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Ms. Jaime Eichen, Assistant Chief Accountant
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U.S. Securities and Exchange Commission
100 F Street, N.E.
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Re: Response to Request for Information on Application of IFRS to Investment Companies

Dear Jaime:

The Investment Company Institute is pleased to respond to your request for information on the application of International Financial Reporting Standards to SEC registered investment companies. In order to be fully responsive to your request, the Institute has convened a group of fund treasurers who assisted in developing responses to your questions and who are prepared to meet with the staff on June 1. Below find the questions you provided and our responses. First, however, we provide information on cross border offering of fund shares, the status of IFRS in the European fund market, and cost/benefit considerations as you weigh application of IFRS to investment companies.

Cross Border Offering of Fund Shares is Limited

The primary benefit typically associated with a U.S. transition to IFRS is an enhanced ability to compare financial information of U.S. companies with that of non-U.S. companies, as well as to compare financial information among investment alternatives that cross national boundaries. With more comparable information on U.S. and foreign issuers, investors should be able to make better-informed investment decisions. Investor benefits of this kind, however, are very limited in the investment company context due to the impact of certain U.S. laws.

With respect to the cross-border distribution of funds, U.S. securities and tax laws strongly limit or discourage the offer and sale of foreign funds in the U.S. and, in addition, U.S. tax policies, when compared with foreign tax regimes, frequently disadvantage the sale of U.S. investment companies overseas. Specifically, Section 7(d) of the Investment Company Act of 1940 limits the ability of a

foreign fund to register and publicly offer or sell its shares to U.S. persons.¹ Recognizing the challenges posed by Section 7(d), the Commission and the staff have recommended that foreign funds instead form and register a U.S. “mirror” fund, (*i.e.*, a U.S. registered fund that mirrors the investments of a foreign manager’s foreign fund.)² Similarly, U.S. tax rules applied to shareholders of passive foreign investment companies (the “PFIC rules”) discourage U.S. investment in foreign funds.³

Differences in tax policies between the U.S. and other jurisdictions also present disadvantages for U.S. registered investment companies overseas. For example, U.S. investment companies generally must distribute their taxable income and gains every year to avoid tax at the fund level, resulting in taxable income and gains to the fund’s shareholders. In addition to current taxation, foreign shareholders often lose the tax benefits (*i.e.*, lower rates) provided by their home countries for capital gains because the home countries typically treat capital gain distributions paid by a U.S. investment company as dividends subject to ordinary income tax rates. In contrast, many foreign jurisdictions do not require investment companies to distribute their income and gains and may impose little, if any, capital gains tax.⁴ This means shareholders in these foreign funds would not recognize any taxable gains or income until their shares are redeemed, as the earnings are “rolled-up” in the share price of the fund. This important difference creates an obvious disadvantage for U.S. investment companies seeking foreign investors; consequently, foreign investors will seek exposure to U.S. securities markets through foreign funds rather than through a U.S.-based fund.

As a result of these impediments, there is limited cross-border distribution of investment companies both into the U.S. and from the U.S. Therefore, from a U.S. perspective, the benefits associated with a transition to IFRS will not be meaningful for investors in the context of investment companies.

Few European Jurisdictions Apply IFRS to Funds

Even absent these impediments to cross-border distribution, the potential for enhanced comparability is limited because many European jurisdictions do not apply IFRS to open end funds. Instead, in most cases, existing national laws permit or require the use of local GAAPs that apply specifically to funds

¹ Section 7(d) under the Investment Company Act prohibits any company organized outside the U.S. from using the U.S. mails or facilities of interstate commerce in connection with a public offering of its securities, except pursuant to an order from the Securities and Exchange Commission. Such an order must be based on a finding that “it is both legally and practically feasible effectively to enforce the provisions of [the Investment Company Act] against such company.” This standard has proven difficult to meet. *See* Framlington Unit Management Ltd., SEC No-Action Letter (Jan. 10, 1992); Global Mutual Fund Survey, SEC No-Action Letter (July 14, 1992). *See also* *Protecting Investors: A Half Century of Investment Company Regulation*, Division of Investment Management, Securities and Exchange Commission (May 1992) (Protecting Investors) Chapter 4, Internationalization and Investment Companies.

