Comment Letter on Annual Accounting Support Fee Under Sarbanes-Oxley

December 20, 2002

Mr. Jackson M. Day
Acting Chief Accountant
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: Annual Accounting Support Fee Required Under Section 109 of the Sarbanes-Oxley Act of 2002

Dear Mr. Day:

The Investment Company Institute[1] is writing in regard to the annual accounting support fees authorized by Section 109 of the Sarbanes-Oxley Act of 2002. As you know, Section 109 authorizes the Public Company Accounting Oversight Board (the "PCAOB") and the accounting standard setting body designated pursuant to Section 19(b) of the Securities Act of 1933 (the "Accounting Standard Setter") to assess reasonable fees on issuers to fund their operations. Section 109 requires that accounting support fees be based on each issuer's average monthly equity market capitalization. Section 109 permits the fee rates assessed against issuers to differentiate among classes of issuers in order to ensure the equitable allocation of accounting support fees. The only legislative history regarding this issue specifically supports the notion of a lower fee rate for registered investment companies.[2]

The Institute recommends that investment companies registered under Section 8 of the Investment Company Act be recognized as a separate class of issuers and that they be assessed accounting support fees at lower rates than operating companies. Specifically, we recommend that investment companies be assessed at ten percent of the rate at which operating companies are assessed (based on market capitalization).

Our recommendation is premised on the fact that the PCAOB and the Accounting Standard Setter will likely devote substantially less time and resources to investment company matters than they will to operating company matters, due to (1) the relatively simple and straightforward accounting and auditing processes applicable to investment companies, and (2) the overlay of substantive Investment Company Act regulation of funds, combined with periodic on-site inspections by Commission staff. Because of these differences, audit fees paid by investment companies are substantially lower (as a percentage of market capitalization) than audit fees paid by operating companies. Our recommended rate tracks the relative level of audit fees paid by investment companies versus operating companies.

We expand upon each of these points in the discussion that follows.

Investment Company Accounting and Auditing

Investment company financial statements are inherently simpler than operating company financial statements given the nature of their assets and liabilities, income and expenses, and related accounting policies. Unlike operating companies, the assets of investment companies consist almost entirely of investment securities. Gains and losses on investment securities are determined daily by reference to readily available market prices. Liabilities typically relate to fees payable to service providers for services received, and amounts payable to settle transactions in portfolio securities and fund shares. Investment income consists primarily of dividends and interest on portfolio securities. Dividend income is recognized on the security's ex-dividend date, while interest income is accrued daily. Fund expenses are accrued daily and generally are based on contract fee rates. Fund accounting policies, which are described in the financial statement footnotes, reflect the circumscribed nature of fund assets, income and expenses.[3]

Audits of investment company financial statements are relatively straightforward as compared to audits of operating companies. The principal objectives of an investment company audit reflect the importance of the fund's securities holdings and related income amounts. The principal objectives in auditing fund security holdings and investment income are to provide reasonable assurance that:

- The investment company has ownership of and accounting control over all of its portfolio investments.
- All transactions are authorized and recorded in the accounting records in the proper account, amount, and period.
- Portfolio investments are valued properly, and their costs are recorded properly.
- Income from investments and realized gains and losses from securities transactions are accounted for properly.
- Investments are free of liens, pledges, or other security interests, or if not, that such matters are identified properly and disclosed in the financial statements. [4]

The Commission requires investment company auditors to independently verify all security valuations used by the fund as of the date of the balance sheet and that valuation methods used by the fund are consistent with Commission valuation standards.[5] Further, the accountant's report on the audit of an investment company must state that its portfolio securities have been confirmed or physically examined to substantiate their existence.[6]

Investment Company Act Regulation and Periodic On-Site Commission Inspections

The stringent regulation of investment companies under the Investment Company Act, combined with the Commission's on-site inspection program, reduce significantly the likelihood of accounting irregularities and audit failures.

The Investment Company Act imposes substantive regulation on funds that goes far beyond the disclosure and anti-fraud provisions found in the other major federal securities laws. The Act contains specific prohibitions against certain transactions between a fund and its investment advisers or other affiliated persons. These provisions are designed to regulate strictly the potential for affiliates to profit unfairly from the operations of investment companies.

The Investment Company Act also requires all funds to safeguard their assets by placing them in the hands of a custodian and by providing fidelity bonding of officers and employees of the fund. In addition, funds are required to maintain detailed books and records regarding both the securities owned by the fund and the fund's outstanding shares. The Act also requires daily valuation of all securities held in mutual fund portfolios so that purchase and redemption orders may be processed at the current net asset value.

The Commission's Office of Compliance Inspections and Examinations conducts on-site examinations of investment companies. Among other things, recent OCIE inspections have focused on the role of the fund's board of directors, personal trading, allocation of portfolio securities, the fund's use of brokerage, and valuation procedures for illiquid securities.[7] OCIE staff recently announced a new risk-based approach for selecting investment company registrants for inspection.[8] According to OCIE staff, the twenty largest investment company complexes will be inspected once every two years and no firm will go more than four years without being inspected.

