

**RESERVE FUND**  
**Draft document intended for public comment**

**A. Purpose of this Document**

The purpose of this document is to offer an updated *Rationale* and *Target Level* of the ICANN Reserve Fund for public comment and input. ICANN welcomes public comments on this document to obtain community and public input on its Reserve Fund for transparency in its management of public funds.

The input collected during this public comment process will be reviewed and addressed consistently with ICANN's public comment process and will be considered by the ICANN Board.

Based on the outcome of the public comment process on the defined *Rationale* and *Target Level*, further work will be performed on the *Governance* of the Reserve Fund (allocation to / withdrawal from, periodic reviews,...) and further community and public input will be solicited.

**B. The Historical Case for ICANN's Reserve Fund**

ICANN provides important global technical coordination functions with respect to the Internet's unique identifiers, yet does not receive any Government funding nor any Government guarantees for its operations, nor does it depend on any private funding from the public or any private organization. ICANN's primary source of funding comes from fees it collects from gTLD registries and registrars. Therefore, ICANN's financial stability is entirely dependent on the registration of domain names.

In the early days of ICANN, these fees were collected on a quarterly basis from primarily a small group of large registries and registrars. The quarterly collection meant that delays in payments would give ICANN issues with its cash flow and its ability to pay wages and other expenses. The reliance on a small group of contracted parties meant that some of these organizations could exert undue influence over ICANN. At the same time ICANN, increasingly, was beginning to deal with significant legal cases over the interpretation of some terms and policies in the registry agreements that could impact its business practices. ICANN decided therefore to set up a Reserve Fund in 2007 in order to reduce its dependence on the timing of fee collections, as well as to provide it with sufficient financial resources to enable it to defend its multi-stakeholder governance model against possible litigation.

A *Target Level* equivalent to "a minimum of 12 months of operating expenses" was also established for the Reserve Fund. This level was primarily based on comparisons with other not-for-profit organizations as well as budget discussions about the appropriate per gTLD domain name fee to charge registrars. To achieve this *Target level*, adopted budgets would have to provide for

contributions to the Reserve Fund on an annual basis until fully funded. The Board supported this approach through its approval of the annual budget, but there has never been a Board resolution that sets out a clear rationale for the *Target Level* of the Reserve Fund. There was however an implicit acceptance that the notion of “12 months of operating expenses” is a sensible level for a not-for-profit organization.

The initial injection of capital into the Reserve Fund was done from ICANN Operational surpluses in two tranches in 2007 and 2009. Since 2013 and until the end of the new gTLD program, the Reserve Fund will have been “topped up” by the reimbursement from the new gTLD program funds for the Historical Development Costs (as defined in the new gTLD applicant guidebook), which were incurred by ICANN during the development phase of the program (2008 to 2011).

The ICANN’s Reserve Fund is governed by the ICANN’s Investment Policy (see <https://www.icann.org/resources/pages/investment-policy-2017-09-18-en>)

### **C. 2012 Benchmarking**

In October of 2012, the ICANN Organization conducted a benchmarking study on how not-for-profit and other organizations set their Reserve Funds. ICANN also obtained regulatory guidelines from Moss Adams, its independent auditors at the time.

In summary, the findings were as follows:

- The only regulatory requirement for a not-for-profit organization is that the Reserve Fund must be  $\leq$  Unrestricted Net Assets. Unrestricted Net Assets are defined as the Net Assets that are not designated for a specific purpose by the Board of Directors.
- The risks covered by the Reserve Fund varied widely. The study identified five main risks: (1) self insurance against a rainy day, (2) proxy for wind-down costs, (3) maintenance and/or replacement of assets, (4) pay-off of committed liabilities and (5) funding of future projects identified in the Strategic Plan.
- A fraction/multiple of operating expenses was found to be the most common formula for calculating the level of the Reserve Fund. However, that fraction/multiple also varied widely from 3 months to 2 years.

### **D. Current status**

As ICANN’s annual expenditures have increased, the *Target Level* of 12 months of operating expenses, expressed in dollars, has increased in relative terms.

In 2014, the Reserve Fund stood at US\$ 85 million corresponding to 11.5 months of operating expenses. Without any withdrawals and taking into account the repayment of new gTLD historical development costs and interest earned, the Reserve Fund should be approximately

US\$94 million by end June 2018.

