Instrument* in ASC 820**, prior to its proposed amendment by the Proposal.

The reference to "contractual" restriction was added by ASU 2011-04 The primary reason for issuing 2011-04 was convergence between FASB's and IASB's fair value measurement frameworks.[2] The Boards worked together to ensure that fair value has the same meaning in US GAAP and in IFRS and that their respective fair value measurement and disclosure requirements are the same (except for minor differences in wording and style).

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[2] This effort was in keeping with FASB's and IASB's Memorandum of Understanding (2006), which has served as the foundation of the Boards' efforts to create a common set of high-quality global accounting standards.

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We have responded to the specific questions posed in the Proposal below:

Questions for respondents

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.

Kroll comments: We agree with the scope to include all contractual restrictions (rather than only certain contractual restrictions) that prohibit the sale of an actively traded (or Level 1) equity security. However, we strongly disagree with the Proposal eliminating the ability to reflect market participant perspectives with respect to such contractual restrictions.

While we agree that the scope of any guidance should include *all contractual restrictions*, we observe that questions may arise if *all equity securities* with contractual restrictions are in its scope of the Proposal[3].

As currently written, certain amendments could be interpreted more broadly, as possibly extending to Level 2 and Level 3 equity securities. This could result in unintended consequences. For example, the proposed amendment in par. 820-10-35-36B follows a discussion on the prohibition of blockage discounts, and leads off with "*Similarly, a discount that reflects a contractual restriction preventing the sale of an equity security is inconsistent…*". However, the prohibition of blockage discounts is not limited to Level 1 but extends to **all levels of the fair value hierarchy**—this change to ASC 820 was made by ASU 2011-04[4]. As a result, some could interpret the proposed amendment more broadly, when it likely is intended to be narrow and pertain to Level 1 only. While par. 820-10-35-36B closes with stipulating the use of an unadjusted Level 1 price, when one is available, in the fair value measurement of an asset or liability, it should be noted that

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[3] Initially, the scope of the project was geared to contractual sale restrictions stemming specifically from an underwriter lock-up agreement; therefore, the scope would logically include equity securities with contractual restrictions that have freely traded equivalents (Level 1). Subsequently, the scope of the project was broadened to include all contractual restrictions, presumably with respect to the same population (Level 1). The example in the Proposal (820-1-55-52A) and much of the discussion in the basis for conclusions also address situations are consistent with the above view.

[4] Also see discussion in BC73 through BC80 of ASU 2011-04.

the paragraph in its totality also addresses general fair value measurement considerations that are not limited to Level 1 inputs.

In addition, it is not clear when reference is made to the “unit of account …[is]… the equity security” in the same paragraph, if it is done with the meaning of: 1) a Level 1 input (quoted price in an active market) is available for the equity security, therefore the unit of account is the individual equity security (a single share); or, 2) the equity security is considered to be a separate unit of account from a related contract specifying a restriction on sale. If read as the latter, the guidance can be interpreted more broadly as applying to any equity security with a contractual sale restriction.

We recommend that the Board adjust the language in the proposed amendments to clearly convey its intended scope.

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?

Kroll comments: We do not agree with the Board’s decision that a contractual restriction should be ignored altogether when considering how a market participant would transact for an actively traded security subject to a contractual restriction. For clarity we would urge the Board to amend guidance in Topic 820 (or at a minimum in Topic 946) to require that contractual restrictions be considered in determining fair value.

From a practical perspective, there is no functional or economic difference between a contractual restriction and a legal restriction. Actively traded equity securities that are subject to a contractual restriction, either by contract with the issuer or another party, cannot be traded in the active market as they are subject to the contractual restriction. The only way that a market participant could purchase such equity securities that are subject to the contractual restriction would be to abide by the same contractual restriction. Such market participant buyers would therefore take the contractual restriction into account in determining what they would pay for the equity securities subject to the restriction. If they did not want to purchase such equity securities subject to contractual sale restrictions, they would purchase securities on the open market at the market price.

The primary reason that market participants would be willing to purchase equity securities subject to a contractual restriction is because they believe the return (based on the price paid—expected to be less than the open market price) would exceed the return they could obtain by purchasing the same actively traded equity security without the contractual restriction; or if this was the only way to obtain such equity securities given customary business practices; or through negotiation with an informed and willing seller. Therefore, it is clear that the contractual restriction impacts the fair value (what a market participant would receive) for securities subject to a contractual restriction. Ignoring the contractual restriction overstates fair value.

