

COMMENT LETTER

September 7, 2004

Comment Letter on Proposed Fair Value Requirements (pdf)

September 7, 2004 Ms. Suzanne Bielstein Director – Major Projects and Technical Activities
Financial Accounting Standards Board 401 Merritt 7, P.O. Box 5116 Norwalk, CT 06856-5116
Re: File Reference No. 1201-100, Fair Value Measurements Dear Ms. Bielstein: The Investment Company Institute¹ is pleased to respond to the Board's request for comment on the proposed Statement of Financial Accounting Standards, Fair Value Measurements (the "Proposal"). The Proposal provides guidance on how to measure fair value. It would apply broadly to financial and nonfinancial assets and liabilities measured at fair value under other authoritative accounting pronouncements. The Institute supports the Board's efforts to provide guidance on fair value measurements, as well as its efforts to supplement historical/depreciated cost-based financial reporting with disclosure of fair value amounts.

Introduction SEC-registered investment companies ("Registered Funds") are subject to extensive SEC regulation, including the manner in which they value their securities holdings, both for purposes of calculating daily net asset values ("NAVs") and preparing financial statements. SEC regulation of Registered Funds' security valuation policies emanates from the Investment Company Act of 1940 ("1940 Act"), the federal statute governing investment company operations. The SEC has also issued several Accounting Series Releases, and various staff letters describing funds' security valuation obligations. Under the 1940 Act, securities for which market quotations are readily available are to be valued at market value, and all other securities are to be valued at fair value as determined in good faith by the fund's board of directors.² SEC Accounting Series Release No. 118 instructs Registered Funds to use the last quoted sales price as of the time of valuation.³ When there is no quoted sales information, ASR 118 contemplates the use of bid and asked prices quoted by broker dealers. In the absence of readily available market quotations, funds must employ fair value methodologies to estimate the value of the

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,605 open-end investment companies ("mutual funds"), 630 closed-end investment companies, 135 exchange-traded funds and 5 sponsors of unit investment trusts. Its mutual fund members manage assets of about \$7.499 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.

² Section 2(a)(41) of the 1940 Act.

³ Accounting Series Release No. 118, Investment Company Act Release No. 6295, (December 23, 1970) ("ASR 118").

security. ASR 118 describes fair value as the amount which the owner might reasonably expect to receive upon a current sale. In certain instances, as explained below, the Proposal conflicts with SEC valuation requirements applicable to Registered Funds. The Commission has recognized the FASB's accounting and reporting standards as "generally accepted" for

purposes of the federal securities laws and indicated that registrants are required to comply with those standards in preparing financial statements filed with the SEC.⁴ The Commission, however, has not delegated authority to the Board to revise or repeal Accounting Series Releases or other policy statements. Accordingly, Registered Funds would be required to continue to comply with SEC valuation requirements, notwithstanding adoption of the Proposal by the FASB. The Institute urges the Board to resolve these conflicts by conforming the proposal to SEC valuation requirements, or at a minimum, to acknowledge that as to conflicts, Registered Funds should follow applicable SEC guidance. Absent resolution of these conflicts, we are unsure how Registered Funds would comply with their obligation under the federal securities laws to file audited financial statements that comply with both generally accepted accounting principles and SEC security valuation requirements.

