

Letter of Comment No: 119
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File Reference No. 1082-200
Financial Accounting Standards Board
401 Merritt 7
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**Re: Proposed Interpretation – Consolidation of Certain Special-Purpose Entities,
an interpretation of ARB No. 51 (File Ref. No. 1082-200)**

Prudential is pleased to take this opportunity to comment on the proposed interpretation captioned above (the ED, or the Interpretation). Prudential supports the Board's efforts to develop a conceptual framework for the consolidation of entities that do not fit neatly into the control-based method of ARB No. 51. As an end-user of financial statements, particularly in connection with our asset management services with over \$400 billion under management, and in managing our own investment portfolio of over \$100 billion, we believe this is an area deserving of the attention it is getting. We believe the Interpretation will be an improvement to financial reporting, leading in particular to improved representational faithfulness in the reporting of SPEs.

We believe there are certain aspects of the ED that merit further deliberation, and submit our comments for inclusion in the staff's analysis that will form the basis of the Board's redeliberation of the subject. While our comments are detailed in the numbered paragraphs below, the following section addresses our more serious issues with the exposure draft as they relate to CDO structures.

Collateralized Debt Obligations

We are concerned with how the ED applies consolidation rules to SPEs that hold certain financial assets (referred to herein as 'financial SPEs', or 'FSPEs'), and, in particular, with how the rules will impact the collateral manager of the SPE created in a CDO structure. Fees earned by collateral managers in a CDO will typically include both a fixed and incentive component – so that the manager's interests are aligned with the investors. To further ensure a proper alignment, CDO investors look positively on the manager's ownership of some portion of the equity in the CDO, such that the manager will prosper if the structure prospers, by virtue of the incentive fee, and will suffer if the structure suffers, by virtue of the manager's equity position – there is both a carrot and a stick. For these marketing reasons, it is standard practice for collateral managers to take

an equity position, alongside other equity investors who have no manager role (i.e., 'pure' investors.)

In terms of the consolidation criteria in paragraph 23, the collateral manager has authority and discretion over purchases and sales of the assets of the CDO, and therefore already meets the first of the three criteria. As exposed, the equity position would be considered to satisfy the 'credit or asset support' criteria in paragraph 23.b., and therefore the collateral manager would consolidate the CDO. This would be the result regardless of the size or significance of the manager's equity position, either by itself (i.e., one share) or when compared to other equity investors (i.e., manager would consolidate even where another equity investor owns significantly more than the manager, or even a majority of the equity.) We do not believe that to be an appropriate outcome, and believe it to be both punitive to the industry and not faithful to the objective of the Interpretation.

It is our belief that an equity security, in which unrelated, outside investors would choose to invest, should not be considered to meet the 'support' criterion in paragraph 23.b. Rather, we believe the focus of that criterion should be on support to be provided in the future, by a transfer of assets (or, transferor equity). Alternatively, some notion of the significance of the manager's equity position should be included, either by reference to total assets or the equity tranche, or to other holders' interests, or both. For example, the second criteria could be amended to provide that support taking the form of an equity another subordinated investment could be found to meet the criteria only where it represents more than some percentage of total assets (say, 10%) or more than some percentage of the equity shares outstanding (say, 20%) where there is no clear majority holder.

Our more specific recommendations and support on this point can be found below in numbered paragraphs 17 through 19.

The previous comments presuppose that the SPE created in a CDO structure would meet the FSPE criteria to begin with. Separate rules were created for FSPEs as they are more clearly effective in diversifying risks and potential benefits from a portfolio of assets. With that objective in mind, CDOs would appear to be prime candidates for FSPE treatment. However, many CDO structures permit the collateral to be invested in credit-linked notes or credit-default swaps. Such derivatives (whether embedded or free-standing) would cause the CDO structure to fail the qualifying SPE criteria in SFAS 140, paragraph 35.c.(2), because they would not be found to pertain to the beneficial interests. We believe the Board should consider either an expansion of the FSPE criteria, to accommodate limited amounts of derivative investments, or a specific rule that CDO-type structures (including CLOs, CBOs, etc.) are to be considered FSPEs.

Whether the CDO structure involves an FSPE or a non-FSPE, we believe that consolidation by the collateral manager will generally not provide end users of the collateral manager's financial statements with a transparent view of the manager's financial position or results of operations. The balances on the manager's stand-alone balance sheet will be vastly overshadowed by the assets and non-recourse liabilities of

the CDOs they serve, and their stand-alone statements of operations and cash flows will all but disappear on consolidation, making it very difficult to begin to understand the manager's true financial position and results of operations, let alone analyze or compare to its peers.

