AICPA Investment Companies Expert Panel
Meeting highlights
September 15, 2020
September 30, 2020

I. AICPA/Administrative:
   1. AICPA Investment Companies Expert Panel (EP) July meetings highlights are available here.
   2. The EP was updated on the availability of the 2020 AICPA Audit and Accounting Guide
      Investment Companies (the guide). The EP also considered potential 2021 guide updates.

II. Accounting/Reporting Issues:
   1. FASB projects updates:
      a. The FASB added a project to its technical agenda on how underwriting restrictions on the
         sale of equity securities should be considered when measuring fair value under FASB
         ASC Topic 820, Fair Value Measurement. The FASB also added a project to its research
         agenda to evaluate the effects of other types of sale restrictions on fair value
         measurements.

      b. At the August 19, 2020 meeting, the Board discussed a clarification related to Subtopic
         310-20, Receivables—Nonrefundable Fees and Other Costs as part of Codification
         Improvements for premium amortization on purchased callable debt securities. The
         Board affirmed its prior decision that an entity should reevaluate whether a callable debt
         security is within the scope of paragraph 310-20-35-33 for each reporting period,
         consistent with its intent when it issued Accounting Standards Update No. 2017-
         08, Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium
         Amortization on Purchased Callable Debt Securities.

         Subsequent to the September 2020 EP meeting, the FASB issued Accounting Standards
         Update (ASU) No. 2020-08, Codification Improvements to Subtopic 310-20,
         Receivables—Nonrefundable Fees and Other Costs, which amended Subtopic 310-20.

   2. The EP revisited a previously discussed topic on whether an investment company, including
      a business development company (BDC), could have other comprehensive income (OCI).
      For example, the EP discussed a scenario where a BDC issues variable rate debt and then
      enters into an interest rate swap to hedge changes in interest rates. The EP reaffirmed that the
      EP views from the March 2016 meeting still apply:
      ASU 2016-01 Financial Instruments—Overall (Subtopic 825-10) amended FASB
      ASC 220-10-45-10A to require the change in fair value caused by a change in
instrument-specific credit risk (own credit risk) to be presented separately in other comprehensive income (OCI) for financial liabilities measured using the fair value option in ASC 825. An EP member questioned if an investment company that elected the fair value option for its debt, would be required to present the change in fair value caused by instrument specific credit risk in OCI. EP members indicated that neither FASB ASC Topic 946 nor Article 6 of Regulation S-X currently provide any guidance for/require presentation of OCI. An EP member noted that investment companies are not excluded from presenting OCI.

The EP members also observed that while nothing prohibits an investment company, including a BDC, from having OCI, it would be unusual for an investment company to have OCI in practice based on the activities of investment companies.

3. The EP revisited its discussion on potential differences between the published NAV of a mutual fund as of its fiscal year end and the NAV reported in the mutual fund’s audited financial statements from the EP May 2020 meeting. Sometimes open-ended mutual funds have differences between their published NAV and the NAV reported in their financial statements. In some cases (e.g. the occurrence of a NAV error), the fund may determine it necessary to reprocess its redemptions and subscriptions impacted by the adjusted NAV. The EP continued discussing situations in which an investment company invests in an open-end mutual fund for which the published NAV differs from the NAV reported in its financial statements and whether the fund should adjust its price of the investee fund to match the NAV in the audited financial statements.

The EP observed that FASB ASC 820-10-35-41C(b) states:

A reporting entity shall not make an adjustment to a Level 1 input except in the following circumstances:

…b. When a quoted price in an active market does not represent fair value at the measurement date. That might be the case if, for example, significant events (such as transactions in a principal-to-principal market, trades in a brokered market, or announcements) take place after the close of a market but before the measurement date. A reporting entity shall establish and consistently apply a policy for identifying those events that might affect fair value measurements. However, if the quoted price is adjusted for new information, the adjustment results in a fair value measurement categorized within a lower level of the fair value hierarchy.

