The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE
Washington, DC // Brussels // London // www.ici.org

Comment Letter to MSRB on Reporting Assets and Liabilities at Fair Value, May 2000

May 31, 2000

Mr. Timothy S. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value
File Reference 204-B

Dear Mr. Lucas:

The Investment Company Institute[1] appreciates the opportunity to express its views on the Financial Accounting Standards Board's Preliminary Views on Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value (the "Proposal"). The objective of the Proposal is to develop guidance for reporting all financial assets and liabilities at fair value. The Proposal is part of an effort to require all issuers to report financial assets at fair value and to reflect changes in value in earnings.

The Institute supports full disclosure of the fair value of financial instruments. It is important to note, however, that unlike historical cost-based issuers, investment companies already are required to value their assets at market or fair value, with changes in value reflected in earnings. Thus, including investment companies within the scope of the Board's fair value initiatives is not necessary to achieve its goal. Moreover, as discussed in greater detail below, the fair value guidance described in the Proposal differs from existing Securities and Exchange Commission guidance on security valuation applicable to investment companies. We are concerned that application of the valuation guidance described in the Proposal to mutual funds could cause funds to undervalue their shares, to the detriment of shareholders. For these reasons, we respectfully request that investment companies be exempted from any financial accounting standard emanating from the Proposal in deference to long-standing security valuation guidance promulgated by the SEC.[2] Alternatively, the Board should indicate that investment companies that comply with SEC valuation requirements are deemed to comply with the FASB standard.

Background—Mutual Fund Valuation of Portfolio Securities

Most mutual funds continuously offer and sell their shares to the public. All mutual funds must stand ready to redeem shares upon demand by the shareholder. In order that purchase and redemption orders may be effected at appropriate prices on an ongoing basis, funds are required to determine the net asset value of their shares based on the current market value of their portfolios on a daily basis.

Proper valuation of fund portfolio securities is critical to ensure that the fund share prices derived from those valuations will be fair to purchasing, redeeming and continuing shareholders. For example, if fund shares are sold and redeemed based on a net asset value that is understated in comparison to the value of the fund's portfolio securities, purchasing shareholders will receive a windfall, redeeming shareholders will receive less than they are due and the interests of continuing shareholders may be diluted.[3]

Comparison of SEC Regulation of Security Valuation and the Proposal

General

The Investment Company Act of 1940 ("1940 Act"), the federal statute regulating the operation of investment companies, sets forth

specific requirements for valuation of fund portfolio securities. Section 2(a)(41) of the 1940 Act defines the "value" of fund assets in terms of a simple dichotomy: securities for which market quotations are readily available are to be valued at "market value;" all other securities are to be valued at "fair value" as determined in good faith by the fund's board of directors. Mutual funds are required to follow the SEC's valuation requirements when both preparing financial statements and calculating their net asset value.

As noted above, the Proposal would require issuers to report financial assets and liabilities at "fair value." It describes fair value as an estimate of the price an entity would have received if it had sold an asset on the reporting date in an arm's-length exchange motivated by normal business considerations (i.e., the "exit price").

Market Value

SEC Accounting Series Release No. 118[4] provides guidance on the meaning of market value and fair value for purposes of security valuation. For securities listed or traded on a national securities exchange, market value is generally the last quoted sales price as of the time of valuation. Neither the statute nor ASR 118 contemplates reducing the last quoted sales price for commissions that may be incurred upon sale of the security.

For securities traded over-the-counter, funds are allowed to use any of several methods utilizing either bid prices alone or the mean of bid and asked prices. ASR 118 states:

A company may 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.

By contrast, the Proposal indicates that the exit price for securities actively traded on an exchange is the closing price less any commissions. Further, for securities traded in dealer markets, where bid and asked prices are regularly quoted, the exit price for assets is the bid price.

We are concerned that the use of exit value may cause funds to systematically understate the value of the fund's portfolio securities and the fund's net asset value.

While the concept of exit value may be suitable for an entity "in liquidation," we believe market value, as articulated in FAS No. 107[5] and ASR No. 118, is appropriate for a "going concern." As a going concern, it is not at all certain if or when a mutual fund's portfolio securities will be sold and brokerage commissions incurred. Valuation of securities at exit value causes redeeming shareholders to bear the pro rata portion of brokerage commissions that would be incurred on liquidation of the entire portfolio, even though these securities may be sold in the distant future, long after the shareholder has left the fund.

A strict regime requiring valuation of securities traded over-the-counter at the bid price in all circumstances fails to recognize that transactions often take place between the bid and ask. Such a regime may be appropriate for an entity in liquidation. However, as a going concern, a fund would have time to "work" an order for the sale of portfolio securities and may be able to achieve a price superior to the bid price. Certain ICI member firms value securities traded over-the-counter at the mean of the bid and ask, as permitted under existing SEC guidance, because they feel the mean best represents the amount that would be realized on the sale of the security.

Fair Value

When there are no readily available market quotations for a security, funds must employ fair value methodologies to price the security. ASR 118 states that as a general principle, the fair value would appear to be the amount that the owner might reasonably expect to receive upon a current sale.

