ACT ICA of 1940
SECTION 8, 18, 30
RULE
PUBLIC AVAILABILITY 11-7-97

DIVISION OF INVESTMENT MANAGEMENT

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

November 7, 1997

Dear Chief Financial Officer:

The accounting staff of the Division of Investment Management (the "Division") has prepared this letter to assist investment company registrants and their independent public accountants in dealing with certain accounting-related matters. These comments represent the views of the staff of the Division and are not necessarily those of the Securities and Exchange Commission (the "Commission"). The comments described below apply to filings, including reports to shareholders, made by registered investment companies. This letter should be read together with earlier letters issued by the Division's Chief Accountant and letters issued by the Division's Office of Insurance Products and Office of Disclosure and Review.

Foreign Pricing Considerations

In its letter dated November 1, 1996[1], the staff discussed certain accounting-related matters involving a fund's ability to obtain and verify foreign corporate actions. In particular, the staff focused on the situation in which management of a fund uses reasonable diligence to attempt to obtain timely notification and verification of the effective date of foreign corporate actions but delayed the recording of the foreign corporate actions until third party confirmation. Such a procedure is commonly referred to as reflecting a "reasonable diligence standard."

Since the letter's issuance, registrants have asked whether a reasonable diligence standard could extend to the pricing of foreign securities. Although the staff recognizes that accounting for both corporate actions and pricing of securities is often intertwined, we do not believe the same standard applies. As noted in a previous letter[2], the Commission's Accounting Series Releases 113 and 118 are the accounting standards that govern the valuation and accounting for investments.[3]

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[1] See Letter to Chief Financial Officers from Lawrence A. Friend, dated November 1, 1996, "Accounting for Foreign Corporate Actions."

[2] See Letter to Chief Financial Officers from Lawrence A. Friend, dated November 1, 1994, "Valuation of Certain Portfolio Investments."

[3] Accounting Series Release 113, (October 21, 1969); Accounting Series Release 118, (December 23, 1970). These releases have been codified in Sections 404.04 and 404.03, respectively, in the Codification of Financial Reporting Policies.

Fund of Funds Considerations

In recent years, the number of fund of funds arrangements,[4] in which one fund ("top tier fund") invests its assets in shares of another fund ("underlying fund") rather than directly in securities, has increased. In some of these arrangements, the top tier fund has invested a significant amount of its investments in an underlying fund. The degree of investment raises financial reporting concerns for these top tier funds. Top tier funds, like all other funds, report each investment separately on their financial statements.[5] When a top tier fund has a significant amount of its portfolio invested in a single underlying fund or owns a controlling interest in an underlying fund, registrants should consider providing additional financial information to shareholders.

For example, if the top tier fund has a significant portion of its portfolio invested in an underlying fund, the top tier fund should consider accompanying its financial statements with those of the underlying fund. Additionally, if a top tier fund owns a controlling interest in an underlying fund, current accounting literature may require consolidating the financial statements of an underlying fund and the top tier fund.[6]

Designation of Segregated Assets

Certain trading practices undertaken by registrants may involve the issuance of senior securities subject to the prohibitions and asset coverage requirements of Section 18 of the Investment Company Act of 1940.[7] In 1979, the Commission issued a General Statement of Policy[8] indicating the staff's view that certain instruments held by a fund would not be deemed subject to Section 18 if the fund's obligation, with respect to any such instrument, was "covered" by assets established and maintained by the fund in a segregated account.

Release 10666 further stated that the board of directors of a fund that is engaged in the specified trading practices should review the fund's portfolio and custodial accounts to determine if the fund has created or should create any segregated accounts *with the company's custodian*. Although Release 10666 includes a section on valuation and accounting, it does not discuss internal accounting control and reporting issues related to the segregated accounts.

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[4] Fund of funds arrangements are subject to the provisions of Section 12 of the Investment Company Act of 1940.

[5] See Regulation S-X, Articles 6-04, 6-10 and 12-12. [17 CFR 210.6-04, 6-10, and 12-12].

[6] Statement of Financial Accounting Standards No. 94, "*Consolidation of All Majority-Owned Subsidiaries*," Financial Accounting Standards Board, (October, 1987) ("SFAS 94"). SFAS 94 requires consolidation of all majority-owned subsidiaries unless control is temporary or does not rest with the majority owner. Control is defined as ownership of over 50% of the outstanding voting shares of another company. While a fund of funds arrangement differs from an operating company envisioned by the current accounting literature, SFAS 94 suggests that consolidation may be appropriate.