Level 1 Reference Market Issue 6: In this proposed Statement, the Level 1 reference market is the active market to which an entity has immediate access or, if the entity has immediate access to multiple active markets, the most advantageous market. Appendix B provides general guidance for selecting the appropriate reference market (Example 5). Is that guidance sufficient? If not, what additional guidance is needed? Stocks may be listed for trading on more than one exchange (e.g., the New York Stock Exchange and a “regional” exchange). The Proposal would seemingly require Registered Funds to consider last sale prices from regional exchanges (assuming they are active markets) and to use those prices if they are more advantageous.⁵ In contrast, ASR 118 indicates: “In the case of securities listed on more than one national securities exchange the last quoted sale, up to the time of valuation, on the exchange on which the security is principally traded should be used or, if there were no sales on that exchange on the valuation date, the last quoted sale, up to the time of valuation, on the other exchanges should be used.” Where a security trades concurrently, or in close time proximity, at or near the close of regular trading, on two or more exchanges, we believe any differences in price would likely be 4 See SEC Release No. IC-26028 (April 25, 2003). 5 Paragraph C46. of the Proposal indicates that the most advantageous market is the market with the price that would maximize the net amount that would be received for an asset and minimizes the amount that would be incurred for a liability. We note that buyers and sellers of fund shares have differing perspectives on the “most advantageous price.” While redeeming/departing shareholders would support the price that maximizes the amount received for an asset (thus maximizing their redemption proceeds), purchasing/incoming shareholders would support the price that minimizes the amount received for an asset (thus minimizing the price paid to purchase fund shares). These competing interests argue that there should be no bias (highest or lowest) in determining security values for Registered Funds. immaterial. We suspect any material differences in price that are not illusory would be arbitrated away. Accordingly, in the context of securities listed for trading on multiple exchanges, we see little benefit associated with Proposal’s best price mandate.⁶ ICI believes (consistent with ASR 118) Registered Funds should designate a principal market for their securities and base value determinations on last sale trades from that market, irrespective of trades on other exchanges. We believe the principal market, the market where the preponderance of share volume normally transacts (i.e., the most liquid market), will likely be a better indicator of value in most situations.

Pricing in Active Dealer Markets Issue 7: This proposed Statement would require that the fair value of financial instruments traded in active dealer markets where bid and asked prices are more readily and regularly available than closing prices be estimated using bid prices for long positions (assets) and asked prices for short positions (liabilities), except as otherwise specified for offsetting positions. Do you agree? If not, what alternative approaches should the board consider? NASDAQ-traded Stocks Paragraph 11.b. of the Proposal indicates that “Over-the-Counter” markets (where prices are publicly reported by the National Association of Securities Dealers Automated Quotations systems)

are dealer markets. Accordingly, the Proposal would require stocks traded on NASDAQ to be valued using bid prices (for long positions). During the past several months NASDAQ has made substantial improvements to its closing price reporting systems. These systems include the NASDAQ Closing Cross and the NASDAQ Official Closing Price. We understand that Registered Funds, index providers and others routinely rely on these systems to value securities and calculate index values. The NASDAQ Closing Cross is a price discovery facility that crosses market-on-close and limit-on-close type orders at a single closing price. NASDAQ Closing Cross disseminates detailed information about order imbalances and likely clearing prices for the ten minutes leading up to the market close. At 4:00 p.m., the NASDAQ then executes the market-on-close, limit-on-close and offsetting orders at a single price that allows the maximum number of shares to execute.⁷ The NASDAQ Official Closing Price ("NOCP") integrates NASDAQ Super Montage quotes and actual trades to develop an official closing price. The NOCP is based on the price of the last trade reported to NASDAQ's proprietary trade reporting system at or before 4:00:02 p.m.⁶ There would be administrative burden associated with searching separate exchanges for the most advantageous price, particularly where a security is listed for trading on exchanges located in several different countries. ⁷ The SEC approved a NASDAQ proposed rule change describing the operation of the closing cross on March 11, 2004. See SEC Release No. 34-49406. p.m. NASDAQ systems "normalize" the price of the trade by comparing it to NASDAQ's best bid and ask prices (i.e., the best prices displayed by all Super Montage participants) at the time the trade was reported, or by comparing it to the NASDAQ best bid and offer ("BBO") at 4:00:00 p.m. for trades reported after that time. If the price of the trade falls at either side of or within the BBO, that price becomes the NOCP. If the price of the trade falls outside the BBO, NASDAQ would adjust it up to the BBO bid if it is below the bid price, or down to the BBO ask if it is above the ask price.⁸ We urge the Board to conclude that last sale closing prices for NASDAQ-traded stocks should be deemed regularly and readily available in light of the closing price systems described above. Fixed-Income Securities Paragraph 11.b. of the Proposal indicates that the market for U.S Treasury Securities is a dealer market. We believe the market for other types of fixed-income securities would also likely be considered a dealer market under the Proposal, since fixed-income securities generally are not listed for trading on organized exchanges. Under the Proposal, fixed-income securities traded in active dealer markets would be valued using the bid price. ASR 118 notes that multiple brokers may provide bid-ask quotes on securities traded over-the-counter and a fund in valuing these securities may have multiple options available to it. SEC ASR 118 permits a registered fund to "adopt a policy of using a mean of the bid prices, or of the bid and asked prices, or of the prices of a representative selection of broker-dealers quoting on a particular security; or it may use a valuation within the range of bid and asked prices considered best to represent value in the circumstances. Any of these policies is acceptable if consistently applied." ICI believes ASR 118 appropriately affords the investment company discretion to apply the valuation methodology that best represents value in the particular circumstances. For certain fixed-income security types that trade in markets with narrow spreads, bid may in fact best represent value. In contrast, other fixed-income security types may trade in markets with wider bid-ask spreads where it is likely that the investment company, upon entering the market, would obtain an execution somewhere between the bid-ask. Given the many different types of fixed-income securities and the markets in which they trade, we do not believe a "one size fits all" policy (i.e., mandated use of bid) will yield the best estimate of value in all circumstances. Measurement of Blocks Issue 8: For unrestricted securities with quoted prices in active markets, many FASB pronouncements (including FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments) require ⁸ The SEC approved a NASDAQ proposed rule change describing the operation of NOCP on March 18, 2003. See SEC Release No. 34-47517. that fair value be estimated as