The final matter on the subject of CDOs relates to the incentive fee arrangements typically found in collateral management agreements. We ask that the Board consider explicitly whether fee arrangements that include a fixed and a variable 'incentive' component could be found to be 'market based', or whether variable fees must be variable interests when being considered in paragraph 19 of the ED. We believe that 'market based' is meant to refer to what is common in the market, and not a fixed, 'cost-plus' type fee.

Definition of terms

1. The ED categorizes entities into two groups – substantive operating entities (SOEs) and special-purpose entities (SPEs). SOE is defined in the ED as an entity that is not an SPE; SPE is undefined, neither in the ED nor in any other GAAP guidance we found. We believe that the Interpretation must be amended to provide further guidance in determining whether an entity is an SPE subject to the Interpretation, as the different model applied in determining whether to consolidate an entity may yield a different result (e.g., the variable interests model used for SPEs not meeting certain criteria, as compared to the control-based model that would be used for an SOE.) While we expect that, in most cases, it will be clear from context and intent whether an entity should be considered an SPE, we see the border between SOEs and SPEs as a wide gray area. A characteristics-based approach should be adequate, but should provide characteristics of both SPEs and SOEs. We believe that such guidance would improve the consistency in application of consolidation principles by investors or variable interest holders, as the case may be, by clarifying the Board's intent as to the entities subject to the Interpretation.

Scope

2. We agree that certain situations should be excluded from the provisions of the interpretation, as listed in paragraphs 8.a. and 8.b. However, we believe that the exclusion in paragraph 8.c., relating to SPE-like entities that are consolidated by an SOE, presupposes that the SOE should consolidate the SPE. If an SOE is consolidating an SPE, but the applicable guidance should have led the SOE to a different conclusion, it seems inappropriate for other holders of variable interests not to consider consolidating that SPE. Additionally, as discussed below under "Transition", we believe the current wording of this exception may, by its operation, effectively grandfather SPEs that were consolidated prior to the adoption of the interpretation.

3. We believe the Board's intent with regard to the exception in paragraph 8.c. is unclear, and probably unmet. If the exception is attempting to exempt specific transaction types, then the amendment should more clearly describe those types and better capture the Board's intent.

Consolidation based on variable interests

4. We agree that an entity should aggregate its related parties' variable interests with its own for purposes of determining whether it is the primary beneficiary, as stated in paragraph 15. As the objective of the ED is to determine whether an entity has a controlling financial interest in an SPE, we believe it is appropriate to include the rights and obligations of its related parties in that determination.
5. Likewise, it should be appropriate for an entity to aggregate into groups, the variable interests of parties that are unrelated to the entity, but are related to one another. As written, paragraph 13.c. requires an enterprise to determine whether it (in combination with its related parties) holds significantly more variable interests than any other individual party, which seems to prohibit the enterprise from aggregating the interests of parties unrelated to it, based on those parties' relationships. Without modification, it would be possible for more than one entity to determine, appropriately, that they are the primary beneficiary. Take as an example a simple case where the equity class is evenly split among four members, where members 1 and 2 are related to one another, and members 3 and 4 are related to one another. When member 1 aggregates its interests with member 2 for purposes of determining whether they are the primary beneficiary, they would compare their combined interest (50%) with the 25% interests of each of members 3 and 4, and determine they have twice any other individual party's interest, and conclude they must consolidate. At the same time, members 3 and 4 will compare their combined interest (50%) with the 25% interest of each of 1 and 2, and also conclude they've got twice any other individual party's interest, and also consolidate.
6. We therefore recommend the final interpretation be clarified on this point, by deleting the word 'individual' at the end of paragraph 13.c. and by amending paragraph 15 to begin along the following lines. 'Variable interests shall be aggregated among related parties (as identified in FASB Statement No. 57, *Related Party Disclosures*) for purposes of determining which group of related parties includes the primary beneficiary.' While we would expect that not all interrelationships among unrelated parties would be known to the entity, we believe they should be considered to the extent they are known.

Identifying and comparing variable interests

7. In determining whether market-based fees are variable interests, paragraph 19 states that market-based fees are variable interests where the holder of the service contract 'has an investment at risk.' We believe that the term 'investment' must

be clarified to include only investments that are directly related to the service – for example, an investment in the entity’s infrastructure or amounts paid to acquire the contractual right. As written, ‘investment’ could be interpreted to include other variable interests unrelated to the service, like an equity investment in the SPE. The inclusion of fees where no investment is directly related to the service could produce counter-intuitive results, as an entity that both holds an equity position and provides services to the SPE (and thus has some element of control of the results), might determine that it has lower variable interests, when measured by expected future losses, as compared to an entity that holds only an equal-sized equity position. This would result because in a given scenario resulting in a loss on the equity investment, the fees will at least partly offset the loss (i.e., it is unlikely the fees will lead to a loss). We recommend, therefore, that paragraph 19 be amended to include in the definition of variable interests market-based fees only where “the holder has an investment *in the contract or its infrastructure* at risk.”

