



August 7, 2015

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: File No. S7-08-15 Investment Company Reporting Modernization

Dear Mr. Fields:

We appreciate the opportunity to respond to the Securities and Exchange Commission's (SEC or "Commission") proposed rule on *Investment Company Reporting Modernization* (the "Proposed Rule").

We support the Commission's objectives to modernize and enhance the reporting and disclosure of information by registered investment companies and investment advisors. We believe that the Proposed Rule will generally provide investors with greater access to information relating to their investments and investment advisors.

The focus of our response is on the aspects of the Proposed Rule that have accounting, auditing, or reporting ramifications. Such areas of focus include the following:

- Amendments to Regulation S-X
- Changes in a Registrant's Certifying Accountant
- Independent Public Accountant Report on Internal Control

Amendments to Regulation S-X

Swap and option contracts linked to index/custom baskets

Under the Proposed Rule, a registered investment company (a "fund") would be required to provide enhanced disclosures in its financial statements about derivative contracts with a referenced index whose (1) components are not publicly available or that is based on a custom basket of investments, and (2) have a notional amount that exceeds one percent of the fund's net asset value. Such disclosure would require the fund to present the details (e.g., shares, value, name, identifier) of each underlying investment comprising such index or custom basket. The Commission has requested comment as to whether better alternatives exist to disclosing the underlying investments for an option and swap contract with a referenced index.

We are concerned that the proposed disclosure may minimize the importance of the direct portfolio holdings given that a similar level of detail would be provided for all underlying notional investments within the index or custom basket. We agree that the proposed disclosures may assist readers in understanding the risks of the derivative contracts; however, experience has shown that there may be a significant number of underlying assets within an index or custom basket, some of which may be individually insignificant to the performance of the derivative contracts and to the financial statements as a whole. We also are concerned that the cost of presenting numerous immaterial notional positions in the financial statements will exceed the benefit to the financial statement readers.

We suggest that the Commission consider an alternative approach in the financial statements to inform readers about the risks of derivative contracts linked to a referenced index. We recommend providing qualitative disclosures about the components of the referenced index/basket, including industry or sector concentrations, and separate disclosure (as described in the proposal) of each individual issuer within the referenced index or custom basket that exceeds, on a notional basis, one percent of net asset value of the fund. For those funds with a substantial portion of holdings



consisting of derivative contracts with a referenced index, we recommend, in addition to the qualitative disclosures previously described, providing summary disclosures similar to instruction three of Regulation S-X Rule 12-12C. This would provide for separate disclosure of the 50 largest issuers and any other individual issuer that exceeds, on a notional basis, one percent of net asset value of the fund. We believe that this alternative would assist readers in understanding the risks associated with these types of derivative contracts in a way that would not minimize the importance of the direct portfolio holdings.

Identification of illiquid investments

Under the Proposed Rule, a fund would be required to identify “illiquid” investments (defined by the Commission as assets that cannot be sold or disposed of by the fund in the ordinary course of business within seven calendar days, at approximately the value ascribed to them by the fund). The Commission has requested comment as to whether a fund should be required to disclose illiquid investments and whether such disclosure would be able to be audited by the fund’s independent accountants.

The Commission’s definition of illiquid has a specific regulatory meaning that is implicitly based on judgements that a user of the financial statements may not be familiar with. Accordingly, we are concerned that users of the financial statements will inappropriately assume that the disclosure is objective and is consistently applied by all funds. In fact, the designation of an illiquid investment will require significant judgement and would be based on management’s understanding of market conditions. As a result, the same investments may or may not be labelled as illiquid by different funds. While we agree with the objective of providing a reader with greater transparency regarding the liquidity of a fund’s investments, we believe this can be accomplished by requesting that the fund disclose its basis for determining illiquid investments as defined by management and/or the Board of Directors. These disclosures will provide users of the financial statements with a clearer understanding of the subjectivity and estimation involved in this assessment.

In addition, we believe that the cost of disclosing each individual illiquid investment will exceed the benefit to the users of the financial statements. As an alternative, we believe that the objective of providing greater transparency regarding liquidity may be met by disclosing the percentage of net assets determined as of the reporting date to be illiquid.

