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Proposed FASB Staff Position No. FIN 46-a, Effective Date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, for Nonregistered Investment Companies (FSP FIN 46-a)

Proposed FASB Staff Position No. FIN 46-b, Effective Date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, for Certain Decision Makers (FSP FIN 46-b)

Proposed FASB Staff Position No. FIN 46-c, Impact of Kick-Out Rights Associated with the Decision Maker on the Computation of Expected Residual Returns under Paragraph 8(c) of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (FSP FIN 46-c)

Dear Mr. Smith:

We are pleased to comment on the above-referenced Proposed FASB Staff Positions, (FSPs), FSP FIN 46-a, FSP FIN 46-b, and FSP FIN 46-c, dated September 3, 2003, related to FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46). We support of the deferral for investment companies in FSP FIN 46-a. We also support the conclusions in FSP FIN 46-b; however, we question whether it will apply to many, if any, fee arrangements in the real world.

We also recommend that the FASB defer the effective date of FIN 46, either in FSP FIN 46-b or a separate FSP, for trust services and activities of banks as discussed in the AICPA Audit and Accounting Guide for Banks and Savings Institutions. We do not believe the FASB intended for FIN 46 to address the off-balance sheet treatment of

conventional trust operations and thus we recommend a deferral to allow the FASB time to address these issues.

We do not support the issuance of guidance provided in FSP FIN 46-c as proposed. The Proposed FSP FIN 46-c indicates that the fees to a decision maker should be included in the calculation of expected residual returns even if the decision maker can be fired without cause. We question the usefulness of this guidance when neither the Proposed FSP nor FIN 46 provides a clear definition or principle for determining who should be considered a decision maker. We believe that the FASB and the staff should take a broader approach to this issue and address how a decision maker(s) should be identified, including related issues such as can there be more than one decision maker, should an enterprise be considered a decision maker when that enterprise can be fired by another party without cause, and how the term decision maker as used in paragraph 8 of FIN 46 compares with "the ability to make decisions" as used in paragraph 5(b)(1) of FIN 46.

Finally, we note that depending on how the FASB staff addresses the issue of who is to be considered a decision maker, many asset managers may have to consolidate investment and securitization vehicles they manage. This will result in them recognizing in their consolidated financial statements assets for which they are neither exposed to risk of loss nor can be used for purposes other than satisfying the vehicle's liabilities and equity interests and liabilities they are not obligated to pay. We would encourage the FASB staff to address the accounting for these consolidated assets and liabilities. In particular, we believe that in certain situations the consolidated liability whose payoff is tied to the consolidated assets contains and embedded derivative that would require separate accounting pursuant to FASB Statement No. 133. We believe that FSP FIN 46-b should also provide a deferral for these circumstances until the issue can be resolved.

Our more detailed comments and concerns on FSP FIN 46-b and FSP FIN 46-c follow as an appendix to this letter. We appreciate your consideration of our comments. Should you have any questions regarding our response, please contact Bob Uhl at (203) 761-3705 or Jim Johnson at (203) 761-3709.

Yours truly,

Deloitte & Touche LLP

APPENDIX
DELOITTE & TOUCHE LLP COMMENTS
Proposed FASB Staff Position No. FIN 46-b
Proposed FASB Staff Position No. FIN 46-c

I. Proposed FASB Staff Position No. FIN 46-b, Effective Date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, for Certain Decision Makers

We agree with the Board's decision to defer the effective date of FIN 46 for certain decision makers. However, we do not believe many entities will be affected by this guidance. Therefore, we question its usefulness in the context of the many other issues related to decision makers that the Board and staff have yet to address (refer to, for example, our comments on FSP FIN 46-c later in this appendix). However, if the FSP is issued in final form, we believe that questions will arise around what is a "fee that has no variability." For example:

- Suppose the contract for decision making services describes a fee that is fixed as a single total amount that will be paid under the contract, but the payments made toward that single amount can vary as to amount or timing, or both. Does variability as to amount or timing of interim payments affect the assessment of whether the fee is fixed for purposes of the Proposed FSP?