The EP members discussed various scenarios, including reprocessing of transactions and timing differences. The EP acknowledged that facts and circumstances may vary. While it may depend on specific facts and circumstances, certain EP members expressed a view that an investment company that invests in an open-end mutual fund for which there is a difference between published NAV and financial statement NAV, may not need to go back and adjust the price of the investee fund to match the NAV in the audited financial statements as long as the original reported NAV is a published price that is determined to be a Level 1 price.
4. At the April 2020 EP meeting, the EP discussed a situation in which a private equity fund is set up for investors that prefer to invest largely in debt rather than equity for statutory or other reasons (for example, 90 percent of the investment will be in debt and 10 percent in equity and all investors would invest pro-rata and have the same 90/10 debt to equity split for their investment for the life of their investment in the fund). Certain EP members expressed a view that for this fact pattern, the debt and equity may be considered a single investor class in presenting the fund’s internal rate of return (IRR).

At the September 2020 meeting, the EP considered how the entities should value its debt and equity interest in the private equity fund, specifically, whether the debt and equity interests are a single unit of account and whether both the debt and equity interests can be valued using NAV as a practical expedient. Some EP members agreed that the investment described above [that consists of pro-rata debt and equity interests] may be considered a single unit of account and can be valued using NAV as a practical expedient in accordance with FASB ASC 820-10-15-4, as long as the investment does not have a readily determinable fair value and is an investment in an entity that meets the characteristics of the investment company within FASB Topic 946.

5. The EP discussed the SEC’s proposing rule and form amendments that would modernize the disclosure framework for open-end management investment companies.

6. The EP considered accounting for cash compensation related to discount rate transition. Clearing organizations are expected to change the rate used for discounting and determining the PAI/PAA on certain cleared derivative instruments. The change in discount rate will result in a revaluation of the cleared derivative which, in turn, will trigger a variation margin payment. To compensate the party required to make (or entitled to receive) this variation margin payment, there will also be a one-time compensating payment made to the party required to make the additional variation margin payment (or by the party entitled to receive the additional variation margin payment). The EP discussed the treatment of the cash compensation.

The EP members discussed a view that technically this cash payment represents compensation for a change in the value of the variation margin account, and therefore, should merely offset the change in the value of that account. Further, for many investment companies these amounts are not likely to be significant, so based on materiality and to avoid operational complexity, there may be diversity in practice in how funds account for this cash compensation.

7. The French and other European Union Tax Authorities have recently informed certain funds about potential refunds of previously paid European dividend withholding taxes. Many funds have not recorded reclaims receivable for these amounts in the past, due to uncertainty around whether they would receive them.

The EP previously discussed potential accounting implications for these situations in May 2013, when “EP member expressed a view that when viewed as a fund’s income tax, the technical answer would be to follow ASC 740 guidance on refunds, which essentially would
result in a receivable for the refund if it is “more likely than not” (MLTN) that the tax position would be sustainable and then identifying the greatest amount of refund that is more likely than not to be received. One EP member noted that when funds pass-through the foreign tax credit to the shareholders, it may be possible to take a view that these potential refunds of tax are not the fund’s income tax. Some expressed a view that they prefer the gain contingency accounting which is a more conservative approach and easier to apply, for example, in situations, where refunds are not material to the fund complex, and nothing is booked until actual receipt of cash refund. It was noted that this is likely not the technically correct approach.”

At the September 2020 meeting, certain EP members acknowledged that significant judgement is involved in recognizing these amounts as an asset. While certain RICs may, based on their specific facts and circumstances, elect to account for these European Union tax reclaims differently, the EP reaffirmed its views from May 2013. The EP members further noted that when received and recorded, these refunds would follow the character of the original withholding.

III. SEC Staff Update

Disclaimer

The following comments and observations were compiled by the AICPA Investment Companies Expert Panel and AICPA staff and are not authoritative positions or interpretations issued by the SEC or its staff. The comments and observations were not transcribed by the SEC or its staff and have not been considered or acted upon by the SEC or its staff. Accordingly, these comments and observations do not constitute a statement of the views of the SEC or its staff.

