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February 15, 2012

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

Re: Proposed Accounting Standards Update, *Consolidation (Topic 810) Principal versus Agent Analysis* – File Reference No. 2011-220

Dear Ms. Cosper:

The Investment Company Institute¹ is pleased to offer comments on the proposed FASB Accounting Standards Update, *Consolidation (Topic 810) Principal versus Agent Analysis* (ASU or Proposal). We support the Board's efforts to develop a principles-based model for determining whether a decision maker is acting in a principal or agent capacity. We commend the Board for responding to concerns expressed by users and preparers by deferring implementation of FASB Statement No. 167. We believe the Proposal represents a substantial improvement upon the consolidation model for asset managers and the funds they manage.

We have concerns, however, that the Proposal may cause investment advisers to consolidate money market mutual funds they manage. In particular, we are concerned that the investment adviser's exposure to variability of returns from other interests (*e.g.*, the notion that an adviser has an implicit financial responsibility to ensure the fund operates as designed) may overcome the fund board's kick-out rights and lead to a conclusion that the adviser is acting as principal. We are concerned that preparers and auditors could reach this conclusion under the Proposal as currently structured, even in instances where the adviser has no equity investment or explicit interest in the money market fund other than its management fee. To address this concern, we recommend that an adviser's interest in a fund that is required to comply with, or operates in accordance with requirements that are similar to those in Rule 2a-7 under the Investment Company Act of 1940 (1940 Act) be explicitly exempted from the Proposal. If the Board is unwilling to provide such an exemption, we recommend: 1) that substantive kick-out rights held by a board of directors be determinative that an adviser is acting as an agent; 2) that the "scope of the adviser's decision making authority over the entity" be added as a fourth factor to be considered in the principal versus agent analysis; and 3) that "redemption rights held by the

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 \$12.5 trillion and serve over 90 million shareholders.

entity's investors" be considered in the analysis as part of "the rights held by other parties" factor. We elaborate on our recommendations below.

Question 10: *Update 2010-10 was issued to address concerns that some believe that the consolidation requirements resulting from Statement 167 would have required certain funds (for example, money market funds that are required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7 of the Investment Company Act of 1940) to be consolidated by their investment managers. The amendments in this proposed Update would rescind the indefinite deferral in Update 2010-10 and would require money market funds to be evaluated for consolidation under the revised guidance. The Board does not intend the application of the proposed Update to result in money market funds being consolidated. Do you agree that the application of the proposed update will meet this objective? If no, why and what amendments would you recommend to address this issue?*

We agree that money market funds that comply with Rule 2a-7 of the 1940 Act should not be consolidated by their investment advisers. Such consolidation would diminish the usefulness of the investment adviser's financial reporting. In particular, consolidation of fund assets would misrepresent the investment adviser's financial position as the money market fund's security holdings are added to the investment adviser's balance sheet along with non-controlling interests. The resulting "gross-up" would substantially increase the size of the adviser's balance sheet, given the significant assets held by money market funds. Also, consolidation would eliminate the investment adviser's fee revenues from the income statement and replace them with interest on the fund's holdings. We believe this presentation would make an investment adviser's fee based revenue model more difficult to understand and analyze, notwithstanding any supplemental disclosures that may be provided in the notes or MD&A.

We are concerned that the Proposal as currently structured, however, may not meet the Board's stated objective. In particular, we are concerned that the Proposal's requirement to consider the adviser's exposure to variability of returns from other economic interests that it holds (*e.g.*, an implicit financial responsibility to ensure that the fund operates as designed) may overcome the fund board's kick-out rights and lead to a conclusion that the adviser is acting as principal. Certain of the examples included in the ASU as implementation guidance enhance these concerns (see our response to Question 3 below).

No implicit financial responsibility should be imputed to investment advisers of Rule 2a-7 money market funds in the principal versus agent analysis. Neither the securities laws nor standard investment advisory contracts require an investment adviser to guarantee or support the fund's stable \$1.00 net asset value. While an investment adviser may provide limited credit support to a money market fund relating to specific portfolio securities, it is under no obligation to do so. The fact that an investment adviser has provided support in the past does not mean it will do so in the future.

We note that 1940 Act Rule 22e-3 permits money market funds to suspend redemptions if the fund's mark-to-market price per share is less than the stable net asset value per share calculated using amortized cost and the fund's board of directors approves the liquidation of the fund. The rule recognizes that a money market fund's share price can decline in value, and provides for an orderly liquidation of the fund's securities in a manner that best serves the fund's shareholders by avoiding the liquidation of portfolio securities in a "fire sale." The rule implicitly

acknowledges that investment advisers are under no obligation to guarantee the value of the money market fund's shares.