Methodology for Recommended Fee Rate

The Institute's recommendation that the accounting support fees required under Section 109 of the Act be assessed such that the fee paid by an investment company with a specified amount of net assets is equal to ten percent of the accounting support fee paid by an operating company with the same amount of market capitalization is based on a comparison of audit fees paid by investment companies and audit fees paid by operating companies. The amount of the audit fee is, in our view, an appropriate indicator of the complexity and risk associated with an audit. We believe this provides a sound basis for assessing the amount of time and resources the PCAOB and the Accounting Standard Setter will likely devote to these classes of issuers and, accordingly, for establishing a methodology for allocating accounting support fees between these two classes of issuers. A more detailed discussion of the methodology used to develop our recommendation and the data on which it is based is included in the attached appendix.

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We appreciate your consideration of our recommendation. If you have any questions, please contact the undersigned at (202) 326-5815, John Rea at (202) 326-5910, or Greg Smith at (202) 326-5851.

Sincerely,

Craig S. Tyle

General Counsel

cc: The Honorable Harvey L. Pitt
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid

Paul F. Roye,
Director, Division of Investment Management
U.S. Securities and Exchange Commission

Appendix

Our recommendation regarding the assessment of accounting support fees for investment companies under Section 109 of the Sarbanes-Oxley Act is based on a comparison of audit fees paid by investment companies and audit fees paid by public operating companies. First, we examined audit fees paid by 5,089 investment companies relative to their net assets[9] and 1,223 operating companies relative to their market capitalization.[10] Our examination revealed that asset weighted mean audit fees paid by mutual funds ranged from 3.98 basis points for small funds (less than $100 million in net assets) to 0.02 basis points for large funds ($50 billion or more in net assets). Asset weighted mean audit fees paid by operating companies ranged from 29.57 basis points for small operating companies to 0.64 basis points for large operating companies. These data are displayed in the table below.

We then compared audit fees paid by investment companies to those paid by operating companies by calculating the ratio of asset-weighted means for these two classes of issuers. This analysis reveals that audit fees paid by small investment companies are 13.45 percent of those paid by small operating companies. Further, audit fees paid by large investment companies are 2.54 percent of those paid by large operating companies. While the ratio of audit fees paid varies by size of issuer, we believe it would be appropriate to select a mid-point with the range. Accordingly, we recommend that accounting support fees be assessed such that the fee paid by a registered investment company with a specified amount of net assets is equal to ten percent of the accounting support fee paid by an operating company with the same amount of market capitalization. This would be achieved by determining the fee for any investment company according to the formula:

0.1 * Fund Assets * Budget
(0.1 * Assets of All Funds) + Market Capitalization of all Operating Companies

For operating companies the appropriate formula would be:

Market Capitalization of the Operating Company * Budget
(0.1 * Assets of All Funds) + Market Capitalization of all Operating Companies

Endnotes

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,949 open-end investment companies ("mutual funds"), 527 closed-end investment companies, and six sponsors of unit investment trusts. Its mutual fund members have assets of about $6.045 trillion, accounting for approximately 95 percent of total industry assets, and 90.2 million individual shareholders.

[2] Senator Michael B. Enzi stated, "I also believe that the Conferees expect that the Board and the standard setting body will deem investment companies registered under Section 8 of the Investment Company Act of 1940 to be a class of issuers for purposes of establishing the fees pursuant to this section, and that investment companies as a class will pay a fee rate that is consistent with the reduced risk they pose to investors when compared to an individual company. Audits of investment companies are substantially less complex than audits of corporate entities. The failure to treat investment companies as a separate class of issuers would result in investment companies paying a disproportionate level of fees." Congressional Record, vol. 148, no. 103, S7356 (daily ed. July 25, 2002) (statement of Sen. Enzi).

[3] The accounting policies footnote typically would describe: (a) security valuation policies; (b) when security transactions are reflected in the financial statements; (c) that income and expenses are accrued daily; and (d) the fund's intent to comply with distribution and other requirements in the Internal Revenue Code so that no income tax liability need be reflected in the financial statements.

[4] AICPA Audit and Accounting Guide – Audits of Investment Companies, section 2.104.

[5] SEC Codification of Financial Reporting Policies, section 404.03c (Accounting Series Release 118).

[6] SEC Codification of Financial Reporting Policies, section 404.03a (Accounting Series Release 118).

[7] During 2001 OCIE examiners inspected 228 investment company complexes managing approximately $2.6 trillion. See 2001 Annual Report of the U.S. Securities and Exchange Commission at p. 67.

[8] Remarks of Lori A. Richards, Director, OCIE, at the Compliance and Inspection Issues for Investment Advisers and Investment Companies Conference, October 30, 2002.

[9] Mutual fund audit fees and net assets are from Strategic Insight Simfund2/MF database. These 5,089 funds represent all funds in the database for which audit fees are available.

[10] Operating company audit fees are from the 2002 Audit Versus Non-audit Fees Survey, conducted by the Investor Responsibility Research Center. Market Capitalization data for operating companies are from Bloomberg, L.P.