The Asset Management Industry
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INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

December 9, 2002

Comment Letter on SEC Corporate Disclosure Proposals

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Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549-0609

Re: Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments (File No. S7-42-02); and Conditions for Use of Non-GAAP Financial Measures (File No. S7-43-02)

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the Securities and Exchange Commission's rulemaking proposals to implement Section 401 of the Sarbanes-Oxley Act of 2002 (the "Act").[2] The Commission's proposals would: (1) require disclosure in the Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") of off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of an issuer;[3] and (2) require public companies that disclose or release certain financial information that is derived on the basis of methodologies other than in accordance with Generally Accepted Accounting Principles ("GAAP") to make additional disclosures that compare such information to GAAP-based financial information.[4]

Institute member firms collectively hold more than $3 trillion in U.S. corporate equity and fixed-income securities on behalf of millions of individual investors. The Commission's proposals seek to enhance the quality and transparency of information that is disseminated to investors. The Institute supports these proposals, which should enhance investors' ability to:

- understand how issuers finance their operations through off-balance sheet arrangements;
- comprehend the attendant risks that are not otherwise apparent on the face of the financial statements; and
- compare an issuer's financial information with other reporting periods and with other

companies.[5]

- Our specific comments on the Commission's proposals are set forth below.

A. Disclosure in MD&A About Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments

1. MD&A Summary Section

The Commission's proposal would require disclosure of off-balance sheet arrangements, contractual obligations, and contingent liabilities and commitments. Our comments focus on the aspect of the proposal related to the disclosure of off-balance sheet arrangements. As proposed, a registrant would be required to disclose its off-balance sheet arrangements under circumstances where management concludes that the likelihood of the occurrence of a future event and its material effect is higher than remote.

The Institute notes that the Commission's proposed "more than remote" disclosure standard for off-balance sheet arrangements is lower than that currently applicable to MD&A disclosure. Currently, a registrant has a duty to disclose prospective information in its MD&A where a trend, demand, event, commitment or uncertainty is both presently known to management and reasonably likely to have future material effects on the registrant's financial condition or results of operations.[6] According to the Off-Balance Sheet Release, however, the Commission interprets the Act as requiring a lower disclosure threshold for prospectively material information related to off-balance sheet arrangements.

While we have not come to any conclusions regarding whether the disclosure threshold the Commission has proposed is the correct one, it appears likely that this threshold will, at least in some cases, result in extensive disclosure that could overwhelm readers. Therefore, we recommend that the Commission require an MD&A summary section. We previously recommended the inclusion of an MD&A summary section in a comment letter to the Commission on its critical accounting policies proposal.[7] The summary section would require management to identify the principal factors driving financial results, the principal trends on which it focuses, and the principal risks to the business. We believe the proposed "more than remote" standard makes a summary section that much more imperative.

2. Content of Required Disclosure

Under the Commission's proposal, registrants would have to disclose and discuss in a separately captioned section of the MD&A those off-balance sheet arrangements meeting the disclosure threshold.[8] The Institute generally supports the proposed disclosure requirements inasmuch as they will enable investors to better understand an issuer's off-balance sheet arrangements. We particularly support the proposal to require management to provide (i) an analysis of the degree to which the registrant relies on off-balance sheet arrangements for its liquidity and capital resources, and (ii) a discussion of the effects of a termination or material reduction in the benefits of off-balance sheet arrangements. Off-balance sheet arrangements frequently include contractual provisions requiring the registrant to undertake specific actions under certain circumstances (e.g., if the registrant experiences a credit downgrade, it must purchase the assets or assume the liabilities of the special purpose entity). We believe disclosure of these types of contractual provisions will better enable investors to assess registrants' creditworthiness and liquidity.

3. Disclosures About Effects of Transactions with Related Parties

As previously noted, the proposed rules would codify many of the views previously expressed by the SEC on required disclosure for off-balance sheet arrangements. FR-61 indicates that the MD&A should also include a discussion of related party transactions to the extent necessary for an understanding of the company's current and prospective financial position and operating results.9 The proposed rules, however, do not address related party transactions disclosures. Consequently, we are concerned that the Commission's proposal could be viewed as superseding FR-61, and that registrants may de-emphasize disclosure of related party transactions in the MD&A. In order to avoid this result, we urge the Commission to reiterate registrants' disclosure obligations for related party transactions as articulated in FR-61.

B. Conditions for Use of Non-GAAP Financial Measures

The Commission's proposal regarding the use of non-GAAP financial measures would do several things. First, the proposal would adopt a new Regulation G, which would require issuers that disclose or release publicly any material information that includes financial information that is derived on the basis of methodologies other than in accordance with GAAP to include a presentation of the most comparable financial measure calculated and presented in accordance with GAAP, and a reconciliation of the differences between the GAAP financial measure and non-GAAP financial measure.

