



Stable Value Investment Association

December 8, 2004

Mr. Lawrence W. Smith
Director of Technical Application and Impleme
Financial Accounting Standards Board
401 Merritt 7
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Letter of Comment No: 1
File Reference: AICPA ICG

Dear Mr. Smith:

We understand that the AICPA Investment Companies Expert Panel and Accounting Standards Executive Committee recently provided an issues paper to you, requesting that the FASB provide direction on generally accepted accounting principles for valuing fully benefit-responsive investment contracts held by non-registered investment companies. We provide this letter for your consideration in connection with your deliberations on that issue.

About Stable Value Investment Association

The Stable Value Investment Association (SVIA) is a non-profit organization dedicated to educating retirement plan sponsors and investors about the importance of saving for retirement and the contribution stable value investments can make toward achieving retirement security. As the voice for the stable value investment community, SVIA takes a leadership role on legislative and regulatory issues affecting stable value and retirement security. Our membership is comprised of organizations representing all segments of the stable value investment community, including public and private plan sponsors, insurance companies, banks, investment managers, and consultants. As of year-end 2003, the 110,000 plans managed by SVIA members invested over \$355 billion, representing 33 percent of assets of plans offering stable value, of which approximately 30,000 plans have invested \$108 billion in stable value through non-registered investment funds.

Issue

At issue is whether stable value non-registered investment funds serving defined contribution employee benefit plans should report fully benefit-responsive investment contracts at contract value.

Background

Since the late 1970s, millions of retirement investors have chosen to invest in stable value investments through defined contribution employee benefit plans. Stable value investments have been a key element in providing retirement security for investors because they are designed to provide safety of principal and relatively high income. In a time when employees are

increasingly being asked to take on greater responsibility for investment decision-making, stable value investments are an important tool for workers and their employers.

Stable value investment contracts are issued by financial institutions such as banks and insurance companies, with the two most common being: (1) traditional guaranteed investment contracts (GICs), which are issued by life insurance companies, generally paying a fixed rate of income for a specified number of years, and (2) benefit-responsive wrap contracts issued by banks and insurance companies, that are combined with other assets, normally intermediate duration bond portfolios, which have a contract value guarantee and interest rate established by a contractual formula. Stable value investment contracts used either directly or indirectly (through stable value funds) in defined contribution plans are benefit responsive, meaning that they allow the plan's participants to withdraw their investment at contract value – principal investment plus accrued income – at any time under the terms of the retirement plan. All such withdrawals are required to be at contract value.

Like most investment asset classes, stable value is delivered to defined contribution plans in a variety of vehicles. The largest plans (typically \$100 million and up in stable value assets) have individual account funds that are managed in a separate trust account or insurance company individually managed separate account(s) for the benefit of a single plan. Many medium sized and smaller plans, however, gain the benefits of stable value by investing in funds established by banks or trust companies. The smaller asset sizes of these plans make individual account investing economically out of reach and administratively impractical. Therefore, the assets of these plans are combined in a “commingled” stable value fund. Were it not for the economies of scale in execution and administration afforded by this approach, small and medium sized plans would almost certainly find stable value investing to be un-economical.

Current Literature

We believe the financial reporting literature most directly relevant to this issue is as follows:

Audits of Investment Companies

Current valuation and reporting guidance under the AICPA investment companies audit guide is taken primarily from SEC reporting requirements for investment companies registered under the Investment Company Act of 1940. Paragraph 1.06 of the investment companies audit guide states: “Investment Companies discussed in this Guide are required to report their investment assets at fair value . . .” Paragraph 1.32 states: “Values and changes in values of investments held by investment companies are as important to investors as the investment income earned. Investment companies, therefore, report investments at fair value. The fair value of an investment is the amount at which the investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.¹ The best evidence of fair value is the quoted market price in an active market. In the absence of a quoted market price,

¹ This definition of fair value is described in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, and FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Paragraph 4 of the June 23, 2004 Exposure Draft for Proposed Statement of Financial Accounting Standards on Fair Value Measurements, would change the definition of fair value to “Fair value is the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties.”

amounts representing estimates of fair values using methods applied consistently and determined in good faith by the board of directors should be used.” Paragraph 2.35 defines “current transaction” as the “realization in an orderly disposition over a reasonable period.”