However, withdrawals from the Reserve Fund have been made since 2015 exclusively for the purpose of paying for the IANA Stewardship transition expenses. Once the last phase of the IANA Stewardship Transition is completed (Accountability WS2, by the end of June 2018), a total of US\$ 36 million will have been withdrawn for this purpose (for more information on these expenses, see [https://www.icann.org/resources/pages/iana-transition-project-costs\[icann.org\]](https://www.icann.org/resources/pages/iana-transition-project-costs[icann.org])). As a result, without any replenishment, the Reserve Fund will be depleted to approximately US\$ 58 million (US\$94 million minus US\$ 36 million) by end June 2018, corresponding to only 4.8 months of operating expenses.

For information, on 30 June 2017, the Reserve Fund was US\$ 62 million.

At the suggestion of the ICANN Organization, the Board Finance Committee has approved, during its meeting held on 22 September 2017, a recommendation to the Board to allocate an additional US\$5 million to the Reserve Fund from ICANN's operational surpluses. The Board will consider this recommendation during its meeting in October 2017 in Abu Dhabi.

Since its early days, ICANN's operations and risk profile have changed significantly, due to ICANN's unique role in the Internet eco-system and its commitment to accountability and transparency to the public.

ICANN is increasingly exposed to legal and other challenges of its activities. This exposure has continuously increased as the Internet and the DNS have expanded and ICANN's role has become more visible. This visibility and exposure has recently significantly increased as a result of the termination of the US Government oversight of the IANA functions.

As ICANN's activities have become more complex and more visible with the expansion of the DNS, it continuously improves its capabilities to plan for the future, to manage and mitigate its exposure to risks, with a high sense of financial responsibility and discipline. This has led ICANN to adopt and live by the simple principle of never spending more than it can afford. ICANN therefore ensures that its expenses never exceed its funding.

ICANN, like many organizations, is exposed to natural disasters, economic fluctuations and regulatory changes. However, unlike any other organization, ICANN's mission has led the Organization and its Multistakeholder model of governance to be subject to the constant changes that affect the Internet, driven by demographic, governmental, economic and technical factors.

No matter how well ICANN can plan, manage risks and apply financial discipline, it is highly exposed to unpredictable events that may have an overwhelming impact on its on-going activities.

In this environment, the only financial resource available to ICANN to face the negative impacts of any events outside of its daily activities, is its Reserve Fund. The Reserve Fund is

the funding of last resort to cover large expenses resulting from unavoidable, unpredictable or unplanned events, which cannot be funded from ICANN's Operations. Without it, any one of these events could severely affect the financial stability of the organization.

## **E. New Reserve Fund Project**

Given the significant change in ICANN's operations and risk profile, the Board felt it necessary to commission a new analysis to revisit the target level of the Reserve Fund. As a result, the ICANN Board initiated recently a new Reserve Fund Project ("the Project") comprising 10 Board members and supported by ICANN's executives, to (i) recommend a *Rationale* for the Reserve Fund and (ii) set an appropriate *Target Level* for it. The methodology adopted by the Project was as follows:

### ***RATIONALE***

1. Assess the potential risks facing ICANN over the next five years. A survey was conducted with all Board members. The risks identified in the survey by the Board members fell into six categories: Financial, Legal, Operational, Reputational, Strategic and Security. These risks were compiled and reconciled to the risks stated in the ICANN Five-Year (FY2016-FY2020) Strategic Plan to generate a list of risks inclusive of both the Board survey input and the Strategic Plan risks.
2. Undertake an analysis of the other five main risks identified in section C above (2012 Benchmarking) and assess their applicability to the ICANN business and risk profile.
3. Determine the principal usage of the Reserve Fund.

Based on the list of risks identified in 1 & 2 and the prioritization of these risks, the Project identified the main Consequential Events that need to be covered by the Reserve Fund, including the events that have required the use of Reserve Fund over the past years (FY15, FY16, FY17).

### ***TARGET LEVEL***

4. Determine, without any a priori assumption about what the financial amount should be, whether the Reserve Fund should be set aside to cater for the worst scenario where all Consequential Events happen at the same time, or for the scenario that covers the most costly Consequential Event, or for some middle of the ground scenario. In total no more than 3 to 5 scenarios.
5. Gather financial and other data related to each Consequential Event, such as:
  - Nature and amount of assets

- Current and future commitments: contracted parties, employees, vendors
  - Type and size of future projects identified in the Strategic Plan
  - Funding sources
  - Other.
6. Quantify each Consequential Event then go back to step 4 to refine/finalize the chosen scenario.
  7. Set the Target Level based on the chosen scenario then convert it into a multiple/fraction of operating expenses that is relevant to ICANN. The purpose of this conversion is to ease the monitoring of the Target Level over time.