We also have concerns that certain language in the Proposal may diminish the weighting afforded to a 1940 Act fund board's kick-out rights. The ASU, at 810-10-25-40A, indicates that for kick-out rights to be considered substantive there should be no significant barriers to their exercise. The Proposal lists various factors that could be considered barriers, including the lack of adequate compensation to attract a replacement adviser. We are concerned that an investment adviser's temporary fee waiver (so as to maintain a positive fund yield in a low interest rate environment) may be viewed as a barrier in the analysis of the fund board's kick-out rights.

We believe the best way to ensure the Board's stated objective is achieved is to provide a scope exemption for an investment adviser's interest in a fund that is required to comply with or operates in accordance with Rule 2a-7. We believe such an exemption is appropriate based upon the strict risk-limiting features in Rule 2a-7.

Rule 2a-7 Risk-limiting Features

Rule 2a-7 includes several risk-limiting requirements intended to minimize the risk of loss to the fund and its shareholders by ensuring that the fund is able to maintain a stable \$1.00 share price. These conditions limit risk in a money market fund's portfolio by governing the credit quality, liquidity, maturity, and diversification of a money market fund's investments. Risk limiting features have been a part of Rule 2a-7 since it first went into effect in 1983. Subsequent to the 2008 financial crisis the rule was amended to further reduce the risk of loss through provisions such as explicit liquidity standards, stress testing, "know your investor" procedures, shorter portfolio maturities, improved credit quality, and more detailed and more frequent disclosure.²

The amendments have made money market funds even more consistent with the objectives of preserving principal and maintaining liquidity. For example, with respect to the objective of preserving principal, the maximum dollar-weighted average maturity ("WAM") of portfolio holdings permitted by Rule 2a-7 as recently amended is now 60 days rather than 90 days. The amendments to Rule 2a-7 also imposed a new 120-day limit on a money market fund's weighted average life ("WAL").³ At least 97 percent of a fund's assets must be invested in government obligations or other securities that either received the highest short-term rating or are of comparable quality. All money market funds now are subject to a uniform limit of 3 percent of total assets on the acquisition of second tier securities, with not more than 0.5 percent of total assets permitted in any issuer of second tier securities.

Amended Rule 2a-7 also requires funds to conduct periodic stress tests and report the results to their boards of directors. These stress tests seek to quantify the changes in interest rates, spreads, credit ratings and redemptions that could cause a money market fund to no longer be able to maintain a stable share price. The stress tests improve the directors' ability to oversee and manage the risks taken by their funds. With respect to maintaining liquidity, Rule 2a-7 requires money market funds to maintain a sufficient degree of portfolio liquidity necessary to meet

² See *Money Market Fund Reform*, SEC Release No. IC-29132 (February 23, 2010) ("Adopting Release"), 75 FR 10060 (March 4, 2010).

³ WAL is the WAM calculated without reference to interest rate adjustments to floating and variable rate securities.

reasonably foreseeable redemption requests. To comply with this requirement, funds must have “know your investor” procedures for gauging the redemption risks posed by individual shareholders or types of shareholders. Also, 10 percent of a taxable money market fund’s portfolio must consist of daily liquid assets, which include cash (including demand deposits), direct obligations of the US government (e.g., Treasury securities), and securities (including repurchase agreements) for which a money market fund has a legal right to receive cash in one business day and all money market funds must have 30 percent of total assets invested in weekly liquid assets which include cash, Treasury securities, short-term government agency discount notes with remaining maturities of 60 days or less, and securities that must be repaid within five business days.

The SEC has increased the transparency of money market funds by requiring them to provide updated portfolio information on their websites as of the end of each month. In addition, each month money market funds must file with the SEC new Form N-MFP, which contains detailed information about the fund and its portfolio, including the market value of each security held. The information provided in Form N-MFP becomes publicly available 60 days after the end of the month covered by the report.

Question 2: *The evaluation of a decision maker’s capacity would consider the following factors:*

- a. *The rights held by other parties*
- b. *The compensation to which the decision maker is entitled in accordance with its compensation agreement(s)*
- c. *The decision maker’s exposure to variability of returns from other interests that it holds in the entity.*

Are the proposed factors for assessing whether a decision maker is a principal or an agent appropriate and operational? If not, why? Are there any other factors that the Board should consider including in this analysis?

