The Asset Management Industry
SERVING INDIVIDUAL INVESTORS

INVESTMENT COMPANY INSTITUTE

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Comment Letter on IASB Interpretation of Financial Reporting Rules, November 2001

November 2, 2001

The Standing Interpretations Committee
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Re: Draft Interpretation SIC-D34 Financial Instruments–Instruments or Rights Redeemable by the Holder

The Investment Company Institute[1] appreciates the opportunity to comment on the draft interpretation issued by the Standing Interpretations Committee of the International Accounting Standards Board. The draft interpretation provides guidance on implementation of IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement (Draft Interpretation).

The Draft Interpretation addresses the financial statement presentation of shares issued by unit trusts, open-end mutual funds and other investment enterprises. The Draft Interpretation indicates that where shares enable the holder to redeem or "put" the shares to the issuer for cash, the issuer should treat the shares as a liability. The Draft Interpretation would cause these entities to report no equity or net assets for financial accounting purposes.[2]

We strongly disagree with the Draft Interpretation. We believe that it mischaracterizes fund shares as "deposits," ignores the ownership rights associated with fund shares, and fails from a cost/benefit perspective.

Fund Shares Are Not Deposits

The Draft Interpretation indicates fund shares are essentially hybrid financial instruments consisting of two components:

- a host contract that is similar to a deposit repayable for a fixed amount; and
- an embedded non-option derivative that represents a principal payment indexed to an underlying variable.

This construction implies that a portion of the value inherent in fund shares is attributable to the right to receive repayment of an initial deposit. It further implies that any changes in the value of the fund's assets represent an indexed principal payment, the amount of which varies in relation to an underlying variable.

Fund shares are not deposits. They do not entitle shareholders to receive repayment of their initial investment or principal. They represent interests in the fund's underlying assets. They entitle the holder to participate in the fund's profits and losses, to receive distributions of income and capital gains, and to receive their pro-rata share of net assets in liquidation.

Fund shares also entitle the holder to receive the pro-rata portion of the fair value of the fund's assets on demand. In this context, fund shares can be viewed as entailing a put option. While this put option could theoretically be separated from the "host contract" and treated as a liability in the fund's financial statements, we believe any such separate treatment would be both incorrect and impractical. Thus, we believe fund shares should be treated exclusively as equity.

This approach is consistent with the U.S. Financial Accounting Standards Board's recent exposure draft, Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both. Paragraphs 54 through 63 of the exposure draft describe various types of financial instruments that should be treated as equity and not obligations or liabilities of the issuer. Common stock that is puttable at its fair value (e.g., fund shares) is one of the types of financial instruments that should be treated as equity. Paragraph 63 of the exposure draft states:

"Certain entities enter into agreements with their stockholders that allow the stockholders to put shares back to the entity at the fair value of the shares. When shares are puttable at the fair value of the underlying shares at the date the put option is exercised, the effect of the put option is to add liquidity to the underlying stock—a value that traditional option pricing models cannot measure. Moreover, although adding liquidity adds value, the value added may be relatively small. Therefore, it is likely that only a small amount (if any) of the proceeds would be assigned to the liability component."

We believe the FASB model correctly characterizes fund shares as equity. Further, we believe the value of the put option granted by the fund is inconsequential andshould not be recognized as a liability in the fund's financial statements.

Ownership Rights

Characterization of fund shares as liabilities ignores the attributes of ownership typically associated with an equity investment. As described above, shareholders participate in the fund's profits and losses through distributions and changes in the value of fund shares. In addition, as owners, fund shareholders have and exercise rights typical of share ownership. For example, shareholders of U.S. registered funds have the right to elect directors, approve changes in the fund's investment adviser, approve changes to advisory contracts, and approve changes in fundamental investment polices as described in the fund's prospectus.

Cost/Benefit

We see no benefit associated with the Draft Interpretation. Indeed, we are concerned that characterization of fund shares as liabilities could do significant harm by causing shareholders to believe that their investment in a fund is analogous to a deposit and is guaranteed against risk of loss.

We foresee substantial costs associated with the Draft Interpretation. Fund offering documents typically provide that transactions in fund shares are processed at the current net asset value. Fund prospectuses typically include investment policies based on net assets (e.g., the fund will invest a specified portion of its net assets in a particular type of security). Management fee rates are typically based on net assets (e.g., 1.00% of average daily net assets). The draft interpretation would require changes to these provisions, as the net assets of open-end funds would be redefined by this interpretation to equal zero. Certain of these changes may require shareholder approval and would entail costs associated with calling a special meeting of shareholders.

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If you have any questions on our comments or would like to discuss them further, please contact the undersigned at 202/326-5851.

Sincerely,

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

cc: Kevin Stoklosa
Financial Accounting Standards Board

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,710 open-end investment companies ("mutual funds"), 481 closed-end investment companies and 7 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.673trillion, accounting for approximately 95% of total industry assets, and over 88.6 million individual shareholders.

[2] The Draft Interpretation would have no effect on U.S. registered investment companies, which are subject to U.S. generally accepted accounting principles.