

## COMMENT LETTER

October 18, 2010

# ICI Responds to SEC Request for Comment on Application of IFRS to Investment Companies (pdf)

10/18/201010/18/201010/18/2010 October 18, 2010 Ms. Elizabeth M. Murphy Secretary U.S. Securities and Exchange Commission 100 F Street, N.E. Washington, DC 20549-1090 Re: Notice of Solicitation of Public Comment on Consideration of Incorporating IFRS into the Financial Reporting System for U.S. Issuers; File No. 4-608 Dear Ms. Murphy: The Investment Company Institute<sup>1</sup> appreciates the opportunity to comment on the Securities and Exchange Commission's request for public comment on incorporating International Financial Reporting Standards ("IFRS") into the financial reporting system for U.S. issuers.<sup>2</sup> In particular, the Commission has requested comment on the impact such incorporation would have on: issuers' compliance with contractual arrangements that require the use of U.S. Generally Accepted Accounting Principles ("GAAP"); issuers' compliance with corporate governance requirements; and the application of certain legal standards tied to amounts determined for financial reporting purposes. Our comments relate solely to the application of IFRS to investment companies. We have previously commented in support of excluding investment companies from the Commission's roadmap for incorporation of IFRS into the U.S. financial reporting system.<sup>3</sup> Our 1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$11.51 trillion and serve over 90 million shareholders. 2 Securities and Exchange Commission Release Nos. 33-9134; 34-62700 (August 12, 2010). 3 See letter from Gregory M. Smith, Director - Compliance and Fund Accounting, Investment Company Institute to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, regarding Roadmap for Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers (April 20, 2009). 2 comments noted that the typical investor benefits associated with a transition to a single set of accounting standards, e.g., comparable financial information for U.S. and foreign issuers, will be limited for investment company shareholders. This is because U.S. securities laws strongly limit or discourage investment by U.S. persons in foreign funds and U.S. tax rules discourage foreign investment in U.S. investment companies. The cross-border sale of foreign funds in the U.S., and of U.S. investment companies in overseas markets, is therefore extremely limited. Further, even absent these impediments, the typical investor benefits would be limited because few European countries apply IFRS to open-end funds.<sup>4</sup> We have also previously expressed concern that the application of IFRS to investment

companies would result in financial statements that are less meaningful and less transparent than those prepared under GAAP.<sup>5</sup> This is because GAAP for investment companies is an industry-specific reporting model that reflects the unique characteristics of pooled investment vehicles. In contrast, IFRS does not provide accounting standards or guidance specific to investment companies. Accordingly, investment companies would have to abide by the same financial reporting standards followed by general corporate enterprises, resulting in financial statements that fail to provide the types of financial information most relevant to fund investors. Our comments below focus on the potential application of IFRS to investment companies and the effects of such application on funds' compliance with securities laws and contractual arrangements. We first describe how differences between GAAP and IFRS would affect certain financial statement balances. We then describe how changes in such balances may raise compliance-related questions. Finally, we describe uncertainties relating to a fund's service contracts that would be created by application of IFRS to investment companies.

### Differences in Financial Statement Balances

If IFRS were to be applied to SEC registered investment companies, various financial statement balances would change due to differences between GAAP and IFRS relating to: 1) fair value measurement; 2) the characterization of the fund's shares as equity or liability; 3) consolidation; and 4) accounting for transaction costs.

#### Fair Value Measurement

IFRS requires assets held by a fund to be measured at the current bid price and financial liabilities to be measured at the ask price.<sup>6</sup> In contrast, GAAP indicates that a quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.<sup>7</sup> If IFRS were applied to funds, this difference in fair value measurement (bid vs. last sale) would impact funds' reported total assets, liabilities, net assets, and net asset value per share.