We agree that the proposed factors for assessing whether a decision maker is a principal or an agent are appropriate. As described above, however, we believe any implied financial responsibility relating to a Rule 2a-7 money market fund should be excluded from the analysis of the decision maker’s exposure to variability of returns from other interests that it holds.

We note that IFRS 10, *Consolidated Financial Statements*, includes a principal versus agent analysis that considers three factors substantially identical to those included in the Proposal.⁴ IFRS 10, however, includes a fourth factor: the scope of the decision maker’s authority over the investee. Under IFRS 10 the scope of a decision maker’s authority is evaluated by considering: a) the activities that are permitted according to the decision-making agreement and specified by law, and b) the discretion that the decision maker has when making decisions about those activities. IFRS 10 also requires the decision maker, in evaluating the scope of its authority, to consider the purpose and design of the investee, the risks to which the investee was designed to be exposed, the risks it was designed to pass on to the parties involved, and the level of the involvement the decision maker had in the design of the investee.

⁴ See IFRS 10, *Consolidated Financial Statements* at B60.

We recommend that the Board include as a fourth factor in the required principal versus agent analysis “the scope of the decision maker’s authority over the entity.” The Proposal, at 810-10-25-39C, indicates that the decision maker shall consider the entity’s purpose and design, including the risks that the entity was designed to create and pass through to its interest holders. Our recommendation would elevate the purpose and design of the entity in the analysis by making the scope of the decision maker’s authority one of four enumerated factors to be considered.

In this regard we note that a money market fund adviser’s discretion over the types of securities to be purchased for the fund is strictly limited by Rule 2a-7. Also, we believe the purpose and design of a money market fund, as disclosed in its prospectus, is to provide investors in the fund with both the rewards and risks associated with an investment in a portfolio of short-term high quality securities.⁵

We also recommend that the Board include “redemption rights held by the entity’s investors” within “the rights held by other parties” factor. Where investors in the entity can redeem their investment on any business day at the current fair value of the entity’s net assets, we believe this is an indicator that the decision maker is acting as agent. In effect, shareholders can decide to replace the decision maker by removing their money from the entity and investing it in another fund managed by a different adviser. Similar to kick-out rights, we believe redemption rights should be deemed substantive before they could be considered in the principal versus agent analysis.

In order for redemption rights to be deemed substantive, we recommend that the entity or the rights must meet each of following:

- Substantially all of the entity’s financing is provided through equity investment;
- All equity holders have the right to redeem their investment on any business day at the current fair value of their proportionate share of the entity’s net assets;
- All redemption proceeds must be paid in cash within seven days;
- The entity cannot “side pocket” certain hard to value assets for redemption at a later date; and
- No fees or charges are assessed against the redemption proceeds.

We do not believe substantive redemption rights are determinative that the adviser is acting as agent, particularly where those rights are widely dispersed among many investors. We do believe, however, they may provide additional evidence that the decision maker is acting as agent, and that they should be considered along with kick-out rights and participating rights in the analysis of rights held by others.

BC 21 of the Proposal indicates that the Board considered whether redemption rights should be considered equivalent to kick-out rights and that the Board concluded that they are inherently different because the decision maker can avoid the loss of its decision-making abilities by

⁵ A money market fund’s prospectus must disclose that “an investment in the fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the fund.” See item 4(b)(1)(ii) of SEC Form N-1A.

obtaining additional investors for the entity. We disagree. As detailed in the data below, a significant number of open-end mutual funds are liquidated or merged out of existence every year because they cannot attract sufficient assets or investors.

Number of Mutual Funds Closed				
	Merged Funds	Liquidated Funds	Total Funds Closed	Total Industry Funds
2007	315	221	536	10,592
2008	257	333	590	10,720
2009	363	504	867	10,370
2010	257	237	494	10,424
2011	292	190	482	10,503

Source: Investment Company Institute

Question 3: *The proposed Update would require judgment in determining how to weigh each factor in the overall principal versus agent analysis. Do you agree that the proposed amendments, including the related implementation guidance and illustrative examples, will result in consistent conclusions? If not, what changes do you recommend?*

The Proposal includes several examples intended to illustrate application of the principal versus agent analysis. We are concerned that two of these examples may be analogized to money market funds and lead to a conclusion that the fund's adviser is acting in a principal capacity. Case F – Commercial Paper Conduit (810-10-55-3AY) and Case C – Structured Investment Vehicle (810-10-55-122) both involve a sponsor creating an investment entity which sells interests to external investors, with the proceeds from the sale of the interests invested in a portfolio of medium-term debt. Both examples consider the sponsor's implicit financial responsibility to ensure that the entity operates as designed in order to manage the risk to the sponsor's reputation in the marketplace. Both examples conclude that the sponsor is using its decision making authority in a principal capacity due, in part, to its implicit obligation to absorb losses.

