

Chartered Accountants agréés of Canada

Comptables du Canada

By e-mail

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> Letter of Comment No: 69 File Reference: 1082-300 Date Received: [1]28/03

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

Dear Sir:

Re: Proposed Interpretation, Consolidation of Variable Interest Entities, a modification of FASB Interpretation No. 46 File Reference No. 1082-300

We are writing to comment on the scope exception in subparagraph 4h of amended FASB Interpretation No. 46, as proposed in paragraph 3c of the Exposure Draft dated October 31, 2003 (the ED).

We are a task force established by the Emerging Issues Committee of the Canadian Accounting Standards Board to address some unexpected results from applying to mutual funds the Canadian standard corresponding to Interpretation 46. The requirements of the Canadian standard, Accounting Guideline AcG-15, are harmonized with those of Interpretation 46. The task force was established in September to try to interpret the standard but has concluded that its objective would be achieved through the proposed scope exception. Our purpose in responding to the ED is to suggest ways in which the scope exception might be improved.

We thank the FASB for its willingness to consider the circumstances that we had brought to its attention while it was developing the proposed amendments to Interpretation 46. We pointed out that mutual funds, particularly those established in the form of trusts, may not be able to satisfy the condition in Director of Technical Application and Implementation Activities Page 2

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paragraph 5b(1) of Interpretation 46 and that this condition would be difficult to apply to them and might not be applied consistently. We noted also that, in the case of mutual funds that could not satisfy the condition in paragraph 5b(1), those with a relatively low volatility of expected returns, such as money market funds and some bond funds, would often have to be consolidated by their sponsor/managers because the sponsor/managers' fees would constitute a majority of the expected residual returns as defined in paragraph 8. Conversely, in mutual funds with a relatively high volatility of expected returns, such as equity funds, the sponsor/managers' fees would be relatively smaller with the result that the volatilities of individual mutual funds change and if a "reconsideration event" occurs pursuant to paragraph 15, a sponsor/manager may be required to consolidate different funds in different periods. A number of preparers and users of financial statements found these results anomalous, and the Board appears to have agreed.

Our research indicates that mutual funds can be established in a variety of forms, both as trusts and as corporations. Some other types of entities possess some of the same fundamental characteristics as mutual funds, which suggests to us that those other entities should qualify for the same treatment under Interpretation 46 as mutual funds. Accordingly, we believe that the scope exception in proposed paragraph 4h would be improved if it were expressed in terms of the characteristics of the qualifying entities, rather than their form. The memorandum accompanying this letter sets out the task force's proposals for the characteristics that should determine eligibility for the scope exception, with supporting commentary.

In summary, we propose that the scope exception should apply under the following conditions:

- The entity is designed to provide investors with a vehicle in which their funds and those of other investors are commingled so as to obtain professional investment management.
- The entity is designed to hold and manage the funds of parties unrelated to the sponsor/manager.
- Except for the fees described in condition 4, the sponsor/manager and the sponsor/manager's related parties do not hold interests in the entity that are more than trivial.
- 4. The fees received by the sponsor/manager are compensation for services provided, are commensurate with the level of effort required to provide those services, and are at or above the same level of seniority as other operating

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liabilities of the entity that arise in the normal course of business, such as trade payables.

We agreed that the name (e.g., mutual fund) or type (e.g., trust) of entity holding the investments should not matter as long as it satisfies the conditions listed above.

Although we have focused on mutual funds, we note that the approach we recommend could be applied with some modification to trusts of a bank's trust department. We support the proposal to exempt such trusts from consolidation by the trustee.

We appreciate the opportunity to comment on the proposals in the ED. We would be pleased to expand on our comments or otherwise assist the Board or its staff in finalizing the proposed amendment to paragraph 4 of Interpretation 46. If you have any questions about the content of this letter or would like to discuss any points further, please do not hesitate to contact the undersigned at (416) 943-3622.

Yours very truly,

/s/ Colin Lipson

Colin Lipson, CA Partner, Ernst & Young LLP Chair, AcG-15 Task Force

on behalf of the Task Force members:

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## Proposed Interpretation, Consolidation of Variable Interest Entities File Reference No. 1082-300

## Comments of the AcG-15 Task Force

This memorandum expands on the proposals set out in the Task Force's comment letter concerning the scope exception for mutual funds in proposed paragraph 4h of amended Interpretation 46.

Mutual funds and certain similar investment vehicles possess some unique features that make it difficult to apply the condition in paragraph 5b(1) of Interpretation 46 (both the original and proposed amended versions). Voting rights are often not equivalent to those of shareholders of business corporations. Decision-making is split between investors, their representatives (trustees or directors) and sponsor/managers. It is assumed in practice, supported by some limited jurisprudence, that investors who are dissatisfied with the decisions made on their behalf may not have an enforceable legal right to remove trustees, directors or sponsor/managers or override their decisions (i.e., kick-out rights as described in FASB Staff Position No. FIN 46-7). Instead, investors typically "vote with their feet" by selling their interests in one fund to redeploy their capital into another. However, although mutual fund sponsor/managers have certain decision-making powers, they are generally constrained to a significant degree by the corporate governance legislation under which the fund entities are created, the applicable securities laws and regulations, and legal agreements under which they are appointed as managers. These legal constraints require a sponsor/manager to act in the best interests of investors.

The scope exemption in the ED is based on a presumption that the problem it addresses relates to the trust form in which some mutual funds are created. The Task Force's research indicates that the trust form is not the real basis of the problem because it is possible for certain corporate forms to exhibit substantially the same dispersion of decision-making power. For example:

- Some mutual funds in corporate form have multiple classes of shares, with the sponsor/manager holding 100% of the voting class of shares and investors holding one or more classes of non-voting shares. This form of mutual fund is seen in practice in Canada
- Some mutual funds in corporate form are established under incorporation statutes that do
  not require annual meetings or elections of directors until such time as a majority of
  directors are not independent. The sponsor/manager is thereby able to appoint the board
  of directors when the fund is established and keep the board in place indefinitely, as long
  as its members do not vacate their office through resignation, death or incompetence. We
  have been advised that this situation exists in some U.S. mutual funds.

