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August 17, 2015

Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

File No. S7-08-15

Dear Mr. Secretary:

The Financial Reporting Executive Committee (FinREC) of the American Institute of Certified Public Accountants (AICPA) appreciates the opportunity to comment on the Securities and Exchange Commission's (Commission or SEC) proposed rules *Investment Company Reporting Modernization* (IC proposal) and *Amendments to Form ADV and Investment Advisers Act Rules* (IA proposal).

FinREC supports the Commission's efforts to modernize the reporting and disclosure of information provided by investment companies regulated under the Investment Company Act of 1940 (1940 Act). Our comments primarily relate to financial reporting matters in response to certain proposed changes to Regulation S-X in the IC proposal. We have also included observations regarding very limited aspects of Form N-CEN and Form ADV.

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Representatives of FinREC and the AICPA Investment Companies Expert Panel are available to discuss our comments with SEC staff at their convenience.

Sincerely,

James A. Dolinar
Chairman
FinREC

Brent Oswald
Chairman
AICPA Investment Companies Expert Panel

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Appendix

I. Investment Company Reporting Modernization (IC proposal)

1. Underlying investments of an option and investments that contain optionality (Page 113)
   Page 113 of the IC proposal indicates that "for options where the underlying investment would otherwise be presented in accordance with another provision of rule 12-12 or proposed rules 12-13 through 12-13D that the presentation of that investment must include a description, as required by those provisions." Instruction 3 to rule 12-12 (page 407) would amend Regulation S-X to incorporate this change as follows: "Options on underlying investments where the underlying investment would otherwise be presented in accordance with §§210.12-12, 12-13A, 12-13B, 12-13C, or 12-13D should include the description of the underlying investment … *as part of the description of the option*" (emphasis added). Proposed rule 12-13, "Open option contracts written," contains the same wording as part of its instruction 3.

   Page 113 of the IC proposal goes on to state that "if another investment contains some sort of optionality (e.g., put or call features), the investment's disclosure must include both a description of the optionality (as required by proposed rule 12-13), and a description of the underlying investments, as required by the applicable provisions of proposed rules 12-12, 12-12A, and 12-13 through 12-13D." We are unable to identify a corresponding proposed amendment to Regulation S-X that would require disclosure regarding the embedded option in another investment.

   If such amendment to Regulation S-X is intended and ultimately made, it may require extensive disclosure for certain securities, such as municipal bonds, convertible bonds, and nonconvertible corporate bonds, containing optionality features that may be interpreted to be within the scope of the disclosure requirements. For example, in addition to providing a holder with the option to convert the bond into an equity position, a convertible bond may also provide the issuer with one or more options to call the bond at various pre-specified prices and dates. As such, each security may have many different options encompassed within it. Considering that 100% of the net assets of a fund may be invested in such securities, this provision could result in significant additional disclosures in the schedule of investments. We believe this level of disclosure would be overly detailed, complex, and difficult for a typical user of investment company financial statements to understand.

   Additional observations:
   - Some options, particularly exchange-traded options, allow for a range of underlying securities to be delivered (e.g., U. S. Treasury bonds or notes). In those situations, we believe identification of the security type would be sufficient to inform the reader, rather than the full description called for in the proposed instructions 3 to rules 12-12 and 12-13.

- Instruction 7 to proposed rule 12-12A, “Investments – securities sold short” states, “Indicate by appropriate symbol each issue of securities held in connection with open put or call option contracts.” Because short positions are not “securities held,” the instruction does not seem relevant.

2. Derivatives linked to custom index or basket (Pages 113-114, & 121)
Relevant questions:
As proposed, rule 12-13 would require disclosure of each option contract with an underlying investment that is an index or basket of investments whose components are not publicly available on a website and the notional amount of the holding exceeds one percent of the NAV of the fund. Are there better alternatives to disclose the underlying investments for an options contract if it consists of a custom basket of securities? If so, what alternatives and why?

