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## **VIA ELECTRONIC DELIVERY**

August 31, 2010

Mr. Russell G. Golden Technical Director Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk , CT 06856-5116

Re: Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities (File Reference No. 1810-100)

Dear Mr Golden:

Franklin Templeton Investments appreciates the opportunity to comment on the proposed accounting standards update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (the "Exposure Draft"). Among other things, the Exposure Draft would require investment companies to include the transaction costs associated with the purchase and sale of financial instruments as an expense in net income when incurred, which is reflected in the expense ratio of an open-end or closed-end fund.

# **Introduction**

Franklin Templeton Services, LLC ("FTS") serves as the fund accounting agent for open-end and closed-end funds within the Franklin Templeton Investments complex of funds. As such, FTS prepares financial statements for registered open- and closed-end investment companies ("Registered Funds"), and based on this experience we believe that the requirement to recognize transaction costs as an explicit expense in the statement of operations will 1) make the comparability between market participants and investment companies less meaningful based upon differing investment strategies between products and across different periods of development or maturity of a single product, 2) add a certain amount of variability and permit differing assumptions by different Registered Funds in the estimated amount of commissions paid due to lack of guidance on implicit transaction costs for certain financial instruments that trade over the counter ("OTC") via various brokers, 3) increase costs and level of effort to capture these trading costs for the preparation of the financial statements, 4) not provide any practical change or benefit to

the overall presentation of the results of operations on the financials, and 5) may create significant differences between US GAAP treatment and income tax treatment of the amounts recognized, which may diminish the usefulness of financial information provided to Registered Fund shareholders as distributions they receive are determined on a tax basis.

We feel that the current GAAP treatment of recognizing transaction costs as part of the cost of the securities purchased (and deducting them from the proceeds of sales) is appropriately reflected in the current net change in net assets resulting from operations as part of the reduced unrealized gain or increased unrealized loss on the daily mark to market fair valuation of the investments.

In addition, we also urge the Board to consider excluding all Financial Instruments from the proposed measurement uncertainty analysis ("MUA"), as we believe that any MUA on Level 3 financial assets and liabilities is inherently subjective and we do not believe that it will provide useful information to investors in the investment decision-making process or to other users of the financial statements of a Registered Fund.

Please find below our response to specific questions raised by the Board and our comments to specific portions of the proposed guidance.

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## **Questions for Respondents**

**Question 11:** Do you agree that transaction fees and costs should be (1) expensed immediately for financial instruments measured at fair value with all changes in fair value recognized in net income...?

For the reasons set forth below, we <u>do not</u> agree that transaction fees and costs should be expensed immediately for financial instruments measured at fair value and included as part of the Registered Fund's expense ratio as described in Example 2 (IG16)

Lack of comparability

We believe the current proposal within the Exposure Draft would distort the comparability of expense information reported by Registered Funds in several ways. First, the comparability across Registered Funds would decrease as differing portfolio strategies employed by the Registered Funds would effectively lead to differing expense accruals. Certain Registered Funds employ an investment strategy that results in higher levels of trading and thus the new requirements would cause an increase in operating expenses relative to another Registered Fund that trades less frequently.

Additionally, the comparability of a Registered Fund's expenses over multiple periods also would be less meaningful, given the proposed requirements in the Exposure

Draft. For example, when a Registered Fund is launched and is in the growth phase, portfolio transactions may be significant as the manager of the Registered Fund invests the fund's capital. During more mature phases, marked by stability of capital, portfolio transactions may occur less frequently. For these reasons, the expenses based upon the requirements in the Exposure Draft may distort comparability between reporting periods for a given Registered Fund.

Finally, we note that investment managers of Registered Funds are subject to differing levels of explicit and implicit trading costs, often related to the manager's size and the volume of business that the manager provides to a specific broker-dealer. Accordingly, larger investment managers of Registered Funds may tend to benefit disproportionately in relation to smaller investment managers simply due to their ability to conduct volume transactions. Inherently, this would lead to a lack of comparability of expense information across Registered Funds in different fund complexes.

## Guidance is vague

The guidance within the Exposure Draft does not address instances where an implicit transaction cost exists and does not provide guidance on the appropriate accounting thereon. We note that many financial instruments trade in the (OTC) market via various broker-dealers. There is no commission on these trades; the compensation that the broker-dealer earns is, in effect, a portion of the bid-ask spread. The current version of the Exposure Draft could be read as requiring an entity, including Registered Funds, to expense these implicit commissions. Significant subjectivity could arise with respect to bifurcating the bid-ask spread between the portion that represents commission and the portion that represents other contributing market factors. Accordingly, Registered Funds may interpret and apply this requirement in very different ways, which would lead to a further diminution in the comparability of expense information across Registered Funds in different fund complexes.

We note that the requirement to expense commissions on financial instrument transactions is currently contained within IFRS; however, we also note that there appears to be a wide range of interpretation, with some entities continuing to capitalize as proceeds implicit commissions related to OTC transactions.

