



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

DIVISION OF INVESTMENT MANAGEMENT

1940 ICA
Section 30
February 3, 1995
Dear Chief Financial Officer:

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Please consult the Accounting Matters Bibliography available at <https://www.sec.gov/investment/accounting-matters-bibliography> for the staff's current position on these matters.

The accounting staff of the Division of Investment Management has prepared this supplemental letter to our November 1, 1994 letter to assist investment company registrants and their independent public accountants in addressing certain timely accounting-related matters. These comments represent the views of the staff of the Division of Investment Management and are not necessarily those of the Securities and Exchange Commission (the "Commission"). The comments addressed in this letter apply to filings made by registered investment companies, including reports to shareholders. While we do not anticipate issuing a regular supplement to our annual accounting letter, this letter is precipitated by the occurrence of certain accounting-related events that we believe merit timely communication.

A. Applying SFAS # 119 to Investment Companies

IM-DCFO 1995-01

In October 1994, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards # 119, *Disclosure About Derivative Financial Instruments and Fair Value of Financial Instruments* ("SFAS # 119" or "the Standard") which requires financial statement disclosures about certain derivative financial instruments. Paragraph 9 of the Standard makes a distinction between financial instruments held or issued for *trading* purposes and financial instruments held or issued for purposes *other than trading*. The Staff recognizes that funds could have instruments in their portfolios from both categories, depending on the purpose for which the derivative is held or issued.

Investment companies should designate each derivative covered by the Standard as either held or issued for *trading* purposes or held or issued for purposes *other than trading*, and should make the designation at the time the derivative financial instrument is acquired. Funds have a continuing obligation to regularly evaluate the appropriateness of the original designations which could lead to changes in a designation, and, accordingly, differences in disclosure requirements during the holding period of the instrument.

B. Presentation and Accounting for Enhanced Securities

The staff has recently addressed several issues related to the accounting for and financial statement presentation of enhanced securities¹. These issues have included 1) the separate valuation of the components of such investments; 2) the appropriate financial statement presentation of these components; and 3) the contribution to capital to be recognized for the enhancement.

¹ Enhanced securities include separate and distinct credit mechanisms provided to maintain the carrying value of an investment.

(1) Valuation

The credit enhancements have been segregated into the two commonly used types, typically issued through the adviser: non-transferable put options (which expire at or prior to maturity of the enhanced security) and non-transferable letters of credit ("LOCs") (which expire at maturity of the enhanced security)². For these enhancements, the staff believes that valuing each component separately is appropriate. For example, a security with a market value of 70, linked with a 90-day put option (or LOC) allowing the fund to put the security to the adviser (or draw against the LOC) for 95, would be valued at 70; the value attributable to the enhancement would be 25³.

(2) Presentation

Separate and distinct disclosure of the components of a credit-enhanced security provides a more complete and meaningful presentation to fund shareholders, and is required by Items 6-04.1 and 6-04.3 of Regulation S-X which require the disclosure of investments in securities of unaffiliated issuers separate from the disclosure of investments other than securities. The staff would not object to presentation of separate, contiguous disclosure on the face of the portfolio of investments schedule of the security (at market value without the enhancement) and the enhancement (valued at the difference between carrying value of the security with the enhancement and market value of the security without the enhancement). For put options, the presentation on the portfolio of investments schedule should describe the option as being from an affiliated party (if applicable) with the name and relationship of the affiliate, and any terms and conditions of the put discussed in a note to the financial statements. If the enhancement is a LOC, the name of the financial institution providing the LOC should be separately disclosed in the notes to the financial statements along with the terms, conditions and other arrangements related to the LOC.⁴ Disclosure should also comply with the requirements of Statement of Financial Accounting Standards number 57 - *Related Party Disclosures* ("SFAS 57"), issued by the Financial Accounting Standards Board. The staff views the relationship between an adviser and a financial institution issuing a LOC (as an enhancement) as being encompassed by SFAS 57

(3) Transferrable Enhancements

The separate valuation and presentation of the components of investments with transferable enhancements (regardless of when the enhancement attaches) would not be required. The presentation of securities with transferrable enhancements on the portfolio of investments schedule should identify the name and relationship of the issuer of the enhancement. The terms, conditions and other arrangements related to the enhancement should be disclosed in the notes to the financial statements.

² Although not specifically addressed here, "portfolio insurance", not tied to an individual security but guaranteeing the timely payment of interest and principal for investments in the portfolio, is also considered a form of enhancement requiring the disclosure, valuation and capital recognition discussed herein.

³ The views expressed herein do not address and are not meant to resolve the issues presented by Sections 17(a) and (d) of the Investment Company Act of 1940 which prohibit certain transactions between an investment company and affiliated persons.

⁴ Separate disclosure is not required for the components of a security which at the time of the fund's purchase included a LOC.

(4) Contribution to Capital

In keeping with related guidance,⁵ the staff believes a contribution to capital is made at the time the enhancement (whether transferrable or non-transferrable) becomes available to the fund. The amount of the contribution is measured by the cost of obtaining a similar enhancement in an arm's-length transaction.

Any change in the value of the enhancement would be recorded as unrealized appreciation or depreciation. There would be no adjustment to contributed capital as a result of a change in value of the enhancement or the disposition of that enhancement.

This letter contains information of importance to the company's independent public accountant; therefore, we encourage these items to be discussed with them. Any questions on the contents of this letter or related matters can be addressed to me, Anthony S. Evangelista or James F. Volk, Assistant Chief Accountants, at (202) 942-0590.

Very truly yours,



Lawrence A. Friend
Chief Accountant

⁵ See letter to Chief Financial Officers from Lawrence A. Friend dated November 1, 1994.