December 22, 2006

VIA COURIER – REQUEST FOR IMMEDIATE ACTION

Nancy M. Morris, Esquire
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Petition to Extend the Effective Date of FASB Interpretation No. 48 for U.S. Registered Investment Companies and for Additional Relief

Dear Ms. Morris:

Fidelity Investments ("Fidelity"), Massachusetts Financial Services Company ("MFS"), and OppenheimerFunds, Inc. ("OppenheimerFunds")[1] respectfully request that the Commission, pursuant to its authority to prescribe financial reporting requirements that will promote the protection of investors, extend the impending effective date for the application of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ("FIN 48")[2] to investment companies registered under the Investment Company Act of 1940, as amended ("Funds"). The purpose of the extension is to give the entire mutual fund industry and the Commission adequate time to address the unique interpretive and implementation issues relating to Funds that, absent Commission action, could adversely affect Fund shareholders as early as January 2, 2007.

A. Need for Immediate Relief

Because of the unique situation of Funds, starting January 2, 2007, FIN 48 could require some Funds to record financial statement liabilities for taxes that they will never be required to pay. If these "liabilities" are also reflected in the net asset value ("NAV") per share at which Fund shares are priced, Fund shareholders who redeem their shares will receive less than the proportionate value of the Fund to which their shares entitle them, and investors purchasing shares will pay an artificially reduced price. Although we anticipate that such distortions will be rare (as discussed

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1 Collectively, Fidelity, MFS and OppenheimerFunds serve as investment advisors to over 490 mutual funds, with over $1.2 trillion in mutual fund assets under management in the U.S. and Canada as of September 30, 2006.

2 FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (Jun. 2006) ("FIN 48").

below, Funds typically take conservative tax positions that would generally not require reporting under FIN 48), we believe that even a single tax-based NAV reduction could both seriously threaten the credibility of Funds as appropriate investment vehicles for long-term investors, and have a series of further unintended consequences.

For example, because FIN 48 would require Funds to carry these artificially depressed values for only a fixed number of years (the duration of the applicable statute of limitations), some future shareholders would receive a windfall at the expense of those who redeemed earlier. Savvy investors, no doubt, will be quick to notice— and seek to exploit— the arbitrage opportunities that this scenario presents, at the expense of long-term investors.

FIN 48 could also pose a serious dilemma for a Fund's principal executive and principal financial officers. These officers are required to certify to the Commission both (1) that the Fund's reports are accurate and fairly present the Fund's financial condition and (2) that they have designed the Fund's internal controls to produce financial statements in accordance with generally accepted accounting principles ("GAAP").[3] Yet, where FIN 48 calls for booking a liability that is highly unlikely ever to be realized, these officers are put in the untenable position of being asked to produce— and also certify— Fund financial information that they believe in reality misrepresents NAV.

Paradoxically, as applied to Funds, FIN 48 threatens to result in the very inconsistencies and lack of comparability in Fund financial information and pricing that it was expressly intended to prevent.

We believe that the Commission has the authority to determine whether FIN 48 protects the interests of Fund investors, and to intervene on behalf of those investors. Because Funds calculate and price at NAV on a daily basis, if the current effective date is allowed to stand, FIN 48 could have a direct and irreparable adverse impact on Funds and their shareholders as early as January 2, 2007. Accordingly, we ask the Commission to act immediately to extend the effective date for at least a six-month period in order to develop an approach to tax uncertainties relating to Funds that will not artificially affect NAVs or facilitate arbitrage opportunities, to the detriment of long-term shareholders. We provide suggestions for such an approach in the last section of this petition.

We appreciate the last-minute nature of this petition but believe that only now have we exhausted all other alternatives. Representatives of Fidelity, MFS, OppenheimerFunds, other Fund

3 *See e.g.*, Form N-CSR, Item 12(a)(2), Certification Items 2, 3, and 4(b).

complexes and the Investment Company Institute[4] (the "ICI") have spent literally hundreds of hours over many months discussing these issues with members of the Financial Accounting Standards Board ("FASB") and its staff, the Commission Staff (the "Staff"), Internal Revenue Service (the "IRS") and Treasury personnel, as well as the major accounting firms that audit Funds. Although regulators and auditors alike have acknowledged and expressed concern that these issues exist, and we were hopeful that a resolution would be forthcoming, no one with whom we have spoken to date has issued supplemental guidance on which we can rely that addresses the issues FIN 48 has created.

B. FIN 48 – Background, Purpose and Application

1. *Background and Purpose*

FASB adopted FIN 48 in June 2006, in order to address perceived inconsistencies, and the resulting lack of comparability, in the way issuers account in their financial statements for uncertainties relating to certain tax positions they may take in their tax returns. FIN 48 thus sets forth the method and criteria to be used for recognition and measurement of these tax positions in the issuer's financial statements, and specifies the type of authorities on which issuers may rely in reflecting their return positions in their financial statements.

At the most basic level, FIN 48 tells issuers how to reflect in their financial statements the tax positions they take on their tax returns. The need for this guidance arises because, in FASB's view:

> Diverse accounting practices had developed with respect to the recognition and measurement of current and deferred tax assets and liabilities in financial statements.[5]

FASB believes that the company's financial statements should reflect the likelihood, if any, that the company will not realize the full benefit of the tax deduction claimed. According to FASB, the treatment required by FIN 48 should allow investors to better compare similarly situated companies.

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4 ICI members include 8,792 open-end investment companies (mutual funds), 662 closed-end investment companies, 269 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $9.898 trillion (representing 98 percent of all assets of U.S. mutual funds); these funds serve approximately 93.9 million shareholders in more than 53.8 million households.

