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VIA ELECTRONIC DELIVERY

September 24, 2010

Mr. Russell G. Golden  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. 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:

The Investment Company Institute<sup>1</sup> 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* (ASU or Proposal). Among other things, the ASU would: 1) require investment companies to recognize transaction costs on the purchase and sale of portfolio securities as an expense in the statement of operations and expense ratio; 2) require money market funds that comply with Rule 2a-7 under the Investment Company Act of 1940 to measure their investments at fair value (rather than amortized cost) when reporting holdings in their financial statements; and 3) require investment companies to measure financial liabilities at fair value, and recognize changes in fair value of financial liabilities in earnings.

The Institute strongly opposes recognizing transaction costs on the purchase and sale of portfolio securities as an explicit expense in the statement of operations. We believe current GAAP for investment companies, which requires transaction costs incurred to be included in cost of securities purchased (and deducted from proceeds of sales) appropriately recognizes these costs as a decrease in

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<sup>1</sup> 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 \$11.66 trillion and serve almost 90 million shareholders.

the reported gain on the fund's portfolio (or as an increase in the reported loss). Current GAAP recognizes transaction costs as a cost of trading the portfolio, rather than a recurring operating expense. We are concerned that the Proposal would diminish the utility of the expense ratio as a measure of funds' recurring operating expenses. We are also concerned that the proposal cannot reasonably be applied to fixed-income securities or any other securities that trade on a bid-ask spread basis without brokerage commissions. The absence of implementation guidance for measuring implicit transaction costs will introduce serious comparability concerns across funds and reporting periods. As noted in our response to the SEC's 2003 request for comment on measures to improve mutual fund disclosure of transaction costs, we support alternative measures to improve shareholder understanding of transaction costs.<sup>2</sup> We urge that the Board retain current fund accounting for transaction costs.

The Institute believes that fair value based financial reporting best serves investment company shareholders. There would be little practical benefit, however, to requiring money market funds to measure their investments at fair value. Rule 2a-7's risk limiting conditions ensure that amortized cost is substantially equivalent to fair value under normal circumstances. In those rare instances where fair value deviates from amortized cost (*i.e.*, an issuer default) industry practice is to measure the defaulted security at fair value in the financial statements, and separately present, at fair value, any related credit support agreement. Further, recently adopted SEC rules will require money market funds to disclose the fair value of each holding on a monthly basis. In lieu of requiring money market funds to measure their investments at fair value, we recommend the Board consider requiring these funds to disclose the fair value of the investment portfolio in the notes to the financial statements.

Changes in the fair value of liabilities that can be realized give rise to economic gains (losses) that accrue to the benefit (detriment) of common shareholders. Such liabilities should be reflected at their fair value to properly present a fund's results of operations and financial position. Where changes in the fair value of a liability cannot be realized or are highly unlikely to be realized, however, we believe measurement of the liability at its amortized cost best reflects a fund's results of operations and financial position. Accordingly, we recommend that the Board require liabilities to be measured at fair value with the change in value reflected in earnings, if the change in value is probable of being realized. Other liabilities, for which the likelihood of realization of the change in value is remote, should be measured at their amortized cost. Further, we recommend that, for liabilities where the likelihood of realization is remote, the fair value be disclosed in the notes to the financial statements.

### **Transaction Costs**

The ASU would require transaction fees and costs to be expensed immediately for financial instruments measured at fair value with all changes in value reported in earnings. Under the Proposal, funds initially would recognize securities purchased at their fair value and any excess would be recognized as transaction expense in the period incurred. In the basis for conclusions, the ASU indicates:

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<sup>2</sup> See letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (February 23, 2004).

*The Board decided that transaction costs and fees relating to financial instruments measured at fair value with all changes in fair value recognized in net income should be recognized as an expense in net income when incurred. The Board believes that these transaction costs should be reflected as current period expenses rather than capitalized and deferred because such costs do not directly relate to the financial asset or liability's fair value, which is consistent with the guidance in Topic 820.*

The ASU, at paragraph IG16, makes clear that, for an equity trade involving payment of brokerage commissions, the security would be initially recognized at its fair value (*i.e.*, price paid multiplied by quantity of shares) and that the brokerage commission would be recognized as transaction expense in the period incurred. The ASU, however, provides no specific implementation guidance for measuring implicit transaction costs. Fixed-income and other securities often trade on a bid-ask spread basis, with no explicit commission. We are uncertain whether the ASU is intended to require measurement and recognition of implicit transaction costs. If the Proposal is intended to apply to fixed-income securities and other securities traded on a bid-ask spread basis, we have serious, additional concerns with its application.