#### Increased burdens and costs

We believe that the cost and level of effort associated with capturing trading costs related to financial instruments would be significant. Investment management computer systems have been built over the years to treat these explicit and implicit costs as a portion of the initial cost of an investment, and as a reduction in proceeds upon the sale of the security. The implementation of the requirements in the Exposure Draft would cause significant costs to be incurred related to systems modifications that would be necessary in order to re-categorize trading costs, without corresponding benefits to the Registered Fund's shareholders.

Additionally, estimating the portion of the bid-ask spread that represents the commission to both the buyer and the seller of the financial instrument will be both problematic and inherently subjective. For a large investment manager that may trade thousands of financial instruments daily on an OTC basis, we believe that the operational considerations far outweigh any benefits of the additional disclosure, particularly given the subjective nature of the results.

# No practical change to results of operations

Although the proposed requirements within the Exposure Draft call for the expensing of trading costs, we note that there would be no change to the Registered Fund's results of operations. Currently, a Registered Fund capitalizes the transaction costs as part of the basis for an acquired financial instrument. Unrealized appreciation (depreciation) is immediately adjusted to account for these capitalized costs, and is recognized in the Statement of Operations. Moving these costs to an operating expense within the Registered Fund's Statement of Operations would effectively be a reclassification and the ultimate results of operations (as well as the Registered Fund's total return) would remain unchanged.

In addition, although operations of a Registered Fund would not change, unintended consequences may arise. For example, if a Registered Fund were to begin seeing larger outflows due to market volatility and thus an increase in trading activity, it likely would see a corresponding increase in its expense ratio. This may have the effect of furthering redemption activity, which could lead to greater expenses related to transaction costs. The result could be a cascading effect which might cause significant movements of capital out of the fund due to this re-classification of expense on the Registered Fund's statement of operations.

# Divergence with tax requirements

The proposed changes set forth in the Exposure Draft will not change the tax rules surrounding the recognition of transaction costs. As a result, income and realized gains will differ between the amounts recognized under GAAP and the amounts recognized for income tax purposes. We note that a Registered Fund's distributions to shareholders are determined on an income tax basis and that further divergence between GAAP accounting income and tax income will continue to diminish the usefulness of the financial information provided to a Registered Fund's shareholders.

## Other information

We note that within the Exposure Draft's basis for conclusions, paragraph BC51, the Board's decision for the expensing of transaction costs is based upon the premise that these costs are period expenses and not directly related to the financial asset or liability. We believe, however, that certain portions of these costs are directly related to the asset or liability in question. For example, assuming that the bid-ask spread on an OTC traded financial instrument was deemed to be a "commission," we believe that the spread is also

effectively compensation to the acquiring party in the form of a liquidity premium required for purchasing the asset or assuming the liability.

#### Conclusions and recommendations

We strongly feel that the current practice of including transaction costs as a part of proceeds enhances the comparability of expense information reported by Registered Funds and that the proposed treatment of these costs ultimately will distort the comparability and the usefulness of the financial information provided to prospective investors, as well as to a Registered Fund's current shareholders. Accordingly, we believe that the expensing of transaction costs should not be required or, if required, Registered Funds and other similar products should be exempted from this requirement.

**Question 65:** Do you agree with the proposed disclosure requirements? If not, which disclosure requirement do you believe should not be required and why?

Within paragraph 109 of the Exposure Draft, we note that unquoted equity instruments are excluded from the proposed measurement uncertainty analysis (MUA) requirements set forth in the recently issued exposure draft on Topic 820. We agree with this exclusion. Additionally, we urge the Board to consider excluding all financial instruments from this requirement. We believe that any MUA on Level 3 financial assets and liabilities is inherently subjective and we do not believe that it will provide useful information to investors in the investment decision-making process or to other users of the financial statements of a Registered Fund. We anticipate that the MUA for fixed income financial instruments would provide such a wide range of possible values that it may undermine the confidence that the investors in a Registered Fund have in that fund's financial statements and may lead to unintended consequences such as increases in litigation. Further, an investor likely would only take away from the MUA certain general relationships such as changes in market interest rates and their relation to a bond's price.

**Question 68:** Do you agree with the transition provision in this proposed Update? If not, why?

Assuming that the requirements set forth in Paragraph 13 surrounding the expensing of transaction costs are implemented as proposed, we have significant concerns with respect to using a cumulative-effect adjustment for implementation. We note that a Registered Fund may have held securities in its portfolio for years, or perhaps decades. Capturing these historical transaction costs, particularly the implicit costs related to OTC financial instruments, would prove extremely challenging.

Rather, if the transaction cost requirement were implemented, we would recommend treating such requirement as a change in accounting estimates prospectively and specifically related to new acquisitions within the Registered Fund's portfolio made after the implementation date.

**Question 70:** How much time do you believe is needed to implement the proposed guidance?

Assuming that the requirements set forth in Paragraph 13 surrounding the expensing of transaction costs are implemented as proposed, we believe that a significant lead time of at least twenty-four months from the finalization of the proposed update would be required to allow for systems modifications to support both the change in categorization of the costs, as well as the required monitoring and calculation of book-tax differences.

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We appreciate your time and consideration of our comments. If you have any questions or wish to discuss any of the issues addressed in this letter, please contact the undersigned at (916) 463-5030.

Very Truly Yours,

/s/

Laura F. Fergerson Senior Vice President Franklin Templeton Services, LLC