ASR 118 suggests a number of methodologies that can be used, and a number of factors that can be considered in making fair value determinations. Methodologies can be based on: (1) a multiple of earnings; (2) a discount from market of a similar freely traded security; (3) with respect to debt instruments, the yield to maturity; or (4) a combination of the foregoing. Factors to be considered in determining fair value methods include: (a) fundamental analytical data; (b) the nature and duration of any restrictions on disposition; (c) an evaluation of the forces that influence the market in which the securities are purchased and sold; and (d) specific factors, including (among others) the type of security, financial statements, cost, size of holding, analysts' reports, transactional information or offers, and public trading in similar securities of the issuer or comparable companies.

Certain aspects of the Proposal are inconsistent with the SEC's guidance on fair value determinations. For example, paragraphs 60-72 of the Proposal discuss situations in which some information about the market price of the specific item or a similar item is available. Paragraph 67 indicates that a market price, regardless of its source is presumed to be the best evidence of the fair value of an asset and delineates an exclusive list of circumstances in which an entity may adjust an observed market price. We are

concerned that the Proposal's approach (i.e., an exclusive list of circumstances) cannot anticipate all situations in which it may be appropriate to adjust an observed market price.

For example, during the October 1997 Asian financial crisis, certain international funds, investing primarily in Asian securities, did not use the exchange last sale price when calculating their net asset value per share. These funds concluded that by the time they calculated their net asset value—in some cases 12 to 14 hours after the close of Asian markets—subsequent market events had rendered the closing Asian prices no longer valid. These funds relied on futures on Asian indices traded domestically or other indicia of value to adjust the Asian last sale price. The Commission's security valuation guidance enables funds to address these types of situations by "fair valuing" portfolio securities.[6]

Materiality

Application of the Proposal to investment companies may give rise to difficult implementation issues. As described above, the Proposal conflicts with SEC guidance on investment company security valuation. Accordingly, funds would be forced to choose between SEC valuation guidance and the Proposal (if it ultimately becomes part of generally accepted accounting principles). Some may suggest that funds could continue to apply existing SEC valuation guidance rather than the Proposal on the basis that the departure from GAAP would be "immaterial." However, funds may be hesitant to do so in light of the recent SEC staff accounting bulletin on materiality.[7]

Estimated Commissions

The Proposal would require funds to reduce the last sale price of exchange traded securities by commissions to be incurred. Paragraph 53 of the Proposal indicates that "some assumptions about expected commissions are necessary." Investment companies may incur a range of brokerage commissions on their transactions, depending on the manner in which the transaction is effected. Funds may place trades through a traditional broker or through an Electronic Communications Network or other automated trading system. In certain circumstances, funds may purchase securities from, or sell securities to, other funds in the same fund family without broker intervention. Accordingly, the commission to be incurred on a transaction can vary substantially based on the manner in which the transaction is effected. We question whether the cost associated with developing and applying estimated commission costs justifies any associated "benefit."

* * *

For the reasons described above, we recommend that the Board exempt investment companies from any standard emanating from the Proposal or, alternatively, indicate that investment companies that comply with SEC valuation requirements will be deemed to comply with any FASB standard in this area. If you have any questions on our comments, please contact the undersigned.

Sincerely,

Gregory M. Smith
Director—Operations/
Compliance & Fund Accounting

cc: John Capone, Chief Accountant
Division of Investment Management
Securities and Exchange Commission

ENDNOTES

[1] Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,036 open-end investment companies ("mutual funds"), 496 closed-end investment companies, and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.264 trillion, accounting for approximately 95 percent of total industry assets, and over 78.7 million individual shareholders.

[2] We note the FASB has previously exempted investment companies from various Financial Accounting Standards. See FAS No. 102 Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale, and FAS No. 115 Accounting for Certain Investments in Debt and Equity Securities. Also, AICPA SOP 98-5, Reporting on the Costs of Start-up Activities, enabled open-end funds to apply the SOP prospectively, exempting existing deferred organization costs from mandatory write-off. AcSEC's basis for conclusions indicates existing shareholders would experience negative economic consequences if capitalized costs were required to be expensed immediately, thereby causing an immediate decrease in net asset value.

[3] Closed-end investment companies do not redeem shares at net asset value like open-end funds. Nevertheless, they must comply

with the SEC's security valuation requirements for investment companies in the preparation of their financial statements. Like open-end funds, they would be subject to the conflicting valuation methodology described in the Proposal and existing SEC requirements. Accordingly, closed-end funds should also be exempt from any accounting standard in deference to SEC security valuation requirements.

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

[5] FAS No. 107 Disclosures About Fair Value of Financial Instruments indicates "If a quoted market price is available for an instrument, the fair value to be disclosed for that instrument is the product of the number of trading units of that instrument times that market price."

[6] Recently, the SEC indicated that funds must consider adjusting the reported last sale price for a security when the exchange on which the security trades does not open for trading for an entire day (e.g., due to an earthquake or other similar emergency). See Letter to Craig S. Tyle, General Counsel, Investment Company Institute from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, SEC (December 8, 1999).

[7] See SEC Staff Accounting Bulletin No. 99—Materiality (August 12, 1999). SAB No. 99 indicates that quantitatively small misstatements may be material in certain circumstances. Further, SEC registrants cannot make intentional immaterial misstatements in financial statements that are inconsistent with GAAP.

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.