#### *Investment Company GAAP*

Investment companies include transaction fees and costs in the cost basis of securities purchased, and deduct transaction fees and costs from the proceeds of securities sold. This accounting treatment causes transaction fees and costs to reduce gain (or increase loss) recognized on the fund's portfolio of investments. Transaction fees and costs are not recognized as an explicit expense in the fund's statement of operations. They are deducted immediately from fund assets, however, thus decreasing net assets and net asset value per share. It is important to note that total return, which is based on the change in net asset value per share over the reporting period, is net of all fees and costs, including transaction fees. Further, funds' bottom line earnings as reported in the statement of operations – net increase/decrease in net assets from operations – currently reflects deduction of transaction fees and costs incurred on portfolio transactions.<sup>3</sup>

The Board's basis for conclusions indicates that the Board believes transaction costs should be reflected as current period expenses, rather than capitalized and deferred, because such costs do not directly relate to the financial asset or liability's fair value. We note that investment company GAAP does not enable funds to capitalize and defer transaction costs. As described above, these costs are recorded immediately in a fund's results of operations by including them in the gain or loss on the fund's investment securities. Funds' measurement of their investment securities at fair value is entirely consistent with Topic 820 in that transaction fees and costs are not included within the fair value of the security.

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<sup>3</sup> See Appendix A to this letter for an illustration of the effects of the Proposal on investment company financial reporting.

The issue, then, is whether transaction fees and costs should be recognized as an explicit expense in the statement of operations, as the Board has suggested in Question 11, or whether such fees and costs should be included in the gain or loss on the fund's investment portfolio, consistent with current practice. For the reasons described below, we strongly believe transaction fees and costs should be offset against the fair value of the fund's investment portfolio. First, however, we describe the fund's expense ratio and its use by investors to assess fund operating expenses.

### Expense Ratio

Funds disclose the expense ratio (*i.e.*, total expenses for the period divided by average net assets) in the financial highlights included in the financial statements. SEC-registered funds also must disclose their expense ratio in the prospectus provided to investors. SEC rules require the prospectus to include a fee table listing sales charges and fund expenses, and an "expense example" intended to illustrate the costs associated with investing in a fund. The expense example applies the fund's expense ratio to an assumed \$10,000 investment to project the dollar costs associated with an investment in the fund over one, three, five and ten year periods. The expense ratio is widely used by investors and fund analysts to compare fund operating costs.

### Support for Current Accounting

We support current fund accounting for the following reasons:

- Current accounting recognizes transaction costs and fees as the cost of purchasing and selling portfolio securities – as opposed to a recurring operating expense – and causes these costs and fees to be recorded as a loss on investments when presenting gain/loss on the statement of operations.<sup>4</sup> Transaction fees and costs are inextricably linked to the acquisition and sale of investment securities and must be offset against the portfolio in order to present an accurate assessment of the gain/loss from investing activities. The ASU inappropriately would characterize these fees and costs as recurring operating expenses, similar to management, shareholder servicing, and other ongoing expenses;
- Portfolio transactions and the amount of transaction costs and fees incurred by a fund can vary substantially from year to year, due to, for example, shareholders entering and exiting the fund, changes in investment strategy, and general economic conditions. If transaction fees and costs are characterized as an operating expense, we are concerned that it will introduce significant volatility into the expense ratio, and diminish its effectiveness as a measure of the regular, recurring costs associated with an investment in the fund;

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<sup>4</sup> See Topic 946-320-40-1.

- If transaction fees and costs are characterized as an explicit expense, it would reduce the fund's reported net investment income ratio and SEC yield, which are presented after deduction of expenses. We are concerned that such change would systematically understate the income return associated with an investment in the fund. These measures of income would also be subject to the volatility described above;
- There is no single agreed-upon measure of transaction costs. While transaction costs may be explicit in the form of brokerage commissions, they may also be implicit in the form of a bid-ask spread. Further, some would suggest that transaction costs should include market impact costs – the price concessions (amounts added to the purchase price or subtracted from the selling price) that are required to find the opposite side of the trade and complete the transaction. The Board should not change current accounting absent a well understood measure that is capable of being consistently applied; and
- Tax law requires transaction fees and costs to be included in the cost basis of securities purchased (and deducted from proceeds of sales) when determining gain/loss, similar to current GAAP. By characterizing transaction fees and costs as operating expenses, the ASU will cause reported GAAP net investment income to decline relative to taxable ordinary income. We anticipate investment company income distributions, which are based on taxable ordinary income, will remain the same. Accordingly, the Proposal would cause GAAP-based net investment income to decline relative to, and be less representative of, the income distribution amounts a shareholder would receive from the fund.