² *See* Applications of Foreign Investment Companies Filed Pursuant to Section 7(d) of the Investment Company Act of 1940, Investment Company Act Release No. 13691 (December 23, 1983); Framlington and Protecting Investors, *supra* note 1.

³ Unlike U.S. registered investment companies, foreign funds tend to roll-up their income and gains and the PFIC rules generally make it uneconomic for U.S. persons to invest in foreign funds that roll-up their income and gains.

⁴ Protecting Investors, at 215-16, *supra* note 1.

and there is no special obligation for funds to prepare financial statements based on IFRS. A recent Ernst & Young publication, *International Financial Reporting Standards European Investment Fund Survey January 2010* (enclosed) explores application of IFRS by investment funds in 44 European countries. The survey illustrates that very few European countries allow or require IFRS to be used for investment funds. For example, the survey indicates that despite the increasing pressure to adopt a single set of accounting standards, there are limited opportunities for investment funds to apply IFRS in European countries. Regulated funds are allowed or required to apply IFRS in 14 of 44 countries surveyed.

The European Fund and Asset Management Association (EFAMA) is the representative association for the European investment management industry. In June 2007, EFAMA issued a discussion paper *International Financial Reporting Standards: application to investment funds*. In this report EFAMA stated that: “EFAMA supports the convergence process but considers that, in general, US standards are more appropriate to open-ended investment funds than existing IFRS. Indeed, the US standards have been tailored to mutual funds and investors’ needs, and are more in line with practices not only in Europe but also in the rest of the world.”

The Irish Funds Industry Association (IFIA) is the representative body for the international investment fund community in Ireland. In April 2011 IFIA submitted a letter to the IASB in connection with an exposure draft issued by the Accounting Standards Board on *The Future of Financial Reporting in the UK and Ireland*. The exposure draft would require all Irish funds to adopt full IFRS, once implemented as a standard. In its letter to the IASB, IFIA indicates: “As an industry with an international investor base, we support the convergence of accounting principles and reporting requirements as a means to improve comparability and efficiency of financial reporting across global capital markets. However, we have concerns over the ability of the IFRS framework as currently constituted, to cope with the specific issues of investment funds. Our principal concern is that the requirements of IFRS include extensive disclosures that don’t take into account the different business processes and accounting features of investment funds. As a consequence, financial statements for investment funds are overly extensive, provide disclosures that are of little relevance and can serve to confuse key users.”

Cost/Benefit

U.S. GAAP as applied to investment companies reflects the unique characteristics of pooled investment vehicles. Funds pool investor assets and purchase investment securities with the objective of earning a return through both income and capital growth. U.S. GAAP as applied to investment companies effectively illustrates the fund’s financial position and results of operations by requiring disclosure of the fund’s portfolio holdings, investment income, the change in value of its holdings, as well as key measures, such as total return, the income ratio, the expense ratio, and portfolio turnover.

In contrast, IFRS does not provide accounting standards or guidance specific to the investment company industry. Accordingly, investment companies would apply the same financial reporting

standards followed by general corporate enterprises and their financial statement presentation would appear very similar to that of corporate entities. As a result, fund financial statements prepared under IFRS would less clearly reflect the nature of the fund's investing activities and thus would be far less meaningful to shareholders than those prepared under U.S. GAAP.

We encourage the Commission staff to articulate the benefits to financial statement users, if any, associated with requiring investment companies to adopt IFRS and to ensure that those benefits exceed the related costs before it proceeds with any mandated transition. In our view, there are significant costs associated with a mandated transition. These costs include: 1) decreased utility of financial statements delivered to fund shareholders; 2) initial conversion costs relating to accounting and financial reporting systems; 3) human capital/training costs; 4) ongoing systems and recordkeeping costs associated with increased volume of book/tax differences; and 5) increased print and mail costs attributable to increased length of shareholder reports.

