

Letter of Comment No: 55 File Reference: 1082-300 Date Received: 11/25/03

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Mr. Lawrence Smith
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference No. 1082-300

Exposure Draft on Consolidation of Variable Interest Entities, a modification of FASB

Interpretation No. 46

Dear Mr. Smith:

J.P. Morgan Chase & Co. appreciates the opportunity to comment on the Financial Accounting Standards Board's ("FASB" or the "Board") October 31, 2003 Exposure Draft of the Proposed Interpretation, Consolidation of Variable Interest Entities, a modification of FASB Interpretation No. 46 (the "Exposure Draft," the "ED" or the "Interpretation").

Prior to highlighting the various key comments that we have with the Exposure Draft, we would like to bring to FASB's attention our significant concerns with the process for establishing standards of financial accounting and reporting regarding entities that have been traditionally known as special-purpose entities (SPEs). While we support the Board's objective of addressing evolving financial and reporting matters on a timely basis and improving transparency in financial statements, we believe that the Board's standard setting process for FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51 ("FIN 46") has been rushed and did not provide adequate due process nor properly address public comments received prior to issuing FIN 46. A more diligent process would have avoided many of the implementation problems that have occurred and eliminated the Board's need to:

- a) defer FIN 46 after the standard was required to have been fully implemented by most public companies for over three months:
- issue multiple FASB Staff Positions ("FSPs") that provide new guidance on FIN 46, which
  require cumulative-effect adjustments with each new issuance (i.e., constantly re-implementing
  the standard); and
- modify the standard with various technical corrections and amendments less than four months after FIN 46's original effective date.

We believe that highlighting this lack of due process is important and necessary because the Board appears to be rushing the amendment process to ensure that the standard is effective prior to perhaps an unrealistic deadline. We agree with three of the seven Board members who have publicly stated in the ED that they disagree with the issuance of the Exposure Draft because they believe that "the Interpretation does not address all the issues that they view as most critical to achieve more consistent application of consolidation policies to variable interest entities." Moving forward without adequately

addressing those issues appears to be in direct conflict with the FASB's mission, as stated in the ED, to establish and improve standards of financial accounting and reporting. Furthermore, it is our view that this accelerated process coupled with the many form-based rules within FIN 46 that conflict with the underlying principles of Accounting Research Bulletin No. 51, Consolidated Financial Statements ("ARB 51"), have resulted in a consolidation model with substantial inconsistencies, operational issues, and inappropriate consolidation conclusions.

To improve the model, we recommend that the Board refrain from issuing additional form-based rules for FIN 46 and consider expanding the concepts within the new paragraph 9A of FIN 46 that was added as part of the ED, which emphasizes that qualitative assessments are critical to reach a reasonable consolidation conclusion. Expansion of this guidance would make the standard more principle-based and not result in incorrectly identifying a non-controlling financial interest as the primary beneficiary. We have included other detailed comments within this letter that we believe are in line with the underlying principles of identifying a controlling financial interest.

# Our Key Comments Cover the Following Topics:

- Scope Exception for Mutual Funds in the Form of Trusts and Trusts of Bank's Trust Department and Similar Arrangements
- II. Reconsideration Events
- III. De Facto Agency
- IV. Disproportionate Voting Provisions in FIN 46
- V. Removal of Paragraphs B1-B10
- VI. Issues with Conceptual Framework Regarding Fees in FIN 46

## I. Scope Exception for Mutual Funds in the Form of Trusts and Trusts of Bank's Trust Department and Similar Arrangements

We support the Board's view that mutual funds organized as trusts and trusts in bank trust departments should not apply the consolidation guidance of FIN 46. However, we would like to recommend that the Board reconsider its language with respect to the scope exception. A literal reading of the exception would only allow mutual funds that are organized as trusts and trusts in bank trust departments to be allotted this exception. Not all "customary" trust arrangements are in the legal form of an entity or a trust, especially in foreign jurisdictions. This type of arrangement may take various legal forms such as a partnership or even be considered an account from a legal perspective and not an actual legal entity, depending on the legal jurisdiction of the "customary" trust activity. We believe that wording the scope exception included in paragraph 3(c) of the ED in the following manner would be more appropriate and would capture what we believe is the Board's objective for including this scope exception in the ED:

"Trust services and similar activities that consist of fiduciary services provided to a business enterprise's customers that are organized and operated in a manner consistent with customary existing practices and that can take various legal forms, depending on the respective legal jurisdiction, such as mutual funds in the form of trusts or partnerships, trusts or accounts of a bank's trust activity, customer accounts, managed accounts, and other similar arrangements are not subject to the requirements of this Interpretation. However, if an entity or legal structure is used by the business enterprises in an effort to circumvent the provisions of this Interpretation, that entity or legal structure shall be subject to this Interpretation."

