INVESTMENT COMPANY INSTITUTE

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July 29, 2019

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: *Amendments to Financial Disclosures about Acquired and Disposed Businesses* (File No. S7-05-19)

Dear Ms. Countryman:

The Investment Company Institute[1] supports the Securities and Exchange Commission's proposal to improve financial disclosure requirements relating to fund acquisitions.[2] Article 6 of Regulation S-X, which governs investment company financial disclosures, currently contains no specific rules or requirements relating to financial reporting for acquired funds. As a result, investment company registrants have looked to ill-suited requirements designed for operating companies when reporting fund acquisitions.[3] The proposal would create new rules that would clarify fund disclosure obligations under these scenarios, making it easier and less costly for investment company registrants to provide relevant financial information about their acquisitions.

We likewise support the related proposal to add a definition of significant subsidiary in Regulation S-X specifically tailored to investment companies. The existing definition[4] incorporates significance tests

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[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$22.4 trillion in the United States, serving more than 100 million US shareholders, and US$6.9 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] *See* Amendments to Financial Disclosures about Acquired and Disposed Businesses, Investment Company Act Release No. 33465 (May 3, 2019) ("Proposing Release"), *available at* https://www.sec.gov/rules/proposed/2019/33-10635.pdf.

[3] *See* Rule 3-05 and Article 11 of Regulation S-X.

[4] *See* Rule 1-02(w) of Regulation S-X.

that reference line items not typically found in investment company financial statements and are difficult to apply to funds. We therefore welcome the proposal to introduce financial disclosure requirements and significance tests that are customized for investment companies. In addition, we strongly support the proposal to eliminate the requirement to provide pro forma financial statements in connection with a fund acquisition and believe that the proposed supplemental information to be provided in lieu of pro forma financial statements will better inform fund investors and reduce costs. We present our comments on those and other aspects of the proposal that affect investment company financial reporting below.

A. Proposed Rule 6-11

Proposed Rule 6-11 of Regulation S-X would address the financial reporting requirements for funds acquired or to be acquired, including any private fund that would be an investment company but for the exclusions provided by Sections 3(c)(1) and 3(c)(7) of the Investment Company Act and any private account managed by an investment adviser. The proposal would require only one year of audited financial statements for fund acquisitions, a change from existing requirements under Rule 3-05 of Regulation S-X that require between one and three years of audited financial statements. Under the proposed rule, the schedules required by Article 12 would be required for the acquired fund or private account.

1. Specify Filings in Which Acquired Fund Financial Statements Must Appear

The Proposing Release indicates that proposed Rule 6-11 specifically would cover financial reporting in the event of a fund acquisition and is modeled after Rule 3-05, which describes the circumstances in which financial statements for an acquired business must be included in a registration statement or proxy statement. We believe proposed Rule 6-11 is intended to require acquired fund financial statements to be included in a Form N-14 filed in connection with a fund merger or acquisition and in an initial registration statement or a post-effective amendment filed under Rule 485(a)(2) under the Securities Act of 1933 where a new fund or series with limited operating history is formed for the purpose of acquiring one or more private funds.[5]

The proposed rule itself, however, does not specify the forms in which the acquired fund's financial statements must appear. We therefore are concerned that the proposed rule could be read to require the acquired fund's financial statements to be included in an acquiring fund's Form N-CSR or Rule 485(b) annual prospectus update.

Paragraph (a) of the proposed rule requires the acquiring fund to provide financial statements and schedules for the acquired fund consistent with the requirements of Regulation S-X if a fund acquisition has occurred or is probable. Paragraph (b)(1) of the proposed rule provides that if securities are being registered to be offered to the security holders of the fund to be acquired, the financial

[5] *See* discussion at page 94 of the Proposing Release.

statements of the fund to be acquired must be filed. Paragraph (b)(2) addresses all other instances and indicates that in all cases not specified in paragraph (b)(1), financial statements of the fund acquired or to be acquired for the periods specified shall be filed (provided certain significance tests are satisfied). We believe paragraph (b)(1) of the proposed rule is intended to cover a Form N-14 filed in connection with a fund merger or acquisition. That form specifically requires the acquired fund's financial statements to be included (or incorporated by reference into) the N-14 registration statement.[6] We are concerned that paragraph (b)(2) of the proposed rule, which covers "all cases not specified in (b)(1)" can be read to require the acquired fund's financial statements to be included in a Form N-CSR filed by the acquiring fund.

