

## COMMENT LETTER

October 12, 2009

# ICI Comment Letter on FASB Fair Value Measurement Disclosures Proposal (pdf)

10/12/200910/12/200910/12/2009 VIA ELECTRONIC DELIVERY October 12, 2009 Mr. Russell G. Golden Technical Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 Re: Improving Disclosures about Fair Value Measurements File Reference No. 1710-100 Dear Mr. Golden: The Investment Company Institute<sup>1</sup> appreciates the opportunity to comment on the proposed accounting standards update Improving Disclosures about Fair Value Measurements (ASU). The proposed ASU would require issuers to disclose: 1) the effect of reasonably possible alternative inputs on Level 3 holdings, sometimes referred to as a “sensitivity analysis”; 2) significant transfers in and/or out of Levels 1 and 2 and the reasons for the transfers; and 3) activity in the Level 3 roll-forward on a gross (rather than net) basis.<sup>2</sup> The Institute has consistently supported mark-to-market or fair value accounting for financial instruments in financial reporting, both for investment companies and other types of reporting entities.<sup>3</sup> The Institute has also supported the Board’s efforts to improve its guidance for determining fair value and disclosure regarding fair value measurements.<sup>4</sup> 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 \$11.2 trillion and serve over 93 million shareholders. 2 The proposed ASU would also clarify existing disclosure obligations regarding: 1) the level of disaggregation for classes of assets and liabilities, and 2) valuation techniques and inputs. 3 See letter from Paul Schott Stevens, President and CEO, Investment Company Institute to the Honorable Christopher Cox, Chairman, U.S. Securities and Exchange Commission, dated November 14, 2008, commenting on the Congressionally-mandated SEC study of mark-to-market accounting. 4 See letter from Gregory M. Smith, Director-Fund Accounting, Investment Company Institute to Suzanne Bielstein, Director-Major Projects and Technical Activities, dated September 7, 2004 regarding the Board’s fair value measurements exposure draft. 2 While we support the objective of the proposed ASU—improved disclosure regarding fair value measurements—we believe that the costs associated with the proposed sensitivity analysis will exceed any benefits. Further, we are concerned that the sensitivity analysis may diminish fund investors’ confidence in financial reporting and reported net asset value per share. Also, we are concerned that the application of the requirement to disclose transfers between Levels 1 and 2 to mutual funds that invest in foreign securities and apply a “fair value adjustment factor” to their holdings may result in disclosure that is not meaningful. We recommend that the Board omit these

disclosures from the proposed ASU. At the very least, the Board should modify the “significance” threshold so that the proposed sensitivity analysis is required only when a reporting entity has substantial exposure to Level 3 holdings.<sup>5</sup> The Institute supports those portions of the ASU that would clarify: 1) the level of disaggregation for fair value measurement disclosures for each class of assets and liabilities; and 2) disclosures about inputs and valuation techniques. In addition, we support the proposed change to the Level 3 roll-forward that would require gross (rather than net) reporting. Finally, we urge the Board to defer the effective date of the proposed ASU to periods ending after June 15, 2010. Sensitivity Analysis Paragraph BC17 of the ASU indicates that financial statement users have concerns about the reliability of fair value measurements using significant unobservable inputs (Level 3) and therefore would benefit from information about the potential range in fair value measurements if the reporting entity were to use reasonably possible alternative inputs. We agree investors in operating companies may find such disclosures useful in assessing earnings “quality” and the potential variability in earnings attributable to management’s estimates of the fair value of Level 3 assets. The variability in earnings attributable to management’s estimates may affect investors’ assessment of the issuer and the price they are willing to pay for the issuer’s shares.

**Benefits Lacking in Fund Context** We see little benefit, however, to these disclosures in the context of an open-end mutual fund that stands ready to redeem its shares each business day at their fair value. Because a fund shareholder may redeem shares at their fair value, the sensitivity analysis would amount to a hypothetical exercise that has no bearing on the fund shareholder’s actual experience in the fund, as measured by the change in the fund’s net asset value per share over the reporting period and the related total return calculation. Indeed, we have concerns that the proposed sensitivity disclosure may cause investor confusion surrounding the fair value of the fund’s shares and lessen confidence in the accuracy of the fund’s net asset value per share and its reported returns.<sup>6</sup> Instead, we believe providing the single best estimate of fair value based on the expertise and knowledge of fund management, under the supervision of the fund’s board of directors, better serves fund shareholders.

<sup>5</sup> While “significance” is not specifically defined in the proposed ASU or the codification, we understand informally that it may mean 10%–20%. “Substantial” in this context is intended to be a level higher than “significance.” <sup>6</sup> We are also concerned that, should the reasonably possible alternatives occur, funds could find themselves subject to legal allegations that they miscalculated their NAVs by not adequately factoring those inputs into the NAV. While a fund that properly documents its valuation considerations should ultimately prevail against such allegations, the fact-based nature of such allegations could prevent them from being rejected as a matter of law, and could therefore result in substantial litigation costs.

**3 Burden** The proposed sensitivity analysis will entail incremental cost and burden associated with preparing the disclosure of the effect of reasonably possible alternative inputs. These costs may be incurred even where no disclosure is required so that a fund can demonstrate that the effects of reasonably possible alternative inputs are not significant. Reporting entities will need to create a process and document their analyses and conclusions so that they are in a position to satisfy financial statement auditors. Ultimately, these costs will be borne by fund shareholders through increased administrative fees charged to the fund.