[7] 15 U.S.C. 80a-18

[8] Investment Company Act Release No. 10666, April 18, 1979 ("Release 10666").

Typically, investment companies have designated securities to be segregated on the records of their custodians. The staff has been asked by registrants whether it would be consistent to segregate accounts on the fund's records. The staff has indicated that it would not object if assets segregated under Section 18 were designated solely on the fund's records and not designated on the fund's custodian's records.[9]

Accounting for Securities Lending Transactions

In a typical fund securities lending transaction, the fund lends its securities to a borrower which pledges cash or securities as collateral for the securities on loan. Generally Accepted Accounting Principles ("GAAP") for securities lending transactions are governed by Statement of Financial Accounting Standards No. 125 ("SFAS 125").[10] SFAS 125 focuses on "effective control"[11] as a key component for determining the accounting treatment for securities on loan and the corresponding collateral exchanged between the lending fund and borrower.

When a lending fund receives securities as collateral and does not have effective control over the securities, it should not record the securities as its asset. Conversely, when a fund receives securities as collateral and has effective control over the securities, it should record the securities as its asset with a corresponding liability for repayment. When a fund receives cash as collateral, it is deemed to have effective control of the collateral and should record the cash as its asset with a corresponding liability for repayment.[12]

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[9] To the extent that a fund designates segregated assets solely on its records, the fund may need to implement additional procedures and controls to ensure that segregation is undertaken in accordance with the interpretation outlined in Release 10666.

[10] "*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*," Financial Accounting Standards Board, (June, 1996) ("SFAS 125"). SFAS 125 was amended by Statement on Financial Accounting Standards No. 127, "*Deferral of the Effective Date of Certain Provision of FASB Statement Number 125*," Financial Accounting Standards Board, (December, 1996) ("SFAS 127") by deferring the effective date of certain relevant portions of SFAS 125, including the paragraphs dealing with securities lending, to December 31, 1997. For the purpose of this letter, the reference to SFAS 125 encompasses SFAS 125, as amended by SFAS 127.

[11] See SFAS 125, Par. 9 (defines the three conditions under which the transferor has surrendered control over transferred assets, all of which must be met: (1) the transferred asset has been put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy, (2) each transferee may use the transferred assets, and (3) the transferor does not have an agreement that maintains effective control over the transferred asset.)

See SFAS 125, Par. 27 (defines effective control as an agreement that has all of the following features: "(a) the assets to be repurchased or redeemed are the same or substantially the same as those transferred; (b) the transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee; (c) the agreement is to repurchase or redeem them before maturity, at a fixed or determinable price; and (d) the agreement is entered concurrently with the transfer.")

[12] See SFAS 125, Par. 161, "... all cash collateral should be recorded as an asset by the secured party, together with a liability for the obligation to return it to the transferor, whose asset is a receivable."

Further, the lending fund remains liable for returning the amount of cash collateral, and incurs the risk of loss from any securities purchased with the cash collateral.

We have noted inconsistent accounting by some funds that automatically reinvest cash collateral in securities. These funds are "looking through" to the securities purchased with the cash collateral and treating the securities received as collateral without effective control. Therefore, the funds do not record them as assets. The staff believes, consistent with SFAS 125, that a fund has effective control over cash collateral and also has effective control over any securities purchased with the cash collateral. As a result, a fund should record these securities as its asset and a corresponding liability for repayment, in the amount of the cash collateral received, in its financial statements.[13]

Closed-End Fund Expense Ratios

In reviewing the financial statements of closed-end funds, we have noted inconsistencies in how they have calculated their expense ratios[14] when they incurred interest expense on debt securities or paid dividends on preferred shares.

Interest Expense

Item 4 of Form N-2, *Financial Highlights*, requires expense ratios to include all expenses of the fund. The instructions to Form N-2 make no exception for any expense item; all expenses, including interest expense, should be included in the fund's calculation of its expense ratio.[15]

We have been asked by registrants and their independent accountants whether more than one expense ratio may be shown as a part of the financial highlights table. For example, some funds believe a more meaningful ratio would be based on expenses that do not include interest ("net expenses"). The staff has not objected to a second ratio that excludes interest in certain circumstances.[16] In all cases, the expense ratio that includes interest expense ("gross expenses") should be shown in the body of the financial highlights. The staff would not object if both the net and gross expense ratios are shown in the body of the financial highlights table or if the expense ratio, without the interest expense, is reflected in a footnote to the financial highlights table. Both ratios should be clearly identified with appropriate disclosure about the differences.