For example, if an acquiring fund with a December 31 fiscal year end consummates an investment company acquisition on March 30, 20X1, should the acquiring fund's Form N-CSR filing covering the six-month period ended June 30, 20X1 include financial statements for the acquired fund? Item 1(a) of Form N-CSR requires a copy of the shareholder report transmitted to shareholders. Item 27 of Form N-1A sets forth the requirements for that shareholder report and indicates that it must include the financial statements required by Regulation S-X.[7] We note that Rule 1-01(a)(3) of Regulation S-X indicates that Regulation S-X applies to both registration statements and shareholder reports under the Investment Company Act.

Continuing with the above example, we are also concerned that paragraph (b)(2) of the proposed rule can be read to require the annual prospectus update filed under Rule 485(b) on May 1, 20X1 to include the financial statements for the acquired fund.

Paragraph (b)(4) of the proposed rule makes clear that separate financial statements of the acquired fund need not be presented after the portfolio investments of the acquired fund have been reflected in the registrant's most recent audited balance sheet after the date the acquisition was consummated. In the example above, that balance sheet would be dated December 31, 20X1 and would be filed with the SEC on or about March 1, 20X2. Paragraph (b)(4) terminates the obligation to provide financial statements for the acquired fund.

We are concerned that the proposed rule can be read to require filings made after the consummation of the acquisition and prior to the filing of the next audited balance sheet that includes portfolio investments of the acquired fund to include financial statements of the acquired fund. We recommend that the Commission clarify that these filings need not include the acquired fund's financial statements. The Commission could, for example, include an instruction in Item 1 of Form N-CSR and Item 27 of Form N-1A similar to the instruction in Item 8(a) of Form 10-K. That instruction would indicate that

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[6] *See* Item 14. Financial Statements of SEC Form N-14.

[7] *See* Item 27(c)(1) of SEC Form N-1A.

acquired fund financial statements required by proposed Rule 6-11 are not required in any Form N-CSR filing or any prospectus update filing.

2. Clarify Filings That Fall Under Paragraph (b)(1) or (b)(2)

Paragraphs (b)(1) and (b)(2) of the proposed rule introduce the significance tests to assess whether the acquired fund's financial statements must be presented and address the acquired fund financial statement periods to be presented. Paragraph (b)(1) of the proposed rule provides that if securities are being registered to be offered to the security holders of the fund to be acquired, the financial statements of the fund to be acquired must be filed. We believe that paragraph (b)(1) is intended to apply to instances where an existing registered investment company is filing a Form N-14 in connection with the acquisition of another investment company.

We are concerned, however, that because open-end funds typically register an indefinite number of shares under Rule 24f-2 under the Investment Company Act, an investment company filing a Form N-14 in connection with the acquisition of another investment company may follow paragraph (b)(2) of the proposed rule and apply the related significance tests. We urge the Commission to clarify the operation of paragraphs (b)(1) and (b)(2) where an investment company previously has registered an indefinite number of shares under Rule 24f-2.

3. Utilize Significance Tests for Acquired Funds Based on Significant Subsidiary Definition

Proposed Rule 6-11 would require financial statements for funds acquired or to be acquired if the acquired fund is significant to the acquiring fund. Significance would be assessed using the definition of significant subsidiary in proposed Rule 1-02(w)(2)[8] using the investment test and the alternate income test and substituting 20 percent for 10 percent.[9] The income test with the 80 percent condition would not be used to assess significance under proposed Rule 6-11.

We support the use of the significant subsidiary definition in proposed Rule 1-02(w)(2) for purposes of determining whether financial statements for the acquired fund must be filed. Specifically, we support the use of the investment test at the proposed 20 percent threshold and the exclusion of the 80 percent income test.

[8] Our comments on proposed Rule 1-02(w)(2) are at Section B below.

[9] The investment test under proposed Rule 1-02(w)(2) deems a subsidiary significant if investments in and advances to the tested subsidiary exceed 10 percent of the registrant's total investments. The alternate income test under proposed Rule 1-02(w)(2) deems a subsidiary significant if a) the sum of the absolute value of the income, realized gains/losses and the net change in unrealized gains/losses exceed 10 percent of the absolute value of the registrant's change in net assets from operations, and b) the investment test exceeds 5 percent.

The alternate income test would be satisfied if the absolute value of the combined investment income, realized gain/loss, and net change in unrealized gain/loss from the acquired fund exceeds 20 percent of the absolute value of the change in net assets from operations of the acquiring fund, and the value of the acquired fund's total investments exceed 5 percent of the acquiring fund's total investments. We are concerned that the alternate income test would require financial statements for the acquired fund in instances where the acquired fund is very small relative to the acquiring fund.

In the investment company context, we believe the size of the acquired fund should be the principal determinant of significance because the change in net assets from operations can be highly variable from year to year due to changes in security values. For this reason, we recommend that the second threshold for assessing significance under the alternate income test under Proposed Rule 6-11(b)(2) be changed from 5 percent of total investments to 10 percent.[10] We note that Item 14 of current Form N-14 provides that pro forma financial statements need not be prepared if the net asset value of the acquired fund does not exceed 10 percent of the acquiring fund's net asset value.