#### II. Reconsideration Events

### General Comment

We support the Board's decision to revise paragraph 7 and 15 of FIN 46 in more of a principle-based manner that requires reconsideration of the standard by each respective business enterprise only after a significant event has occurred that could change the original determination. However, we believe that the lists of examples provided by the Board, specifically paragraphs 5(b), 10(b), 10(c), and 10(d) of the Exposure Draft, may be viewed as form-based rules and would require reassessment of the entity by each respective business enterprise involved with the entity without those business enterprises being aware that the event that "triggered" their reconsideration has occurred. In many situations, there is no obligation of the VIE or the variable interest holders to advise other variable interest holders that a transaction has taken place that may require reconsideration of consolidation. We believe these examples create the same issues that were addressed by many constituents on the original exposure draft to FIN 46 issued in June 2002. It creates an operational burden for business enterprises, requiring them to follow the activities of third-party investors and/or primary beneficiaries and raises potential legal issues by requesting variable interest holders to disclose their interests and details of any anticipatory transactions that they may have entered into to sell (or buy) variable interests.

We recommend that the Board focus on the principle, stating that reconsideration is required for a business enterprise after it has entered into a significant transaction with the entity or consented to a significant change in the entity's design that could have an impact on the business enterprise's original FIN 46 assessment.

#### Trouble Debt Restructurings Impact on a Voting Interest Entity

We agree that the incurrence of operating losses by an entity or renegotiations of an entity's debt caused by the incurrence of operating losses should not cause a change in the determination of whether an entity is a voting interest entity. However, we are concerned with the Board's view that reconsideration should occur if the level of subordinated financial support provided to the entity is modified as a result of a debt restructuring. We do not understand how an increase in the subordinated financial support, as a result of extinguishing a loan obligation, would increase an entity's overall expected losses as described in A25 and cause the need for reconsideration. The restructuring is the result of operating losses, and adequate consideration for providing that service should be allowed. For example, in certain instances a loan may be restructured that results in the lender receiving newly issued subordinated debt or equity of the borrower in consideration for extinguishing the loan obligation. While the issuance of subordinated debt or equity may increase the total subordinated financial support level and change the capital structure of an entity, we do not believe that a restructuring of this kind changes the lender's exposure to the entity's expected losses that weren't captured within the original instrument at the time of restructuring. Our conclusions equally apply to equity kickers that might be issued in a trouble debt restructuring. We request that the Board reconsider their intentions in A25 of the ED.

### III. De Facto Agency

We agree with the Board that qualitative and quantitative factors should be considered in applying the guidance of de facto agency in paragraph 17 of FIN 46 and that the activities of the parties associated with the variable interest entity are an important qualitative factor. However, we believe that the wording for the modification in paragraph 12 of this ED is ambiguous and may not always achieve the objective of identifying the true primary beneficiary. By revising FIN 46's guidance on de facto agency in a manner that allows a party's activities to always take priority over the principal/agency relationship, an enterprise that is actually making the decisions and that has the risks and rewards of the entity (i.e., the principal)

may not consolidate the entity if its business activities are not considered closely associated with the VIE. Applying this new provision may seem straight forward to the Board for business enterprises with one type of business activity, but the application of this modification to large institutions and major conglomerates that have a multitude of business activities may lead to inappropriate results. We believe the Board's objective would be better achieved by revising paragraph 12 of the ED to the following:

"If two or more parties with variable interests have an agency (or de facto agency) relationship, the principal (or de facto principal) is presumed to be the primary beneficiary. Both quantitative and qualitative factors should be considered in this determination. If it is apparent that there are more relevant factors in identifying the primary beneficiary other than the agency/principal relationship, such as the activities of the entity being more closely associated with a particular business enterprise, then those factors could overcome the presumption."

## IV. Disproportionate Voting Provisions in FIN 46

We support the revision of the last sentence in paragraph 5 of FIN 46. We agree that consideration should be given to situations where the voting interests are structured in a manner to prevent a primary beneficiary from avoiding consolidation of a variable interest entity; however, we believe that this would be better accomplished by documenting it as a principle as opposed to a rule. Legitimate operating companies that are controlled by its equity holders may not be deemed voting interest entities because of the wording of the revision.

For example, this provision does not contemplate a newly established venture company; where an employee(s) brings a product, an idea, and/or specific expertise to start the business and who is awarded with a compensation package that includes equity with voting rights in the company (i.e., "sweat equity") in lieu of a higher salary or bonus. The purpose of structuring the entity with "sweat equity" is to offer consideration to the employee for the knowledge or product brought to the investment group, to provide the employee/management with incentives to produce superior results and to ensure continuity of the entity's decision makers (i.e., management), which are all customary business practices for establishing a newly-formed company. It may be interpreted that "sweat equity" would not be included in the "group" of equity investors for purposes of evaluating the characteristics in paragraphs 5(b) of FIN 46. As a result, the other investors are deemed to have disproportionately low voting rights because a percentage of the voting rights are assigned to the sweat equity holders, who are not considered part of the equity "group."