*Application to Fixed-Income Securities and Other Securities Traded on a Bid-Ask Basis*

As noted above, we are unsure if the Proposal's requirement to recognize transaction costs as expense applies to fixed-income securities. If the ASU is intended to apply to fixed-income securities and other securities traded on a bid-ask spread basis, we believe that, in addition to the problems and mischaracterizations described above, it will entail practical difficulties that will limit its ability to be applied consistently across different funds, leading to comparability concerns.

As a preliminary matter, we note that the Proposal is substantially similar to corresponding IFRS in that it requires financial instruments to be initially recognized at their fair value.<sup>5</sup> We understand, however, that funds based in jurisdictions that apply IFRS do not recognize transaction costs incurred in the form of the bid-ask spread as an explicit expense. Instead, fixed-income securities purchased are initially recognized at their purchase price, which is consistent with current U.S. investment company accounting under GAAP. If the ASU is intended to require recognition of transaction costs on fixed-income securities as an explicit expense, then it would cause GAAP to diverge from the manner in which international standards are being applied and represent a step backward from the Board's stated objective of standards convergence.

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<sup>5</sup> See IAS 39, *Financial Instruments: Recognition and Measurement*, and IFRS 9, *Financial Instruments*.

The Proposal would require funds to initially recognize securities purchased at their fair value. We believe this would require funds, contemporaneous with each purchase or sale of securities, to measure the fair value of the securities purchased or sold. The purchase or sale price would then be compared to the fair value measurement in order to determine the transaction expense.<sup>6</sup> We are concerned that centralized transaction reporting systems for many types of fixed-income securities are not sufficiently developed to a degree that would enable the contemporaneous fair value measurement that would be required under the Proposal. Indeed, many funds investing in fixed-income securities rely on independent pricing vendors to provide them with “evaluated” prices for their fixed-income holdings as of 4:00 p.m. eastern time each business day, so that they can calculate their net asset value. These evaluated prices consider a number of different inputs (*e.g.*, recent trades, bids, interest rates, credit spreads, pre-payment speeds, default rates, *etc.*).<sup>7</sup>

Practically speaking, it would be extremely difficult for funds to develop the contemporaneous fair value measurements for fixed-income securities that would be required under the Proposal. If the Proposal were to be adopted without implementation guidance for measurement of transaction costs on fixed-income securities, we believe funds would be forced to apply their own methodologies for estimating transaction costs, which will create serious comparability concerns. Indeed, our concerns go beyond fixed-income securities and would apply to any security traded over-the-counter on a bid-ask spread basis without explicit commissions. Such securities may include, for example, derivatives traded over-the-counter.

The Board, in Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information* recognized that, “information about a particular enterprise gains greatly in its usefulness if it can be compared with similar information about other enterprises.”<sup>8</sup> The SEC in its release proposing the prospectus fee table and expense example explained that it wished to “explore ways to improve the quality of prospectus disclosure so that investors may more easily and more clearly understand mutual fund fee and expense arrangements.”<sup>9</sup> One of the great benefits of the fee table is that sales charges and

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<sup>6</sup> For equity securities traded on an exchange, where buyers and sellers are matched, we believe the trade price would be the fair value and that transaction expense generally would be equal to the brokerage commission paid. For fixed-income securities, which generally are traded over-the-counter on a bid-ask spread basis, the purchase price may be different than the fair value (exit value).

<sup>7</sup> We believe the 4:00 p.m. fair value measurement could not be used to measure transaction costs, because it would not consider changes in fair value subsequent to the trade time and prior to 4:00 p.m.

<sup>8</sup> The FASB Concepts Statements are intended to serve the public interest by setting the objectives, qualitative characteristics, and other concepts that guide selection of economic phenomena to be recognized and measured for financial reporting and their display in financial statements or related means of communicating information to those who are interested. Concepts Statements guide the Board in developing sound accounting principles and provide the Board and its constituents with an understanding of the appropriate content and inherent limitations of financial reporting.

<sup>9</sup> SEC Release Nos. 33-6556, IC 14230 (November 8, 1984).

fund expenses are presented in a uniform manner and calculated pursuant to prescribed methods, ensuring that information is presented on a consistent, comparable basis. We believe the Proposal, absent specific guidance on measuring implicit transaction costs, would cause expense information to be less comparable, to the detriment of fund investors.