Is our exceeding one percent of the NAV disclosure threshold appropriate? Should there be a different disclosure threshold applied to an option contract’s underlying investments? If so, what threshold and why? For example, should there be a disclosure threshold applied to individual holdings (e.g., if the notional amount of a single underlying investment in a custom basket is less than a certain percentage of a fund’s net assets)? Should we use a different percentage for the disclosure threshold, such as exceeding five percent of the NAV? Alternatively, would summary disclosure be adequate to inform investors, similar to instruction 3 of rule 12-12C, which requires disclosure of the 50 largest issues and any other issue the value of which exceeded one percent of net asset value of the fund as of the close of the period? If so, how should such a disclosure be handled?

Comment

The proposed requirement to separately disclose each investment comprising an index or custom basket referenced by a derivative contract whose notional amount exceeds one percent of NAV may result in the disclosure of a significant number of investments. In our experience, a custom index or basket may contain a significant number of assets with varying sizes, concentrations and exposures, some of which are individually insignificant to the overall custom index or basket and to the financial statements as a whole. While we do not disagree that such disclosure may assist investors in better understanding and evaluating the full risks of the derivative, we are concerned that the potential volume of investments disclosed may minimize the importance of the overall investment portfolio by requiring notional positions to have similar, if not the same, level of disclosure as investment positions directly held. We are also concerned that the cost of identifying and auditing numerous individual notional positions which may only have an insignificant effect on investment results – and which typically are not reflected in the same accounting records as investment positions directly held, but instead appear in such media as term sheets, counterparty confirmations, and off-line valuation spreadsheets – will exceed the benefit to financial statement readers.

We recommend that the Commission consider an alternative approach to providing financial statement disclosures about the components of the custom index or basket. We believe such disclosure should include a narrative description of the custom index or basket, including the type of underlying investments and any industry or sector concentrations. The disclosure should include separate identification of each individual issuer within the custom index or basket that exceeds, on a notional basis, one percent of the fund's net assets as of the close of the period. For funds that obtain a substantial portion of their exposure through custom index or basket derivative contracts, we recommend, in addition to the qualitative disclosures described above, providing summary disclosures similar to instruction 3 of current S-X rule 12-12C (proposed to be relocated as instruction 4 of S-X rule 12-12B in the IC proposal). This disclosure would include presenting the 50 largest issues on a notional basis and any other individual issue which exceeds, on a notional basis, one percent of the fund's net assets as of the close of the period. This alternative would assist investors in understanding and evaluating the specific exposures obtained by a fund from certain swap and option contracts linked to a custom index or basket in a way that would better balance the disclosure of investments held directly by the fund and those held indirectly through custom indices or baskets.

3. Identification of securities that are illiquid (Pages 114-115)
   Relevant questions:
   We request comment on our proposed requirements in rules 12-13 through 12-13D that the fund identify investments that are considered to be illiquid. Is this requirement appropriate? Why or why not? What are the costs and benefits associated with this requirement? Will independent accountants be able to audit this disclosure?

   Comment
   In order to provide greater transparency to investors regarding the liquidity of a fund's investments, the IC proposal would require funds to identify illiquid investments. An illiquid asset is defined by the Commission as an asset 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 it by the fund.

   While we do not disagree that the identification of illiquid investments may allow an investor to better understand the risk exposure of a fund and provide greater transparency regarding the liquidity of a fund's investments, we are concerned that determining whether an investment is illiquid is highly subjective and may be applied inconsistently, which would compromise the comparability of the financial statements across registrants. The determination of whether a security is illiquid is highly subjective, based on management's understanding of market conditions, and may result in an inconsistent disclosure of the same asset across registrants. These inconsistencies may be supportable based on differences in market access and subjective opinions of registrants. We are concerned that a lack of comparability in liquidity designations for the same investment could be misinterpreted and cause confusion to a reader. In addition, the liquidity of investments can change over time as demonstrated over recent years (most notably 2008-2009). The simple characterization of an investment as "illiquid" as of the close of the reporting period as proposed (for example, in instruction 10 of proposed rule 12-12) may be interpreted by a reader as though such investment will remain "illiquid" until the next reporting date. Conversely, for an investment not designated as "illiquid", a reader may interpret that such investment will remain liquid until the next reporting date.