the product of a quoted price for an individual trading unit. For large positions of such securities (blocks) held by broker-dealers and certain investment companies, the AICPA Audit and Accounting Guides for those industries (the Guides) permit fair value to be estimated using blockage factors (adjustments to quoted prices) in limited circumstances. In those cases, the unit of account is a block. The Board initially decided to address that inconsistency in this proposed Statement as it relates to broker-dealers and investment companies. The Board agreed that the threshold issue is one of determining the appropriate unit of account. However, the Board disagreed on whether the appropriate unit of account is the individual trading unit (requiring the use of quoted prices) or a block (permitting the use of blockage factors). The majority of the Board believes that the appropriate unit of account is a block. However, the Board was unable to define that unit or otherwise establish a threshold criterion for determining when a block exists as a basis for using a blockage factor. The Board subsequently decided that for measurement of blocks held by broker-dealers and certain investment companies, current practice as permitted under the Guides should remain unchanged until such time as the Board fully considers those issues. For those measurements, do you agree with the Board's decision? If applicable, what approaches should the Board consider for defining a block? What, if any, additional guidance is needed for measuring a block?

Registered Funds Precluded From Application of Block Discounts/Premiums

As described above, Registered Funds are required to value their holdings by reference to readily available market quotes (i.e., last sale trades for exchange-traded securities and bid/ask quotes in the absence of last sale trades). The SEC has on several occasions indicated that it would be inappropriate for a Registered Fund to mark-up or mark-down a readily available market price for an unrestricted security solely because the company holds a large quantity of the outstanding shares of the issuer or holds an amount that is a significant portion of the security's average daily trading volume.⁹ The Turner Letter discusses AICPA consideration of a standard setting project related to block discounts noting, "Even if AcSEC completes a project on blockage, SEC registrants will continue to be precluded from applying a blockage factor in estimating the fair value of unrestricted investments if a quoted price in an active market is available." Reduces Consistency and Comparability The Proposal indicates that the Board's fair value guidance will improve financial reporting through increased consistency, reliability and comparability. If block discounts are applied to Registered Funds' holdings based on the number of shares held relative to trading volume, market capitalization or other measures, we believe the Proposal will reduce consistency and comparability relative to current practice. For example, a Registered Fund with a "small" holding in a particular security would presumably apply a higher share price to its

⁹ See "Dear CFO" letter from John Capone, Chief Accountant - Division of Investment Management, Securities and Exchange Commission (February 14, 2001) and Letter from Lynn Turner, Chief Accountant, Securities and Exchange Commission to Mark Sever, Chair - Accounting Standards Executive Committee, (April 11, 2001) ("Turner Letter").

holding in that security than a fund with a "large" holding in that same security. This may occur within a particular fund family (e.g., two funds within a fund family hold shares in a particular issuer), as well as funds in different fund families. We are concerned that funds' reported performance would be affected by the size of their holdings (and the related discount) rather than the change in value of their holdings over the reporting period. The Turner Letter indicates that the SEC staff is concerned that application of blockage factors could create earnings management opportunities. "For example, a block of stock may be acquired and a discount from the market value may be recorded. In many cases, that stock will not be sold as a block, but instead in smaller amounts, creating gains, and increasing earnings reported to investors. This practice decreases the quality of earnings." The Institute shares these concerns.