5 FIN 48, *supra* note 2, at ¶B2.

2. *Application of FIN 48*

To this end, FIN 48 treats any tax position that reduces an issuer's income tax as a "benefit" and requires the issuer to carry out a two-step process when determining how to reflect the benefit in its financial statements. The first step ("recognition") requires an issuer to determine whether a tax position, based on its "technical merits," is "more likely than not" to be sustained upon examination by the relevant taxing authority. FIN 48 appears to prescribe a limited range of authorities on which an issuer may rely in determining the "technical merits" of a particular tax position ("permitted guidance"). Specifically, the technical merits of the tax position "derive from sources of authorities in the tax law (legislation and statutes, legislative intent, regulations, rulings and case law)."[6] Permitted guidance may include the past "administrative practices and precedents" of the taxing authority in its dealings with the issuer or similar issuers, provided that such practices are widely understood.[7] FIN 48 expressly states that, when making the "more likely than not" determination, the issuer must presume that the tax position will be examined by the relevant taxing authority, which will have full knowledge of all relevant information. This

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6 FIN 48, *supra* note 2, at ¶7b.

7 In a recent call involving members of the Staff, FASB staff, the ICI, audit firms, Fidelity and MFS, one member of the Staff suggested that the list of authorities permitted by FIN 48 should be read more broadly to include, for example, statements made by IRS personnel at conferences. Suggesting an even more flexible view of FIN 48, in remarks before the American Institute of Certified Public Accounts ("AICPA"), a senior staff member in the Commission's Office of the Chief Accountant went so far as to say that "FIN 48 does not place any limits on the type of evidence that an enterprise can look to in making its more-likely-than-not determination." The staff member also said: "While I would certainly encourage preparers and their auditors to comply fully with FIN 48, I would also encourage them to focus on the principles in the Interpretation and not lose sight of reasonable judgment and common sense in its implementation." Senior Associate Chief Accountant, Office of the Chief Accountant, U.S. Securities and Exchange Commission, Jenifer Minke-Girard, Remarks Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments (Dec. 13, 2006), *available at* http://www.sec.gov/news/speech/2006/spch121306jmg.htm.

While we agree that this would indeed be an appropriate approach to accounting for tax uncertainties, these remarks fall short of giving Funds meaningful relief from the potential adverse effects of FIN 48. First, they are somewhat difficult to square with the actual language of FIN 48, which, as read by many in the industry, does indeed seem to limit the type of evidence Funds may rely on (for example, see the discussion of the relevant audit history in note 8, *infra*). Second, as was made explicit in the remarks before the AICPA, these statements do not necessarily reflect the Commission's views or those of the Staff generally. For these reasons, until the Staff puts these positions in writing, some Funds may be reluctant to rely on them, which could lead to additional inconsistencies and lack of comparability in this area. In addition, it should be noted that, even in writing, such advice from the Staff would only partially alleviate the problems and issues raised by FIN 48. For example, there may be some tax positions where there is no specific guidance at all.

appears to imply that the issuer may not rely on low probability of audit, in itself, as a factor in making the recognition determination.[8]

If the issuer does not determine that the tax position taken, based on its technical merits under the permitted guidance, is more likely than not to be sustained, the issuer must record as a liability on its financial statements the entire amount of the tax benefit claimed on its return.

If the recognition threshold is satisfied (that is, if the issuer is able to make the more likely than not determination for recognizing a benefit from the tax position, based on permitted guidance), the second step ("measurement") requires the issuer to measure the amount of the tax benefit resulting from the tax position that should be reflected on its financial statements. Under FIN 48, the issuer may record as an asset only the largest amount of tax benefit that is greater than 50 percent likely to be realized upon settlement with the relevant taxing authority having full knowledge of all relevant information.[9]

In making determinations for both the recognition and measurement components of FIN 48, issuers must consider the facts, circumstances and information available at the reporting date.

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8 The precise implications of this statement for Funds, however, are far from clear. In light of (a) the unique audit environment for Funds, (b) certain illustrative examples provided in FIN 48 that appear to factor in likelihood of audit (see ¶¶A14 and 15), and (c) general ambiguity in the connection (or lack thereof) between likelihood of audit and administrative practice, there has been considerable debate on how Funds should interpret this aspect of FIN 48.

9 FIN 48 provides the following example. Assume that an issuer has determined that a tax position resulting in a benefit of $100 qualifies for recognition and should be measured. The issuer has considered the amounts and probabilities of the possible estimated outcomes as follows:

Possible Estimated Outcome	Individual Probability of Occurring (%)	Cumulative Probability of Occurring (%)
$100	5	5
80	25	30
60	25	55
50	20	75
40	10	85
20	10	95
0	5	100

Because $60 is the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement, the issuer would recognize a tax benefit of $60 in the financial statements. FIN 48, *supra* note 2, at ¶A21-22.

FIN 48 takes effect beginning in fiscal years that start after December 15, 2006 and applies to all open tax positions taken by issuers. An open tax position includes those tax positions for which the relevant statute of limitations period has not expired.

C. Unique Situation of Funds

Because of the unique features of Funds and how they are taxed, the practical effect of FIN 48 on Funds and their shareholders is fundamentally different from its effect on operating companies and could cause immediate and irreparable harm to Fund shareholders.

1. ***Timing: Immediate and Daily Effect***

Operating companies issue financial statements at the end of each quarter. As a result, operating companies will have until at least March 31, 2007 to resolve any implementation issues arising out of FIN 48. Thereafter, operating companies will be faced with such implementation issues once every three months.