Below are the questions you provided to the Institute and our responses. Our responses are from the perspective of investment companies as issuers of financial statements.

Background and Other Information

1. *Please provide background on ICI (e.g., membership base, etc.) and investment company industry (e.g., size of industry – AUM and number of funds).*

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. At December 31, 2010, members of ICI managed total assets of \$12.6 trillion and served over 90 million shareholders. The table below summarizes assets and funds managed by ICI member firms by fund type relative to industry totals at December 31, 2010.

	ICI Members		Total Industry	
	Assets (Billions)	Funds	Assets (Billions)	Funds
Mutual Funds	\$11,681	8,586	\$11,817	9,671
Closed-end Funds	\$221	630	\$241	761
ETFs	\$737	766	\$755	879

2. *Please describe the manner in which financial information based on U.S. GAAP is used for regulatory or other purposes, if applicable (e.g., advertising, contractual purposes/terms, etc.)*

Fund accounts are maintained in a manner consistent with GAAP and are used to prepare

financial statements, which are delivered to shareholders and filed with the Commission in order to satisfy shareholder and regulatory reporting requirements.

Fund accounts and related financial information maintained in accordance with GAAP are also used for other purposes including compliance testing, contractual expense accruals, fund share trade processing, performance calculation, advertising, and tax.

- a. Compliance testing – The Investment Company Act limits the extent to which funds can engage in certain activities. In many instances, these limits are based on fund total assets or fund net assets. For example, to be characterized as a “diversified” company under Section 5(b), as to 75% of the fund’s total assets, the fund cannot invest more than 5% of its total assets in securities of any one issuer. Other compliance tests based on fund total assets or fund net assets include, for example, senior security asset coverage (Section 18(f)); acquisitions of issuers in securities-related businesses (rule 12d3-1); investment concentration in securities of issuers in a particular industry (Section 8(b)); and investment in securities indicated by the fund’s name (rule 35d-1).
- b. Contractual expense accruals – Funds contract with different service providers to provide services to the fund. Service providers include, for example, the investment adviser, custodian, transfer agent, and distributor. Often fees for services are contracted for and accrued based on a percentage of the fund’s average daily net assets. Investment advisory contracts often include “expense caps” which obligate the fund’s adviser to waive fees or reimburse fund expenses to the extent the fund’s total expenses exceed specified thresholds.
- c. Fund share trade processing – Mutual funds issue and redeem shares daily at the net asset value per share next calculated after receipt of the shareholder’s purchase or redemption order (rule 22c-1).
- d. Performance calculation – Funds calculate and disclose total return pursuant to an SEC-prescribed formula that considers an initial hypothetical investment in the fund relative to the ending redeemable value over prescribed periods (Form N-1A, Item 26). Total return information must be included in the prospectus and shareholder report.
- e. Advertising – Total return performance information may be included in fund advertisements and sales literature.
- f. Tax – Investment companies may qualify for regulated investment company (or “RIC”) status under Subchapter M of the Internal Revenue Code and take a deduction for distributions paid to shareholders, enabling them to eliminate income tax liability at the fund level. Qualification entails satisfying various tests including, for example, diversification of the fund’s investments measured based on the fair market value of the

fund's total assets.

3. *How do investment company personnel educate themselves about accounting standards both during the standard setting process and after a standard has been issued, particularly with respect to the impact a standard may have on regulatory reporting requirements? How would that process differ if the SEC were to further incorporate IFRS into the domestic financial reporting system, if at all?*

Investment company personnel responsible for fund financial reporting follow developments at the FASB and the SEC. Fund sponsors may comment on proposals affecting investment company financial reporting, either directly or through ICI. The Institute analyzes recently adopted accounting standards affecting investment companies and distributes memoranda to industry personnel describing their effects. The Institute has organized a standing committee of fund treasurers from its member firms. This committee meets quarterly to discuss accounting and financial reporting developments affecting funds. The ICI sponsors an annual conference dedicated to investment company accounting and tax matters. Investment company personnel also rely on audit firm analyses to educate themselves about proposals and standards adopted. Audit firms may also provide training programs on standards, including programs targeted at investment company personnel. We do not anticipate this process would change significantly if the SEC were to further incorporate IFRS into the domestic financial reporting system.