Audits of Employee Benefit Plans

The employee benefit plans audit guide, as amended by SOP 94-4, states (Paragraph 3.09): “The primary objective of a defined contribution plan’s financial statements is to provide information that is useful in assessing the plan’s present and future ability to pay benefits.” Paragraph 3.17 states: “Plan assets of defined-contribution pension plans should be measured and reported at values that are meaningful to financial statement users, including plan participants. The contract value of a fully benefit-responsive investment contract held by a plan is the amount a participant would receive if he or she were to initiate transactions under the terms of the ongoing plan. Defined-contribution pension plans should report fully benefit-responsive investment contracts at contract value, which may or may not be equal to fair value.”

Paragraph 3.18 of the employee benefit plans audit guide defines fully benefit-responsive contracts. It states: “Benefit responsiveness is the extent to which a contract’s terms permit and require withdrawals at contract value for benefit payments, loans, or transfers to other investment options offered to the participant by the plan.” “Investment contracts must transfer the risk of principal and accrued interest to a financially responsible third party (that is, they provide for all participant-initiated transactions permitted by an ongoing plan at contract value with no conditions, limits, or restrictions) to be considered fully benefit-responsive. The plan itself must also allow plan participants reasonable access to their funds.”

Paragraph 3.19 of the employee benefit plans audit guide states “If a plan invests in pooled funds that hold investment contracts, each contract in the pooled fund should be evaluated individually for benefit responsiveness. However, if the pooled fund places any restrictions on access to funds for the payment of benefits, the underlying investment contracts would not be considered fully benefit-responsive.”

FASB Statement Nos. 133 and 149

Some investment contracts in stable value funds may be considered derivatives under FASB Statement No. 133. Derivatives are required to be reported at fair value under this statement. FASB Statement No. 149, however, recognizes the importance of reporting information in a manner that is relevant to the financial statement users, and excluded defined contribution plans from its scope, such that the plans are not required to apply the fair value reporting requirements as long as the investment contract and the plan met the requirements outlined in SOP 94-4. Paragraph 10 (h) of the amended FASB Statement No. 133 states: “. . . a contract that is accounted for under either paragraph 4 or paragraph 5 of AICPA Statement of Position 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*, is not subject to this Statement.”

Regulations

Most federal and state chartered banks follow the rules promulgated by the Office of the Comptroller of the Currency (OCC). Code of Federal Regulations, Title 12, Chapter 1, Part 9 “Fiduciary Activities of National Banks Regulations,” Section 9.18 “Collective investment

funds" (CFR 12 [9]) provides direction for collective investment funds. CFR 12 sections 9.18(b)(1)(vi) and 9.18(b)(4)(ii)(A) state that each fund asset should be valued at market value in the financial statements and in computation of the net asset value to use for investor transactions. However, the OCC recognized that there are issues with this methodology as it applies to stable value funds holding investment contracts. Office of Comptroller of the Currency Trust Interpretation No. 716 provides an exemption to these valuation rules. It provides that stable value funds should value benefit-responsive investment contracts at contract value, where: the underlying plan investors are compliant with the rules in SOP 94-4; the investment contracts meet the benefit-responsive criteria in SOP 94-4; and the valuation method is consistent with SOP 94-4, the national banks' fiduciary duty under common laws, ERISA, and in all other aspects CFR 12 [9]. It states that the OCC recognizes that fair value is not equal to contract value for these investment contracts, but that it allows this exception because these benefit plans must disclose contract value to their employee plan participants.

Current Practice

Non-registered investment funds invested in fully benefit-responsive investment contracts, whose units are held by defined contribution employee benefit plans, have long presented these contracts at contract value.

Recommendation

Fully benefit-responsive investment contracts held by non-registered investment funds, substantially all of whose units are held by defined contribution employee benefit plans, should continue to present these contracts at contract value.² The underlying rationale for this conclusion is described below.

- *Differences between Commingled Funds and Registered Investment Companies.* Important distinctions exist between commingled investment funds and investment companies registered under the 1940 Act.
 - Commingled funds are established pursuant to OCC rule to allow national banks and trust companies to invest fiduciary assets of their smaller qualified retirement plans for administrative convenience, diversification and scale. These funds are exempt from registration as securities under the 1933 Securities Act and as investment companies under the 1940 Act.
 - Whereas registered investment companies legally and beneficially own the underlying investments, this is not the case with commingled funds. Commingled fund assets are beneficially owned by the employee benefit plans participating in the fund. The commingled fund is established for administrative convenience of the bank to provide a pass-through vehicle to the employee benefit plans, which have an undivided beneficial interest in those assets.