## **F. The Project Results**

The Project completed its work for the *Rationale* and *Target Level*. This section summarises the results for each.

### ***RATIONALE***

The list of possible Consequential Events for which the Reserve Fund is considered to be an expected source of funding includes, but not limited to, the following:

- Replenishing Operating Fund levels depleted by unbudgeted and unmitigated short-term events or maintenance and replacement of assets, or payment of liabilities,
- Undertaking major downsizing or significant restructuring of ICANN's operations.
- Mitigating major security and stability threats and attacks.
- Covering unplanned legal costs.
- Undertaking new and major programs resulting from a new strategic plan or exceptional unforeseen external events
- Continue operations after a disaster.

### ***TARGET LEVEL***

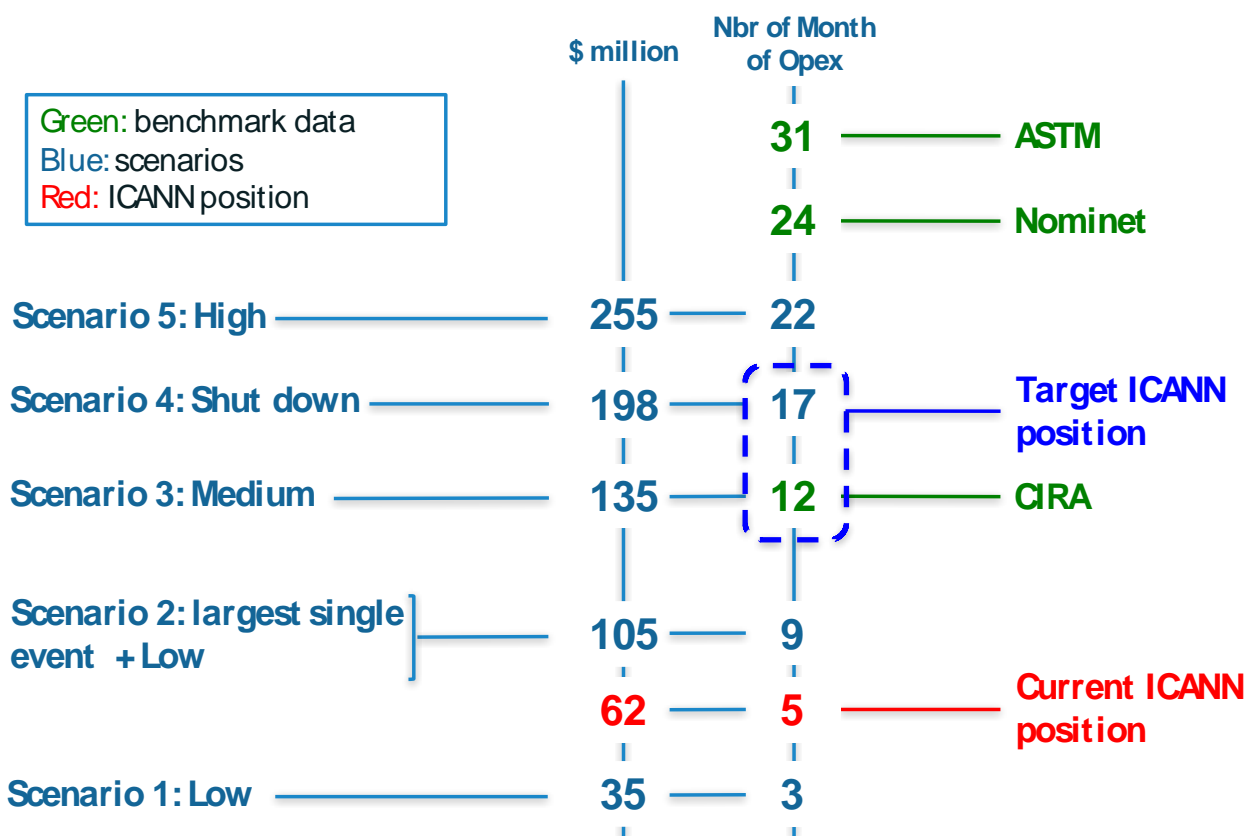
Considering factors specifically related to ICANN's operational and risk profile as well factors related to market trends, ICANN Organization estimated the cost of each of the Consequential Events and quantified 5 scenarios (low, largest single occurrence, medium, shut-down, and high).