In the past, when several money market funds approached the point of deviating from their stable \$1.00 NAV, fund sponsors have provided limited financial support to those funds through capital infusions or capital support agreements. It may be argued that this was done to ensure that the entity operated as designed and to manage the sponsor's risk to its reputation in the marketplace. As stated above, neither securities laws nor standard investment advisory contracts require the adviser to guarantee or support the fund's stable \$1.00 net asset value. Any implicit financial responsibility should not be a consideration in the analysis of the adviser's interest in the money market fund.

We recognize there are important differences between the two examples cited above and an adviser's interest in a money market fund. These differences include for example, the presence of a 1940 Act board with substantive kick-out rights, the strict risk limiting features of Rule 2a-7, and the absence of debt or any form of leveraging (money market funds are financed entirely through equity investment). Indeed, we believe these distinguishing features should enable the FASB to exempt an adviser's interest in a money market fund from consolidation, while still addressing variable interest entities that it believes should be consolidated.

Nevertheless, if the Board does not accept our recommendation to provide a scope exemption for an adviser's interest in a money market fund, we recommend that it include an example that illustrates application of the Proposal to money market funds and that the example affirm the Board's intent that money market funds should not be consolidated.

***Question 4:** Should substantive kick-out and participating rights held by multiple unrelated parties be considered when evaluating whether a reporting entity should consolidate another entity? If so, do you agree that when those rights are held by multiple unrelated parties, they should not in and of themselves be determinative? If not, why? Are the guidance and implementation examples illustrating how a reporting entity should consider rights held by multiple unrelated parties in its analysis sufficiently clear and operational?*

Substantive kick-out or removal rights should be determinative that a decision maker is acting as an agent, even if the rights are held by more than one unrelated party. For example, substantive kick-out rights held by a board of directors should be determinative that a decision maker is acting in an agency capacity. The consideration of whether the kick-out rights are substantive should consider all the facts and circumstances, including (a) the number and dispersion of the parties that need to collectively exercise the kick-out rights, and (b) whether the decision maker's other interests could create a barrier to the exercise of kick-out rights, consistent with 810-10-25-40A. Once the kick-out rights are deemed substantive, however, we believe they provide conclusive evidence that the decision maker is acting as agent. We recommend that the Proposal be revised accordingly.

We agree that the assessment of the rights held by a board of directors would need to include an evaluation of the board's authority and composition. Below we describe certain regulatory requirements relating to a 1940 Act fund board and our conclusion that such a board would be "substantive" and have "significant authority" as described at 810-10-25-39G.

- Fund boards are robustly independent. Federal securities laws require that at least 40 percent of the directors on a fund board be "independent," as defined by SEC rule. In 2001 the SEC adopted rules that require a majority of directors on a fund board be independent for those funds relying on common exemptive rules. In practice, the proportion of independent directors is significantly higher throughout the industry. In nearly 90 percent of fund complexes, 75 percent or more of fund directors are independent.
- While there is no legal requirement for a fund board to have an independent board chair, approximately 63 percent do so. An additional 24 percent have designated an independent director as "lead" director.
- New independent directors of a fund board are selected and nominated by the existing independent directors on the board, not by the fund's adviser.
- A fund's adviser cannot "fire" or otherwise remove an independent director.
- Independent directors—not the fund's adviser—set their own compensation.