- Would a fee be considered to lack variability if it is fixed on a per-unit basis, or must it be fixed in the aggregate? For example, would a fixed hourly fee be considered a fixed fee if the number of hours of decision-making services can vary?

- Is a fee that is based on actual costs incurred in providing decision-making services plus a fixed dollar profit margin (i.e., a cost plus contract) considered fixed or variable?

While the decision maker's fee may vary in total dollar amount in our second and third examples, there may be no correlation between the decision maker's fee and the variability in the assets, net assets, revenue, net income, or cash flows of the variable interest entity.

Paragraph C31 of FIN 46 states that "[t]he ability to make decisions is not a variable interest, but if the decisions significantly affect the value of the variable interests, decision making will almost certainly be directly or indirectly associated with the holder of a significant variable interest." Paragraph 2(c) of FIN 46 indicates that variable interests in a variable interest entity are interests that change with changes in the entity's net asset value. We question whether the concept to be inferred in the Proposed FSP is that the service contract in that FSP is not a variable interest in the entity because its value does not change with the changes in the value of the entity's net assets, and if so, how broad is that concept.

As the FASB considers modifying paragraph 8(c) of FIN 46, we urge the staff to provide clarification about what is specifically meant by "no variability." We believe that the Proposed FSP would be more useful if it indicated which unit of measure should be used in determining whether a fee has no variability (i.e., per unit or per contract).

Decision Maker Fees with Limited Variability

As indicated above, we believe that the deferral of FSP FIN 46-b would apply to few, if any, fee arrangements. We recommend that the FASB consider expanding the deferral in FIN 46-b to situations in which (1) the decision maker fees have limited variability, and (2) the decision maker does not hold more than insignificant variable interests (other than the fees) in the aggregate. By limited variability, we are referring to fees that are based on a percentage of assets that also meet the following criteria:

- The entity must have a limited life and no additional assets can be transferred to the entity after it is formed.
- The percentage used in the fee calculation must be fixed and cannot vary based on results.
- The total fee can only decline because of non-contractual prepayments, contractual amortization, or certain declines in the assets due to defaults or downgrades in the assets (e.g., if assets decline because they are sold in response to a downgrade or default, the decision maker must have limited discretion on alternative disposition strategies and cannot hold a call on such assets).

We believe that broadening the deferral in this manner would make the Proposed FSP applicable to real life situations, such as for static portfolios of debt securities, and would not be inconsistent with the intent of FIN 46.

Trust Services and Activities of Banks

We also recommend that the final FSP defer the effective date of FIN 46 for trust services and activities of banks as described in the AICPA Audit and Accounting Guide for Banks and Savings Institutions. Many banks have trust departments that provide services to thousands of personal and employee benefit trust accounts. For example, a bank might manage an irrevocable trust for beneficiaries who do not have the ability to replace the bank as trustee (no substantive kick-out rights as discussed in our response to FSP FIN 46-c as discussed below). The trust appears to be a variable interest entity. If no beneficiary has a majority of the expected losses or expected residual returns, the bank might conclude that the trustee fees make it the primary beneficiary (especially in instances when the assets themselves have little variability). In this case, the "decision maker" fee is a fixed percentage of the trust's assets.

However, the fees vary as the assets in the trust increase or decrease in value and as assets are transferred into the trust. We do not believe that FIN 46 intended to address the off-balance sheet treatment of conventional trust services. We believe that a deferral is warranted until the FASB can further study this issue.

II. Proposed FASB Staff Position No. FIN 46-c, Impact of Kick-Out Rights Associated with the Decision Maker on the Computation of Expected Residual Returns under Paragraph 8(c) of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*

We do not agree with the guidance issued in the above-noted Proposed FSP. Rather, we believe that the Proposed FSP would be more useful if the staff provided guidance that directly addressed the definition of a decision maker.