The ICANN Organization reviewed the draft results with the Board and finalized the results in the table below:

			Scenarios				
			1	2	3	4	5
	Consequential Events	Per Occurrence	LOW (number of occurrences)	Largest Single "low" occurrences	MEDIUM (number of occurrences)	Shut down scenario (Yr)	HIGH (number of occurrences)
			1	Replenishing operations fund levels depleted by unbudgeted & unmitigated short-term events	\$12M	12 1 occurrence	12 1 occurrence
2	Downsize operations	Restructure: \$35M Downsize: \$70M Shutdown: 1 Yr Dep		70 Downsize	35 Restructure	140 Shut down	70 Downsize
3	Mitigating major security & stability threats/attacks	\$3M	9 3 occurrences	9 3 occurrences	21 7 occurrences	21 7 occurrences	45 15 occurrences
4	Covering unplanned legal costs	\$4M	4 1 occurrence	4 1 occurrence	12 3 occurrences	12 3 occurrences	20 5 occurrences
5	Major program, significant programs undertaken as a result of exceptional unforeseen events	Major: \$30M Significant: \$5M	10 2 Sign.	10 2 Sign.	40 2 Sign. + 1 Maj.	10 2 Sign.	75 3 Sign. + 2 Maj.
6	Continue operations after disaster	\$3M			3 1 occurrence	3 1 occurrence	9 3 occurrences
<b>Total Cost (in \$)</b>			<b>35</b>	<b>105</b>	<b>135</b>	<b>198</b>	<b>255</b>
			<b>3</b>	<b>9</b>	<b>12</b>	<b>17</b>	<b>22</b>

A few comparable organizations were identified to help benchmark the above analysis, from both within and outside the DNS industry. The range of reserve targets observed for these organizations extends from 12 months to 31 months of annual operating expenses.

The data points resulting from both approaches above are summarized in the graph below:



The ICANN Organization collaborated with the chairpersons of the Board Finance Committee, Board Audit Committee, Board Risk Committee to obtain and review benchmark data. The result of the benchmark research is displayed in the picture above and include ASTM (international standards organization, member-based, that develops and publishes voluntary consensus technical standards for a wide range of materials, products, systems, and services.), Nominet (official registry for .UK domain names), and CIRA (official registry for .CA domain name. Canadian tax authority guidance offers 12 months of operating expenses as reasonable target. Cira has restricted investments in place corresponding to this level).

## Conclusion

The analysis performed and the results collected indicate that the target level for the ICANN Reserve Fund should be of a minimum of 12 months and a maximum of 17 months of operating expenses. This is consistent with the *Target Level* currently stated in the ICANN Investment Policy (a minimum of 12 months of operating expenses), and no change is therefore recommended at this time...

Once the Board will have considered the public comments received, changes to the Investment Policy will be evaluated to reflect the retained policy.





## **Appendix 1 – funds held by ICANN (as of 30 June 2017)**

This funds held by ICANN consist of:

- permanent funds: the Operating Fund and the Reserve Fund, governed by the ICANN Investment Policy,
- temporary funds: the new gTLD program application fees and the new gTLD program auction proceeds, governed by the New gTLD Investment Policy.

### Permanent funds:

**Operating Fund (USD 35m):** The target level of this is fund is set at “3 months of operating expenses”. This fund has also been referred to as the Working Capital Fund and its purpose is to provide day-to-day liquidity to support ICANN operations.

**Reserve Fund (USD 62m):** This is the fund subject of this paper. It represents 5 months of operating expenses, using as a reference the FY18 Budget of \$143m.

### Temporary funds:

**New gTLD application fees (USD 128m):** This is the unspent money remaining from the fees collected from the new gTLD applicants in 2012. The purpose of this money is to: (a) continue to cover the cost of the application processing until the program is completed, (b) refund applicants as applications are withdrawn, and (c) cover future costs that are hard to predict. Among these future costs that are hard to predict are the financial impacts of risks (for example, operational, legal, reputational, etc.) relating to the New gTLD Program.

**Auction proceeds (USD 235m):** This is the money collected as a result of the auctions of last resort held by ICANN for the resolution of string contention sets of competing applicants to the new gTLD program (for more information, see LINK).