8. Additionally, preparers will need some guidance on the subject of measurement of that investment, particularly in situations where the entity may already have a system in use – either for the expressed purpose of servicing one or more structures, or where the system was already in use elsewhere in the organization. In particular, it would be helpful if the Board could clarify whether their intent was to capture primarily direct costs (e.g., purchase price of servicing rights), or to require that entities providing services to SPEs adopt some method to allocate their costs across SPEs. If the latter, some guidance should be provided as to the nature of the costs that should be allocated for this purpose and acceptable allocation methods.
9. The ED requires that a comparison of an entity’s variable interests to other entities’ variable interests be based on measures of expected future losses. The concept of expected future losses is also used in determining whether an equity investment is sufficient to allow the SPE to finance its own activities. We recommend that both uses of this measure should incorporate a time-value concept. Doing so, we believe, will provide a fairer measure of potential loss and, at the same time, provide a practical way to give additional weight to first-dollar losses, as required by paragraph 20.
10. All variable interests are compared at an entity/ownership level. We believe that, without amendment, this may lead to inconsistent consolidation decisions among similarly structured SPEs. Consider the following example, in which senior debt is determined to have expected future losses of \$100, while the equity class has expected future losses of \$500. The sole debt investor would determine they have the same or lower expected future losses than the equity investors, when there are from 1 to 5 equity investors (assuming even distribution among the equity holders). As the number of equity holders increases above 6, the senior investor would eventually determine they have a significantly greater amount of expected future losses, even when considering the additional weight put on the equity class

due to their first-loss position. Thus, consolidation by the senior investor may result based only a proliferation of equity holders, and not from the senior investor's own rights and obligations. We believe this would be an unreasonable outcome, and therefore recommend that an entity should assume that 100% of any class of variable interest that is not held by the entity, is held by one investor. In the example above, the senior investor will compare their own holdings to the equity class as a whole, and will get the same answer regardless of the number of equity owners. This will allow the investor to determine whether to consolidate the SPE based on their investment and the structure taken as a whole, greatly simplifying the application of the interpretation, as entities will not require investor-level information in classes they don't own (which in practice they would likely have trouble getting). This will also serve to increase consistency across periods, as sales among one class of holders will not by itself change the consolidation conclusion by members of a different investor class. Further, this will improve comparability of the financial statements of SPE investors, as like investments will be accounted for in like manner, even where one SPE has many more participants taking smaller equity positions.

SPEs that hold certain financial assets

11. The ED provides simplified principles to be used in determining whether certain SPEs should be consolidated. FSPEs are defined by reference to the qualifying SPE criteria of SFAS 140, with modifications. As the objective of segregating FSPEs is based on the effective diversification of risks and potential benefits, and the similarity of that objective with the use in practice of QSPEs, we believe that using the QSPE rules as a starting point is appropriate. However, we believe that some differences between QSPEs and SPEs that effectively diversify risks have not been included in the list of modifications in the ED, but should be.
12. In particular, we refer to the requirement that a QSPE hold only passive derivatives that pertain to beneficial interests. As written, the ED also applies this restriction to FSPEs. However, we believe that the discretion that is associated with nonpassive derivatives is no different than the discretion associated with the purchases and sales of assets from the SPE, which are permitted for FSPEs. We therefore believe that it is appropriate to permit FSPEs to hold both passive and non-passive derivatives, and recommend that paragraph 22 be amended appropriately.
13. Further, as discussed previously under Collateralized Debt Obligations, we believe the derivative financial instruments held by FSPEs need not be strictly limited to those that pertain to beneficial interests.
14. A financial SPE need not have a 'transferor'. However, the criteria for a qualifying SPE in SFAS 140 paragraph 35 are sensitive to relationships between the SPE and the transferor. The following table summarizes our recommendations for addressing this disparity.

QSPE Criteria

- Demonstrably distinct from the transferor. (35.a.)

- Permitted activities may be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than the transferor (35.b.)

- May hold only passive derivative financial instruments that pertain to beneficial interests issued or sold to parties other than the transferor (35.c.2.)

Recommendation

Where there is no transferor, this criterion should be met only where no single variable interest holder holds more than 90% of the fair value of the SPE's beneficial interests. We believe that where one entity holds greater than 90% (the level described in paragraph 36 of SFAS 140), the SPE is less effective at diversifying risk.

Where there is no transferor, approval of significant changes to permitted activities should require at least a simple majority of holders of beneficial interests.