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[13] The Staff noted in Norwest Bank Minnesota N.A., SEC No-Action Letter (pub. avail. May 25, 1995) that cash collateral should be invested in accordance with the fund's investment policies. Because the fund invests the cash collateral in securities consistent with its policies, the fund exercises control over the cash collateral and the securities purchased with that cash. As fund assets, the securities purchased with the cash collateral are subject to the fund's usual valuation procedures.

[14] See Form N-2, Item 4.1, line i.

[15] In proposing Form N-2, the Commission stated that "interest payments on long-term debt, which may be part of the capitalization of a closed-end fund, would be included among the annual shareholder expenses." (Release No. IC-17091, July 28, 1989, footnote 38).

[16] This position reflects an application of a general principle stated in the instructions to Form N-2. General Instructions (2) to the form states: "The prospectus or the SAI may contain more information than called for by this form, provided the information is not incomplete, inaccurate, or misleading and does not, because of its nature, quantity, or manner of presentation, obscure or impede understanding of required information."

Dividend Payments

GAAP defines preferred stock to be a component of equity and not debt, even though it has characteristics of both.[17] Accordingly, dividend payments to preferred stockholders are not considered to be an expense of the fund and, in the staff's view, should not be included as expenses in the financial statements.[18] Instruction 15 to Item 4 of Form N-2 requires a fund to "indicate in a note that the expense ratio and net investment income ratio do not reflect the effect of dividend payments to preferred shareholders." Also, Instruction 9 to Item 3, *Fee Table and Synopsis*, states that other expenses includes all expenses that will be reflected as expenses in the registrant's statement of operations. Because GAAP does not permit dividends to be included as expenses in a statement of operations, the staff's position is that dividends would not be included as an expense in either Item 3 or 4 of Form N-2.

In view of the reporting differences, the staff takes the position that it would not object to additional ratios reflecting the treatment of the preferred shares. In the staff's view, the additional ratios should not be included on the face of the financial highlights table; rather, they should be included in the footnotes to that table.

Other Disclosures

Instruction 6 to Item 3 of Form N-2 prescribes "other expenses [to] be stated as a percentage of net asset value attributable to common shares." Although this instruction is to Item 3 and is not repeated as an instruction to Item 4, the staff believes the concept should be consistently applied in both tables. Expense ratios should be presented as a percentage of the net asset value attributable to common shares only.[19] The staff would not object to the inclusion, in the footnotes to the financial highlights table, of additional ratios that are clearly identified and explained.

The Division acknowledges that its positions stated above with respect to closed-end funds may result in some funds changing their financial statements. To enable those funds sufficient time to complete these changes, the staff would not object if registrants implement these interpretations for all ratios contained in financial statements for fiscal years that begin after November 15, 1997.

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[17] See Accounting Principles Board Opinion Number 10 - Omnibus Opinion. American Institute of Certified Public Accountants. (December. 1966).

[18] Distributions to preferred and common stockholders are required to be shown broad in Form N-2, Item 4.1.

[19] Similarly, the ratio of net income to average net assets (Form N-2, Item 4.1 line i.) should also be presented as a percentage of the net asset value attributable to common shares only.

Organization Costs Considerations

The staff continues to address questions from registrants and their independent accountants regarding the accounting treatment for organization costs[20] that arise in connection with a merger, liquidation, or dissolution of a fund.[21] The staff has indicated that the remaining amount of organization costs, in such a transaction, are the responsibility of the holder of the original shares and should be netted against redemption proceeds of the original shares.[22] The staff has indicated that it is not appropriate to accelerate the write-off of the remaining organization costs to the date of the merger, liquidation, or dissolution, or to immediately charge to fund expenses the remaining amount of organization costs.

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This letter contains information of importance to the company's independent public accountants; therefore, we encourage you to discuss these items with them. Address any questions about the contents of this letter or related matters to John S. Capone or Paul T. Kraft, Assistant Chief Accountants, or me, at (202) 942-0590.

Very truly yours,

Lawrence A. Friend

Lawrence A. Friend
Chief Accountant

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[20] This item does not address any possible changes to the accounting for and the reporting on organization costs as contemplated in proposed Statement of Position (SOP) "Reporting on Costs of Start-Up Activities," dated April 22, 1997, issued by the American Institute of Certified Public Accountants.

[21] The staff would not object if, in the case of a merger, the organization costs of the acquiring, legal survivor fund are capitalized and amortized. However, remaining organization costs of the target fund should be netted against the redemption proceeds of the original shares.

[22] See Letter to Registrants from Carolyn B. Lewis, dated January 3, 1991, Item II. E. "Organization Expenses."