MEMO# 9430

November 19, 1997

SEC ISSUES GENERIC COMMENT LETTER FOR INVESTMENT COMPANY CFOS

[9430] November 19, 1997 TO: ACCOUNTING/TREASURERS MEMBERS No. 50-97 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 46-97 SEC RULES MEMBERS No. 83-97 RE: SEC ISSUES GENERIC COMMENT LETTER FOR INVESTMENT COMPANY CFOs ____ The Division of Investment Management recently issued the attached letter to the investment company industry to provide guidance on certain accounting and financial reporting issues. Set forth below is a brief summary of the issues addressed in the letter. Foreign Pricing Considerations The 1996 CFO letter indicated that delayed recording of foreign corporate actions may be appropriate if the investment company, exercising reasonable diligence, did not know that the corporate action had occurred. The 1997 letter indicates that registrants have asked the staff whether this "reasonable diligence standard" could be extended to the pricing of foreign securities. The letter indicates that the Commissions Accounting Series Releases 113 and 118 are the applicable standards for accounting and valuation of investments, and that the reasonable diligence standard should not be extended to pricing of securities. Fund of Funds Considerations The letter addresses financial reporting considerations where one fund ("top tier fund") invests its assets in shares of another fund ("underlying fund"). The letter indicates that when a top tier fund has a significant amount of its portfolio invested in a single underlying fund or owns a controlling interest in an underlying fund, registrants should consider providing additional financial information to shareholders. For example, if the top tier fund invests a "significant" portion of its assets in the underlying fund, the top tier fund should consider accompanying its financial statements with those of the underlying fund. Further, if a top tier fund owns a controlling interest in an underlying fund, current accounting literature may require consolidation. Designation of Segregated Assets The letter notes that the staff has required segregation of assets in connection with certain instruments or trading practices to address senior security concerns under Section 18 of the Investment Company Act of 1940. Typically, investment companies have designated securities to be segregated on the records of their custodians. The attached letter indicates that the staff would not object if assets segregated under Section 18 were designated solely on the funds records, and not designated on the funds custodians records. Accounting for Securities Lending Transactions The attached letter indicates that a fund lending its portfolio securities should not record securities received as collateral from the borrower as its asset unless the fund has "effective control" of the securities received. Conversely, where the fund does have effective control over the securities collateral, the fund should record the securities as its assets with a corresponding liability recognizing the obligation to return the collateral at the conclusion of the loan. The staff references paragraph 9 of Statement of Financial Accounting Standards No. 125, which defines effective control. The letter indicates that when a lending fund receives cash as collateral, it is deemed to have effective control and should record the cash as its asset, with a corresponding liability, even where the cash is automatically invested within a short period in securities. Closed-end Expense Ratios The attached letter indicates that closed-end funds that have issued debt securities should include interest expense in the calculation of their expense ratio. These funds may also include a second expense ratio, excluding interest payments, in the body of the financial highlights table or as a footnote to the table. Closed-end funds that have issued preferred shares should exclude dividend payments from the expense ratio included in the body of the financial highlights table. Finally, the letter indicates that the staff believes that the expense ratio of a closed-end fund with preferred shares outstanding should be based on assets attributable to the common shares only. The staff would not object to additional expense ratios (e.g., based on average net assets including the value of preferred shares) so long as they are disclosed as a footnote to the financial highlights table. Changes conforming expense ratio presentation to the staff position should be reflected in financial statements for fiscal years beginning after November 15, 1997. Organization Cost Considerations The attached letter indicates that any remaining organization costs recognized by a fund that is being merged, liquidated, or dissolved are the responsibility of the holder of the original shares and should be netted against redemption proceeds of the original shares. The letter indicates that the staff believes it is inappropriate to accelerate the write-off of the remaining organization costs to the date of the proposed transaction. Gregory M. Smith Director - Operations/ Compliance & Fund Accounting