Characteristics of IFRS and Its Standard Setting

4. *Please provide a summary of significant differences between U.S. GAAP and IFRS. Do any of these significant differences create issues when considering Regulation S-X?*

The following summarizes significant difference between GAAP and IFRS and describes how these differences relate to investment company financial reporting under Regulation S-X. We note that certain of the differences described below may be affected by the Boards' convergence projects.

- a. Comparatives – IFRS requires presentation of two years in the balance sheet, income statement, statement of changes in equity, cash flow statement, and notes.
- b. Equity classification – Under IAS 32, open-end single share class funds generally characterize investor ownership as equity (*i.e.*, net assets). Open-end multiple class funds generally characterize investor ownership as liabilities (with total assets in excess of liabilities, other than those relating to shares outstanding, described as “net assets attributable to holders of redeemable shares”). For funds with redeemable shares characterized as liabilities, distributions paid to shareholders are characterized as “finance cost” on the income statement.

- c. Schedule of investments – IFRS does not require funds to provide a schedule of investments.
- d. Income statement presentation – IFRS has no requirement to separately present the amount of realized gain/loss or the change in unrealized appreciation/depreciation.
- e. Withholding taxes – IFRS requires presentation of income on a gross basis. Withholding taxes are presented as a separate component of income tax for the period and as a result, would be included in the fund’s expense ratio.
- f. Statement of changes in net assets – Under IFRS, open-end funds generally have no equity or net assets and accordingly, there is no statement to present. We understand, however, some consider it “best practice” to present a statement of changes in “net assets attributable to holders of redeemable shares.”
- g. Statement of cash flows – IFRS requires a statement of cash flows in all instances. There is no exemption for investment companies similar to that provided in GAAP (ASC 230-10-15-4).
- h. Consolidation – IFRS currently requires consolidation of controlled investees. We understand, however, this may change in the next several years. Later in 2011, the IASB is scheduled to issue a proposal that would provide an exemption from consolidation of controlled investees, similar to that found in ASC 946/rule 6-03(c) of Regulation S-X.
- i. Initial measurement/Transaction costs – IFRS requires initial recognition at fair value, with transaction cost (both commissions and bid-ask spread) recognized as an expense. We note the FASB proposal, *Accounting for Financial Instruments* would also require transaction costs to be characterized as expense (rather than included in a security’s cost basis). As we stated in our comment letter to the FASB on its proposal, we strongly oppose recognition of transaction costs on portfolio trades as expense because it will diminish the utility of the expense ratio. It is unclear, however, whether the FASB will ultimately require transaction costs to be expensed as proposed.

As a practical matter, foreign funds applying IFRS recognize only brokerage commissions as transaction cost expense. We understand that they do not separately recognize transaction costs on fixed-income securities (where securities are traded on bid-asked spread basis) because there is no practical, objective means to measure transaction costs on fixed-income securities. If IFRS is applied to investment companies causing brokerage commissions on equity trades to be reflected as expense – without first developing a methodology to measure and recognize transaction costs on fixed-income transactions – it would artificially cause equity funds to appear more expensive

relative to fixed-income funds.

- j. Financial assets classification – Under GAAP funds measure all securities at fair value with the change in fair value reflected in earnings. There is no specific classification scheme (*e.g.*, held to maturity, available for sale, trading). Under IAS 39, financial assets are classified as: 1) at fair value through profit and loss; 2) held to maturity; 3) loans and receivables; 4) available for sale. We understand investment companies that apply IFRS typically classify their investments as fair value through profit/loss. We understand, however, they may also use the available for sale category (giving rise to “other comprehensive income”).

Under IFRS 9 (effective January 1, 2013), entities will classify financial assets as either amortized cost or fair value through profit and loss on the basis of both i) the entity’s business model for managing the financial assets and ii) the contractual cash flow characteristics of the asset.