² Such valuation should be based on the conditions described in SOP 94-4. For example, occurrence of an event that may affect the value of the contract, such as a decline in the creditworthiness of the contract issuer or third-party guarantor, may call for reporting of the contract at less than contract value.

- Unlike a registered investment company, which represents the primary reporting entity, commingled funds are a pass-through vehicle with the employee benefit plan as the primary reporting entity.

These distinctions are further evidenced by requirements of commingled funds related to tax compliance. Funds are established under a trust which must itself be adopted as a part of each retirement plan, the trust must limit participation to only qualifying retirement plans, and it must prohibit the assets from being used for any purposes other than for the exclusive benefit of the plan's participants. Further, each plan must declare the group trust to be a part of the qualified plan.

These distinctions are consistent with ERISA rules for employee benefit plan reporting, which recognize these important distinctions in determining what constitutes a plan's assets. The rules distinguish investments in registered investment companies from other pooled investment funds. In the case of a plan's investment in a registered investment company, the plan's assets are the units issued by the fund, and none of fund's assets are considered to be the plan's assets. In the case of a plan's investment in a commingled fund, however, the plan's assets are an undivided portion of each of the fund's assets, which are owned by the plan.

- *Best Serves Financial Statement Users.* It has long been recognized that the most relevant and useful information for users of defined contribution plan financial statements – namely, plan participants, plan sponsors, and the Department of Labor – relates to the ability of the plan to pay benefits when due. The users of financial statements of the subject investment funds, by definition, are defined contribution employee benefit plans. And the only amount relevant to such ability (subject to matters relating to the creditworthiness of the related financial institution(s)) is contract value. Contract value is the amount the plan, and the plan participants, will receive when benefits are paid.
- *Legally Contracted Amount of Benefits.* The reason contract value is the amount the plan, and in turn plan participants, will receive is because that is what is legally contracted to be paid. The investment contract is a legally binding agreement setting the amount at which the employee benefit plans may deposit or withdraw funds. The investment contract, the terms of the plan, the declaration of trust, and the investment management agreement all specify that plan participants will purchase and redeem units of the stable value fund at contract value. Accordingly, no other amount is as relevant to valuation as contract value.
- *Consistency with Other Reporting Standards.* It is recognized that the FASB is moving financial reporting in the direction of fair value in a number of areas. Similarly, valuing fully benefit-responsive investment contracts at fair value would promote consistency with the carrying value of investment companies. There are, however, issues of consistency with other elements of financial reporting that are also relevant, and we believe more compelling:
 - Carrying these contracts at contract value promotes consistency with financial reporting for defined contribution employee benefit plans – which, as noted, are the entities investing in the subject investment funds.

- Carrying the contracts at fair value would result in inconsistent reporting by defined contribution employee benefit plans. This is because plans holding investments both in stable value commingled funds and in individual stable value investments – a common practice – would be required to use different reporting for these investments with identical substance.
- *Retaining a Valued Investment Option.* Requiring fair value reporting would effectively remove these investment contracts as a viable investment option by small and medium size companies' employee benefit plans, to the detriment of their plan participants. These plans can access this type of investment in a cost effective manner only through stable value commingled funds. Because commingled funds' units must by OCC regulation be traded at net asset value, requiring the investment contracts to be carried at fair value would remove the ability to trade at the legally contracted amount. As a result, these funds could no longer exist, causing the benefit plans and their participants to no longer gain the benefits of desired yield, low expense, and virtually no volatility.

It is recognized that the FASB looks to financial reporting to reflect economic realities, and not to shape standards to drive or prevent a particular economic outcome. Here, however, the advantages of continuing contract value reporting outweigh the disadvantages, both in conceptual financial reporting terms and real life economics. And, there is little doubt that a change to fair value reporting indeed would change the investment landscape. We have seen this occur when the SEC staff recently advised registered funds to switch from contract value to fair value. Those funds already have eliminated, or are in process of eliminating, benefit-responsive investment contracts from their portfolios.

Stable value investment funds serving the defined contribution employee benefit plan community have long carried fully benefit-responsive investment contracts at contract value for good reason. We recommend that the FASB make explicit that such valuation is appropriate.

We appreciate your deliberative process, and would be pleased to provide further information on this important issue. We would welcome the opportunity to meet with you to answer any questions and address these issues and our position in more detail. We will contact you to determine whether we might have that opportunity.

Sincerely,



Gina Mitchell
President
Stable Value Investment Association

Cc: Mr. Steven Belcher, FASB
Mr. Brian Gallagher, AICPA