

## COMMENT LETTER

January 6, 2010

# ICI Comment Letter on FASB Proposal to Defer Adviser Consolidation of Funds Advised (pdf)

1/7/20101/7/20101/7/2010 January 6, 2010 Mr. Russell G. Golden Technical Director  
Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116  
Re: Amendments to Statement 167 for Certain Investment Funds File Reference No.  
1750-100 Dear Mr. Golden: The Investment Company Institute<sup>1</sup> appreciates the opportunity  
to comment on the proposed accounting standards update Amendments to Statement 167  
for Certain Investment Funds (ASU). The ASU would defer the requirements in Statement  
167 for an investment adviser's interest in an investment company<sup>2</sup> except where the  
investment adviser has an explicit or implicit obligation to fund actual losses of the  
investment company that could be significant to the investment company. In addition, the  
ASU would defer the requirements in Statement 167 for an investment adviser's interest in  
a money market fund that is required to comply with, or operates in accordance with  
requirements that are similar to those in, Rule 2a-7 of the Investment Company Act of 1940  
("1940 Act"). Investment advisers would consider consolidation of the funds they manage  
under existing consolidation guidance (before its amendment by Statement 167). <sup>1</sup> 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 \$11.62 trillion  
and serve almost 90 million shareholders. <sup>2</sup> Investment company for this purpose includes  
SEC registered investment companies (i.e., mutual funds, closed-end funds, and ETFs) as  
well as unregistered investment companies such as hedge funds, mortgage real estate  
investment trusts, private equity funds, and venture capital funds. <sup>2</sup> The Institute  
commends the Board for issuing the proposed deferral and strongly supports its adoption.  
We believe that the application of Statement 167 to asset management arrangements may  
require investment adviser consolidation of investment companies that is unwarranted. We  
note that the IASB is currently developing consolidation guidance and that the IASB's  
approach may yield different results for investment adviser consolidation of investment  
companies. These differing results support deferral of Statement 167 so that the Board and  
the IASB can converge their standards. We strongly encourage the Board to consider the  
principal and agent model being developed by the IASB.<sup>3</sup> Consolidation Diminishes  
Usefulness of Investment Adviser's Financial Reporting The Statement 167 consolidation  
model is based on power and economics. A reporting company may be required to  
consolidate another entity when the reporting company has (1) the power to direct the

activities of the entity that most significantly impact the entity's economic performance, and (2) the obligation to absorb losses that could potentially be significant to the entity or the right to receive benefits that could be significant to the entity. We support the Board's efforts to require consolidation of off-balance sheet financing vehicles such as SIVs, commercial paper conduits, credit card securitizations and similar structures that present ongoing risk to the sponsoring company and believe these efforts will improve financial reporting. We believe investment companies can be readily distinguished from these structures in that they are not established to obtain financing for the investment adviser. Rather, they are established to provide clients with access to professional asset management. Further, the investment adviser does not bear risk of loss on fund assets. The risk of loss is disclosed to and fully borne by the fund's shareholders. We believe investment adviser consolidation of investment companies, which may be required by Statement 167, would diminish the usefulness of the investment adviser's financial statements. In particular, consolidation of fund assets would misrepresent the investment adviser's financial position as the investment company's securities are added to the investment adviser's balance sheet. Also, consolidation would eliminate the investment adviser's fee revenues from the income statement and replace them with dividends/interest and gains/ losses attributable to the investment company's portfolio securities. We believe that this presentation would make investment adviser financial statements substantially more difficult to understand and analyze, notwithstanding any supplemental disclosures that may be provided in the notes or MD&A. Power We believe investment adviser consolidation of investment companies is unwarranted where the investment adviser does not have the "power" necessary to establish a control relationship. Where the investment adviser can be removed at any time without payment of any penalty by the investment company's directors or shareholders, the investment adviser is merely acting as agent on behalf of those directors or shareholders.<sup>4</sup> In such instances, the investment company's directors and shareholders <sup>3</sup> See IASB Staff Paper No. 3F regarding agency relationships dated October, 2009 ("IASB Staff Paper"). <sup>4</sup> Section 15(a) of the 1940 Act provides that it shall be unlawful for any person to serve as an investment adviser to a registered investment company, except pursuant to a written contract that provides that it may be terminated at any time, <sup>3</sup> control the fund, not the investment adviser. We note that, for registered investment companies, current SEC rules require independent directors constitute a majority of the fund's board of directors.<sup>5</sup> Further, we believe removal rights need not be held by a single party in order to be substantive. In this regard, we support the IASB Staff Paper's recommendation that the final consolidation standard clarify that an agency relationship exists when there are substantive removal rights and that the exercise of those rights can require the agreement of more than one party. Returns Management and performance incentive fees paid by an investment company to an investment adviser may be deemed to be a right to receive benefits that could be significant to the fund. Paragraph B22 of Statement 167 provides a limited exception to the consolidation requirement for investment advisers. In particular, fees paid to an investment adviser would not be deemed benefits if they meet six delineated criteria. In practice, it may be difficult to satisfy these criteria where the investment adviser has an equity investment in the fund or charges a performance incentive fee, even where there are protections in place to ensure that the investment adviser uses its decision making authority to benefit the fund and its shareholders rather than itself.<sup>6</sup> We are concerned that Statement 167 may require consolidation in circumstances in which the investment adviser has no right to use the assets of an investment company for its own benefit and has limited, if any, exposure to the fund's assets. Money Market Funds The ASU notes that some have concluded that a money market fund manager's fees represent a variable interest in the money market fund as a result of implicit or explicit guarantees to subsidize credit losses of the fund in situations