*Prior SEC Consideration of Mutual Fund Transaction Costs Measurement and Disclosure*

In 2003 the SEC issued a concept release requesting public comment on issues relating to measurement and disclosure of mutual fund transaction costs.<sup>10</sup> The SEC Release requested comment on whether mutual funds should be required to record some or all of their transaction costs as an expense in their financial statements. The SEC Release also requested comment on whether mutual funds should be required to quantify and disclose to investors the amount of transaction costs they incur, include transaction costs in their expense ratios and fee tables, or provide additional quantitative or narrative disclosure about their transaction costs.

The Institute's response to the SEC Release argued against requiring funds to recognize transaction costs as an explicit expense in their financial statements and in the expense ratio, for many of the reasons articulated above. The Institute's response also noted that brokerage commissions may be the primary type of transaction cost incurred for certain fund types, while other fund types transact on a bid-ask spread basis and incur little or no brokerage commissions. Accordingly, requiring only brokerage commissions to be recognized as an explicit expense in financial statements would create misleading expense comparisons and destroy the ability of investors to compare fund expenses on an "apples-to-apples" basis. In particular, equity funds that incur brokerage commissions would artificially appear more expensive than fixed-income funds. Further, expense information for balanced funds would be a function of their asset allocation between equities (with explicit transaction costs) and fixed-income securities (with implicit transaction costs).

The Institute's response to the SEC Release recommended alternative measures to improve shareholder understanding of mutual fund transaction costs. In particular, the ICI recommended that the SEC:

1. Require new disclosure in the financial highlights table of brokerage commissions paid by a fund (1) as a percentage of average net assets and (2) as a percentage of the principal amount of transactions, and require accompanying disclosure stating the portion of trades that were executed on a commission basis, spread basis, or some other basis;
2. Require new disclosure in the financial highlights table of a fund's gross inflows and outflows as a percentage of average net assets; and

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<sup>10</sup> SEC Release Nos. 33-8349, 34-48952 and IC-26313, December 18, 2003 ("SEC Release")

3. Require expanded and more prominent disclosure in a fund's prospectus relating to portfolio turnover, which many view as a proxy for transaction costs.

Since the 2003 SEC Release, the Commission has not changed its rules or disclosure forms to require funds to recognize transaction costs as an explicit expense in their financial statements, or to include such costs in their expense ratios. The SEC has, however, required expanded and more prominent disclosure in the mutual fund prospectus relating to portfolio turnover. We believe the Commission's decision to require more prominent disclosure of portfolio turnover, without taking further actions, acknowledges the practical difficulties associated with measuring and recognizing transaction costs.

➤ *Recommendation* – We urge that the Board retain current fund accounting for transaction costs. The Board should affirm that current accounting effectively recognizes these costs as an expense by requiring that they reduce reported gain (or increase reported loss) on the fund's portfolio.

### **Money Market Funds**

The ASU would require money market funds that comply with rule 2a-7 under the Investment Company Act of 1940 to measure their investments at fair value, rather than amortized cost. The Proposal, at Question 6, asks whether reporting those investments at fair value, rather than amortized cost, would provide financial statement users with decision-useful information.

#### **Rule 2a-7**

Rule 2a-7 permits SEC-registered money market funds to calculate their net asset value per share for purposes of issuing and redeeming fund shares using amortized cost (in lieu of fair value), provided they meet certain risk-limiting conditions. The risk-limiting conditions are intended to provide assurance that any deviation between the fair value of the portfolio and its amortized cost is minimal, and results in calculation of a share price that represents fairly the current net asset value per share of the fund. The risk-limiting conditions minimize a money market fund's exposure to credit, currency, interest rate, and liquidity risks.<sup>11</sup>

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<sup>11</sup> Rule 2a-7 includes the following risk-limiting conditions: 1) investments must be rated in either of the two highest short-term debt ratings categories by a nationally recognized statistical rating organization; 2) investments must be determined, by the fund's board of directors (or its delegate) to present minimal credit risks; 3) investments must be U.S. dollar denominated; 4) the portfolio must have a weighted average maturity of 60 days or less; 5) the portfolio must have a weighted average life of 120 days or less; 6) investments must have a maturity of 397 days or less; 7) taxable funds must hold 10% or more of their total assets in daily liquid assets (cash, direct obligations of the U.S. Government, and securities that will mature or are subject to a demand feature that is exercisable and payable within one business day); and 8) all funds must hold 30% of their total assets in weekly liquid assets (cash, direct obligations of the U.S. Government, certain other Government securities, and securities that will mature or are subject to a demand feature that is exercisable and payable within five business days).