It would also be difficult for the fund's independent accountants to audit this proposed disclosure due to challenges in corroborating management's subjective judgment regarding whether or not the investment *can or cannot be sold* (emphasis added) at the value ascribed to it by the fund within seven days. It would require the auditor to evaluate the liquidity of each investment held by the fund. The determination of whether an investment is "illiquid" requires ongoing contact with the market for investments of that type and is outside of the auditor's expertise, such that the cost of auditing the disclosure may exceed the benefit to financial statement users.

We recommend that the Commission not require this disclosure in the financial statements. We note that this information will be provided in Form N-PORT. If the Commission believes that further disclosure about these investments is needed, we recommend the Commission consider requiring a fund to disclose the total value of illiquid investments as a percentage of net assets in an open-end fund's annual registration statement. Since closed-end funds do not have limitations on investments in illiquid securities and do not provide liquidity to shareholders in the form of ongoing redemptions, we believe this disclosure is not relevant for closed-end funds.

4. Tax basis disclosures for derivatives (Page 115)

The IC proposal would require an investment company to disclose information about the tax basis cost of investments sold short, open futures contracts, open forward currency contracts, open swap contracts, and other investments presented under rule 12-13D. We agree that because investment companies are generally flow through entities, tax information is important to investors in investment companies. However, we believe the objective of presenting meaningful tax information about an investment company's investments may be achieved by an aggregate presentation of the tax basis of all securities and derivative investments (excluding purchased options which are presented in the schedule of investments) that are recorded as assets and those that are recorded as liabilities. Providing tax information by individual security and derivative type would result in additional effort for preparers and increase the volume of disclosure that may add unnecessary complexity to the financial statements. The categorization of investments by type is an important disclosure for investors in investment companies to understand the nature of the investments. However, providing additional disclosures about the tax basis cost by the same categorization would result in up to eight individual tax disclosures (securities, short positions, written options, futures, foreign currency contracts, swaps, other investments, and investments in affiliates) – a level of fragmentation that may be difficult for users to understand.

5. Disclosures regarding open futures contracts (Page 116)

   The IC proposal would require disclosure of the “notional amount”, “value”, and “unrealized appreciation/depreciation” of futures contacts. We believe the definitions of these terms should be clarified since the term “notional amount” may be used to refer to the notional amount at the time the futures contract was entered into or the current notional value. In addition, the term “value” is commonly used to refer either to the unrealized appreciation/depreciation or current variation margin. We are also concerned that a user of the financial statements may mistakenly believe that the term “value” represents the amount that the fund would pay or receive (depending on whether the contract represents a long or short position) if the contract were closed/terminated as of the date of the financial statements.

6. Schedule of investments categorization (Page 131)
   Relevant questions:
   We request comment on instruction 2 to proposed rule 12-12 (and the corresponding instructions to rules 12-12A, 12-12B, and 12-14) which would require funds to categorize the schedule by type of investment, the related industry, and the related country, or geographic region. Should we include this instruction in our proposed rules? What are the costs or benefits associated with such a requirement?

   Comment
   The proposed rule would require an investment company to present certain schedules of investments required by article 12 of Regulation S-X to be categorized by the type of investment, the related industry of the investment and the related country or geographic region of the investment. Currently these schedules are required to be categorized by the type of investment and the related industry of the investment **or** the related country or geographic region of the investment. As part of the rationale for proposing this change, the Release cites the fact that U.S. GAAP requires a nonregistered investment partnership to categorize its schedule of investments by type, industry and geography.

   Categorization of the schedule of investments by type, industry and geography may create a significant number of categories and subcategories and significantly lengthen the schedule of investments. We do not believe this level of detail is useful to a typical user of the financial statements of a registered investment company. A nonregistered investment partnership is only required to separately disclose investments that represent five percent or more of its net assets. As such, the requirement for nonregistered investment partnerships to categorize investments by type, industry and geography contemplates this threshold for disclosing individual investments and does not result in a lengthy schedule with substantial detail. In the case where investments are disclosed separately only when they represent five percent or more of an investment company’s net assets, we believe it is informative to users of the financial statements to use more detailed categories by which investments are aggregated. There is less need for multiple levels of categorization when, as required by both the existing and proposed rules, investment schedules present (except for the limited "miscellaneous security" category) every investment position.

