

# BLACKROCK

October 27, 2010

Mr. Tom Linsmeier  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116

Re: Financial Instruments Public Roundtable

Dear Mr. Linsmeier:

BlackRock, Inc. (“BlackRock”) appreciates the opportunity to have participated in the FASB’s October 19<sup>th</sup> Public Roundtable on *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)* (the “Proposed ASU”).

During the Roundtable, we expressed concern that one of the consequences of requiring investment companies to expense transaction costs would be the creation of book/tax differences that could confuse investors. The purpose of this letter is to provide clarity regarding your question as to how such book/tax differences would differ from those that exist today.

Investment companies currently capitalize transaction costs for both book and tax purposes. Although the costs are recognized immediately as part of unrealized loss on the statement of operations for book purposes, the unrealized loss is not recognized for tax purposes until the security is sold, at which time the costs are included as part of realized gain/loss for both book and tax. Thus, there currently is symmetry for both book and tax purposes.

Under the Proposed ASU, transaction costs would be expensed for book purposes but would continue to be capitalized for tax purposes. Expensing for book purposes would result in taxable Net Investment Income (“NII”) in excess of book NII<sup>1</sup>(see the example that follows). As registered investment companies are required to distribute all of their taxable income to avoid income tax, such distributions would be part book net investment income and part book return of capital. Registered investment companies are required by Rule 19(a) of the Investment Company Act of 1940 to send a notice to shareholders, on a separate piece of paper, accompanying each payment, whenever there is a distribution in excess of accumulated book net investment income. Thus, as a result of the Proposed ASU, shareholders may be notified that they received a book return of capital, even though at the end of the calendar year they would receive a tax Form 1099 that would disclose no such tax return of capital.

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<sup>1</sup> Under current guidance, transaction costs for investment companies are reported as a component of Realized and Unrealized Gain/Loss rather than as part of NII; as a result, NII for book and tax purposes does not differ.

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In addition to creating additional cost to send the notices, investment companies would need to maintain two sets of accounting records for every lot of every security. The impact of expensing transaction costs is illustrated through the following example.

## Expensing Transaction Costs - Book/Tax Difference Created Under Proposed ASU

	<u>Proposed ASU Book Treatment</u>	<u>Current Book Treatment</u>	<u>Tax Treatment</u>
<b>Dividends &amp; Interest, less expenses</b>			
Dividends & Interest (excluding transaction costs)	\$500	\$500	\$500
Transaction costs	<u>(5)</u>	<u>-</u>	<u>-</u>
<b>Net Investment Income ("NII")</b>	<b>495</b>	<b>500</b>	<b>500</b>
<b>Realized and Unrealized Gain/Loss</b>			
Cost at purchase (excluding transaction costs)	1,000	1,000	1,000
Transaction costs	<u>-</u>	<u>5</u> <sup>(1)</sup>	<u>5</u> <sup>(1)</sup>
Cost basis	1,000	1,005	1,005
<b>Assumed market value, end of period</b>	<b><u>1,100</u></b>	<b><u>1,100</u></b>	<b><u>1,100</u></b>
<b>Unrealized appreciation</b>	<b>100</b>	<b>95</b>	<b>95</b>
<b>Distribution (to avoid tax)</b>			
Distribution from book NII	500	500	500
	495 <sup>(2)</sup>	500	500 <sup>(3)</sup>
Book return of capital	5 <sup>(2)</sup>	-	-

(1) Although included in the cost basis for tax purposes, the transaction costs are not recognized for tax purposes until the security is sold.

(2) For the tax year ended 12/31/10, the fund made a distributuon from book NII of \$495 and a \$5 book return of capital.

(3) Form 1099 (Dividend) would reflect Taxable/Ordinary Income of \$500.

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We hope that the example above clarifies your question regarding the book/tax differences that would occur as a result of the proposal to expense transaction costs. For your reference, we have included Appendix A which outlines our additional comments regarding the proposal to expense transaction costs. We look forward to the Board's continued deliberations on this project. Please contact me at (212) 810-5467 should you have any questions regarding our response.

Sincerely,

Ann Cavanaugh  
Director

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## Appendix A

### 1. Expensing transaction costs is likely to distort an investment company's expense ratio.

Expense ratios generally are viewed by investors and analysts as an indicator of ongoing, expected costs and are used to compare funds. The proposal to expense transaction costs would introduce volatility into funds' expense ratios (expense/average net assets), which would undermine the ability of investors to compare expected ongoing costs of funds.

- Main expense ratio components are advisory, custodian, distribution and transfer agent fees which are relatively stable as a percent of a fund's net asset value
- Transaction costs on the other hand can be volatile and may vary as they are impacted by:
  - Where a fund is in its life cycle (during ramp up, a fund is likely to have more purchases leading to higher transaction costs). An actively managed portfolio likely also will have a higher expense ratio.
  - Expensing transactions costs could increase expense ratios by 0.2% to 0.5% (average total expense ratios generally range from .5% to 2.0%).

### 2. The Proposed ASU contains no specific guidance for measuring implicit transaction costs.

- Equity securities have stated commissions while fixed income securities are traded based on a bid-ask spread.
- Investment companies would need to develop their own methodologies to calculate fixed income transaction costs.
- IFRS compliant funds currently do not break out and expense implicit commissions on fixed income securities.

### 3. The Proposed ASU would not change an investment company's total return.