Funds, by contrast, must generally compute their NAVs each business day.[10] Thus, calendar year Funds would be required to reach a final resolution as to outstanding FIN 48 issues, including an initial FIN 48 analysis of all past positions for the previous open tax years, by January 2, 2007. On an ongoing basis, Funds would be required to make the FIN 48 determinations on every business day and, as a result, when new tax issues arise, or even if a past inadvertent error is discovered, Funds would have to make immediate judgments involving potentially complex issues in a matter of hours. Because of the direct impact on Fund pricing described below, these are high-stakes decisions.

2. ***Share Pricing: Direct Impact on Shareholder Value***

Shares of public operating companies trade on the secondary market at prices determined by market forces. Financial statements, which are required to be issued only on a quarterly basis, comprise only one factor in determining the prices at which investors will buy and sell an operating company's shares. Accordingly, recognition of a tax liability may or may not affect the price of a company's shares, and any effect would be indirect rather than on a dollar-for-dollar basis.

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[10] Open-end Funds calculate their NAVs every day because they offer only redeemable securities, that is, shares that can be redeemed on presentation at the holder's proportionate share of the issuer's current net assets. 15 U.S.C. § 80a-2(a)(32). Many closed-end Funds also calculate NAV daily as a matter of practice.

The price of Fund shares, by contrast, is determined by NAV, which Funds calculate in accordance with GAAP.[11] Fund determinations under FIN 48 would thus have a direct and immediate impact on shareholder value. Accordingly, on any day that a Fund recognizes a tax liability based on FIN 48 (*e.g.*, on January 2, 2007), a shareholder redeeming shares would receive a cash payment that is less than the value that the shareholder would have received if the shares had been redeemed the previous business day. The diminished value would be equal to the shareholder's *pro rata* share of the tax liability recognized by the Fund, which itself would reduce the Fund's net assets on a dollar-for-dollar basis. Similarly, if an investor considering buying Fund shares at the end of December 2006 waits until after January 2, 2007 to purchase the shares, the investor would pay the reduced price for the same shares.[12]

3. *Danger of FIN 48 "False Positives": Absence of Audit History and Regulatory Guidance*

Operating companies typically have audit histories of their own or of similar companies and a wealth of other permitted guidance on which to rely in applying the FIN 48 recognition and measurement criteria. Thus, there is likely to be a significant correlation between (i) the recognition and measurement of an uncertain tax position by an operating company for FIN 48 purposes and (ii) the real-world likelihood of a tax benefit or liability ultimately being realized by that company.

As described in further detail below, Funds do not pay any income taxes if they meet certain qualification and distribution requirements. The tax treatment of Funds is based on a Congressional policy determination that Fund investors, who themselves pay income taxes on Fund distributions, should not be subject to double taxation. For this and other reasons described below, Funds typically have very little, if any, audit history and often do not have definitive guidance upon which to rely when making tax-related determinations. This absence of definitive

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11 This discussion applies primarily to open-end Funds. *See supra* note 10. Open-end Funds are required to calculate NAV in accordance with the Commission's Rule 2a-4, which does not expressly mention GAAP but refers to items that will be on the Funds' financial statements at such times as they are issued.

12 The same artificial effects on NAV would also distort presentations of Fund performance, which is based on beginning and ending Fund NAVs for the periods presented. Thus, in cases where FIN 48 has an impact, shareholders would have a hard time assessing the investment performance of their Funds, and prospective investors could misinterpret performance results of Funds they are considering purchasing. This would also undermine an investor's ability to compare investment performance of similar Funds, which is an important goal of the Commission's rules on calculation and presentation of Fund performance.

authority is particularly acute with respect to investments in new and innovative financial instruments. Given this limited guidance, the Fund industry has responsibly self-regulated in this area by taking reasonable and conservative approaches in determining an appropriate tax treatment for Fund investments. Further, when taxing authorities have issued guidance relating to financial instruments, such guidance has typically been prospective in nature and the IRS has not historically challenged a taxpayer's reasonable treatment of a financial product in a prior year.

For these reasons, the real-world likelihood that Funds will have to pay a tax liability in a situation in which there was no clear guidance is remote. FIN 48 could thus require the accrual of a liability, with a reduction in NAV, when there has been no real impairment of shareholder value.

Of course, in some isolated cases FIN 48 may require a Fund to reduce its NAV by a tax liability that it legitimately may incur (*e.g.*, due to an internal compliance error by its advisor's personnel). In some of these situations, the Fund's advisor may step in and agree to pay any such tax liability. It is unlikely, however, that the advisor will be able to make such an arrangement at the moment that the potential tax liability is discovered. Thus, the Fund will not be able to book immediately an offsetting receivable, so that, at least on an interim basis, the Fund's NAV will be reduced by a tax liability that the Fund will never pay.[13]

4. *Unintended Consequences: Arbitrage, Excessive Trading, and Harm to Long-Term Shareholders*

As a result of the timing, share pricing, and "false positive" dangers described above, FIN 48 has the potential to create substantial arbitrage opportunities that could invite exploitation by sophisticated investors, encourage frequent trading, and deter investment by the long-term investors that Funds are designed to protect. This danger is exacerbated by the mechanical operation of tax-related statutes of limitation under FIN 48, whereby a recognized tax liability will automatically disappear—and, correspondingly, a Fund's NAV will immediately increase—upon expiration of the statute of limitations.[14]

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[13] Even if the advisor were able to agree immediately to cover the tax liability, there is debate as to whether the Fund could immediately offset the liability with the anticipated payment from the advisor. Some view such an asset as a contingent gain that cannot be recognized until the advisor ultimately settles with the IRS. Additional guidance is necessary to resolve this debate.

