



INVESTMENT COMPANY INSTITUTE

Letter of Comment No: 106
File Reference: 1082-300
Date Received: 12/01/03

December 1, 2003

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

Re: *Consolidation of Variable Interest Entities*
Modification of FASB Interpretation No. 46
File Reference No. 1082-300

Dear Sir or Madam:

The Investment Company Institute¹ appreciates the opportunity to express its views on the proposed modification to FASB Interpretation No. 46 ("FIN 46"). The proposal clarifies the circumstances in which a "primary beneficiary" is required to consolidate the assets, liabilities, and results of a "variable interest entity" into its financial statements. While we support the intent of the proposal, we are concerned that the scope exception for "mutual funds organized as trusts" is too narrow. We recommend that the scope exception in proposed paragraph 4.h. be revised to include all SEC registered investment companies. The basis for our recommendation is set forth below.

Proposal

FIN 46 requires companies involved with variable interest entities (often referred to as special purpose entities) to consolidate those entities, if the company bears the majority of the economic risks and/or rewards related to those entities.² Variable interest entities generally exhibit one or both of the following characteristics:

1. The equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support (i.e., the equity investment at risk is not greater than the total expected losses of the entity); or

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,672 open-end investment companies ("mutual funds"), 603 closed-end investment companies, 107 exchange-traded funds and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about \$6.946 trillion, accounting for approximately 95% of total industry assets, and 90.2 million individual shareholders.

² Paragraph 4.e. of Interpretation No. 46 indicates that SEC registered investment companies are not required to consolidate the companies in which they invest.

2. The equity investors lack the essential characteristics of a controlling financial interest, including: a) the ability to make decisions about the entity's activities through voting rights; b) the obligation to absorb expected losses of the entity; or c) the right to receive the expected residual returns.

Investments or other interests that will absorb portions of a variable interest entity's expected losses or receive portions of the entity's expected residual returns are called variable interests. A company must consolidate a variable interest entity if it has a variable interest that will absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both. The Interpretation sets forth a framework whereby a company may have a controlling financial interest (requiring consolidation) as opposed to a controlling voting interest.

Paragraph 4 of the Interpretation excludes certain specified entities from the scope of the standard. Specifically, proposed paragraph 4.h. states:

Mutual funds in the form of trusts and trusts of a bank's trust department and similar arrangements that are organized and operated in a manner consistent with customary existing practices are not subject to consolidation according to the requirements of this Interpretation. However, if a fund or trust is used by business enterprises in an effort to circumvent the provisions of this Interpretation, that fund or trust shall be subject to this Interpretation.

We agree that mutual funds should not be subject to consolidation under the requirements of FIN 46. However, as drafted the proposed scope exception could be read to exclude those mutual funds that are organized as corporations.³ As described more fully below, mutual funds and other types of SEC registered investment companies, regardless of their form of organization, have voting rights, independent directors and sufficient equity capital to ensure that they are operated for the benefit of their shareholders and not for the benefit of their sponsors or other related parties.

SEC Registered Investment Companies

Mutual funds and other registered investment companies⁴ are regulated by the SEC under the Investment Company Act of 1940 ("1940 Act"). The 1940 Act imposes substantive regulation on investment companies that goes far beyond the disclosure and anti-fraud provisions characteristic of other federal securities laws. The 1940 Act places restrictions not only on funds themselves, but also on their advisers, underwriters, directors, officers, and employees.

³ We note that the vast majority of mutual funds are organized as business trusts under Massachusetts or Delaware law or as corporations under Maryland law.

⁴ "Other investment companies" would include, for example, closed-end investment companies, which, unlike mutual funds, do not issue redeemable shares.

A. Capitalization

The ability of investment companies to borrow money or issue senior securities is strictly limited under the 1940 Act.⁵ As a result, in most instances, substantially all of the company's capitalization is equity investment provided by common shareholders. These common shares absorb losses and are entitled to gains on the fund's investments. We believe these capitalization requirements ensure that a fund's equity capital will substantially exceed its expected losses.

B. Voting Rights

The 1940 Act provides investment company shareholders with certain specified voting rights. For example, all shares issued by investment companies must be voting shares and have equal voting rights. The 1940 Act requires that at least forty percent of the fund's directors be independent and that directors be elected at a meeting called for that purpose.⁶ The 1940 Act requires that each of the following changes must receive prior approval by the company's shareholders:

- Changes in the investment advisory contract between the fund and its investment manager;
- Changes in the fund's investment objectives and policies (i.e., policies on borrowing money, issuing senior securities, purchasing or selling real estate, making loans to other persons);
- Change in the fund's status from a diversified company to a non-diversified company; and
- Change in the nature of the fund's business so as to cease to be an investment company.

Furthermore, the 1940 Act requires that the investment advisory contract between an investment company and its investment manager must: 1) be approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities; and 2) provide that it may be terminated at any time, without the payment of any penalty, by the board of directors or by vote of a majority of the outstanding voting securities of the fund on not more than 60 days written notice.

⁵ Mutual funds cannot issue senior securities. However, they can borrow money from banks, but only if they maintain 300% asset coverage (i.e., the ratio of the company's total assets, less all liabilities other than bank borrowings exceeds the amount of the bank borrowing by 3 to 1). Closed-end funds may issue senior securities. Closed-end funds must maintain 300% asset coverage for debt securities and 200% asset coverage for preferred shares.

⁶ Rules promulgated under the 1940 Act effectively require a majority of a fund's board to be independent. Virtually all investment companies meet this standard.

Recommendation

For the reasons described above, we believe SEC registered investment companies generally would not be variable interest entities. While we strongly support the Board's decision to exempt mutual funds from consolidation, since they do not afford sponsors or related parties the ability to exercise a controlling financial interest, we recommend that the scope exception in proposed paragraph 4.h. be revised to include all SEC registered investment companies.⁷

Sincerely,

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

⁷ For similar reasons, we support exempting unregistered investment companies that entail substantially similar shareholder protections designed to ensure that the company is operated for the benefit of its equity shareholders.