- k. Financial liabilities classification – IFRS 9 permits financial liabilities to be measured at amortized cost. Although this treatment is permitted by current GAAP, the FASB *Accounting for Financial Instruments* proposal calls for financial liabilities to be measured at fair value. We expect this difference will be resolved in the final standard.
- l. Fair value measurement – Prior to the May 12, 2011 release of IFRS 13, *Fair Value Measurement*, IFRS required long positions to be valued at the bid price and short positions to be valued at the ask price for financial reporting purposes. The prospectus/offering documents for funds that apply IFRS typically require valuation at last sale for purposes of issuing and redeeming fund shares. This difference in valuation methodology caused funds that applied IFRS to have two NAVs (one for daily issuance/redemption of fund shares and one for financial reporting). The recent issuance of IFRS 13 (effective January 1, 2013) eliminates the requirement to value long positions at the bid price and conforms fair value measurement principles under GAAP and IFRS.
- m. Initial recognition/Settlement – Domestic funds recognize portfolio trades in the daily net asset value per share calculation used to issue/redeem shares no later than T+1 (as permitted by rule 2a-4). Under GAAP, portfolio trades are recognized on T+0 (the difference between 2a-4 and GAAP typically results in a “top-side” adjustment for financial reporting purposes). Under IFRS regular-way purchases and sales of financial instruments can be recognized based on either trade date or settlement date.⁵

⁵ Under IAS 39 a regular-way purchase or sale is the acquisition of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the relevant market. Examples include securities traded on an exchange or over-the-counter market.

- n. Note disclosures – The disclosure requirements under IFRS 7 are extensive relative to those provided under GAAP (*e.g.*, sensitivity analysis to each type of market risk to which the fund is exposed at the reporting date).
- o. Financial Highlights/Earnings Per Share – Domestic funds provide financial highlights under GAAP and are exempted from the requirement to provide EPS (ASC 250-10-15-3). IFRS does not currently require funds to provide financial highlights. IFRS requires funds to provide EPS. Most open-end fund shares are liabilities under IFRS, however, and accordingly they have no earnings per share. The IASB’s consolidation project is expected to define “investment company” in IFRS and will likely require funds to provide financial highlights, including ratios and total return information.
- p. Cost basis of securities sold – GAAP permits cost identification based on either specific identification or average cost. IFRS requires FIFO or average cost. Most funds use specific identification (for book and tax, selling highest cost basis lots first, so as to reduce taxable income and distributions to shareholders). If IFRS is applied to investment companies, we anticipate funds would continue with specific identification for tax purposes (because it reduces taxable distributions and minimizes shareholders’ tax liability). Accordingly, any transition to IFRS would create significant book/tax differences.

In certain instances the differences described above directly conflict with Regulation S-X (*e.g.*, consolidation of controlled investees, characterization of open-end fund shares as liabilities) and would need to be resolved. Resolution of these differences could occur, for example, if IFRS is conformed to GAAP (and Regulation S-X) through the convergence process. Absent such conforming changes, SEC rulemaking would be required to conform Regulation S-X to IFRS.

In other instances IFRS does not currently require disclosures required by GAAP and Regulation S-X (*e.g.*, schedule of investments, financial highlights, and separate presentation of the amount of realized gains and the change in unrealized appreciation/depreciation). We believe, however, that the Commission’s rules (*e.g.*, Regulation S-X, Form N-1A) would cause registered funds to continue to provide these disclosures.

Other items (*e.g.*, statement of cash flows, IFRS 7 sensitivity disclosures, comparatives) would be additive. We believe these additive items would increase fund financial reporting and print/mail costs (reducing shareholder returns) without any commensurate benefit.

Finally, other items would unnecessarily increase cost and complexity, and reduce shareholder understanding of the fund’s results and financial position (*e.g.*, differences in

book gain/loss vs. tax gain/loss due to change in cost basis identification, characterization of portfolio transaction costs as expense).