Lastly, we believe that the proposed disclosure would be difficult to audit as it would rely on incremental procedures designed to assess the process management utilized in the development of its estimate.

Tax basis disclosures for derivatives

The Proposed Rule would require a fund to disclose information about the tax basis of investments sold short and derivatives, including futures contracts, forward currency contracts, and open swap contracts, as well as other investments. The Commission has asked whether these disclosures would provide meaningful information for investors.

We agree with the Commission that tax information is important to investors in funds given that funds are generally flow through entities for tax purposes. We also agree that the categorization of investments by type in the financial statements is an important disclosure and provides investors with an understanding of the nature and risks of the investments held. However, providing additional disclosures about the tax basis by individual derivative type would not necessarily provide meaningful information for investors in understanding the tax characteristics of their investment in the fund. First, for those funds that engage in all four types of derivatives subject to revised Regulation S-X Rule 12-13 A-D, the proposed format would require investors to aggregate five individual presentations of gross appreciation and depreciation (including the investment portfolio). Second, a number of tax characterizations of derivative gains and losses depend on several complex sections of the Internal Revenue Code, which may not easily be captured using the proposed format. As such, we recommend that the Commission consider an alternative approach to inform investors of tax information of a fund. We believe that a reasonable alternative would be to require a fund to disclose the aggregate tax basis of all investments and derivatives that are recorded as assets, as well as for all



investments and derivatives that are recorded as liabilities. Such an alternative would provide investors with the tax information related to their investment without adding unnecessary complexity to the financial statements.

Securities lending disclosures

The Commission has proposed a number of additional disclosures regarding fund securities lending activities through proposed Regulation S-X Rule 6.03. The Commission has asked whether the information would be useful to Boards in evaluating securities lending arrangements.

We wish to first note that we believe that the value of any financial statement disclosure should be measured in relation to an external user. In this particular instance, Board members, if they wish to evaluate a securities lending program, have access to the actual contract with the lending agent and could request analyses from management in a much greater level of detail than would be practical in general purpose financial statements.

While we believe the categories of disclosure would provide meaningful information to readers, we do not support the proposed disclosure in Item 4 of the terms of compensation, including any revenue sharing split. We understand from our experience with both funds and securities lending agents that revenue splits can depend on numerous factors, including not only the range and amount of securities a fund complex as a whole can make available to a lending agent, but the relative attractiveness of particular types of securities within those portfolios to potential borrowers. Fund Boards can evaluate the terms of lending arrangements, including profit splits, because they can obtain lending contracts and other detailed information unavailable to external users of financial statements. Without access to this additional information, financial statement users may inappropriately conclude that certain funds either negotiated poorly or were somehow disadvantaged in entering agreements with lending agents.

Disclosures regarding non-cash income

The Proposed Rule would require separate disclosure of non-cash dividends and payment-in-kind interest earned on securities on the statement of operations. This disclosure is intended to increase transparency for investors in order to allow them to better understand when income is earned, but not received in the form of cash. The Commission has asked whether the proposed disclosure requirement under Regulation S-X Rule 6-07.1 for non-cash dividends and payment-in-kind interest on the statement of operations is meaningful to investors or other potential users of the fund's financial statements. The Commission also asked whether all non-cash interest should be disclosed, including amortization and accretion, or just payment-in-kind interest.

We noted that the terms "non-cash dividends" and "payment-in-kind interest earned" were not defined in the Proposed Rule and recommend that the Commission provide clarification of these terms for the following reasons:

- With respect to non-cash dividends, we believe that the Commission's objective would be met based on the guidance in ASC 946-320-35-7. However, ASC 946-320-35-6 provides separate guidance when a holder has the option to elect payment of dividends in stock or cash, requiring that the in-kind dividend normally be valued based on the cash option. We believe that the proposed disclosure requirement should not be applied to dividends for which payments can be elected in stock or cash given that there is no apparent measurement uncertainty in the non-cash dividend received that would make the distinction useful to the readers of the financial statements.
- With respect to "payment-in-kind" interest, we believe this term is intended to align to the manner in which it is used in the FASB ASC Glossary, which relates to "bonds in which the issuer has the option at each interest payment date of making interest payments in cash or additional debt securities." The Proposed Rule did not make this distinction and we believe that it is important to provide clarification as other types of bonds that increase their par value over time rather than issue additional securities (e.g., inflation-indexed



securities) could be interpreted as being in-kind securities under the Commission's guidance. We do not believe this guidance would apply to broader types of securities.