Contemplates Forced Sale or Liquidation Mandated block

discounts may be based on the assumption that Registered Funds will be forced to accept reduced prices when they sell securities to meet redemption requests. Funds, however, do not typically sell securities to meet redemption requests. Instead, funds meet redemption requests in different ways. Funds often use incoming cash (e.g., proceeds from newly issued shares, dividends and interest on portfolio securities). Also, funds typically invest a portion of their assets in short-term securities (i.e., commercial paper, repurchase agreements) that can be readily converted to cash for the purpose of paying redemption orders. Funds also may reserve the right to borrow money from banks and/or other funds in the complex. Finally, not all Registered Funds provide shareholders with the right to redeem their shares. Closed-end investment company shares are listed for trading on organized exchanges. ARB No. 43 indicates that financial statements of a going concern are prepared on the assumption that the company will continue in business. 10 Application of block discounts to last sale prices for actively traded securities seems to suggest that the Registered Fund's securities will be sold or that the fund itself will be liquidated in the near-term. Funds often hold positions in individual companies for several years or more. Absent any indication that securities will be sold in the near-term, we are concerned that application of block discounts would cause redeeming/departing shareholders to receive less than their fair share of fund assets. Similarly, purchasing/incoming shareholders would be buying shares at "bargain" prices to the detriment of existing long-term shareholders.

Level 3 Estimates Issue 9: This proposed Statement would require that in the absence of quoted prices for identical or similar assets or liabilities in active markets, fair value be estimated using multiple valuation techniques consistent with the market approach, income approach, and cost approach whenever the information necessary to apply those techniques is available without undue cost and effort (Level 3 estimates). 10 See ARB No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 3, Section A, Paragraph 2. Appendix B provides general guidance for applying multiple valuation techniques (Examples 6-8). Is that guidance sufficient? If not, what additional guidance is needed? Paragraph 7 of the proposed Statement indicates that, "Valuation techniques consistent with the market approach, income approach, and cost approach shall be considered for all estimates of fair value. However, for estimates of fair value that are developed using quoted prices in active markets (an application of the market approach), the results of other valuation techniques may not provide significant additional information." We are concerned that paragraph 7 could be read to suggest that, application of multiple valuation techniques would be required even if the entity has access to Level 1 quoted prices in active markets for identical assets, or Level 2 quoted prices in active markets for similar assets. Where a Registered Fund has access to Level 1 or Level 2 quoted prices in active markets, application of the income approach and the cost approach would likely not improve the fair value estimate. Where market quotations are readily available, Registered Funds may be precluded from adjusting last sale quotes based on input derived from the income approach and cost approach methods. SEC staff, in discussing Registered Funds' security valuation policies has indicated: We also wish to set forth our views on the obligation of funds to value their portfolio securities for which market quotations are readily available. In such circumstances, funds are not permitted to ignore these quotations and fair value price the securities. This would not be consistent with a fund's obligation under the 1940 Act and could result in an incorrect NAV. We believe that funds must exercise reasonable diligence to obtain market quotations for their portfolio securities before they may properly conclude that market quotations are not readily available. If, for example, a fund obtains market quotations for a portfolio security from one source and determines that they are unreliable, the fund should diligently seek to obtain market quotations from other sources, such as other dealers or other pricing services, before concluding that market quotations are not readily available.¹¹ We urge the Board to