We recommend that registered investment companies be permitted to continue to categorize investments by type of investment and the related industry **or** country or geographic region and that any concentration in the category (industry or geography) not disclosed directly in the schedule of investments be separately identified in a table or narrative disclosure as required by paragraphs 20–21 of FASB ASC 825-10-50.

7. Securities lending disclosures (Page 147)

Relevant questions:
Would the disclosure required under proposed rule 6.03(m) concerning income and expenses in connection with securities lending activities provide meaningful information to investors or other potential users? For example, would the disclosures regarding compensation and other fee and expense information relating to the securities lending agent and cash collateral manager be useful to fund boards in evaluating their securities lending arrangements?

Comment
We believe the six categories of disclosure required under proposed rule 6-03(m) of Regulation S-X concerning income and expenses in connection with securities lending activities would provide meaningful information to investors or other potential users and would allow them to better understand the fund's securities lending activities, with one exception. Item (4), "the terms governing the compensation of the securities lending agent, including any revenue sharing split, with the related percentage split between the registrant and the securities lending agent" could be considered proprietary information. Disclosing such details could result in a fund losing a competitive advantage with regards to negotiating such arrangements. While such information would be important to a fund's board of directors in helping them approve and oversee the securities lending program, disclosing such details publicly may not be advantageous to the fund. We believe that the value of any proposed financial statement disclosures regarding securities lending should be measured in relation to an external user of the financial statements, and not by what may be useful to the board of directors in fulfilling their governance responsibility.

However, we note that in situations where a securities lending agent is a related party of the fund and the relationship is material, disclosure of the related party arrangement is required by FASB ASC 850-10-50-1.

Would these disclosures be sufficient for this purpose, or would additional information be necessary, for example, to put the fee and expense information in

context (e.g., the nature of the services provided by the securities lending agent and cash collateral manager)? Should the Commission instead require that these or other similar disclosures, be provided elsewhere in the fund's financial statements (e.g., the Statement of Operations), or provided as part of other disclosure documents (e.g., the Statement of Additional Information) or reporting forms (e.g., proposed Form N-CEN)? Why or why not?

With the exception of Item (4), we believe that the proposed disclosures are sufficient and would provide the desired transparency when provided in the notes to financial statements. Should the Commission require disclosure of information in Item 4, we believe it may be helpful to provide additional qualitative disclosures to put the fee and expense information in context (e.g., the nature of the services provided by the securities lending agent and cash collateral manager). However, as discussed above, we believe this information should not be required to be provided in the financial statements, except for material related party transactions.

8. Disclosures regarding non-cash income (Page 144)
   Relevant questions:
   Is the proposed disclosure under rule 6-07.1 for non-cash dividends and payment in-kind interest on the statement of operations meaningful to investors or other potential users of the fund's financial statements? Should all non-cash interest be disclosed, including amortization and accretion, or should just payment-in-kind interest be disclosed?

   Comment
   The IC proposal would require separate presentation of "non-cash dividends" and "payment in kind interest on securities" (in 6-07.1(b) and (d), respectively). However, neither term was defined either in the proposed amendments or in the text of the proposing release. We believe that in each case, further clarification of the Commission's intent would be useful. The Commission noted in the proposing release that the intent of the amendment was "to increase transparency for investors to allow them to better understand when fund income is earned, but not received in the form of cash". It is clear that this objective would be met for dividends paid solely in property other than cash, based on the guidance in FASB ASC 946-320-35-7. However, FASB ASC 946-320-35-6 provides separate guidance when a holder has the option to elect payment of dividends in stock or cash; in those cases, the holder recognizes income based on the cash option as "cash is usually the best evidence of fair value of the stock". We believe the proposed rule should not be applied to this latter category of dividends, as there is no apparent measurement uncertainty in the non-cash property received that would make the distinction useful to financial statement users. Accordingly, we recommend that the Commission modify the proposed guidance to clarify that it should apply only to non-cash dividends subject to the guidance of FASB ASC 946-320-35-7, and exclude dividends for which payment can be elected in cash or stock.