On the other hand, some mutual funds in trust form have established advisory boards or similar vehicles to represent investors' interests. Quite apart from these factors, the Task Force believes it undesirable for key features of an accounting standard to rest on some aspect of form rather than substance. Accordingly, the Task Force recommends that the FASB adopt a characteristics-based approach to specifying which entities or circumstances qualify for the scope exception. Such an approach would focus on the key characteristics of mutual funds and similar entities that distinguish them from other entities that would not qualify for the scope exception.

The Task Force proposes that the scope exception apply in the case of consolidation of mutual funds, pooled investment funds, hedge funds, investment companies and any other form of investment entity that satisfies the four conditions set out and discussed below. The form of these investment entities may differ depending on the legal and tax environment in which they operate. The name and matters of form, which may be dictated by the requirements of the jurisdiction(s) in which an entity is established and operates, should not determine whether it qualifies for the scope exception.

The characteristics of mutual funds and similar investment entities that the Task Force believes distinguish them from other entities are listed and discussed below.

1. The entity is designed to provide investors with a vehicle in which their funds and those of other investors are commingled so as to obtain professional investment management.

Mutual funds are set up to take in capital from large numbers of investors and invest the commingled funds on behalf of, and for the benefit of, the investors. Mutual funds provide a vehicle by which investors can obtain professional investment management from the sponsor/manager at a more competitive price than they would generally be able to receive through individual contracts with investment advisers. The underlying purposes of a mutual fund, reflected in its design, do not include providing the sponsor/manager with a degree of control over the invested funds beyond that required to provide professional investment management. Regardless of the form in which a mutual fund is set up, the sponsor/manager has a fiduciary responsibility to act in the best interests of the investors.

The entity is designed to hold and manage the funds of parties unrelated to the sponsor/manager.

Mutual funds are designed to attract investors who are unrelated to the sponsor/manager (or each other). Investors are accorded certain protections by statute, regulation and contract that make it unnecessary for them to have any relationship with the sponsor/manager to protect their interests. Those protections would make the structure unattractive to any sponsor/manager or related party that may wish to use a mutual fund to circumvent the intentions underlying Interpretation 46. The Task Force noted situations in which a mutual fund in a group of funds may acquire units of another fund in the same group (e.g., a "fund of funds" structure). The Task Force concluded that such situations would meet this condition because the ultimate beneficial interests in both funds would still rest with unrelated parties.

3. Except for the fees described in condition 4, the sponsor/manager and the sponsor/manager's related parties do not hold interests in the entity that are more than trivial.

In a mature mutual fund, the sponsor/manager normally does not have an interest that is more than trivial other than its contractual entitlement to management fees. For example, it would not have any significant ownership interest or an interest from being a counterparty to a derivative instrument held by the fund. A sponsor/manager has no need to invest through a fund it manages and may find it easier to make its own investments directly.

There are circumstances in which a sponsor/manager may have a significant ownership interest in a mutual fund. When a mutual fund is set up, it is common for the sponsor/manager to provide initial seed capital to achieve a critical mass of funds (this practice may be required by some regulators). The critical mass makes it possible to have a suitably diversified portfolio of investments in place before offering fund units to the public and to make reliable daily valuations of fund units for sale and redemption purposes. The investment made by the sponsor/manager in this case is intended to be liquidated in the near term. When the sponsor/manager has a significant investment interest, the Task Force could see no reason for the proposed exception to cover it.

Certain investment arrangements contractually require the sponsor/manager to maintain a continuing, long-term ownership interest, as in the case of many CDOs, CBOs and CLOs. A requirement for a sponsor/manager to have no significant interest in an entity other than its entitlement to management fees would effectively distinguish mutual funds from those other arrangements.

4. The fees received by the sponsor/manager are compensation for services provided, are commensurate with the level of effort required to provide those services, and are at or above the same level of seniority as other operating liabilities of the entity that arise in the normal course of business, such as trade payables.

Management fees that compensate a sponsor/manager for professional investment management provided to a mutual fund do not normally provide a basis for the sponsor/manager to participate with investors in the success or failure of the investments in the fund. A mutual fund sponsor/manager's periodic fee for management services is most commonly a fixed percentage of the fair value of assets under management. In some cases, the fee is set on a downward graded scale as the amount of assets increase. In limited circumstances, the fee is a fixed dollar amount. Fees are set in a competitive environment.

The Task Force notes the Board's recently issued FASB Staff Position No. FIN 46-7, in which the Board has reached a conclusion to exclude certain decision-maker fees from the determination of expected residual returns. The Task Force believes that management fees that meet the condition stated above, which is derived from the guidance concerning kick-out rights, should qualify entities for the scope exception.

Members of the Task Force also note that there can be considerable similarity between an equity mutual fund and a hedge fund, so that exempting one from the scope of Interpretation 46 and not the other would seem inconsistent. Managers of hedge funds typically receive fees that can be larger in comparison to the funds' expected long term returns than is typically the case for equity mutual funds, reflecting the more active management generally required for hedge funds. The Task Force considered how the second factor identified on page 2 of FSP 46-7 concerning a "commensurate level" of compensation would apply to a hedge fund. We reached a view that the fees typically received from hedge funds would not be considered "relatively large" in the context of that factor. If others interpret that factor differently, our proposed fourth condition may need to be modified accordingly.