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 response.

Kroll comments: We understand that the issue explored by this question is whether to merge the contractual restriction on sale into the equity security as a unit of account or to consider it separately from the equity security as a standalone unit of account. While having 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 is very attractive in its simplicity, it cannot be pursued without considering several factors, including the below:

- **Existing Unit of Account Guidance.** As a start, it would be necessary to understand if the unit of account (*what is being measured at fair value*) in the respective standard is stipulated to be a single equity instrument vs. an investment or an interest or some other level of aggregation. Unit of account is driven by the applicable accounting standard requiring the use of Fair Value.
    - In the case of investment companies, Topic 946 would be expected to define the Unit of Account. ASC Topic 820 infers that the unit of account for an actively traded security (actively traded meaning sufficient volume and frequency to determine a price, a Level 1 input) that is not subject to a contractual restriction is a single share.

      In 2011 (through ASU 2011-04), FASB (and IASB) concluded that blockage factors should not be taken into account in fair value measurement notwithstanding that from a NAV practical expedient perspective the failure to reflect the size of a position potentially economically overstates reported NAV. However, also in 2011, FASB added language to ASC Topic 820 which referred to considering a legal or contractual restriction in the fair value measurement. Just as it was appropriate in 2011 to consider contractual restrictions as an overlay on a single share concept, it remains appropriate in 2021 to reflect contractual restrictions from a market participant perspective. Again, even a single share with a contractual restriction cannot be sold at the Level 1 P*Q price—the economic impact of the contractual restriction is always attached to shares subject to the contractual restriction.

  - Outside of investment companies and other fair value entities, the FASB should identify the situations (ASC Topics) that would be affected by the Proposal and consider how the unit of account subject to measurement is defined therein.

- **Market participant perspective.** The purpose and context of arrangements that introduce contractual restrictions on sale should be assessed from a market participant perspective to inform a decision on where to reflect the restriction.

- **User-friendliness.** The decision on where to reflect the contractual restriction should ensure that the impact of the restriction is communicated in a meaningful and user-friendly way.

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?

Kroll comments: The use of qualitative or quantitative disclosures, rather than reflecting the impact of a contractual restriction in the fair value measurement itself would be counterproductive, particularly in the case of investment companies. Users of financial statements, especially investors in a fund, would be faced with a question as to whether reported NAV needs to be adjusted for their purposes, and if so, they would need to perform extra calculations to adjust reported NAV. Therefore, the only logical and practical answer is to include the impact of the restriction in the fair value measurement in the first place.

Outside of investment companies (and other 'fair value' entities), it could be argued that disclosures might be appropriate in certain cases—for example, when the fair value measurement is one-off (only required upon initial recognition) or when the adjustment is not significant. In other words, rather than changing the principle, the FASB could provide practical expedients to the measurement in such instances. However, this path could require the application of judgment as to whether an adjustment is 'significant' and would likewise introduce divergence from the principle in IFRS.

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

Kroll comments: As previously stated we do not agree with the Proposal. However, if the Proposal were adopted, the transition guidance is workable.

Question 6—Implementation: How much time would be necessary to implement the proposed amendments? Should the amount of time needed to implement the proposed amendments by entities other than public business entities be different from the amount of time needed by public business entities? Please explain your response.

Kroll comments: For certain simple cases, implementation would not be problematic. However, the Proposal will likely create questions for more judgmental fact situations and divergence in practice. For example:

A. **Six-month Underwriter Lock-up Impact on NAV**

Facts: Entity (investor) received 1,000,000 shares in an IPO priced at $50 (IPO price), subject to a 6-month underwriter lock-up. **What is the NAV (fair value practical expedient) reported to LPs on Day 1?**
Current GAAP: NAV reported to LPs $45,000,000 (assuming 10% discount reflecting the 6-month lockup).
Proposed GAAP: NAV reported to LPs $50,000,000. Entity (investor) recognizes a Day 1 gain of $5,000,000.