1. The SEC staff provided an update on emerging markets initiatives:
   a. SEC Chairman Jay Clayton, SEC Division of Corporation Finance Director William Hinman, SEC Division of Investment Management Director Dalia Blass, SEC Division of Trading and Markets Director Brett Redfearn, SEC Office of International Affairs Director Raquel Fox, and SEC Chief Accountant Sagar Teotia, Statement on SEC Response to the Report of the President’s Working Group on Financial Markets (8/10/2020)

2. The SEC staff highlighted July 28, 2020, Dalia Blass, Director, Division of Investment Management Speech: PLI Investment Management Institute

3. The Commission remains fully operational in current telework environment due to COVID-19 and continues to maintain its enforcement and investor protection efforts.

4. Rulemaking:
   a. The SEC issued a final rule “Amending the “Accredited Investor” Definition”, which, among other things, expands eligibility to participate in private capital markets to qualified natural persons. The final amendment identified holders in good standing of the Series 7, Series 65, and Series 82 licenses as qualifying natural persons and also provided that “the Commission may designate qualifying professional certifications, designations, and other credentials by order, with such designation to be based upon
consideration of all the facts pertaining to a particular certification, designation, or credential.”

b. The SEC proposed to “Improve the Retail Investor Experience through Modernized Fund Shareholder Reports and Disclosures”, including rule and form amendments that would modernize the disclosure framework for open-end management investment companies, including ETFs. The framework proposal would feature:

- A summary shareholder report that would highlight key information that is particularly important for retail investors to assess and monitor their fund investments,
- An alternative way to keep shareholders informed about their fund investment and fund updates, instead of delivering prospectus updates to existing shareholders, and
- Amendments to the scope of Rule 30e-3 to exclude open-end funds. Instead, under this proposal, an investor will receive the summary shareholder report in the mail unless the investor opts into electronic delivery.

The SEC also proposed amendments to:

- Prospectus disclosure requirements for open-end funds to provide greater clarity and more consistent information about fees, expenses and principal risks, and
- Advertising rules for all RICs and BDCs to promote more transparent and balanced statements about investment costs.

c. The SEC staff discussed recently adopted Securities Offering Reform for Closed-End Investment Companies as the staff have started to see registration statements for closed-end funds applying the status afforded under the new rule. The staff highlighted reminders including changes to annual reports, the addition of management’s discussion of fund performance, changes to senior securities tables, and disclosure of certain strategy and risk items in the annual report for funds relying on Rule 8b-16(b) of the 1940 Act to not amend their registration statement every year.

d. The SEC staff is actively working through comment letters received on the Investment Company Fair Value proposal and shared several common themes from the comment letters, including regarding the definition of a “readily available market quotation”, the prompt reporting requirement and certain documentation requirements, among others.

5. The SEC staff shared one financial statement comment regarding appropriateness of categorization of certain expenses as extraordinary expense. FASB ASU 2015-01 eliminated the concept of extraordinary items from US GAAP, but the instructions for the operating expense table for investment company registration statements in Item 3(c) of Form N-1A retained that concept using the exact same definition from US GAAP. The SEC staff offered several examples where a registrant classified certain fees, for example, audit fees, proxy fees, or professional fees in connection with filing foreign tax reclaims, as extraordinary. Since these fees occurred for more than one year or would be expected to occur in future periods, the staff questioned their extraordinary categorization and reminded registrants that an item or transaction would need to be both unusual in nature and infrequent in occurrence to potentially qualify as “extraordinary.” The SEC staff acknowledged that compliance with expense limitation agreements is a separate legal determination. The SEC staff also encouraged advisers and fund administrators in consultation with the fund’s auditor to evaluate the classification of extraordinary expenses.

6. Lastly, the SEC staff shared the following OCIE risk alerts:

a. “Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers”
b. “Examination Initiative: LIBOR Transition Preparedness”