

EFAMA's comments on IASB's Discussion Paper regarding Financial Instruments with Characteristics of Equity

General Remarks

EFAMA¹ is grateful for the opportunity to comment on IASB's discussion paper "*Financial Instruments with Characteristics of Equity*", dated June 2018. The paper at hand sets out the views and concerns of the European fund and asset management industry with regards to the suggestions of the discussion paper. Below, we make some general remarks before responding to the Discussion Paper.

Our main issue is that the new approach in the Discussion Paper introduces completely new terminology, and although current IAS 32 has shortcomings on the distinction between liabilities and equity, we do not observe any entities having problems currently applying IAS 32. Therefore we conclude that the shortcomings are better addressed by specific amendments to the current approach instead of introducing an entirely new complex standard.

Furthermore, we fully support the required puttable exception as indicated under the Board's preferred approach. We have included our detailed response on question 4.

Another issue we would like to address in this letter is the accounting treatment of investments in investment funds made by (institutional) investors².

The economies of scale from investments held through investment funds give access to markets, appropriately diversified, in which investors would otherwise not be able to invest. Should investors have to invest directly, they would incur substantial time and costs and would often not be able to achieve an appropriate diversification of their portfolio. The classification requirements under IAS 39 and IFRS 9 for investments held directly and those held through an investment fund result in a very different accounting treatment – which is inconsistent with the IASB framework which indicates that transactions should be presented in accordance with their substance and economic reality and not merely their legal form.

Most countries within the OECD have a tax system that should, in principle, treat direct investments and investments through a Collective Investment Vehicle (CIV) equally, in order to maintain "the

¹ EFAMA is the representative association for the European investment management industry. EFAMA represents through its 28 member associations and 62 corporate members close to EUR 23 trillion in assets under management of which EUR 15.6 trillion managed by more than 60,000 investment funds at end 2017. Just over 32,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds, with the remaining 28,100 funds composed of AIFs (Alternative Investment Funds). Please visit www.efama.org for further information.

² See our publication of May 2016: 'The IFRS 9 Phase 1 implementation will have a negative impact on asset management industry'

economic efficiency and other advantages CIVs provide”³. Likewise, this neutrality should be maintained for accounting purposes.

EFAMA understands that investors investing in investment funds could be subject to significant changes to their financial reporting as a result of IFRS 9. With the introduction of this standard, investments in mandatorily redeemable preferred shares and puttable instruments, that give the holder the right to give the instrument back to the issuer, are obligated to recognize changes in fair value in profit and loss as they arrive (“FVPL”). The definition of “puttable instruments” includes mutual fund units which leads to a significant impact of IFRS 9 for EFAMA’s members.

With respect to equity instruments, IFRS 9 provides the entity holding the instruments with the possibility to make an irrevocable election at initial recognition to present changes in fair value in other comprehensive income (“FVOCI election”). This possibility does not exist with respect to mutual fund units that are mainly open ended funds with puttable features, even if the respective investment fund is mainly invested in equities, as these instruments debt instruments based on the definition in IAS 32.11. EFAMA would like to underline that this leads to an unequal treatment of direct and indirect investments. EFAMA is concerned that institutional investors, subject to IFRS 9, might withdraw their mutual fund shares as a result of these differences in treatment. Amongst others, this could lead to the following unintended consequences for these institutional investors:

- Higher administrative costs and burdens for investors (due to individual investment decisions instead of a pooled investment decision for a fund)
- Loss of market risk diversification and appropriate hedging of assets
- Higher trading costs and loss of economies of scale as these costs can no longer be shared with the other investors of the mutual fund
- Less professional management of the investment portfolio

In order to improve the situation EFAMA would like to propose the following two suggestions:

- IFRS 9 should be amended in order to classify investments in investment funds as FVOCI (by amending IFRS 9.5.7.5) in order to include the new asset category “Investment Entity” holdings as defined in IFRS 10.
- Alternatively, EFAMA would suggest to introduce a ‘look through’ approach in IAS 32.11 for classifying holdings in “Investment Entities”. This look-through approach would result in a debt classification for instruments passing the IFRS 9 SPPI test and an equity classification for anything else. Subsequent changes will also be required to IFRS 9 to recognise this revised approach.

³ OECD report “The granting of treaty benefits with respect to the income of collective vehicles”, 23 April 2010, Section I, para. 1

Question 4: The Board's preliminary view is that the puttable exception would be required under the Board's preferred approach. Do you agree? Why, or why not?

Given the current situation, EFAMA would like to insist on the puttable exception. Paragraphs 16A to 16D of IAS 32 provide for an accounting treatment that is very relevant for the investment fund industry and should be retained unless the IASB is able to find another solution.

We are grateful in advance for your attention to the concerns expressed in this response and we welcome the opportunity to discuss these with you in further detail. In case there is any additional information that we can provide, please contact EFAMA at info@efama.org or [+32 \(0\) 2513 3969](tel:+3225133969).

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