clarify that application of the income and cost approaches are not required when Level 1 or Level 2 market quotations are readily available. Fair Value Disclosures Issue 11: This proposed Statement would require expanded disclosures about the use of fair value to remeasure assets and liabilities recognized in the statement of financial position. Appendix B illustrates those disclosures. This proposed Statement also would encourage disclosures about other similar remeasurements that like fair value, represent current amounts. The Board concluded that those disclosures would improve the quality of information provided to users of financial statements. Do you agree? If not, why not? 11 See Letter from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, Securities and Exchange Commission to Craig S. Tyle, General Counsel, Investment Company Institute (April 30, 2001). For assets and liabilities recognized in the statement of financial position that are remeasured at fair value on a recurring or ongoing basis during the reporting period, the Proposal would require disclosure of: (1) the fair value amounts at the end of the period, in total and as a percentage of total assets and liabilities, (2) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques), indicating the extent to which market inputs were used, and (3) the effect of the remeasurements on earnings for the period (unrealized gains or losses) relating to those assets still held at the reporting date. The example provided in paragraph B22. of the Proposal intended to illustrate compliance with item (2) above suggests that issuers would be required to disclose, for various categories of assets (e.g., trading securities, derivatives, venture capital investments, etc.) the value attributed to the category and the manner in which value was determined (i.e., trades/bids in identical securities, trades/bids in similar securities as adjusted for differences, and valuation models). Registered Funds currently provide similar information in a disaggregated fashion (i.e., at the security level as opposed to the portfolio level) in their financial statements. Registered Funds provide a schedule of investments listing each security holding, the number of shares/principal amount, and the related fair value.¹² The accounting policies footnote (as well as the fund's prospectus) describes how each type or category of security held by the fund will be valued.¹³ Further, Registered Funds are required to identify each restricted security held and disclose the acquisition date, cost, and current fair value at the balance sheet date. We respectfully suggest that existing disclosure requirements applicable to Registered Funds provide information sufficient to enable an investor to understand the fund's holdings, the related fair value amounts, and how those fair value amounts were determined. Effective Date and Transition Issue 12: This proposed Statement would be effective for financial statements issued for fiscal years beginning after June 15, 2005, and interim periods within those fiscal years. The Board believes the effective date provides sufficient time for entities to make the changes necessary to implement this proposed Statement. Do you agree? If not, please explain the types of changes that would be required and indicate the additional time that would be needed to make those changes. 12 See SEC Regulation S-X, rule 12-12. Registered Funds may choose to provide a summary schedule of investments listing the top fifty holdings in their shareholder reports. Funds providing a summary schedule of investments in their shareholder report must file the full schedule of investments with the SEC and provide the full schedule of investments to shareholders upon request without charge. 13 The SEC recently amended open-end mutual fund prospectus disclosure requirements to include an explanation of the circumstances in which the fund will use fair value pricing and the effects of using fair value pricing. These amendments were adopted in response to the increased incidence of market timing. See SEC Release No. IC-26418 (April 16, 2004). We believe a substantial number of Registered Funds currently use the NOCP to value their NASDAQ-traded stocks. Further, we believe a substantial number of Registered Funds currently use the mean of the bid-ask to value their fixed-income securities. If these funds were to apply

the Proposal's requirement to value securities traded in dealer markets at the bid price to their daily net asset value calculation process, there would be a decline in their net asset values associated with the change on the first business day of the fiscal year beginning after June 15, 2005. We are concerned that shareholders in these funds could experience an immediate diminution in the value of their fund investments due to the proposed change. Furthermore, we suspect certain investors may try to take advantage of this "predictable" decline in share net asset value by redeeming shares immediately prior to the change and subsequently repurchasing shares after the change, particularly in tax-deferred accounts. This may cause funds to: 1) incur substantial transactions costs; and 2) realize taxable gains, that would then be distributed out to shareholders. We urge the Board to carefully consider the Proposal's effects on Registered Fund shareholders. * * * * * If the Proposal is adopted without resolution of the conflicts described above, we are uncertain how Registered Funds will comply with their obligation to file financial statements that comply with generally accepted accounting principles and SEC security valuation requirements. We urge the Board to conform the Proposal to SEC security valuation requirements or to acknowledge that as to conflicts, Registered Funds should follow applicable SEC guidance. We appreciate the Board's consideration of our comments. If you have any questions, please contact the undersigned at 202/326-5851. Sincerely, Gregory M. Smith Director - Operations/ Compliance & Fund Accounting cc: Douglas Scheidt, Associate Director and Chief Counsel Brian D. Bullard, Chief Accountant Division of Investment Management Securities and Exchange Commission