

COMMENT LETTER

March 23, 2009

ICI Comment Letter on IASB Consolidation Proposal (pdf)

3/23/20093/23/20093/23/2009 March 23, 2009 International Accounting Standards Board
30 Cannon Street London EC4M 6XH United Kingdom Re: Exposure Draft 10 Consolidated Financial Statements The Investment Company Institute¹ appreciates the opportunity to comment on the IASB's exposure draft relating to consolidated financial statements (the "ED"). The ED requires a reporting entity to consolidate in its financial statements entities that it controls. Under the ED, a reporting entity controls another entity when the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity. According to the ED, the power to direct the activities of another entity can be achieved in many ways, such as by having voting rights, by means of contractual arrangements, or by having an agent with the ability to direct the activities for the benefit of the controlling entity. The ED also addresses consolidation of structured entities. SEC registered investment companies are not currently included within the SEC's proposed transition from generally accepted accounting principles ("GAAP") to international financial reporting standards ("IFRS"). Nevertheless, we provide comment on the application of the ED to investment companies in hopes of promoting convergence in fund financial reporting under the two regimes. We also provide comment on agency relationships, which affect fund manager accounting for funds they manage. We recommend that the Board provide a scope exception for investment companies that account for their investments at fair value with the change in value reflected in earnings. We believe requiring investment companies to consolidate companies in which they invest would result in financial reporting that misrepresents their net asset value and total return, the most widely used measures of performance by fund investors. We support the development of the agency principle into the control analysis and believe that it effectively recognizes the nature of the relationship between the fund manager, the fund and its investors. We elaborate on our comments below. 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 \$9.88 trillion and serve over 93 million shareholders. March 23, 2009 International Accounting Standards Board Page 2 of 6 Investment Company Consolidation of Investees The ED, in the Basis for Conclusions, notes that investment companies have previously requested scope exceptions from consolidation (e.g., IAS 27). The Board states its belief that fund investors' information needs are best served by financial statements that consolidate controlled companies, thus revealing the extent of the operations they control. Failure to consolidate would leave unreported the assets and liabilities of a controlled entity. Consolidation would require the

fund to report as its own in its financial statements the assets, liabilities, earnings and cash flows of any investee companies that it “controls” even though it owns less than 100% of the investee company. We believe consolidation of controlled companies will primarily affect master/feeder and fund of funds structures, but may also affect certain fixed-income funds that invest in debt securities that may be deemed structured entities. We agree that failure to consolidate would leave unreported the assets, liabilities, earnings and cash flows of a “controlled” investee. However, we believe the fund’s net asset value per share based on the fair value of its net assets and the related total return over the reporting period are of paramount importance to fund investors. Indeed, total return based on the change in net asset value per share over the reporting period assuming reinvestment of distributions is the primary means by which fund investors, management, analysts and others assess the performance of funds. Fund investors may also consider a fund’s expense ratio (fund expenses divided by average net assets) when evaluating funds. Consolidation of controlled companies would cause these performance measures, if based on financial statement amounts, to be misstated. We believe fund financial reporting should be designed to ensure that these measures are correctly stated so that investors can assess and compare the performance of funds. The ED, in the Basis for Conclusions, notes that a fund consolidating an investee may provide information in the footnotes about the fair value of its investments or prepare separate financial statements in addition to its consolidated financial statements. We agree a fund could provide separate fair value-based disclosures in order to provide shareholders with the performance measures they need to evaluate their funds. However, rather than impose consolidation requirements on investment companies that cause them to incur additional costs associated with maintaining separate reporting systems to generate these performance measures, we believe it would be more cost effective and in the best interests of shareholders to ensure that their primary financial statements provide investors with the information they need to evaluate the fund.

Relevance and Comparability The Board adopted a “Framework for the Preparation and Presentation of Financial Statements” in 2001. The Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. For example, the Framework indicates that the March 23, 2009 International Accounting Standards Board Page 3 of 6 objective of financial reporting is to provide information about the financial position, performance and changes in financial position of an entity that is useful to users in making economic decisions. The Framework identifies four qualitative characteristics of financial information that make it useful to financial statement users. These four characteristics are understandability, relevance, reliability, and comparability. We believe investment company consolidation of investee companies causes funds to report financial information that is not relevant from the fund shareholder’s perspective. Requiring funds to report 100% of an investee’s assets when they may own only a portion of the investee’s outstanding shares will confuse shareholders, who are accustomed to seeing the fund’s actual ownership of investee companies in the fund’s financial statements. Further, we have concerns that consolidation will diminish comparability. For example, the financial statements for a fund that controls and consolidates an investee company will reflect assets that it does not actually own. In contrast, the financial statements for a smaller fund with similar holdings that is not deemed to control any investees will not consolidate any holdings. For the reasons described above, U.S. generally accepted accounting principles exempt investment companies from consolidating controlled companies and variable interest entities.² Similarly, funds do not apply the equity method of accounting to investees.³ Further, SEC regulation precludes investment companies from consolidating any entity other than another investment company.⁴ We note that paragraph one of IAS 28, Investments in Associates provides a scope exception for investment funds that account for their investments at fair value with the change in

