INVESTMENT COMPANY INSTITUTE

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May 15, 2013

Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Financial Instruments Overall (Subtopic 825-10) – *Recognition and Measurement of Financial Assets and Liabilities*
File Reference No. 2013-220

Dear Ms. Cosper:

The Investment Company Institute[1] appreciates the opportunity to comment on the proposed Accounting Standards Update, *Recognition and Measurement of Financial Assets and Liabilities.* We strongly support the existing recognition and measurement model for financial instruments applied to investment companies and the proposed scope exception for funds. We also support the Board's efforts to develop a financial reporting model for financial instruments that provides investors with more useful, transparent, and relevant information about an operating company's exposure to financial instruments.

We are concerned, however, that the proposal would eliminate the *available-for-sale* classification for an operating company's investments in investment companies and cause these investments to be classified as *fair value – net income* in all instances. We recommend that the ASU include an irrevocable election to classify investments in equity securities as *fair value – other comprehensive income* similar to that provided in IFRS 9 – *Financial Instruments.* If the Board is unwilling to provide an irrevocable election, we recommend that it permit equity investments in investment companies that invest substantially all of their assets in financial instruments that give rise to contractual cash flows that are solely payments of principal and interest ("SPPI") to be eligible for classification as *fair value – other comprehensive income.* We elaborate on our recommendations below.

[1] 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. Members of ICI manage total assets of $14.96 trillion and serve more than 90 million shareholders.

Question 2: Do you agree with the industry-specific specialized guidance scope exceptions in paragraph 825-10-15-9? If not, why? What would you propose instead?

We strongly support the industry-specific specialized guidance scope exceptions for investment companies described in paragraph 825-10-15-9-b. In particular, we support retention of guidance in Topic 946 that requires investment companies to a) initially measure their assets and trading liabilities at the transaction price (including commissions paid), b) subsequently measure their assets and trading liabilities at fair value, c) report separately realized and unrealized gain/loss on investment transactions, and d) include the net gain/loss on investment transactions in earnings (net increase/decrease in net assets from operations). We believe this presentation best reflects the fund's investment operations, and is consistent with Regulation S-X reporting requirements applicable to SEC registered investment companies.

Question 3: The proposed amendments would require an entity to classify financial assets into the appropriate subsequent measurement category (that is, at amortized cost, at fair value with qualifying changes in fair value recognized in other comprehensive income, or at fair value with all changes in fair value recognized in net income) on the basis of the contractual cash flow characteristics of the instrument and the business model within which financial assets are managed. Does the classification of financial assets based on the cash flow characteristics and the business model assessment provide decision-useful information? If yes, how will this classification influence your analysis of the entity? If not, why?

Irrevocable Election to Present Changes in Fair Value of Equity Instruments in OCI

The proposal would eliminate the *available-for-sale* classification for equity investments in investment companies and cause these investments to be classified as *fair value – net income* in all instances. This change would cause the unrealized change in value of an equity investment in an investment company to be reflected in net income and earnings per share, rather than other comprehensive income.

We recommend the Board provide an irrevocable election to present subsequent changes in the fair value of an equity instrument (such as common shares issued by an investment company) in *other comprehensive income*. The irrevocable election would be made at initial acquisition of the equity instrument. Equity instruments held at the time the ASU is effective should also be eligible for the irrevocable election. Entities that make this election should recognize dividends from the equity instrument in net income.

Our recommendation is based on the notion that an entity that invests in a portfolio of fixed-income securities that generate payments of principal and interest through an investment company should be able to report changes in fair value in *other comprehensive income*. While the conceptual basis for other comprehensive income is not well defined, it is intended to present, at minimum, financial performance information useful to investors without also overstating or understating core operating performance information.

The entity's decision to invest in the investment company may be for the purpose of generating interest income or managing liquidity rather than trading or realization of changes in fair value. In such instances, we believe presentation of the change in fair value would best be reflected in *other comprehensive income* so as to not distort or misrepresent the entity's core operating performance by including unrealized changes in fair value in net income.

We note that our recommendation is consistent with IFRS 9 – *Financial Instruments,* which provides an irrevocable election to present subsequent changes in the fair value of an equity instrument in *other comprehensive income*. The Institute supports convergence of GAAP and IFRS and believes that more closely aligned accounting standards should contribute to effective and efficient operation of global capital markets.[2]

If the Board is concerned that in irrevocable election for all equity instruments is overly broad, it could limit the availability of the election to those instances in which the equity investment is held in a business model with the objective of holding the investment to collect dividend income attributable to an underlying portfolio of interest paying securities and to sell the equity investment for liquidity management and not solely for the purpose of realizing appreciation in the fair value of the investment.

<u>Look through to Fund's Investments to Determine SPPI</u>

If the Board is unwilling to provide for an irrevocable election, then we recommend the Board enable investments in an investment company that invests substantially all of its assets in financial instruments that give rise to contractual cash flows that are SPPI to be eligible for the *fair value – other comprehensive income* classification. The investor in the fund would look through to the fund's assets to determine whether the *fair value – other comprehensive income* classification is appropriate.[3]

If substantially all of the fund's investments give rise to contractual cash flows that are SPPI, then the investor would apply the business model assessment described in the proposal to determine whether the investment in the fund is eligible for classification as *fair value – other comprehensive income*. The investor in the fund would have to redeem or sell its equity investment in the fund to convert its investment to cash. The investor in the fund could sell shares, for example, to manage liquidity needs, as described at 825-10-55-37 in the proposal. We believe such sales would be consistent

[2] The Institute notes that IFRS contains no industry-specific accounting standards for investment companies like that contained in GAAP (*i.e.*, ASC Topic 946). For this and other reasons, we believe there would be no benefit associated with application of IFRS to U.S. investment companies.

[3] SEC registered investment companies disclose each of their individual holdings four times per year in SEC forms N-CSR and N-Q.

with the *hold and sell* business model and should qualify the investment in the fund for the *fair value – other comprehensive income* classification. Because the investor must sell or redeem its investment in the fund to convert its equity investment to cash, the investment in the fund would not fall within the *hold to collect* business model and measurement of the investment at amortized cost would be precluded.

We believe enabling investments in investment companies to qualify for the *fair value – other comprehensive income* classification is consistent with the treatment afforded to beneficial interests in securitized financial assets at 825-10-55-26 in the proposal. We believe our recommendation to look through to the investment company's investments places substance over form. That is, the investor in the fund has a pro-rata ownership interest in a portfolio of securities that give rise to contractual cash flows that are SPPI. The form of that interest should not disqualify the investor from classifying the investment as *fair value – other comprehensive income.* We believe our recommendation is consistent with the proposal in that it emphasizes the cash flow characteristics of the investment and the business model in which it is held, and deemphasizes the legal form of the investment. Finally, we note that the proposal may cause investors in funds to convert to direct holding of fixed-income securities (so as to qualify for *fair value – other comprehensive income).* This would deprive investors of professional management, diversification, administrative convenience and other benefits associated with investing in investment companies.

If you have any questions on our comments or require additional information, please contact the undersigned at 202/326-5851 or smith@ici.org.

Sincerely,

Gregory M. Smith

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cc: Jaime Eichen, Chief Accountant
Division of Investment Management
U.S. Securities and Exchange Commission