5. *How would the convergence projects identified in the memorandum of understanding between the FASB and IASB impact investment company financial reporting?*

- a. Financial Instruments – The FASB proposal may require: 1) funds to recognize transaction costs on portfolio trades as a fund expense, increasing expenses and the expense ratio, decreasing net investment income, and increasing gain (or decreasing loss); 2) funds to fair value their own debt, with the change in value reflected in earnings; 3) money market funds to report holdings at fair value (rather than at amortized cost).

The IASB is addressing financial instruments (IFRS 9) in three separate phases: 1) classification and measurement; 2) impairment methodology; and 3) hedge accounting. Classification and measurement of financial assets was completed in November, 2009 and liabilities in October, 2010. The classification and measurement principles in IFRS 9 require financial assets to be recognized at either amortized cost or fair value through net income on the basis of both i) the business model for managing the financial assets, and ii) the contractual cash flow characteristics of the financial asset.

- b. Consolidation – The IASB is expected to provide an exemption from consolidation of controlled investees, similar to that found in GAAP/rule 6-03(c) of Regulation S-X. Instead, controlled investees would be recognized at fair value. The IASB is expected to issue a proposal on investment company consolidation in 2011. The proposal is expected to define the term “investment company” in IFRS.
- c. Fair Value Measurement – With the recent release of ASU No. 2011-4, *Fair Value Measurement* and IFRS No. 13, *Fair Value Measurement*, the boards have converged their fair value measurement principles, eliminating the IFRS requirement to value at bid. ASU No. 2011-4 is effective for periods beginning after December 15, 2011. IFRS No. 13 is effective January 1, 2013, with earlier application permitted.
- d. Financial Statement Presentation – This project entails a reordering of financial statements intended to better enable users to understand performance by separating each of the balance sheet, income statement, and statement of cash flows between core operations and other activities (*e.g.*, business; financing; income tax; and discontinued operations). “Business” would be further broken into: operating; finance; and investing. ICI has separately met with the FASB to express concern that the proposal would unnecessarily complicate investment company financial statements. Further, the contemplated format seemingly conflicts with the S-X prescribed format for investment companies, and would seemingly require SEC rules changes. Further

deliberations on this project likely will not take place until later in 2011 or 2012.

- e. Financial Instruments with Characteristics of Equity – This project is intended to provide guidance on distinguishing equity and liabilities. We understand the project will address the characterization of open-end fund shares redeemable on demand. We believe strongly that open-end fund shares are best characterized as equity, consistent with existing GAAP. We are concerned that the hybrid/option model being considered (where open-end fund shares have both: 1) an equity component; and 2) a written put option component), would also be problematic if any value is attributed to written put. This would cause immediate diminution in value of fund net assets upon adoption, and dilution of NAV each time new shares are issued. Further deliberations on this project likely will not take place until later in 2011 or 2012.
 - f. Other projects included in the FASB/IASB memorandum of understanding are not expected to significantly affect investment company financial reporting.
6. *What would be the impact on regulatory reporting if the Commission were to mandate application of IFRS in financial statements filed with the Commission?*

Application of IFRS to investment companies may cause certain financial statement balances to change. For example, differences between GAAP and IFRS relating to consolidation (prohibition on consolidation of controlled investees vs. required consolidation of controlled investees); characterization of open-end fund shares (equity vs. liability); and accounting for transaction costs (as a component of cost basis vs. expense) may cause total assets, total liabilities, net assets, expenses, net investment income, reported gain/loss, financial highlights ratios, and other financial statement balances to change. We believe these changes create the potential for significant shareholder confusion.

As described above, fund accounts and related financial information maintained in accordance with GAAP are used for other purposes (compliance testing, contractual expense accruals, fund share trade processing, *etc.*). Any mandated application of IFRS would also affect these processes and may require the Commission to address issues or uncertainties that result. For example, fund contracts with service providers typically provide for the fund to compensate the service provider based on a percentage of average daily net assets. Because funds have no equity or net assets under IFRS, it is uncertain whether funds would be able to compensate their service providers under their existing contracts. Section 15(a) of the Investment Company Act requires any changes to investment advisory contracts to be approved by shareholders. If all funds were required to hold shareholder meetings to obtain shareholder approval to modify their investment advisory contracts, we anticipate funds (and their shareholders) would collectively incur millions of dollars in costs.