Second, the proposal would require issuers that use non-GAAP financial measures in filings with the Commission to provide: (i) a presentation of the most directly comparable GAAP financial measure; (ii) a quantitative reconciliation of the difference between the GAAP and non-GAAP financial measure; (iii) a statement discussing the purposes for which the non-GAAP financial measure is being presented; and (iv) the reason(s) why management deems such presentation useful to investors. Third, the proposal would require issuers to file a Form 8-K within two business days of any public announcement or release disclosing material non-public information regarding a registrant's results of operations or financial condition for a completed annual or quarterly fiscal period.

The Institute supports these proposals. This past May, we made a similar recommendation to the Commission in a comment letter regarding the Commission's proposal to accelerate the filings of Forms 10-K and 10-Q reports under the Exchange Act by public companies.10 In that letter, we expressed the view that an effective way to respond to the "gap" that frequently exists between the time earnings announcements are released and the time periodic reports are filed with the Commission would be to require reporting companies that release earnings announcements to file such information with the SEC on Form 8-K, and if such announcements include pro forma or non-standardized earnings information, require the Form 8-K to contain a reconciliation to GAAP-basis earnings.11 Accordingly, we are pleased that the Commission's proposals are consistent with our recommendations.

The Institute recognizes the benefits of using pro forma financial information inasmuch as it can focus investors' attention on critical components of quarterly and annual financial results. By the same token, however, we are mindful of the potentially distorting effects that can result from the release of pro forma financial information that is not accompanied by, or reconciled to, GAAP-basis information. Because pro forma financial information tends to depart from traditional accounting conventions, its use makes it that much more difficult for investors to compare an issuer's financial information with other reporting periods and with other companies. By imposing a reconciliation requirement, the Commission's proposal

would improve the quality and transparency of issuer disclosures by eliminating the distorting effects noted above and enabling greater comparability of an issuer's financial information with other reporting periods and other companies.

* * *

The Institute appreciates the opportunity to comment on the Commission's rulemaking proposals. If you have any questions, or would like additional information, please contact the undersigned at (202) 326-5824, Barry Simmons at (202) 326-5923 or Greg Smith at (202) 326-5851.

Sincerely,

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Senior Counsel

cc: Alan L. Beller, Director
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ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,955 open-end investment companies ("mutual funds"), 533 closed-end investment companies, and six sponsors of unit investment trusts. Its mutual fund members have assets of about $6.216 trillion, accounting for approximately 95 percent of total industry assets, and 90.2 million individual shareholders.

2 Registered investment companies are excluded from these proposals pursuant to Section 405 of the Act.

3 SEC Release Nos. 33-8144; 34-46767 (November 4, 2002); 67 Fed. Reg. 68054 (November 8, 2002) (the "Off-Balance Sheet Release"). The proposed rules codify and extend many of the previously expressed views of the Commission on required disclosure for off-balance sheet arrangements. See Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations, SEC Release No. 33-8056; 34-45321; FR 61 (January 22, 2002) ("FR-61").

4 SEC Release Nos. 33-8145; 34-46788 (November 4, 2002); 67 Fed. Reg. 68790 (November 13, 2002) (the "Pro Forma Release").

5 The Institute has consistently supported the SEC's initiatives to improve the financial reporting and disclosure system embodied in the Securities Exchange Act of 1934 and its rules. The disclosure rules under the Exchange Act are designed primarily to ensure that sufficient information is available in the marketplace to establish the appropriate value of securities issued by publicly-traded companies. Recent corporate scandals have highlighted the importance of markets and investors having more timely access to a greater range of important information concerning publicly-traded companies. We note that the pricing of mutual fund shares is governed by specific requirements under the Investment Company Act of 1940. Accordingly, the rationale underlying the SEC's recent disclosure initiatives

under the Exchange Act is inapplicable in the context of mutual fund reporting and disclosure.

6 See SEC Release No. 33-6835 (May 18, 1989).

7 See Letter from Craig S. Tyle, General Counsel, ICI, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (July 19, 2002).

8 Specifically, the proposal would require disclosure of: (i) the nature and business purpose of the company's off-balance sheet arrangements; (ii) the nature and amount of the total assets and of the total obligations and liabilities (including contingent obligations and liabilities) of an entity in which off-balance sheet activities are conducted; (iii) the amounts of revenues, expenses, and cash flows of the company arising from the arrangements, the nature and amounts of any interests retained, securities issued and other indebtedness incurred by the company; and any other obligations or liabilities of the company arising from the arrangements that are or may become material and the triggering events or circumstances that could cause them to arise; and (iv) management's analysis of the material effects of any of the foregoing items on the company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, and capital resources.

9 As FR-61 points out, issuers "should consider whether investors would better understand financial statements in many circumstances if MD&A included descriptions of all material transactions involving related persons or entities, with clear discussion of arrangements that may involve transaction terms or other aspects that differ from those which would likely be negotiated with clearly independent parties." FR-61 at 10.

10 See Letter from Craig S. Tyle, General Counsel, ICI, to Jonathan G. Katz, Secretary, SEC, dated May 21, 2002.

11 To facilitate this process, our letter added that such a reconciliation should consist of a side-by-side tabular presentation, along with a "plain English" narrative summary of the differences.