Rule 2a-7 also requires money market funds to calculate, on a periodic basis, the current net asset value per share using available market quotations for their portfolio securities. This “shadow pricing” is intended to illustrate, for the fund’s board and management, any deviation between the current net asset value per share based on amortized cost and net asset value per share based on available market quotations. If the deviation results in material dilution or other unfair results to existing shareholders, under the rule, the fund’s board must cause the fund to take action to eliminate or reduce such dilution or unfair results.

*Rule 30b1-7 and Form N-MFP*

The SEC recently adopted Rule 30b1-7, which requires money market funds to report portfolio information on new Form N-MFP to the SEC within five business days after the end of each month.<sup>12</sup> Form N-MFP requires money market funds to disclose, for each portfolio security held by the fund, 1) the total principal amount to the nearest cent, 2) the total current amortized cost to the nearest cent, and 3) the value of the security, calculated using available market quotations (or an appropriate substitute that reflects current market conditions). In addition, Form N-MFP requires money market funds to disclose the most recently calculated net asset value per share using available market quotations (or an appropriate substitute that reflects current market conditions) to the nearest hundredth of a cent.

Money market funds must first file Form N-MFP beginning with the filing covering the month ended November 30, 2010. The SEC has indicated that it will make funds’ filings on Form N-MFP publicly available 60 days after the month end to which the filing relates. Accordingly, beginning on or about February 1, 2011, current fair values for money market fund holdings, as well as the net asset value per share based on those fair values, will be publicly available through the SEC. Such information will be updated on a monthly basis.

*No Practical Benefit*

We see no practical benefit associated with requiring money market funds to measure their holdings at fair value (in lieu of amortized cost) when reporting their investments in their financial statements. Accordingly, we urge the Board to clarify that money market funds that comply with rule 2a-7 may continue to measure their investments at amortized cost for financial reporting purposes.

First, due to rule 2a-7’s risk limiting conditions, under normal circumstances, any deviation between the amortized cost value and the fair value of the fund’s holdings will be insignificant. We note that money market funds have, for many years, measured their holdings at amortized cost for financial reporting purposes, and that auditors, notwithstanding GAAP’s requirement for investment companies to measure their holdings at fair value, have not objected to this presentation. We believe

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<sup>12</sup> SEC Release No. IC-29132 (February 23, 2010) 75 FR 10060 (March 4, 2010).

auditors have concluded appropriately that amortized cost does not differ materially from fair value. Further, we believe the fund's periodic shadow pricing process, in which the fund calculates net asset value per share based on available market quotations, confirms there is no significant deviation. In those rare circumstances where the fair value of a particular holding differs materially from amortized cost (*i.e.*, due to an issuer default), industry practice is to measure the holding at its fair value in the fund's financial statements. In addition, the fund would separately disclose any credit support arrangement from the fund sponsor measured at fair value. Such presentation would be supplemented with note disclosure detailing the terms of any credit support arrangement.

Second, as described above, fair value information for each money market fund holding will be publicly available in SEC Form N-MFP beginning on or about February 1, 2011. This information will be updated on a monthly basis. Accordingly, the fair value information that the Board would require under the Proposal will be available through the SEC to investors and others, and it will be updated more frequently (monthly vs. quarterly).

For the reasons described above we believe there is no practical benefit associated with measuring the money market fund's investments at fair value in the fund's financial statements and urge the Board to clarify that such funds may continue to measure their investments at amortized cost.

➤ *Recommendation* – In lieu of requiring money market funds to measure their investments at fair value, we recommend the Board consider requiring these funds to disclose the fair value of the investment portfolio at the reporting date in the notes to the financial statements. Such disclosure would enable financial statement users to assess any difference between the amortized cost and fair value of the fund's portfolio.

### **Liabilities at Fair Value**

The ASU would require investment companies to measure their financial liabilities at fair value, with the change in fair value recognized in the net increase/decrease in net assets from operations. In the basis for conclusions, the Proposal indicates that the Board believes that recognizing all financial assets and liabilities at fair value with changes in fair value included in determining the net increase/decrease in net assets resulting from operations would provide users of investment company financial statements with the most relevant information. Question 5 in the ASU asks whether the effect on net asset value associated with changes in the fair value of financial liabilities will provide financial statement users with decision-useful information.