The disproportionately low voting rights for the other investors are not designed to circumvent the consolidation rules of FIN 46, but to accurately reflect the ownership participation of <u>all</u> equity holders, some of whom are employees of the entity contributing their products, ideas, and/or expertise to the company. The allocation of voting interests to the employees is designed to provide an incentive to the employees to produce superior results for the entity and to provide them with the necessary means of achieving those results (i.e., participation in meaningful decisions). It is not designed to make the voting interests of other investors "non-substantive." We believe that in these situations, where control does reside with the entire equity "group," including the sweat equity holders, the voting interest model is appropriate as long as the other provisions of paragraph 5 of FIN 46 are met. Accordingly, we believe that the last sentence in paragraph 5 of FIN 46 should be principles-based instead of a two-part rule and replaced with the following language:

"The provisions of paragraph 5 should be analyzed both from a qualitative and quantitative perspective, ensuring that the equity holders, as a group, have the controlling financial interest in the entity and ensuring that no other business enterprise is benefiting or absorbing risks of the entity in a disguised manner that would take away that controlling financial interest from the equity holders. If an entity or legal structure is used by the business enterprise in an effort to

circumvent the provisions of this Interpretation, that entity or legal structure shall be subject to this Interpretation."

### V. Removal of Paragraphs B1-B10

We do not support the removal of paragraphs B1-B10 in FIN 46 without replacing that guidance with new guidance. It is the sole guidance in FIN 46 that provides business enterprises with an understanding of a variable interest—a significant part of the FIN 46 model. Rushing the standard setting process to ensure that this ED is finalized without adequately addressing all of the significant issues that the Board plans to address in this ED does not help, but rather creates additional burdens on the financial statement preparers and users. Further, the absence of such guidance results in an incomplete document and prevents due process as material understanding may be lacking, precluding proper analysis of the document.

#### VI. Issues with Conceptual Framework Regarding Fees in FIN 46

We have actively participated in the preparation of the comment letter submitted by the New York Clearing House Association on FIN 46-d, but felt it was important to once again comment on what we believe are major flaws with the FIN 46 consolidation model. It is our view that the Board has not adequately provided conceptual support for the current bias in the FIN 46 calculation towards a decision maker. A scenario where a business enterprise, as decision maker, could be required to consolidate a variable interest entity where its sole activity is receiving fees that are a fixed dollar amount or a fixed percentage of assets managed does not appear to be in line with the concept of a "controlling financial interest." The guidance that the Board provides in Exhibit A of FIN 46-d, causes the decision maker to consolidate the vehicle in the example even though the decision maker does not own 10% of the beneficial interest and the risks and rewards have been dispersed in the following manner:

- No single beneficial interest holder bears the risks of the assets in the vehicle.
- The residual rewards of the assets are distributed to the various beneficial interest holders after the
  decision maker receives a reasonable fixed fee.
- The fixed fee is for services provided that would be otherwise required and purchased by the entity.

While we understand that the Board is addressing whether to include fees to a decision maker in a forthcoming FSP, we believe the issue would be more appropriately addressed in this Exposure Draft. Furthermore, the Board should focus on how fees are included in the FIN 46 model. Fees to a decision maker should be included in the FIN 46 calculation of expected losses and residual rewards, but only in a manner similar to all other variable interest holders (i.e., include only based on variability and not gross). There is no conceptual support for treating these variable interests any differently than any other variable interest in the model. The Board should consider emphasizing a qualitative assessment when analyzing a decision maker's role in the FIN 46 model instead of a having a rule that treats decision maker fees differently than other variable interests in the calculation. Fixing the FIN 46 model in this manner will result in identifying the decision maker as the primary beneficiary in situations where a business enterprise truly has a controlling financial interest and not in situations where the decision maker is acting in a fiduciary manner designed to provide required services or rewarded for producing superior results for the beneficial interest holders as is the case in the Board's FIN 46-d example.

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In summary, we believe that there are significant deficiencies with the Board's standard setting process regarding variable interest entities that should be addressed to ensure that many of the problems that have

occurred to date with FIN 46 are not replicated. We urge the Board to consider the comments in our letter and to ensure that future guidance is consistent with the principle of identifying a "controlling financial interest."

We appreciate the opportunity to submit our views and would be pleased to discuss our comments with you at your convenience. If you have any questions, please contact me at 212-270-7559.

Very truly yours,

Joseph L. Sclafani