B. Special Purpose Vehicle Investment with Exit Restrictions

Facts: Fund A Invests $500,000,000 and Fund B Invests $ 150,000,000 into a SPV; the SPV purchases $ 650,000,000 of a publicly traded equity security. • Contractually, Fund A cannot exit for 4 years other than at Fund B's discretion • Contractually, Fund A receives the first $650,000,000 of returns; Fund B receives the next $300,000,000 million; pari-passu thereafter. **What is the fair value of Fund A's interest on Day 1?**
Current GAAP: $500,000,000 (calibration implies that the $150,000,000 or 23% discount to the SPV value of $650,000,000 is the market participant impact of a 4-year contractual restriction).
Proposed GAAP: $650,000,000 (contractual restriction must be ignored for Fund A's interest)
Food for Thought: • Will LPs of Fund A be concerned that reported NAV (which is the basis for the LPs fair value measurement) is $650,000,000 rather than $500,000,000, resulting in a Day 1 gain of $150,000,000 or 30%? • How will the LPs of Fund B interpret their Day 1 loss, bringing the value of their investment from $150,000,000 to zero? (Contractually, Fund A receives the first $650,000,000 in returns, leaving zero to Fund B on Day 1.) • Or could it be argued that the Unit of Account is the interest of each fund in the SPV, and therefore the impact of the contractual restriction can be reflected in the fair value estimate through calibration to the purchase price on Day 1? • Practice would diverge as the judgment on how to apply the proposed change to situations such as this, which are not uncommon, will differ.

Additionally, the Proposal introduces confusion when dealing with different types of contractual frameworks (addressing different stages or hurdles while holding the investment) for equity securities that become actively traded at certain points during the holding period but are contractually restricted from sale.

Further to the examples above illustrating implementation challenges, given the potential divergence between the Proposal and IFRS 13, investors following the practical expedient in ASC Topic 820 or GASB 72 would be faced with a question as to whether

NAV reported under IFRS 13 would need to be adjusted to match the proposed ASC Topic 820 amendments. Two funds investing in the same security with the same contractual restriction, with one fund reporting under IFRS and the other reporting under US GAAP (Topic 946), would report different Net Asset Values because of the divergent treatment of contractual restrictions.

An investor using the practical expedient under ASC 820 would be faced with the dilemma of adjusting the fund NAV reported under IFRS to US GAAP or vice versa. Additionally, an investor reporting under IFRS and using reported NAV as a starting point for valuing their fund interest would need to expend additional time and resources to determine which basis of fair value (US GAAP or IFRS) should be used to properly estimate the fair value of their fund interest.

C. Fair Value Measurement of Consideration Comprising Restricted Equity Securities in a Business Combination

By extension, the logic set forth in the Proposal can also impact business combinations in which the seller receives shares of the buyer that are contractually restricted from sale for a certain period. Pursuant to ASC 805, the buyer is required to measure all forms of consideration transferred at fair value at the acquisition date. The potential impacts are shown below:

Fair Value of Consideration Transferred	Goodwill**
↑	↑

** **Note**: The IRR of the transaction would decrease (holding other factors constant) because the fair value of consideration is higher as a restriction on sale is not considered in the fair value measurement. This fact may influence judgment around discount rates used in the valuation of intangible assets by an income approach, resulting in slightly higher values. Therefore, in some cases, the increase in value would be captured in the intangible assets rather than in goodwill.

As stated elsewhere in our comments on the economic effects of restrictions, the seller in this transaction has considered the sale restrictions imposed upon them by the contract in negotiating the price. So has the buyer of the business, in their decision on the price to pay (consideration transferred). Ignoring this would introduce an extrinsic factor in the valuation analysis.

An argument that a contractual restriction may have a limited impact—as it may be generally short-term in nature or because it only affects the initial measurement—is not a basis on which to construct a flawed principle. Instead, practical expedients can be provided as an exception to the principle (when the restriction is short, or in a one-off situation). In other words, it is not appropriate to alter the underlying principle to get to a cost-effective solution.

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?

Kroll comments: The proposed definition of a restricted security is clear. However, the Proposal provides a suboptimal result which is not based on economic reality. It will also likely increase diversity in practice and will cause institutional investors additional work and analysis in arriving at a fair value estimate for fund interests.

Therefore, we strongly encourage FASB to withdraw the Proposal or amend it such that it does not have an adverse impact on investment companies in particular, as well as a broader negative impact on convergence of fair value measurement guidance with IFRS.