4. *Align Financial Statement Periods with Investment Company Reporting Obligations*

Only one year of audited financial statements and unaudited statements for any interim period would be required for fund acquisitions that fall under paragraph (b)(2) of proposed Rule 6-11. Under existing Rule 3-05, the staff has required up to three years of audited financial statements.

We support this proposed change as it better aligns the financial statement periods to be presented with investment company reporting obligations under Rule 3-18 of Regulation S-X. We believe fund investors typically focus on returns, expenses and portfolio investments, and that older historical financial statements are generally less relevant.

5. *Terminate the Obligation to Provide Acquired Fund Financial Statements*

Paragraph (b)(4) of the proposed rule indicates that separate acquired fund financial statements need not be presented after the acquired fund's portfolio investments have been reflected in the acquiring fund's most recent audited balance sheet for a year-end following the date the acquisition was consummated. The Proposing Release requests comment on whether the acquiring fund should be required to provide financial statements for the acquired fund until an audited statement of operations for a complete fiscal year reflecting the acquired fund has been filed.

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[10] Under our recommendation an acquired fund would be significant under the alternate income test if a) the absolute value of the income from dividends, interest, and other income, the net realized gains and losses on investments, and the net change in unrealized gains and losses on investments from the acquired fund exceed 20 percent of the absolute value of the change in net assets resulting from operations of the registrant and b) the value of the acquired fund's investments exceed 10 percent of the value of the registrant's total investments.

We believe requiring the acquired fund's financial statements to be provided until an audited statement of operations reflecting the acquired fund has been filed for a complete fiscal year is unnecessary. Instead, we believe terminating the obligation to provide the acquired fund's financial statements is appropriate once an audited balance sheet is filed for a year-end after the date the acquisition was consummated.

6. *Financial Statements for Acquired Private Funds*

Paragraph (c) of proposed Rule 6-11 addresses financial statements for acquired private funds and indicates that they must comply with US generally accepted accounting principles (GAAP) and Article 12 of Regulation S-X, which requires each investment to be listed separately in the schedule of investments. Under the proposed approach a private fund would not be permitted to provide a condensed schedule of investments.[11]

Private fund financial statements that comply with GAAP do not provide the same level of detail as financial statements prepared in accordance with Regulation S-X. Currently, a fund acquiring a private fund must typically revise the historical financial statements so that they comply with Regulation S-X and possibly re-audit those statements.

We support the proposed approach, which should enable acquisitions of private funds to avoid the cost associated with revising the historical financial statements so that they comply with Regulation S-X. We also support requiring the financial statements for the acquired private fund to include the schedules required by Article 12. We recommend that the Commission permit the Article 12 schedules to be unaudited, to avoid any costs associated with auditing the schedules. This should not decrease investor protection, as the related financial statements will be audited and comply with investment company GAAP.

7. *Require Supplemental Financial Information in Lieu of Pro Forma Financial Statements*

The proposal would eliminate the requirement to provide pro forma financial statements in connection with fund acquisitions and instead would require more relevant information. The Proposing Release indicates that applying the pro forma financial statement requirements, which were developed primarily for non-investment company registrants, to investment company acquisitions may increase costs borne by investors without yielding significant benefit. We agree.

The proposal would require investment companies to provide supplemental information about the newly combined entity in lieu of pro forma financial statements. The supplemental information is intended to be more relevant to fund investors and would include: 1) a pro forma fee table, describing the post-transaction fee structure of the combined entity; 2) if the transaction will result in a material

[11] *See* FASB ASC Topic 946-210-50-6.

change in the acquired fund's investment portfolio due to investment restrictions, a schedule of investments of the acquired fund modified to show the effects of such change accompanied by explanatory narrative; and 3) narrative disclosure about material differences in financial and operating policies of the acquired fund when compared to the acquiring fund.

We recommend that the Commission clarify the presentation of the modified schedule of investments required by proposed Rule 6-11(d)(1)(ii). Specifically, should securities that must be sold due to investment restrictions be eliminated from the modified schedule of investments? Should the modified schedule include as cash balances the proceeds from any securities to be sold due to investment restrictions?

We note that proposed Rule 6-11(d)(1)(iii) requires narrative disclosure about material differences in financial and operating policies of the acquired fund when compared to the acquiring fund, whereas the Proposing Release text describing the proposed rule asks for narrative disclosure about material differences in accounting policies.[12] We recommend that the Commission clarify the types of material differences for which disclosure is required.