**Single Broker Quoted Securities** Where a security does not trade regularly and independent pricing services do not provide an evaluated price due to lack of observable inputs, funds may obtain an indicative bid for the security from a broker-dealer. Funds often classify securities valued through reference to an indicative bid obtained from a broker-dealer as Level 3 holdings in fair value measurement disclosures. We understand that some funds may use proprietary pricing models to validate indicative bids obtained from broker-dealers. However, the fund likely would not know the valuation technique(s) or unobservable

input(s) used by the broker-dealer in developing the indicative bid. Therefore, as a practical matter, the fund would not be able to perform the sensitivity analysis called for in the ASU. The fund could, in this circumstance, decide to use its own proprietary pricing model to value the security (in lieu of obtaining bids from broker-dealers) and thus be in a position to develop the related sensitivity analysis. We are concerned that the proposed sensitivity analysis creates an incentive to internalize fair value measurements in the circumstance described above. Internalization would diminish the role of independent broker-dealers in the pricing process and create additional burdens on fund management.

**Transfer Between Levels 1 and 2** The ASU would require disclosure of the amounts of significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for the transfers. The ASU specifies that, for this purpose, any significant transfer shall be presumed to have occurred as of the beginning of the interim period in which the transfer occurred. Also, the ASU specifies that, for purposes of preparing the Level 3 roll-forward, transfers shall be presumed to have occurred as of the beginning of the interim period in which the transfer occurred. For SEC registered investment companies, given the unique regulatory and GAAP requirements to disclose a complete schedule of investments describing each fund holding, we believe the requirement to disclose significant transfers between Levels 1 and 2 would provide limited value to fund shareholders. In particular, we believe users of fund financial statements will gain little from additional quantitative disclosure when fair value measurements are based on observable inputs. For this reason, we recommend that the requirement to disclose quantitative information on transfers between Levels 1 and 2 be omitted from the proposed ASU.

**4 Fair Value Adjustment Factor** Funds investing in securities that trade in foreign markets that close prior to 4:00 p.m. eastern time may apply a fair value adjustment factor to the foreign market closing price when valuing foreign securities and calculating their daily net asset value per share. This factor adjusts foreign market closing prices for changes in value that occur subsequent to the foreign market close and prior to 4:00 p.m. and is intended to more accurately reflect the fair value of the fund's holdings as of the close of the U.S. securities markets.<sup>7</sup>

**Fair value adjustment factors** may be based on U.S.-traded futures on foreign securities indices, ADRs, and similar instruments. Consistent with ASC 820-10-35-43, funds generally classify securities valued through reference to fair value adjustment factors as Level 2 in the fair value hierarchy. While certain funds apply fair value adjustment factors daily, others apply a factor only when the change in value subsequent to the foreign market close exceeds some predetermined threshold or trigger amount. For these latter funds, foreign securities would be characterized as Level 1 on those days when no factor is applied (and the foreign market close is used to value holdings) and as Level 2 on those days when the predetermined threshold is satisfied and the factor is applied. Indeed, for these funds, it is common for foreign securities holdings to move back and forth between Levels 1 and 2 many times over the reporting period. In this circumstance, the movement from Level 1 to Level 2 is not indicative of a decrease in the availability of quoted prices or a heightening of investment risk. Assuming the fair value adjustment factor was applied at the period end, the reported transfer from Level 1 to Level 2 would result in disclosure that is not particularly meaningful. Funds currently provide extensive disclosure in both the financial statements and the prospectus on their valuation policies, including the application of fair value adjustment factors. We believe these disclosures, which can be tailored to a fund's unique circumstances, better communicate the application of fair value adjustment factors and do not hold the potential to be misunderstood.

**Transfers Presumed to Occur at Beginning of Period** By specifying that transfers are presumed to occur at the beginning of the period, the proposed ASU should enhance comparability across different reporting entities. However, we note that, in connection with the Level 3 roll-forward, certain funds have developed the ability to track transfers intra-period. For example, where a fund

holding is Level 2 at the beginning of a period and Level 3 at the end of the period, the security would appear in the Level 3 roll-forward as a “transfer in.” Such funds would track and disclose the change in value of this security from the date it actually transferred from Level 2 to Level 3 (rather than assuming the holding was transferred into Level 3 at the beginning of the period). Where the security was transferred into Level 3 at or near the end of the reporting period, tracking the change in value from the actual transfer date would provide more accurate disclosure than presuming that the security was transferred at the beginning of the period. We recommend that the ASU permit those issuers that can track the change in value of transfers from the actual date of transfer to do so when preparing the Level 3 roll-forward. 7 The application of a fair value adjustment factor has the salutary effect of reducing or eliminating any opportunity for market timers to profit from predictable short-term movements in the price of fund shares. 5 Effective Date We believe additional time is necessary to implement the proposed disclosures. In particular, we believe the sensitivity analysis will require the development of new processes and controls. Also, the presumption that transfers occur at the beginning of the period may require programming changes to certain accounting systems. We recommend that the effective date for the proposed ASU be changed to periods ending after June 15, 2010, with early adoption permitted. 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 – Operations/ Compliance & Fund Accounting cc: Richard F. Sennett Chief Accountant – Division of Investment Management U.S. Securities and Exchange Commission

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