[14] This movement in a Fund's NAV tied solely to the FIN 48 requirements has the effect of harming Fund shareholders that held shares while the Fund recorded the tax liability and redeemed their shares prior to the expiration of the applicable statute of limitations. These shareholders would be unable to attain

As a result, sophisticated investors who are aware that application of FIN 48 to a Fund may result in an artificial decrease in the Fund's NAV could redeem their shares prior to this decline. Depending on the number of such investors, the Fund may experience a large outflow of assets, which could require it to liquidate a corresponding portion of its holdings and expose the Fund to disruption in its investment program and increased transaction costs.

D. Taxation of Funds

Funds normally elect to be taxed as regulated investment companies ("RICs") under Subchapter M of the Internal Revenue Code of 1986, as amended (the "Code"),[15] in order to take advantage of the "pass through" taxation regime available to RICs under Subchapter M. Congress provided this tax treatment for RICs – which has been credited as one of the most critical factors in the enormous success of mutual funds as an investment vehicle for small long-term investors – in order to provide Fund investors tax treatment comparable to what they would achieve by direct investments in securities.[16] A Fund will qualify as a RIC with respect to a taxable year if it satisfies certain requirements with respect to the source of its income[17] and the diversification of its assets in that taxable year.[18]

As the following discussion explains, RICs can, and typically do, take steps designed to maximize the tax advantages available to them and their shareholders, which is consistent with the expectations of Fund investors. Specifically, they seek (1) to eliminate any tax liability at the Fund level, thus avoiding double taxation altogether, and (2) to flow through to their shareholders the character of income and gains on Fund investments. This involves hundreds of individual decisions about the timing, character and amount of the many items of income and gains the Fund must analyze and take into account.

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the full economic benefit of their investment in the Fund even where the Fund knew, or had reason to believe, that it would never make a payment in connection with the artificially recorded tax liability. Further, shareholders that entered the Fund after the redeeming shareholders, and that remained in the Fund when the statute of limitations expired, would receive an economic benefit tied to Fund activities that took place prior to their purchase of Fund shares. This economic benefit would effectively accrue at the expense of the redeeming shareholders.

15 A very limited number of registered investment companies are taxed as partnerships. Under the tax rules applicable to entities taxed as partnerships, a partnership does not have liability for federal tax and the partners instead generally include their share of the partnership's income and gains in determining their tax liability.

16 Matthew P. Fink, *Guest Column,* WINDOWS INTO THE MUTUAL FUND INDUSTRY, Dec. 15, 2005, at 15.

17 Code Section 851(b)(2).

18 Code Section 851(b)(3).

A RIC that satisfies certain minimum distribution requirements[19] is able to avoid taxation at the RIC level to the extent that it distributes its net income and net gains to its shareholders. As a result, almost all Funds taxed as RICs never pay any tax, since they distribute all of their income and gains to their shareholders. This treatment is achieved through the allowance of a deduction to a RIC for the amount of its dividends paid in a timely manner to its shareholders (the "dividends paid deduction") in computing the amount of its "investment company taxable income"[20] and net capital gains.[21]

Distributions eligible for the dividends paid deduction with respect to a taxable year must generally be distributed to shareholders during the taxable year, or, if certain conditions are satisfied, within twelve months after the taxable year under the so-called "spillover" dividend procedures.[22] A RIC must also generally distribute during each calendar year an amount at least equal to the sum of 98% of its ordinary income (generally measured over the calendar year) plus 98% of its capital gain net income (generally measured over the twelve month period ending October 31st) in order to avoid a 4% excise tax on the amount of any underdistribution.[23]

Thus, under the tax rules applicable to RICs, a RIC will not be liable for any tax as long as it distributes its net income and net gains to its shareholders in a timely manner. Although a RIC must determine the exact amount of its net income and net gains in each taxable year, it does so for the purpose of determining the amount that should be distributed to shareholders.

If certain conditions are satisfied, a RIC can also generally flow through to its shareholders the character of certain types of its income and gains, including long-term capital gains,[24] income from qualified dividends,[25] and tax-exempt interest.[26] Thus, a RIC must also determine the tax character of items of income and gains so it can properly designate and flow through the character of these items to its shareholders. As an example, a RIC determines whether gains are long-term capital gains (which generally requires a holding period of more than one year) in order to

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19 Code Section 852(a)(1).

20 Code Section 852(b)(2) provides that a RIC is taxed on its investment company taxable income, which is defined as taxable income with certain adjustments that include the dividends paid deduction.

21 Code Section 852(b)(3) provides that a RIC is taxed on its net capital gain reduced by the amount of capital gain dividends paid to its shareholders.

22 Code Section 855.

23 Code Section 4982.

24 Code Section 852(b)(3).

25 Code Section 854.

26 Code Section 852(b)(5).

determine the amount of distributions that can be designated as capital gain dividends (taxable as long-term capital gains) to its shareholders.[27] Similarly, a RIC determines the amount of dividends it receives that can be flowed through to its shareholders as "qualified dividends" that are eligible for lower tax rates for non-corporate shareholders.[28]

When a RIC determines the timing, amount and character of its income and gains, there are some situations where the tax treatment of items is not certain as a result of a lack of definitive guidance by the Treasury and/or IRS with respect to the tax treatment of particular investments or transactions.