- In broad terms, independent directors oversee the management and operations of the fund and are not involved in its day-to-day management.
- A critical component of a board's oversight responsibility is to protect the fund's shareholders against potential conflicts of interest between the fund and its service providers, including the adviser.
- Independent directors have a fiduciary duty to protect the interests of fund shareholders.
- In addition to their general oversight responsibilities, fund directors have specific and significant responsibilities under the federal securities laws, ranging from overseeing the fund's compliance program to approving the fees paid to the fund's adviser.
- Independent directors are required to consider whether to approve the fund's management contract with the investment adviser annually. By law, the term of the contract cannot exceed one year. Directors exercise this responsibility with the utmost diligence and care, often consulting with independent counsel and third party consultants, reviewing hundreds if not thousands of pages of detailed information, and participating in numerous meetings throughout the year. The fund's SEC filings must describe the material factors and conclusions that formed the basis for the board's decision to approve the contract.
- Directors are not required to negotiate for the absolute lowest rate with the adviser. Instead, there is broad recognition by regulators and the courts that directors must balance a number of considerations, including the nature, extent, and quality of the services provided by the adviser. Good performance, which is ultimately what shareholders are seeking, may best be achieved by paying the adviser a competitive rate, rather than the lowest possible fee. In the fee approval process, however, directors do often require the adviser to take steps to bring fees down—steps such as breakpoints at specified asset levels, fee waivers, outright fee reductions, or service enhancements.
- Fund performance is an important component and focus of extensive board oversight. In fulfilling their oversight responsibilities, directors seek to ensure that the adviser is managing the fund in a manner consistent with the fund's stated investment objectives. Quarterly reviews with the adviser keep attention focused on performance issues until they are resolved.
- Directors have many means to carry out their duty to forcefully represent shareholders' interests and effect changes in their funds' best interests. For example, directors can require the adviser to increase the quality of its services or to take appropriate steps to improve its performance, such as by hiring a new portfolio manager for the fund, increasing the adviser's investment research capability, retaining a sub-adviser, or merging the fund.
- Every investment advisory contract between a 1940 Act fund and its investment adviser must, by law, provide that it may be terminated at any time, without the payment of any penalty, by the board of directors of the fund, or by vote of a majority of the outstanding voting securities of such company on not more than 60 days written notice.

Based on the above we believe a 1940 Act fund board would be substantive and have significant authority. We recommend that fourth sentence of 810-20-25-39G be revised to read (new language underlined): “For example, a board of directors for a fund established in accordance with the Investment Company Act of 1940, which is legally required to have an independent board of directors, ~~may~~ shall be considered substantive and yield significant authority when assessing whether to retain a decision maker.”

We also wish to comment on the discussion of kick-out and participating rights in the basis for conclusions. BC18 indicates that such rights should receive less weight in the principal versus agent analysis as the number of parties required to act together to exercise the rights increases and that these rights should affect only the consolidation analysis when there is a realistic possibility that the other interest holders may exercise those rights. We agree that where a large number of parties are required to act together to exercise the rights they should be afforded less weight in the analysis. We believe, however, that the number of directors on a 1940 Act fund board would not represent any impediment to the exercise of the board’s kick-out rights.⁶ Also, we believe that the existence of the kick-out rights is more important than the probability that they will be exercised. The existence of the kick-out rights reinforces the fund board’s authority and creates a strong incentive for the decision maker to be fully responsive to the board.

Regulatory Considerations

SEC Chairman Schapiro recently indicated that the Commission, along with the Financial Stability Oversight Council, is considering additional regulatory reforms for money market funds.⁷ These reforms include, for example, a floating NAV, a capital buffer, and redemption restrictions. A capital buffer could come from the fund’s sponsor, the fund’s shareholders, or the market, through the issuance of debt or a subordinated equity class. While it is unclear at this time what reforms, if any, may ultimately be adopted, we encourage the Board to be mindful of regulatory developments as it finalizes the principal and agent model.

If regulators require fund sponsors to provide some form of subordinated capital, we do not believe it should necessarily dictate that the fund sponsor consolidate the fund. Instead, a regulatory capital requirement that applies equally to all sponsors should not be viewed as a barrier to the exercise of the board’s kick-out rights. Any replacement adviser would, presumably, also be subject to the same regulatory requirements and therefore, their presence should not act as a barrier to the fund board.

⁶ ICI data show that 1940 Act fund boards typically have eight or nine directors and that six or seven of these directors are independent. See Overview of Fund Governance Practices, 1994-2010 available at http://www.ici.org/pressroom/news/11_news_fund_gov_pract.

⁷ See Remarks at SIFMA’s 2011 Annual Meeting (November 7, 2011) available at <http://www.sec.gov/news/speech/2011/spch110711mls.htm>.

We appreciate the opportunity to comment on the Proposal. 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,

A handwritten signature in black ink that reads "Gregory M. Smith". The signature is written in a cursive style with a large, prominent "G" and "S".

Gregory M. Smith
Director – Fund Accounting

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