FIN 46 in its current state does not provide a clear definition of a decision maker. While not directly on point, some believe the third sentence of paragraph 14 indicates that a decision maker is a party that has the direct or indirect ability to make decisions that significantly affect the results of the activities of a variable interest entity. However, there may be more than one party that can significantly affect the results of the activities of a variable interest entity, which raises the question of whether an entity can have more than one decision maker. If decision making is an indicator of the primary beneficiary, and there should only be one primary beneficiary for an entity, we believe there should be only one decision maker.

In determining if a party associated with a variable interest entity is a decision maker for purposes of paragraph 8 of FIN 46, we note that paragraph 5(b)(1) provides for a similar determination. That is, in order to determine that equity holders as a group have a controlling financial interest in an entity, the equity holders must have the direct or indirect ability to make decisions about an entity's activities. We believe that "decision maker" for purposes of paragraph 8 and the equity holders as a group as the "decision maker" for purposes of paragraph 5(b)(1) should be interpreted similarly as both provisions have a similar goal – determine who has the controlling financial interest.

For purposes of paragraph 5(b)(1), we believe that if the equity holders as a group can fire a service provider, such as an asset manager, without cause and this right is substantive, the equity holders and not the service provider would be deemed to have the ability to make decisions about an entity's activities. We believe this interpretation is consistent with other consolidation guidance such as SOP 78-9,

Accounting for Investments in Real Estate Ventures[1], and EITF Issues 97-2, "Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements"[2], and 98-6, "Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Approval or Veto Rights"[3].

Consider the following example. An asset manager runs the daily operations of an investment entity that holds financial assets. However, the asset manager can be fired, without cause, by the equity holders of the investment entity and the right to fire the asset manager is substantive and reasonably possible of exercise. Also, the equity holders' investment is sufficient to absorb the expected losses of the entity, they are obligated to absorb any expected losses if they occur, and have the right to receive expected residual returns along with the asset manager. In this situation, we believe the equity holders would be considered, as a group, as the party with the ability to make decisions about the activities of the entity and, as a group, has the controlling financial interest in the entity. Now, consider the same situation but instead the equity holder's investment is in the form of subordinated debt. The subordinated debt has the same right to fire the asset manager without cause, the obligation to absorb expected losses, and the right to receive expected residual returns (such as would be the case with a participating debt security). In this situation, the entity would be considered a variable interest entity because the entity does not have any equity as classified under GAAP. As the substance in this example is exactly the same as the previous example, we would expect that the subordinated debt holders would, as a group, be deemed to have the ability to make decisions about the activities of the investment entity. That is, as a group the subordinated debt holders and not the asset manager is the decision maker.

We believe that a manager of the assets of an entity that can be fired without cause should not be considered a decision maker for purposes of paragraph 8(c), and that there should be symmetry between paragraphs 5(b)(1) and 8(c). That is, when substantive kick-out rights exist, it is our view that the decision maker is serving at the pleasure of the interest holders as a service provider and it is the interest holders who hold the kick-out rights who have the ultimate control over the activities of the

[1] In SOP 78-9, a general partner that can be replaced without cause by the limited partners is not deemed to be in control of the entity for consolidation purposes, even though the general partner generally is responsible for conducting the daily operations of the venture.
[2] In EITF Issue 97-2, in order for a PPM to be determined to have a controlling financial interest, the contractual arrangement may not be terminable except in the case of gross negligence, fraud, or other illegal acts by the PPM, or bankruptcy of the PPM.
[3] In EITF Issue 98-6, the Task Force did not object to the general concepts proposed by the working group, including the notion that a partnership agreement that provides for the removal of the general partner by a reasonable vote of the limited partners, without cause, and without the limited partners or partnership incurring a significant penalty, indicates that the sole general partner does not control the limited partnership.

entity. For example, the interest holders could fire the decision maker and hire a replacement to conduct the daily activities of the entity if they desire. Thus, the decision maker will conduct the operations of the entity in a manner consistent with, and not counter to, the interests of the interest holders or it will risk being replaced. (We would arrive at the same conclusion when substantive kick-out rights exist for any group of or all interest holders, not limited to equity holders.)