The Treasury and the IRS have limited resources and differing priorities (that include monitoring abusive tax shelters and other harmful tax practices). Congress enacts frequent changes in the provisions in the Code that apply to various Fund investments, and there are normally significant time delays (sometimes a decade or more) between the enactment of a statutory change and the promulgation of applicable Treasury Regulations. In addition, many RICs invest in recently developed financial products that are not addressed specifically in either the Code or Treasury Regulations.

In some situations there are legitimately differing views on the proper tax treatment of a particular financial product that are carefully considered by the IRS before final guidance is issued. As an example, in determining the proper treatment of debt instruments with contingent interest, the Treasury issued several differing proposed regulations over a period of ten years before adopting final regulations in 1996. Additional delays in issuing guidance can also occur in situations where the IRS specifically solicits submissions on the treatment of particular types of instruments prior to issuing guidance. As an example, in Notice 2004-52,[29] the IRS solicited comments on the proper treatment of credit default swaps.

In light of the typical delays in the issuance of guidance by the Treasury and/or IRS with respect to the tax treatment of financial products, such guidance is normally effective on a prospective basis. In such a situation, as a practical matter, the IRS typically does not challenge a taxpayer's treatment of a financial product in a prior year as long as the taxpayer's treatment was reasonable and consistent with relevant Code provisions. As an example, when the IRS issued a Revenue Ruling in December 2005 that held that certain income from commodity index swaps was not qualifying income for a RIC, it did not apply the position on a retroactive basis, and instead

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[27] Code Section 852(b)(3).

[28] Code Sections 854 and 1(h)(11).

[29] 2004-32 I.R.B. 168.

applied the Ruling to swaps entered into after June 30, 2006; the IRS subsequently postponed the effective date until September 30, 2006.[30]

In addition, as a practical matter, the IRS rarely audits Funds. There are several reasons for the lack of frequent audits. As discussed above, Funds typically would have no tax at the Fund level. In addition, Funds normally obtain expert advice on the tax treatment of new or unusual transactions and normally take conservative positions in determining the tax treatment of particular transactions in situations where there is no clear guidance. In situations where there is no clear guidance on an issue, representatives of Funds and the Investment Company Institute often have informal discussions with representatives of the IRS and in many cases make submissions on suggested guidance. Representatives of the Treasury and the IRS are also invited to speak at industry conferences and at meetings of the Investment Companies Committee of the American Bar Association Tax Section. As a result, the Fund industry has developed a well deserved reputation for responsible and conservative behavior in determining tax positions, which has been a factor in the infrequency of Fund tax audits.

In the rare situation where the tax treatment by a RIC of an item is questioned by the IRS in connection with an audit, it is normally possible to resolve the issue through a settlement that may involve payment of only a portion of the potential liability. Further, under a special procedure, a RIC can avoid any tax at the fund level that would otherwise result from an increase in taxable income or gains in a prior year by making an additional distribution of a "deficiency dividend" to its shareholders.[31] In such a case, the RIC would then only need to pay interest and a specified penalty that would normally be lower than the potential tax liability.[32]

Thus, although there may be "uncertain" tax positions taken by Funds, particularly in situations where there is an absence of clear guidance, as a practical matter tax liabilities will almost never be paid by the Fund as a result of the factors discussed above.

E. Discussion

As a preliminary matter, we emphasize that we fully endorse an accounting approach that requires a Fund's financial statements to reflect liabilities for taxes that it is likely to pay. Any material amount of a contingent tax liability that is likely to reduce shareholder value should, of

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[30] Rev. Rul. 2006-1, 2006-2 I.R.B. 261, as modified by Rev. Rul. 2006-31, 2006-25 I.R.B. 1.

[31] Code Section 860.

[32] Deficiency dividends are not a panacea, however, because they cannot be used to cure all violations of the requirements under Subchapter M (*e.g.*, a violation of the diversification requirements in Code Section 851(b)(3)).

course, be reflected both in a Fund's financial statements and the NAV at which investors buy and sell their shares. Indeed, we believe the Fund industry already has adopted an approach that achieves this result and that there may be other approaches that would improve the process. However, while FIN 48 may be intended, in theory, to result in such an approach, its application to the unique features of Fund pricing and the relevant tax environment could, in fact, lead to the opposite effect.

1. *FAS 5 Provides an Appropriate Framework for Recognizing Potential Tax Liabilities in NAV*

We submit that FASB Financial Accounting Statement No. 5, *Accounting for Contingencies* ("FAS 5")[33] provides the appropriate framework for Funds in determining whether to reflect tax positions in their financial statements and, as a result, in their NAV. FAS 5 employs a three-part test to determine whether an issuer should accrue a liability regarding a loss contingency involving the possible disallowance of a tax position: (1) it must be probable that the reported tax treatment will be challenged; (2) it must be probable that the future resolution of the challenge will confirm that a loss has been incurred; and (3) the amount of the loss must be reasonably estimable (the "probable and estimable standard"). As applied to tax uncertainties, when a Fund has a potential tax liability that is probable and the amount can be reasonably estimated, the Fund would generally record a liability in the amount reasonably estimated. FAS 5 does not dictate the type of evidence or reasoning the issuer may consider in determining whether the potential liability is probable or in estimating the amount. Accordingly, the practical effect of FAS 5 is that Funds record a tax liability and reflect that liability in NAV when, but only when, there is a real-world likelihood that the tax in question will be paid and shareholder value actually will be impaired.