B. Proposed Rule 1-02(w)(2)

The proposal would add a definition of significant subsidiary to Regulation S-X that is specifically tailored for investment companies based on the current Investment Company Act Rule 8b-2 definition with certain modifications. Investment companies currently use the significant subsidiary tests in Rule 1-02(w) when applying Rule 3-05. The significant subsidiary tests in Rule 1-02(w) were not written for investment companies. They reference line items not typically found in investment company financial statements and are difficult to apply to funds.

Proposed new Rule 1-02(w)(2) would create a definition of significant subsidiary in Regulation S-X specifically for investment companies. Under the proposal a subsidiary would be deemed significant if it satisfies either an investment test or an income test. Importantly these tests consider the unique characteristics of investment companies and reference line items required in investment company financial statements. In this regard, the tests should reduce complexity and uncertainty associated with the current tests in Rule 1-02(w).

1. Proceed with the Proposed Investment Test

Under the proposed investment test a subsidiary would be significant if the value of the registrant's investments in and advances to the tested subsidiary exceed 10 percent of the value of the total investments of the registrant as of the end of the most recently completed fiscal year. We support the proposed investment test and its use of total investments rather than total assets in the denominator. Investment companies may file a statement of net assets in lieu of a balance sheet if at least 95 percent of

[12] *See* page 115 of the Proposing Release.

total assets are represented by investments in securities of unaffiliated issuers. In such situations, the fund would not file a balance sheet or disclose total assets.

2. *Clarify the Proposed Income Test*

The proposed income test considers the "income" from the tested subsidiary in relation to the registrant's income for the most recently completed fiscal year. A tested subsidiary would be significant if the test yields greater than either a) 80 percent of the registrant's income or b) 10 percent of the registrant's income *and* the investment test yields a result of greater than 5 percent (alternate income test).

The tested subsidiary's income would include the absolute value of the combined 1) investment income, such as dividends, interest, and other income; 2) the net realized gain/loss on investments; and 3) the net change in unrealized gain/loss on investments, for the most recently completed fiscal year. The registrant's income would be the absolute value of the change in net assets from operations for the most recently completed fiscal year.

The proposal also would allow the registrant to calculate the change in net assets from operations using an average of the amounts from the last five years if the change in net assets from operations for the most recent fiscal year is insignificant. Averaging should reduce the likelihood of a "false positive" (*e.g.*, where investment income and realized gains at the registrant are nearly entirely offset by a negative change in the unrealized gain/loss amount for the most recent fiscal year, making registrant's change in net assets from operations insignificant).

We support the proposed income test and the 80 percent threshold. We also support the proposed alternate income test and the 10 percent and 5 percent thresholds. In addition, we support using the absolute value of the components of income from the statement of operations for purposes of calculating the tested subsidiary's income and the registrant's change in net assets from operations.

We are unclear, however, on how the absolute value of the tested subsidiary's income should be calculated. Specifically, should the absolute value of each individual component be summed, or should the components be summed and then the absolute value of that sum be used? For example, if investment income is 2, realized gain/loss is (8), and the change in unrealized gain/loss is (6), would the absolute value of the tested subsidiary's income be 16 [2+8+6=16] or 12 [2-8-6=(12)]. We believe the proposed rule text suggests the latter and note that methodology would prevent double counting of a gain (loss) related to a sale that was previously recorded as an unrealized gain (loss).

We support the ability of the registrant to use the five-year average of the change in net assets from operations where the most recent fiscal year's change in net assets is insignificant. We recommend that the Commission clarify that the ability to use the five-year average applies to both the income test and the alternate income test.

C. Form N-14

Proposed Rule 6-11(c) provides that if the fund to be acquired is a private fund, then the required financial statements should comply with GAAP and only Article 12 of Regulation S-X. We believe Item 14.2 of Form N-14 should be revised so that it is consistent with proposed Rule 6-11(c). Specifically, Item 14.2 should be revised as follows:

> if the company to be acquired is a private fund, then such company may provide the financial statements~~, including the schedules thereto, described in Rule 3-18 of Regulation S-X~~ that comply with U.S. Generally Accepted Accounting Principles and only Article 12 of Regulation S-X;

D. Amendments to Rule 3-05

Footnote 222 in the Proposing Release indicates that "[i]n the event of a non-fund acquisition, investment companies would follow Rule 3-05." It is our understanding that an investment company would follow Rule 3-05 only for an acquisition of an operating company that it would be required to consolidate or apply the equity method of accounting pursuant to ASC Topic 946-310-45-3 or Topic 946-323-45-2. We recommend that the Commission clarify the circumstances in which an investment company would apply Rule 3-05 for non-fund acquisitions.

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We appreciate the Commission's consideration of our comments and recommendations. If you have any questions or require further information, please contact me at [redacted] or [redacted].

Sincerely,

Gregory M. Smith

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