#### Open-end Fund Shares Characterized as Liabilities

IFRS treats a financial instrument that gives the holder the right to put it back to the issuer for cash as a financial liability. For example, open-end mutual funds, unit trusts, and partnerships that provide their unit holders with the right to redeem their interests in the issuer at any time for cash are classified as financial liabilities.<sup>8</sup> In contrast, GAAP characterizes open-end fund shares as equity. If IFRS were applied to funds, this difference in characterization of fund shares as liabilities would impact funds' reported liabilities, net assets, and net asset value per share. Under IFRS, the classification of fund shares as liabilities does not preclude the use of descriptors for line items in the financial statements such as "net asset value attributable to unit holders" and "change in net asset value attributable to unit holders" for a fund that has no equity. Notwithstanding this flexibility, characterization of fund shares as liabilities would cause funds to have no net assets under IFRS.

#### Consolidation

IFRS requires investment companies to consolidate controlled investees.<sup>9</sup> Control is presumed to exist when the fund owns more than half of the voting power of an investee. Control may also exist in circumstances where the fund owns half or less of the voting power (e.g., power to govern the financial and operating policies of the investee under a statute or agreement). In contrast, GAAP precludes an investment company from consolidating a non-investment company investee.<sup>10</sup> Further, Regulation S-X, Rule 6-03(c)(1) also precludes consolidation by a registered investment company of any entity other than another investment company. In addition, feeder funds in a master-feeder structure do not consolidate controlled investee funds. Feeder funds measure their investment in the master fund at fair value. SEC

registered feeder funds typically present the master fund's financial statements with the feeder fund's financial statements so as to ensure that the feeder fund's shareholders understand the nature of the master- 7 See FASB ASC 820-10-35-41. 8 See International Accounting Standard 32, Financial Instruments: Presentation, paragraph 18. We believe open-end funds that issue two or more classes of shares would not be able to satisfy the conditions in paragraphs 16A and 16B to characterize their shares as equity. 9 See International Accounting Standard 27, Consolidated and Separate Financial Statements. 10 See FASB ASC 810-10-15-10(a)(3). 4 feeder structure. These differences in consolidation policy would affect financial reporting by funds with controlling interests if IFRS were to be applied to investment companies. In particular, such funds' total assets, liabilities, net assets and net asset value per share would change. Transaction Costs IFRS requires investment companies to measure and recognize transaction costs on portfolio transactions as expense in the income statement.<sup>11</sup> In contrast, GAAP requires that these costs be included in the cost of securities purchased and deducted from proceeds on sales.<sup>12</sup> GAAP causes transaction costs to be reflected as a reduction in the reported gain on the fund's investment portfolio (or an increase in the reported loss). If IFRS were applied to funds, this difference in recognition of transaction costs would impact funds' expenses, net investment income, and gains/losses as reported in the income statement, as well as funds' expense ratio and net investment income ratio as reported in the financial highlights. Compliance-related Questions Applying IFRS to funds would raise a variety of compliance-related issues for investment companies as a result of the financial reporting changes discussed above. Investment companies maintain and keep current accounts, books, and other documents relating to their business that form the basis for their financial statements. The accounts generally are maintained in a manner consistent with GAAP and also are used for purposes of measuring compliance with various requirements of the Investment Company Act of 1940 ("1940 Act"). For example, Sections 5 and 12 of the 1940 Act impose compliance tests based on the fund's total assets. As described above, the amount of a fund's total assets for financial reporting purposes would change if IFRS were applied to funds due to differences in fair value measurement and consolidation. The 1940 Act also imposes certain compliance tests based on net assets. For example, Rule 35d- 1 requires a fund with a name suggesting investment in certain securities or industries to invest at least 80% of the value of its assets in the particular type of security or industry suggested by its name. For this purpose, "assets" means net assets plus the amount of any borrowings for investment purposes. As described above, the amount of a fund's net assets for financial reporting purposes would change if IFRS were applied to funds due to differences in fair value measurement, consolidation, and characterization of fund shares as liabilities. Today, Section 2(a)(41) defines value for purposes of the 1940 Act and that definition and related Commission guidance is generally consistent with fair value measurement under GAAP. 11 See International Accounting Standard 39, Financial Instruments: Recognition and Measurement, paragraphs 43 and AG13. 12 See FASB ASC 946-320-40-1. We note that the FASB is currently considering accounting for transaction costs. See FASB proposed Accounting Standards Update: Accounting for Financial Instruments and Revisions to the Accounting for Derivatives and Hedging Activities (May 26, 2010). 5 Presumably Section 2(a)(41) would continue to define value for purposes of the 1940 Act and compliance tests. This would result, however, in requiring funds to follow two separate valuation regimes, one for compliance purposes and one for financial reporting purposes. We believe the Commission would need to address the impact of IFRS on financial statement balances and their use in these and other compliance tests applied to funds under the 1940 Act. In addition to the 1940 Act compliance-related issues noted above, a transition to IFRS would also raise compliance questions relating to funds' financial reporting obligations. Regulation S-X prescribes a specific format to be followed by investment companies in preparing their