   We believe the Commission intended the term "payment in kind interest" in the manner 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*" (emphasis added), but did not make this explicit in the proposal. We believe that making this distinction is important, as other types of bonds (most notably inflation-indexed securities, but also some negative-amortizing asset-backed securities) do not issue additional securities, but increase their par value over time, and could also be construed (at least in part) as meeting the definition of "in-kind" securities. We do not believe the Commission intended this guidance to apply to these securities. In addition, we believe the proposed disclosure would be more relevant for typical "payment in kind interest" since it is generally paid by entities that have lower credit standing and the ultimate collectibility of the face amount of the "payment in kind" bonds has a greater amount of uncertainty. Directly linking the S-X guidance to the FASB ASC Glossary definition would make the distinction clear.

We also believe that the requirement to separately identify in-kind dividends and interest should be subject to a materiality threshold. Our experience has been that many high-yield bond funds only invest a small percentage of their portfolios in in-kind securities. We are concerned that, for these funds, the proposed requirement will only present clearly immaterial amounts where the cost of identifying and auditing these amounts will easily exceed any benefit to financial statement users. We believe a reasonable threshold for presenting in-kind dividends and interest is when the aggregate amount exceeds 5% of total income. This threshold is consistent with the 5% threshold for identification of individual expense categories.

Regarding the Commission's question as to whether all non-cash interest, including amortization and accretion, should be separately disclosed, we believe this should not be required. Most or all of the interest income on a number of securities of high credit standing (most notably U. S. Treasury STRIPS) is earned through accretion. Further, given that prevailing interest rates currently are historically low, any significant future increase in interest rates could result in amortization of secondary-market purchase discounts for many low-coupon bonds issued in recent years, which would not necessarily reflect any uncertainty in the issuer's ability to make payment. Simply reporting all non-cash income in one line would provide the user no insight as to whether that income came from highly credit-worthy or lower credit quality bonds or what the mix was between the two. We are concerned that separate presentation would suggest that all such income is of lower quality, regardless of the credit standing of the bonds from which it was earned, detracting from, rather than enhancing, user understanding of the financial statements.

9. Disclosure regarding change in auditor on Form N-CEN (Page 195)

   As part of the replacement of Form N-SAR with Form N-CEN, the Commission transferred the current requirement for an exhibit reporting a change in the fund's independent registered public accounting firm consistent with the requirements of Item 4 of Form 8-K, along with the predecessor accountant's "agreement" letter, from Item 77K of Form N-SAR to proposed Items 18f and 79.a.iii of Form N-CEN. As a result, this information would only be required to be filed on an annual basis rather than semi-annually. However, Item 27(c)(4) of Form N-1A and Item 24, Instruction 5, of Form N-2 both require the 8-K Item 4 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 but there is no logical place for an accountant's "agreement" letter to that statement to be filed concurrently – only in the Form N-CEN six months later. We do not believe the Commission intended this anomalous result, nor do we believe that the Commission would wish to remedy it by removing the Form N-1A/Form N-2 requirements to report changes in the independent registered public accounting firm in semi-annual reports, which would only delay public reporting of the change until the annual shareholder report. We suggest instead that the requirement for "change in accountant" filings for investment companies be transferred from Form N-SAR to a location other than Form N-CEN (such as 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.

II. Amendments to Form ADV and Investment Advisers Act Rules

Under this proposal (page 41), advisers will need to provide the PCAOB registration number for the auditor performing their surprise security examination. Although there are certain exceptions, rule 206(4)-2(a)(4) under the Investment Advisers Act of 1940 requires all registered investment advisers (or an investment adviser required to register) who have custody of client funds or securities, as defined, to have an independent public accountant conduct an examination on a surprise basis once every calendar year. We would like to point out that this rule does not necessarily require an independent public accountant to be registered with the PCAOB to perform such annual examination unless an adviser or its related party is serving as a qualified custodian. Therefore, we recommend that the instructions should be modified to indicate "if applicable" so that they do not appear to unintentionally modify the existing rule.