Changes to financial statement balances and related information associated with a conversion

to IFRS would affect other disclosure documents. For example, fee table and expense example information presented in the prospectus is based on expenses presented in the income statement. Conversion would also affect financial balances presented in Form N-SAR.

7. *What would be the impact on regulatory reporting if the Commission were to permit investment companies to elect to apply either US GAAP or IFRS in financial statements filed with the Commission?*

Any investment company electing to apply IFRS would encounter the issues described above in No. 6. If certain funds elected to apply IFRS, it would create comparability issues for financial statement users. If given a choice, virtually all U.S. funds would continue to apply GAAP and therefore any comparability concerns would be inconsequential.

Transition Considerations

8. *Would acceptance of financial information prepared in accordance with IFRS, rather than U.S. GAAP, require any changes in laws and/or rules and regulations?*

Yes, we believe conversion to IFRS would require certain rules and regulations to be changed. Where IFRS and Regulation S-X conflict, a fund could not concurrently comply with both.

- a. Rule 6-03 of Regulation S-X precludes an investment company from consolidating any investee that is not an investment company. In contrast, IFRS currently requires investment companies to consolidate controlled investees.
- b. Under IFRS open-end fund shares generally are characterized as liabilities. Classification of fund shares as liabilities causes open-end funds to have no equity or net assets. Rule 6-04 of regulation S-X characterizes fund shares as equity and requires funds to disclose the components of net assets (*e.g.*, paid in capital, undistributed net investment income, accumulated net realized losses, unrealized appreciation/depreciation, *etc.*).
- c. Characterization of fund shares as liabilities also would affect presentation of distributions paid in the financial statements. IFRS requires dividend and capital gain distributions paid to fund shareholders to be reflected as “financing costs” in the income statement (as though distribution of income and gains are similar in nature to interest expense on borrowings). Rule 6-09 of regulation S-X requires distributions paid to be presented in the statement of changes in net assets.
- d. If fund shares are characterized as liabilities, would funds present a statement of changes in net assets, as required by rule 6-09 or Regulation S-X?

- e. Finally, we note that characterization of open-end fund shares as liabilities gives rise to numerous related concerns. For example, many investment policies and fee calculations are based on “net assets.” It is unclear how these policies and fee calculations would be applied if the fund were deemed to have no equity. Further, if fund shares were characterized as equity, would funds still be required to disclose the components of net assets? Would funds continue to perform ROC-SOP adjustments to adjust the fund’s capital accounts for permanent book-tax differences? How would the Commission monitor compliance with rule 19a-1 (describing the character of distributions paid)? The effect on other Investment Company Act rules that incorporate *net assets* (e.g., rule 35d-1) or *net asset value per share* (e.g., rule 22c-1) should also be carefully considered.
9. *Would the incorporation of IFRS by investment companies impact any other investment company specific regulation (e.g. Tax and Subchapter M of the IRC)?*

Investment companies typically maintain their books and records in a manner generally consistent with GAAP. These GAAP basis books are adjusted for “book-tax differences” to develop tax basis information that is used to calculate taxable income and to comply with Subchapter M of the IRC. These book-tax differences are well known to industry practitioners, and funds and their service providers have built systems to convert book basis information to tax basis information for tax compliance purposes.

Incorporation of IFRS by investment companies would not affect funds’ tax basis income or gains, or cause funds to change the amounts of distributions paid. Funds will continue to calculate taxable income in accordance with tax law. Incorporation of IFRS would, however, give rise to additional book-tax differences (e.g., cost basis identification, characterization of transaction costs as expense) that would significantly increase the cost and complexity of adjusting the fund’s books to determine tax basis income and gains. Systems currently in place that are used to convert GAAP-basis information to tax-basis information would need to be reviewed and modified as part of any transition to IFRS.