value reflected in earnings. IAS 28 acknowledges that the use of fair value as a measurement basis provides more meaningful information for investment fund financial statement users than the equity method of accounting. We fail to understand how the Board can conclude that fair value measurement is appropriate for investments in associates and at the same time require consolidation of investees. We recommend that the Board provide a scope exception for investment companies that account for their investments at fair value with the change in value reflected in earnings. We view such an exception as one of several steps necessary to make IFRS a relevant reporting framework for investment companies globally. 2 See paragraph 7.04 of the AICPA Audit and Accounting Guide, Investment Companies (May 1, 2008). See also paragraph 4.e. of FIN 46R, Consolidation of Variable Interest Entities (December, 2003). 3 See paragraph 2 of APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock (March, 1971). 4 See rule 6-03(j) of Regulation S-X. March 23, 2009 International Accounting Standards Board Page 4 of 6 Adviser Consolidation of Funds Advised Paragraph 9 of the ED indicates that a reporting entity can have power by having an agent act on its behalf. Further, a reporting entity does not have power when it is acting solely as an agent. We support the introduction of the agency principle into the analysis of control and believe that it acknowledges the economic substance of the relationship between the fund, the fund's shareholders (as principals) and the fund's adviser (as agent). Paragraph B3 of the ED, in describing the basis for the agency principle, indicates: An agent might have the ability to direct the activities of an entity, for example by making decisions concerning the operating and financing activities of the entity. However, that ability is governed by agreement, law or fiduciary responsibility that requires the agent to act in the best interests of the principal. The agent must use any decision-making ability delegated to it to generate returns primarily for the principal. We believe managers of SEC registered investment companies would be agents as described in the ED as applicable law imposes a fiduciary duty on the adviser with respect to the receipt of compensation for services, or payments from the fund or its shareholders to the adviser or its affiliates.⁵ Further, applicable law proscribes "self-dealing" (i.e., the adviser acting as principal selling securities to the fund or purchasing securities from the fund).⁶ Agency Relationships Paragraphs B5 through B8 of the ED discuss remuneration of agents and indicate that fees that are not commensurate with the services performed indicate involvement with an entity beyond that of an agent and, therefore, might indicate control. The ED identifies several factors that might indicate that fees are not commensurate with the services performed, including situations where the fees are large relative to the total expected returns of the entity to which the services are provided. Under normal circumstances, we agree that fees that are large relative to expected returns may be an indicator that the relationship goes beyond agency. However, in markets where expected returns on securities are exceptionally low, as is the case currently in certain short-term government securities, this criterion alone should not cause a fund manager to consolidate a fund it manages. We recommend that this criterion for assessing remuneration in agency relationships be modified so that it will not cause consolidation due to exceptional market conditions. For example, the relationship between fees earned ⁵ See Investment Company Act of 1940, Section 36(b). ⁶ See Investment Company Act of 1940, Section 17(a). March 23, 2009 International Accounting Standards Board Page 5 of 6 by the fund manager and expected returns of the fund could be evaluated under normal circumstances or over the expected life of the agency relationship. Dual Role Relationships We agree in general that returns and power are correlated as stated in paragraph 13 of the ED. However, we believe it is critical that the new standard achieves the correct balance between returns and power, as there may be situations, in the context of a fund manager subject to fiduciary duty, where there is no quantitative correlation between the level of returns received and the control over the assets of the

fund. Where a fund manager owns shares in a fund that is offered to the public, the fund manager may, depending on its ownership level, receive more returns than any other shareholder. Nevertheless, the fund manager is bound by its fiduciary duty to act in the best interests of the fund and its shareholders. Further, the investment of the fund's assets is dictated by the investment policies described in the fund's prospectus. Moreover, the fund's board, a majority of which must be independent of the fund manager, is responsible for overseeing the fund and addressing any conflicts that may arise. This structure ensures that the fund is managed for the benefit of all of its investors. In such a scenario, the level of returns received is not an indicator that the fund manager has the power to direct the activities of the fund to generate returns primarily for its own benefit. Accordingly, we recommend that the Board consider adding additional guidance to the discussion of agency arrangements that describes factors that may ameliorate the fund manager's power when it is both an agent and an investor in a fund it manages. For example, language such as that underlined below, could be added to BC 91. In some cases, the line between principal and agent might be blurred. An agent with self investment in an entity would have a dual role. For example, a fund manager may act in a fiduciary capacity and have a direct investment in the fund it is managing. In such situations a fund manager needs to carefully assess whether it has sufficient power over the activities of the fund to generate returns primarily for itself as principal or whether the fiduciary duties imposed on the fund manager by virtue of law, regulation, or agreement limit such powers in a way that prevents it from acting other than in the sole interest of all investors. When assessing the extent of the limitations on the fund manager's ability to direct the activities of the fund to generate returns for itself the fund manager shall consider all relevant facts and circumstances including:

- Laws, regulations, or contractual obligations
- Regulatory supervision
- Prospectus requirements that dictate investment policies
- Governance requirements, such as majority independent board of directors

March 23, 2009 International Accounting Standards Board Page 6 of 6 We appreciate the opportunity to comment on the ED. If you have any questions on our comments please contact the undersigned at 202/326-5851 or smith@ici.org. Sincerely, /s/ Gregory M. Smith Director – Fund Accounting cc: Richard F. Sennett Chief Accountant – Division of Investment Management U.S. Securities and Exchange Commission