2. *FIN 48 Should Not Be Used to Determine NAV*

As explained above, the confluence of two circumstances uniquely affecting mutual funds poses a significant threat that application of FIN 48 to Funds will cause irreparable harm. These circumstances are: (1) a tax environment characterized by uncertainties that are widespread, yet highly unlikely to be resolved in a manner imposing tax liabilities on Funds, which under the "permissible guidance" constraints of FIN 48 could lead to artificial recognition of liabilities in Fund financial statements and (2) the direct and daily impact of these artificial determinations on Fund shareholders through the pricing of shares at NAV. Clearly, reducing NAV for contingent tax liabilities when, as a practical matter, there is only a remote possibility of payment, and then increasing it again upon expiration of the statue of limitations where no real change in value has occurred, would be misleading and harmful both to Fund shareholders and prospective investors.

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33 Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (Mar. 1975).

Accordingly, FIN 48 should not be applied to Funds in a manner that affects NAV of Fund shares.

Application of FIN 48 to tax positions taken by a Fund in prior years is particularly pernicious. Under applicable tax law, the statute of limitations typically remains open for three years after a return is filed (six years in the case of significant understatements of tax liability).[34] Consequently, FIN 48 may require Funds in 2007 to record liabilities for positions they took on returns many years in the past. For example, a Fund with a calendar tax year would, on January 2, 2007, potentially have to book liabilities relating to tax positions taken on its tax returns for years dating back to 2003 (or even dating back to 2000). It is quite likely that a number of shareholders who received the benefits of those prior-year positions will have left the Fund, while a number of the Fund's current shareholders will have acquired shares after the benefits were realized. The impact of any NAV reduction in respect of prior-year positions therefore will be extremely inequitable.

We also note that requiring daily reductions in NAV for uncertain tax positions is not even reasonably feasible, since in many cases reliable information necessary to make the determinations required by FIN 48 simply will not be available on a same day basis. A Fund may not be in a position to finalize its tax position with respect to a particular transaction or investment until after it consults with its tax advisors. Often, a final resolution on tax treatment is not reached until financial statements and/or tax returns are prepared, which would normally be substantially after the time when a Fund makes an investment for which there is no definitive guidance on the tax treatment. In addition, where applied to NAV on a daily basis, FIN 48 could operate to require an immediate deduction based on a condition that may well later be reversed. For example, even if a Fund could have additional net income or net gains if a different tax treatment applies to an investment, the Fund could eliminate any liability by making additional distributions to its shareholders either during the tax year or, as discussed above, within twelve months after the tax year under the spillover dividend procedures and it could also reduce any potential liability through settlement and/or by payment of a deficiency dividend, as discussed above.

Because of these difficulties and uncertainties, which Funds would need to resolve on a daily basis under severe time constraints, and their draconian effects on shareholders, it is inevitable that inconsistent and diverse practices will arise. Thus, paradoxically, in addition to harming investors, FIN 48 would itself defeat the sole purpose it was designed to serve, thereby causing substantial harm without any offsetting benefit.[35]

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[34] Code Section 6501.

[35] We also ask the Commission to consider the fact that a Fund may find itself facing an uncertain tax position based on circumstances that are beyond the Fund's control. A Fund may acquire and hold a

Moreover, from a longer-term perspective, if FIN 48 is implemented in its current form, one of its unintended effects may be to force Funds to avoid newly developed financial products until such time as the Treasury or IRS issues guidance that addresses their tax treatment. This result would be a great disservice to mainstream investors, who would effectively be denied access to innovative financial products that were available to their wealthier counterparts.

F. The Commission's Authority to Act and Petition for Rulemaking

1. *The Commission's Authority Over Accounting Methods and NAV Calculation*

We believe that the Commission has the authority to prescribe the form and content of financial statements and to ensure that investors are furnished with the information they need to make investment decisions, and that the Commission has acknowledged as much.[36] Historically, the Commission has looked to the private sector, primarily FASB, to assist in carrying out these functions by developing accounting principles and standards, including GAAP.[37] However, FASB's authority to determine accounting principles and standards is subject in all instances to the Commission's determination to the contrary, in order to improve the accuracy and effectiveness of financial reporting and to promote the interests of investors.[38]

Section 108 of the Sarbanes-Oxley Act of 2002 increased the Commission's oversight of FASB's standard setting activities. Section 108 amended Section 19 of the Securities Act of 1933, as

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security for which the tax position is well established, but which then, through no action or fault of the Fund, is transformed into a different security or instrument that raises tax uncertainties. For example, where the issuer of a conventional security undergoes a fundamental change, such as in bankruptcy or reorganization, the outstanding security held by the Fund may convert into a derivative security, payment stream, or other unconventional instrument for which there may be no specific tax guidance.

36 *Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter*, SEC Rel. No. 33-8221 (Apr. 25, 2003); *see e.g.*, Section 108(c) of the Sarbanes-Oxley Act of 2002 ("Nothing in this Act, including this section...shall be construed to impair or limit the authority of the Commission to establish accounting principles or standards for purposes of enforcement of the securities laws."); 15 U.S.C. §§ 77g, 77s(a), 77aa(25) and (26); 15 U.S.C. §78c(b), 78l(b) and 78m(b).