where the net asset value declines to a value less than \$1.00 per share. Further, some have concluded that any historical funding of losses by the investment adviser creates an implicit guarantee, even in situations where the investment adviser has no statutory or contractual obligation to provide future funding. Under this view, the implicit guarantee may cause the investment adviser to consolidate the money market funds it manages. The ASU indicates that based on the restrictive requirements of Rule 2a-7 and the credit quality of the securities in which money market funds are permitted to invest, the Board believes that Statement 167 should not result in investment advisers having to consolidate money market funds. without the payment of any penalty, by the board of directors of such registered company or by vote of the majority of the outstanding voting securities of such company. 5 Section 10(a) of the 1940 Act requires that at least 40 percent of the fund's board be comprised of independent directors. In 2001 the SEC adopted rules requiring funds that rely on common exemptive rules to have boards with a majority of independent directors. A recent ICI study found that independent directors held 75 percent or more of board seats at nearly 90 percent of fund complexes. See Overview of Fund Governance Practices 1994-2008, [http://www.ici.org/pdf/pub\\_09\\_fund\\_governance.pdf](http://www.ici.org/pdf/pub_09_fund_governance.pdf). 6 For example, Section 36(b) of the 1940 Act imposes a fiduciary duty on investment advisers to registered investment companies with respect to the receipt of compensation for services, or payments from the fund or its shareholders to the adviser or its affiliates. 4 The Institute agrees and strongly supports the proposed deferral of Statement 167 to an investment adviser's interest in a money market fund that is required to comply with, or operates in accordance with requirements that are similar to those in, Rule 2a-7. We disagree with those who contend that an investment adviser to a money market fund provides an explicit or implicit guarantee of the money market fund's share value. Neither the securities laws nor standard investment advisory contracts require any such guarantee. While an investment adviser may provide limited credit support to a money market fund relating to specific portfolio securities, it is under no obligation to do so. The fact that an investment adviser has historically provided credit support does not necessarily mean that it will do so in the future. Further, money market fund shareholders are informed of risk of loss when they purchase fund shares. Each money market fund prospectus must disclose that "An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the Fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the Fund."7 We note that the SEC recently proposed rule amendments designed to make money market funds more resilient to certain short-term market risks, and to provide greater protections for investors in a money market fund that is unable to maintain a stable net asset value per share.8 Proposed Rule 22e-3 would permit money market funds to suspend redemptions in order to facilitate an orderly liquidation of the fund. Specifically, the proposed rule would allow a money market fund to suspend redemptions if the fund's current price per share is less than the stable net asset value per share and the fund's board of directors approves liquidation of the fund. The proposed rule recognizes that a money market fund's share price can decline in value, and provides for an orderly liquidation of the fund's securities in a manner that best serves the fund's shareholders by avoiding the liquidation of portfolio securities in a "fire sale" and thereby maximize recoveries to the extent possible. The proposed rule implicitly acknowledges that investment advisers are under no obligation to guarantee the value of the money market fund's shares. The SEC also recently proposed amendments to Rule 2a-7 intended to tighten the rule's risk-limiting conditions, further reducing the likelihood that money market fund investors would experience any loss. The proposed amendments are intended to enhance fund liquidity, diminish interest rate risk, and diminish credit risk. In particular, the proposed amendments would require money market funds to: 1) maintain a specified

portion of their assets in highly liquid instruments (e.g., cash, repurchase agreements, or U.S. Treasury securities); 2) reduce the maximum weighted average portfolio maturity from 90 days to 60 days; and 3) limit fund investments to those rated in the highest 7 See Item 4(b)(1)(ii) of SEC Form N-1A. 8 See Investment Company Act Release No. IC-28807 (June 30, 2009). For a discussion of the Institute's position's on the proposed amendments, see letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission (September 8, 2009) <http://www.ici.org/pdf/23769.pdf>. 5 (rather than the highest two) short-term debt ratings category from a nationally recognized statistical rating organization. As noted above, investment advisers to money market funds do not provide implicit or explicit guarantees to subsidize credit losses. Accordingly, we believe consolidation is unwarranted. At a minimum, application of consolidation principles to money market funds subject to Rule 2a-7 should be deferred until the SEC's proposed amendments are finalized and implemented, and both the Board and investment advisers can better understand their effects on potential risk and rewards to both shareholders and investment advisers. We appreciate the opportunity to comment on the proposed ASU and would be pleased to provide any additional information you may require. Please contact the undersigned at 202/326-5851. Sincerely, /s/ Gregory M. Smith Director – Fund Accounting cc: Sir David Tweedie Chairman, IASB

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