We are also concerned that the Proposed Rule will result in the presentation of immaterial amounts for which the cost of identifying the disclosure will exceed the benefit to the financial statement users. The Commission might consider establishing a materiality threshold for this disclosure (e.g., similar to the current requirement to disclose expense items that exceed 5% of total expenses).

Lastly, we believe the Proposed Rule should not require separate disclosure of amortization and accretion. There are a number of security types (most notably U.S. Treasury STRIPS), of high credit standing, whose income is earned mostly through accretion. Reporting all non-cash interest income separately would not provide transparency as to whether or not such income came from securities of higher credit quality or securities that may be impaired. We are concerned that disclosing separately on the statement of operations all non-cash interest income amounts, including amortization and accretion, may imply that all such income is of lower quality and therefore would not enhance a user's understanding of the financial statements.

Changes in a Registrant's Certifying Accountant

The Commission should revisit the transfer of the "change in accountants" guidance from Form N-SAR to Form N-CEN.

The Proposed Rule would replace Form N-SAR with Form N-CEN, which would result in the transfer of the exhibit reporting a change in independent registered public accountants, along with the predecessor accountant's letter from Form N-SAR to proposed Items 18f and 79.a.iii of Form N-CEN, respectively.

As a result, this information would only be required to be filed on an annual basis rather than semi-annually. Item 27(c)(4) of Form N-1A and Item 24, Instruction 5, of Form N-2 both require the 8-K Item 4.01 management statement to be presented in semi-annual, as well as annual, shareholder reports. Thus, for any change in accountants occurring in the first six months of a registrant's fiscal year, management's statement regarding the change in accountants would be required to be issued and filed publicly in the semi-annual shareholder report while the accountant's letter would be filed in the Form N-CEN six months later. We believe this result was unintended. We suggest instead that the requirement for "change in accountant" filings for funds be transferred to a location other than Form N-CEN (perhaps Form N-CSR) in order to ensure concurrent review and written agreement by the predecessor accountant of the required management statement in both annual and semi-annual reports.

Independent Public Accountant Report on Internal Control

Similar to Form N-SAR, Item 19 of Form N-CEN would require management investment companies (excluding small business investment companies) to file a copy of their independent public accountant's report on internal control as an attachment to the form. However, Form N-CEN would also include the following new question:

For the reporting period, did an independent public accountant's report on internal control find any material weaknesses? [Y/N].

We believe the word "find" could easily be misinterpreted, creating an "expectation gap" over the nature of the consideration of internal control in an audit of financial statements, particularly for investment companies, which (except for business development companies) are not subject to the integrated audit requirements of the Sarbanes-Oxley Act. Auditors of investment company financial statements obtain an understanding of internal control to identify the types of potential misstatements, assess the factors that affect the risks or material misstatements, design further audit procedures and to comply with the requirements of the Commission's Form N-SAR; not for the purpose of expressing an opinion on the effectiveness of internal control over financial reporting. The current internal control report issued by the independent accountant and filed on Form N-SAR describes whether or not any deficiencies in the investment company's internal control over financial reporting were noted that are considered to be material



weaknesses under the standards established by the Public Company Accounting Oversight Board. To be consistent with the auditor's professional standards, and to avoid potentially misleading readers of Form N-CEN as to the auditor's responsibility for reporting on an investment company's internal control over financial reporting, we suggest that the question be modified to replace "find" with "note".

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We are available to discuss our comments and to answer any questions that the SEC staff may have. Please contact Peter Finnerty (617-530-4566) regarding our submission.

Sincerely,

PricewaterhouseCoopers LLP

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