37 *Id.*

38 *Id.*; *see also* Rule 4-01 of Regulation S-X (Rule 4-01 generally requires financial statements filed with the Commission to include information necessary so that they are not misleading; Rule 4-01(a) states that financial statements that are not prepared in accordance with GAAP will be presumed to be misleading or inaccurate, despite footnote or other disclosures, unless the Commission provides otherwise).

amended ("1933 Act"), to establish criteria that must be met in order for work product of an accounting standard-setting body to be recognized as "generally accepted." In 2003, the Commission determined that FASB met such criteria and stated that the standards set by FASB are "recognized as 'generally accepted'..., unless the Commission directs otherwise."[39] Accordingly, issuers must follow the accounting pronouncements and standards put forth by FASB when filing financial statements with the Commission. Pursuant to the Commission's overarching authority to protect investors, however, it is clear that the Commission may amend, modify or otherwise address accounting standards set by FASB.[40]

The Commission has used this authority before to delay the effective date of a FASB pronouncement. In April 2005, based on "feedback from public companies, industry groups, and registered public accounting firms" facing an "impending deadline," the Commission determined that delaying the effectiveness of a new FASB accounting standard was necessary for the protection of investors, and adopted an amendment to Rule 4-01 of Regulation S-X to implement such a delay.[41]

In generally recognizing FASB's pronouncements as authoritative, the Commission premised its determination on an expectation that FASB will "continue to serve investors and protect the public interest" and that FASB's "conclusions will promote the interests of investors."[42] Further, the Commission stated that it expected FASB to "weigh carefully the views of its constituents and

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[39] *Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter*, SEC Rel. No. 33-8221 (Apr. 25, 2003).

[40] *Id.* at n. 18 ("[T]he Commission and its staff do not prohibit the FASB from addressing a particular topic and do not dictate the direction or outcome of specific FASB projects *provided that the conclusions reached by the FASB are in the interest of investor protection*" (emphasis added)).

[41] *See Amendment to Rule 4-01(a) of Regulation S-X Regarding the Compliance Date for Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment*, SEC Rel. No. 33-8568 (amending Rule 4-01 to delay the effective date of Statement of Financial Accounting Standards No. 123 (Revised 2004) ("FAS 123R")).

[42] *Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter*, SEC Rel. No. 33-8221 (Apr. 25, 2003). In fact, Section 108 of the Sarbanes-Oxley Act of 2002 provides that the standards set by a private sector standard-setting body can only be recognized by the Commission if, among other things, "the Commission determines that the private sector body 'has the capacity to assist the Commission in fulfilling the requirements of...the Securities Exchange Act...because, at a minimum, the standard setting body is capable of improving the accuracy and effectiveness of financial reporting and the *protection of investors* under the securities laws" (emphasis added) *Id.*

the expected benefits and perceived costs of each [of FASB's] standard[s]."[43] As explained above, FIN 48, when applied to Funds, fails to meet these expectations.

In addition to its authority to prescribe accounting methods, the Commission has direct authority over the calculation of NAV under Sections 22 and 38(a) of the 1940 Act. Section 38(a) of the 1940 Act authorizes the Commission to, among other things, make rules and regulations defining "accounting, technical and trade terms" used in the 1940 Act. Such terms would include NAV, which is used in Section 22 of the 1940 Act. Section 22 of the 1940 Act authorizes the Commission to make rules and regulations applicable to Funds regarding, among other things, the method for calculating the price at which shares of a Fund may be bought or sold, in relation to the current NAV of such shares. In fact, when adopting, and subsequently amending, Rule 2a-4 ("Definition of 'Current Net Asset Value' For Use in Computing Periodically the Current Price of Redeemable Security") under the 1940 Act, the Commission has expressly relied on these sections for its authority.[44]

2. *Petition for Rulemaking – Provision for Emergency Action*

Rule 192 of the Commission's Rules of Practice affords any person desiring the issuance, amendment or repeal of a rule of general application the opportunity to file a petition for such relief with the Secretary of the Commission.[45] This rule expressly contemplates that, in certain exigent circumstances, notice and public comment will be impracticable, unnecessary or contrary to the public interest, and that emergency action will be appropriate.[46]

Rule 192 requires that a petition for rulemaking set forth the text or the substance of any proposed rule or amendment desired, and state the nature of the petitioner's interest and the reasons for the relief requested. The language we propose is set forth under the heading "Substance of Proposed Rulemaking" below, and our reasons for seeking this relief are set forth in the body of this letter.

In addition, Sections 3(f) and 23(a)(2) of the Securities Exchange Act of 1934, as amended ("1934 Act"), Section 2(b) of the 1933 Act, and Section 2(c) of the 1940 Act require the Commission, in the context of rulemaking in general, to consider whether the action will promote

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43 *Id.*

44 *See e.g., Adoption of Rule 2a-4 Defining the Term "Current Net Asset Value" in Reference to Redeemable Securities Issued by a Registered Investment Company*, SEC Rel. No. IC-4105 (Dec. 22, 1964); *Adoption of Amendments to Rule 6-02-9 of Article 6 of Regulation S-X and Rule 2a-4 under the Investment Company Act of 1940 with Respect to Provision by Registered Investment Companies for Federal Income Taxes*, SEC Rel. No. IC-5943 (Dec. 31, 1969).

45 Securities and Exchange Commission, *Rules of Practice*, Rule 192.

46 *Id.* at Rule 192(b).

efficiency, competition and capital formation. We respectfully submit that Commission action delaying the effective date of FIN 48 for Funds will promote these goals. For the reasons described above, we believe that Commission action in this respect will avert adverse impacts on efficiency, competition and capital formation by protecting long-term Fund shareholders from the harm to which they would otherwise be exposed should the Commission fail to take the action requested.

Finally, we believe that the Commission would be justified in adopting the proposed amendment immediately, on an emergency basis, without the provision of notice and an opportunity for comment. If the Commission does not act immediately, shareholders of Funds with calendar fiscal years may be affected by a sudden drop in NAV on January 2, 2007, the first business day of the first such fiscal year beginning after December 15, 2006. Accordingly, in light of these concerns and the limited time available to address them, we ask the Commission to find, for good cause, that providing notice and opportunity for comment would be impracticable, unnecessary and contrary to the public interest.[47]

3. *Substance of Proposed Rulemaking*

By this petition, we respectfully request that the Commission extend the effective date of FIN 48 at least six months in order to avoid the potential for irreparable harm to shareholders on January 2, 2007, and to provide adequate time for Funds and the Commission to resolve the issues described above.