financial statements and that format is consistent with GAAP. The reporting format required by IFRS differs in certain respects. For example Rule 6-07 of Regulation S-X requires the income statement to present separately realized gain/loss and the change in unrealized appreciation/depreciation over the reporting period. In contrast, these items are combined and presented as a single line item under IFRS. Also, Rule 6-09 of Regulation S-X requires the statement of changes in net assets to present separately distributions to shareholders from net investment income and realized gain. In contrast, these items are combined and presented in the income statement as “finance costs” as though they were interest expense on borrowings under IFRS. We believe the Commission would need to address the impact of IFRS on fund financial reporting obligations under Regulation S-X.

**Fund Service Contracts** Many fees for services provided to funds are calculated based on a percentage of average net assets. As described above, characterization of open-end fund shares as liabilities would affect the amount of funds’ net assets. We are concerned that application of IFRS to funds would require funds and their service providers to amend their service contracts so as to eliminate any uncertainty relating to calculation of fees. Moreover, any amendments impacting investment advisory contracts may require a shareholder vote, at considerable expense to fund shareholders. Certain investment advisers may contractually agree to waive fees and reimburse fund expenses to the extent necessary to cap the fund’s expenses at a specified percentage of net assets. Characterization of transaction costs as fund expenses subject to any expense cap could affect an adviser’s obligation to waive fees or reimburse fund expenses. If the Commission were to apply IFRS to funds, a fund’s expenses could exceed the contractual cap, causing the adviser to waive fees or reimburse expenses, solely due to the recognition of transaction costs as expense. Funds, their advisers, and other service providers would need significant lead time to address these contractual issues, if the Commission were to apply IFRS to investment companies.

**Accounting Standards Convergence** Certain of the IFRSs described above are subject to change as the IASB and the FASB pursue accounting standards convergence. For example, in May, 2009 the IASB issued an exposure draft of a proposed standard on fair value measurement that generally would conform IFRS to GAAP. Also, we expect the IASB to issue an exposure draft of a proposed standard during the fourth quarter of 2010, which would exempt investment companies from consolidating controlled investees. While we are encouraged by these developments, there is no assurance that the contemplated changes will be adopted. We continue to have concerns with other IFRSs, which if applied to investment companies, would impose additional costs on funds and their shareholders without any commensurate benefits. For example, IFRS would require funds to provide multi-year comparative information, and a statement of cash flows in all instances. Indeed, as we have noted, the benefits associated with application of a single set of global accounting standards to investment companies would be very limited due to existing legal and tax structures. We encourage the Commission to identify any benefits to funds and their shareholders associated with application of IFRS to investment companies and to carefully weigh those benefits against the related costs. We appreciate the opportunity to respond to the Commission’s request for comment and would be pleased to respond to any questions. Please contact the undersigned at 202/326-5851 if you require additional information. Sincerely, /s/ Gregory M. Smith Director – Operations/ Compliance & Fund Accounting cc: Andrew J. Donohue, Director Division of Investment Management Richard F. Sennett, Chief Accountant Division of Investment Management

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