Investment companies currently measure certain financial liabilities at fair value, with the change in fair value recognized in earnings. For example, where a fund sells securities short, the liability created (reflecting the fund's obligation to purchase the securities sold) is measured at its fair value, with changes in fair value recognized as gain/loss. Other liabilities are measured at amortized cost. For example, closed-end investment companies may issue debt securities as part of a leveraging strategy to increase returns to common shareholders. Typically, such a fund would issue debt securities paying a

fixed rate of interest and invest the proceeds in relatively higher yielding securities. The incremental income earned on the securities purchased with the proceeds of the debt offering can be distributed to the common shareholders to increase their current yield. Such funds do not, however, measure such debt securities at their fair value under current GAAP.

Changes in the fair value of liabilities that can be realized give rise to economic gains (losses) that accrue to the benefit (detriment) of common shareholders. Such liabilities (*e.g.*, short sales) should be measured at their fair value to properly present a fund's results of operations and financial position. Where changes in the fair value of a liability cannot be realized, or are highly unlikely to be realized, however, we believe measurement of the liability at its amortized cost best reflects a fund's results of operations and financial position. For example, in the scenario described above involving issuance of fixed-rate debt securities by a closed-end fund, changes in interest rates would cause the fair value of the fixed-rate debt to change. Because the debt securities enable the fund to earn incremental income and increase income distributions to common shareholders, however, it is highly unlikely that the closed-end fund would ever realize the change in value. Instead, we believe the fund would continue its leveraging strategy, consistent with its investment policies disclosed in its prospectus. Ultimately, such debt securities would mature and be redeemed at their principal amount.

➤ *Recommendation* – We urge that the Board require liabilities to be measured at fair value with the change in value reflected in earnings, if the change in value is probable of being realized. Other liabilities, for which the likelihood of realization of the change in value is remote, should be measured at their amortized cost. Further, we recommend that for liabilities where the likelihood of realization is remote, the fair value be disclosed in the notes to the financial statements.

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We appreciate the opportunity to comment on the ASU and would be pleased to provide any additional information you may require. Please contact the undersigned at 202/326-5851 if you have any questions or require any additional information.

Sincerely,

/s/

Gregory M. Smith  
 Director – Operations/  
 Compliance & Fund Accounting

cc: James Kroeker, Chief Accountant  
Office of the Chief Accountant

Richard F. Sennett, Chief Accountant  
Division of Investment Management  
U.S. Securities and Exchange Commission

## APPENDIX A

### ABC Mutual Fund

#### Statement of Operations

Year ended 12/31/09  
(\$000s)

#### Investment Income

Income	
Dividend	424,442
Interest	4,092
Total Income	<u>428,534</u>

#### Expenses

Management fees	81,940
Shareholder servicing fees	22,475
Rule 12b-1 fees	4,451
Custody and accounting fees	435
Legal and audit fees	142
Registration fees	59
Directors' fees	112
Total expenses	<u>109,614</u>

Net Investment Income

318,920

#### Realized and Unrealized Gain (Loss)

Net realized loss	(1,050,809)
Change in net unrealized gain	4,343,067
Net realized and unrealized gain	<u>3,292,258</u>

#### Increase in Net Assets from Operations

3,611,178

#### Financial Highlights

##### Net Asset Value

Beginning of period	\$17.08
Investment activities	
Net investment income	0.39
Net realized and unrealized gain	3.91
Total from investment activities	<u>4.30</u>
Distributions	
Net investment income	(0.39)
Net realized gain	-
Total distributions	(0.39)

##### Net Asset Value

End of period \$20.99

##### Ratios and Supplemental Data

Total return	25.62%
Ratio of expenses to average net assets	0.72%
Ratio of net investment income to average net assets	2.19%
Portfolio turnover rate	14.6%
Net Assets, end of period (millions)	15,494

(1) Under current GAAP, transaction costs are included in the cost basis of securities purchased and deducted from proceeds of sales, reducing reported gain (or increasing loss).

(2) The ASU would require transaction costs to be reported as an expense, increasing expenses, decreasing net investment income, and increasing net realized and unrealized gain.

(3) Bottom line earnings - Increase in Net Assets from Operations - would be unchanged.

(4) The ASU would cause transaction costs to be recognized as expense, decreasing net investment income and increasing net realized and unrealized gains. Total from investment activities would be unchanged.

(5) The ASU would have no effect on net asset value or total return.

(6) The ASU would cause the expense ratio to increase and the net investment income ratio to decrease.