FIN 46 states that the ability to make decisions that significantly affect the results of the activities of a variable interest entity is a strong indication that the decision maker has the obligation to absorb the majority of the expected losses, the right to receive a majority of the expected residual returns, or both. We believe that the decision maker who can be fired without cause does not have an obligation to absorb expected losses and its right to receive expected residual returns could be taken away. Because the returns can be taken away, the decision maker should not be deemed to control the entity simply because the model in FIN 46 requires the service provider's fees to be treated on a different basis than the interests of other variable interest holders. Instead, we believe the service provider who is subject to substantive kick-out rights held by other interest holders should evaluate its position as would any other variable interest holder (assuming that the entity is a variable interest entity). If it is the primary beneficiary under this analysis, it should consolidate.

On the other hand, if a service provider makes decisions that affect the results of the activities of the entity and is not subject to dismissal (except for cause), we understand an approach as proposed in FSP FIN 46-d of treating the fees on a different basis than other variable interests because, in such situations, the decision maker would otherwise control in a conventional ARB 51 sense.

It would be understandable (given the recent widely publicized business failures resulting - in part - from inappropriate off-balance sheet accounting for certain structured transactions), if the Board and the staff leaned toward "too much consolidation" as a superior trade off compared to "too little consolidation." While understandable, it is a leaning we are reluctant to support. First, we believe that other provisions of FIN 46 are appropriately targeted at ferreting out potential abuses (FIN 46 eliminates an arbitrary level of required equity, it requires an economic analysis of expected losses and residual benefits, and it mandates the identification and aggregation of interests held by related parties and de facto agents). Second, we are concerned that the outcome is intentionally non-neutral. Under the decision maker analysis, certain cash flows emanating from an entity are somehow "special." We can discern no conceptual basis for treating certain dollars differently than other dollars if, in both cases, the timing of the dollars' distribution and their exposure to risk is identical.

We suspect that the Board and the staff may have come to their conclusions in FSP FIN 46-c because they believe that kick-out rights are rarely substantive even if legally available. We believe there are many arrangements where kick-out rights are

substantive. A natural question is "why are they rarely invoked?" There are a number of reasons, including the following:

- The decision maker's performance is acceptable and in accordance with its fiduciary responsibilities.

- In many transactions, an interest holder can "vote with its feet." That is, a disgruntled investor sells its investment rather than seeks to replace the asset manager.

- In many transactions, the decision maker is subject to fairly restrictive constraints on the nature and extent of its decision making activity. Investors are more likely to chalk up poor performance to causes other than poor execution by the decision maker (i.e. the original strategy and design of the entity).

Thus, we do not conclude that kick-out rights lack substance because such rights are only occasionally invoked.

We believe the FSP would be more effective if it acknowledged that a service provider subject to substantive kick-out rights is not a decision maker and there is guidance regarding the substance of kick-out rights. Some factors that the staff should consider include the following:

- The kick-out rights are unconditional,

- The kick-out rights do not require an unacceptably high percentage of votes to remove. We believe percentages in excess of a two-thirds majority would be too high and the decision makers should not be permitted to vote. Others might insist on a simple majority.

- The kick-out right is available no less frequently than annually.

- There is an explicit mechanism in the contractual arrangement for exercising the kick-out right.

- The activities of the decision maker can be performed by an acceptable number of other entities and the compensation to the replacement decision maker is adequate to attract a replacement.

- There are no penalties associated with replacing the decision maker that would act as a more than an insignificant disincentive for removal.

In summary, we believe the FASB should redraft the Proposed FSP to address (1) the definition of a decision maker for purposes of paragraph 8 in a manner similar to the concepts in paragraph 5(b)(1), (2) that an asset manager would not be deemed a

decision maker if the manager can be fired without cause (kick-out rights) and such right is substantive, (3) factors to consider in determining whether kick-out rights are substantive, and (4) the point that there can be only one, if any, decision maker.