Specifically, we respectfully ask the Commission to adopt the following amendment to Rule 4-01 of Regulation S-X:

> *(a)(4) Notwithstanding the effective date set forth in FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ("Interpretation No. 48"), an investment company (as defined in the Investment Company Act of 1940, as amended) registered with the Commission shall account for uncertainty in*

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[47] Section 553(b)(3)(B) of the Administrative Procedure Act, 5. U.S.C. § 553(b)(3)(B) permits an agency to dispense with prior notice and comment when it finds, for good cause, that notice and comment are "impracticable, unnecessary, or contrary to the public interest." The Commission similarly approved amendments to Rule 4-01 without notice or the opportunity to comment with respect to FAS 123R. *See Amendment to Rule 4-01(a) of Regulation S-X Regarding the Compliance Date for Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment*, SEC Rel. No. 33-8568.

> *income taxes in accordance with Interpretation No. 48 for fiscal years beginning after June 15, 2007.*[48]

We direct the Commission to Rel. No. 33-8568 in which the Commission took similar action to delay the effective date of a Financial Accounting Statement issued by FASB.[49]

During this extension, we ask the Commission to consider the following actions that would alleviate the adverse impact of FIN 48 on Fund shareholders.

a. Exempt Funds from FIN 48 Requirements

We believe that an exemption for Funds from the requirements of FIN 48 when calculating NAV or issuing financial statements would be in the best interests of Fund shareholders. Such an exemption would allow Funds to continue to use the accounting framework established by FAS 5 when assessing the impact of uncertain tax positions on NAV. The Fund industry has demonstrated that, in an environment of uncertain or absent guidance from the relevant regulatory authority, it is capable of developing rational and appropriate approaches to account for the various tax issues that arise. The FAS 5 approach accurately captures those tax liabilities that a Fund believes it is likely to pay in future years and, unlike FIN 48, does not require Funds to recognize liabilities for certain tax positions that they will never be required to pay.

b. Apply FIN 48 Standards without Affecting NAV

To the extent the Commission continues to believe that FIN 48 would provide useful information to Fund investors, we ask the Commission to consider applying FIN 48 to Funds in a manner that does not affect a Fund's NAV. For example, the Commission could consider requiring Funds to make certain disclosures in its financial statements, consistent with the requirements of FIN 48, that set forth the extent of tax positions that they have taken and the potential liability that may result from such positions. Such disclosure would serve the purposes of informing investors of a Fund's uncertain tax positions, and of facilitating comparisons of Funds by investors, without negatively affecting the Fund's shareholders.

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[48] This effective date would also apply to conforming changes made to other FASB pronouncements adopted in conjunction with the adoption of FIN 48, including, but not limited to, the amendments made to FAS 5 and Financial Accounting Statement No. 109, *Accounting for Income Taxes* (Feb. 1992).

[49] *See infra* note 41 and accompanying text.

c. Exempt Prior Year Tax Positions from FIN 48

In the event that the Commission, after addressing these issues, determines that FIN 48 should apply to Funds, we ask the Commission to exempt open Fund tax positions taken in years prior to the effectiveness of FIN 48. The retroactive application of FIN 48 would both (i) be inconsistent with the regular practice of the IRS with respect to tax positions taken by Funds and (ii) have an exaggerated effect on a Fund's NAV on the first day FIN 48 becomes effective when nothing substantive has in fact changed.

d. Clarify the Application of FIN 48 Where Guidance is Absent

As described above, Funds are frequently faced with circumstances in which little or no guidance is available for evaluating a particular tax position, or where it is not clear whether the guidance available is "permitted guidance" under FIN 48. In the event that the Commission, after addressing these issues, believes that FIN 48 should apply to Funds, we respectfully request that the Commission issue guidance that would permit Funds to continue to rely on their reasonable tax positions with respect to circumstances where Funds reasonably believe that ultimate tax payments are unlikely and without artificially limiting the facts and circumstances that Funds may consider. This would include but not be limited to guidance that both expands the list of permissible authorities on which Funds may rely and clarifies that Funds may take into account the fact that they are rarely audited.[50] The purpose of this guidance would be to ensure that the financial statements correspond with the real-world likelihood of shareholder value being sustained or impaired.

e. Alternative or Combination Approaches

We recognize that there may be alternative ways in which the Commission could resolve the issues that FIN 48 has raised other than (or in combination with) those we are suggesting. We are amenable to any approach, or combination of approaches, that would remove the potential for Fund NAV reduction based on phantom tax liabilities.

G. Conclusion

For the reasons set forth above, we respectfully request that the Commission take immediate action to delay the effectiveness of FIN 48 with respect to Funds in order to resolve the issues raised in applying FIN 48 to Funds and their shareholders. Although we expect that NAV distortions caused by FIN 48 will be rare, given the responsible and conservative approach the

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[50] *See* notes 7 and 8 and accompanying test, *supra*.

Fund industry has taken toward the considerable tax challenges it faces, we believe that the threat of even a single instance of an artificially reduced NAV impacting shareholder value— and the unintended adverse consequences likely to flow from that threat itself— justify immediate Commission intervention to protect the public interest.

Thank you for your consideration of this petition. If you need additional information, please contact Stephen D. Fisher at (617) 563-7139.

Very truly yours,

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