10. *Would the mechanism for incorporation of IFRS into the U.S. financial reporting system for issuers impact the investment company industry? For example, would the impact differ between an “adoption” of IFRS versus an “incorporation” of IFRS with the retention of our domestic standard setter?*

We interpret “adoption” in this context to mean application of IFRS in its entirety to financial reporting at a specified date (*i.e.*, conversion from GAAP to IFRS). We interpret “incorporation” to mean that existing GAAP would be retained and specific IFRS would be endorsed by the FASB and incorporated into GAAP over time (ideally after standards are converged).

We strongly endorse the latter approach. GAAP provides an industry-specific reporting model

for investment companies (ASC 946) that largely conforms with Regulation S-X. In contrast, IFRS contains no industry-specific reporting model. We believe investment company financial statements prepared under GAAP are more informative to shareholders than those prepared under IFRS. Further, there exists a significant amount of interpretive guidance under GAAP as applied to investment companies (*i.e.*, the AICPA Investment Company Audit Guide) that benefits preparers and promotes comparability.

We believe the “incorporation” approach would enable the industry-specific reporting model currently employed by investment companies as described in ASC 946 to be retained, and modified as necessary as particular IFRS are incorporated into the U.S. financial reporting system.

11. *Please provide information about the nature of IT systems changes that would be expected to be required should the SEC accept or mandate financial statements prepared in accordance with IFRS.*

As described above, there are significant differences between GAAP as applied to investment companies and IFRS. Accordingly, we believe accounting and financial reporting systems would need to undergo significant change if the SEC were to mandate application of IFRS. We are not aware of any formal or informal analysis that examines the necessary systems changes, the related costs, or the timeframes necessary to make the changes.

We note that investment companies try to conform book and tax accounting policies to the extent practicable. Certain of the changes mandated by a conversion to IFRS would create additional book-tax differences that may require funds to maintain separate book and tax records. For example, funds currently include transaction costs on portfolio purchases in the cost of the security, and deduct transaction costs on portfolio sales from proceeds when calculating gain/loss for both book and tax purposes. IFRS would require transaction costs on portfolio trades to be characterized as expense, creating a book-tax difference. A typical fund may have hundreds or thousands of securities, and each security may have been purchased in multiple lots. One fund sponsor estimated that the maintenance and reconciliation of separate book and tax records for each security lot would cost approximately \$7 - \$10 million dollars up front and \$1.5 million each year thereafter. These costs would provide no added benefit to users of financial statements because the changes would result solely in reclassification between captions in the fund’s income statement and would have no effect on the fund’s reported total return.

Requiring transaction costs on portfolio trades to be expensed for financial accounting purposes would also affect funds’ compliance with Section 19(a) of the Investment Company Act. Section 19(a) and rule 19a-1 prohibit funds from paying a dividend from any source other than “accumulated undistributed net income determined in accordance with good accounting practice” unless such payment is accompanied by a written statement disclosing the source(s) of

the payment. Currently, many fund's net income for tax purposes and net income for financial accounting purposes are the same. Requiring funds to expense transaction costs for financial accounting purposes would cause taxable income (on which distributions are based) to exceed financial accounting income. This would require funds to send rule 19a-1 notices to every shareholder with every distribution – a change that would be costly to funds and confusing to shareholders.

12. Please provide any quantifiable information available to you about the expected costs to convert. If possible, please separate costs of conversion to IFRS from other costs (such as other costs related to adopting standards issued by the FASB pursuant to convergence projects).

See response No. 11.

13. How much time would the industry need in order to develop sufficient understanding of IFRS and the impact it will have on investment companies?

See response No. 11.

14. How much time would it take for the industry to fully incorporate IFRS into accounting systems and operations?

See response No. 11.

We appreciate the opportunity to respond to your questions and would be happy to provide any additional information you may require. The Institute and its members look forward to our meeting on June 1 with you and your colleagues. Please do not hesitate to call me if I can be of assistance.

Sincerely,

/s/

Gregory M. Smith
Director – Fund Accounting

cc: Eileen Rominger, Director
Division of Investment Management

Barry D. Miller, Associate Director
Office of Legal and Disclosure
Division of Investment Management