As previously discussed, we do not believe derivatives should be strictly limited to those that pertain to beneficial interests.

15. We had considered whether 'primary beneficiary' could be substituted for 'transferor' in each case, but determined that doing so would be impractical, as it would require an entity to identify the primary beneficiary using the criteria in paragraph 23, before determining whether that is the right criteria.

16. We also considered whether these criteria could be deleted even where there is a transferor. Here, we determined that it would be prudent to keep the criteria where there is a transferor in order to limit the applicability of the special provisions to SPEs that may not be diversifying risk.

17. Once it is determined that an SPE is indeed a financial SPE, an entity would be found to provide significant financial support through a variable interest only if it meets two of three conditions. The second of those conditions is the entity 'provides a guarantee, back-up lending arrangement or other form of liquidity, credit or asset support that is subordinate to the interests of other parties.' As previously discussed in the Collateralized Debt Obligations section, we believe this condition should be amended to refer to arrangements or forms of support that, at inception of the SPE or of the arrangement (whichever is later), could require a future transfer to the SPE, of assets or of shares of the entity providing the support.

18. We do not believe it is appropriate to interpret the holding of an equity investment as a form of support, as the fundamental reason underlying the purchase of an equity investment is not to provide support to senior debt investors, but, rather, to earn a return commensurate with the risk. Ultimately each tranche of investor supports the senior tranches. Therefore, we recommend the following clarification of the second condition: 'It provides a guarantee, a back-up lending arrangement, or other form of liquidity, credit or asset support that, at inception of such support: (1) is subordinate to the interests of other parties, and (2) may require a future transfer of assets or the entity's own equity to the SPE.'
19. If in the Board's view it is appropriate to continue to include subordinated investments, then it is important that the final Interpretation include some notion of financial significance of the support provided by a subordinated investment. We believe some threshold should be given, below which an investment would not be considered to be financially significant support. That limit can be a percentage of total assets of the SPE or a percentage of equity shares. Or, it could even be as simple as to require the investment be less than another entity's share of the same class.
20. Where more than one entity is determined to provide significant financial support to an FSPE, 'variable interests' is defined by the three conditions in paragraph 23, and not by paragraphs 18-21. We had understood that the special criteria would limit the parties that would potentially consolidate an SPE, but that entities meeting 2 of the 3 criteria would consider all of their relationships and interests, such that the special criteria filters out entities, not variable interests.
21. We therefore recommend amending paragraph 13.a to read as follows:

"The enterprise shall determine whether it provides significant financial support to the SPE through a variable interest. If the enterprise does not meet at least two of the three criteria in paragraph 23, then it does not provide significant financial support to an SPE that meets the criteria in paragraph 22. If the enterprise does meet two or more of the criteria in paragraph 23, and the SPE meets the criteria in paragraph 22, then the enterprise shall use the provisions in paragraphs 18-21 to determine whether it is the primary beneficiary, except that the provisions of paragraphs 20 and 21 shall only be used to compare the enterprise's variable interests to the variable interests of other enterprises that also meet two or more of the criteria in paragraph 23. All enterprises holding variable interests in an SPE that does not meet the criteria in paragraph 22 shall follow the provisions in paragraphs 18-21 to determine whether it is the primary beneficiary."

Disclosure

22. Paragraph 25 of the ED requires that an enterprise that provides services to an unconsolidated SPE, 'Shall disclose the assets and liabilities of the SPEs that it serves and shall describe the purpose of those SPEs.' The ED does not provide

guidance with regard to the specific information that must be incorporated into the disclosure, such that there may be wide diversity in the level of information provided under this requirement. However, we do not believe that providing detailed guidance for this disclosure item would necessarily improve financial reporting, as the lack of detailed guidance will encourage enterprises to think through the nature of the information that would be most useful to readers of their financial statements, rather than leading to boiler-plate, fill-in-the-blanks type of disclosures we might otherwise see.

Effective date and transition

23. The ED does not address deconsolidation of previously-consolidated SPEs, for the reasons discussed in paragraph B18. We note, however, that the ED proposes to nullify a number of EITF Issues, which may have led to the consolidation of SPEs in periods prior to the adoption of the interpretation. As entities are generally required (and specifically required, pursuant to paragraph 13) to reconsider the consolidation question at each reporting date, we believe there will be situations in which SPEs, previously consolidated under nullified guidance, will cease to be consolidated by that entity, as of the adoption of the Interpretation. This is appropriate, as it suggests that such SPEs were consolidated by an entity other than the SPE's primary beneficiary. We do not believe any modification to the ED is necessary to address this issue, beyond the amendment to paragraph 8.c. discussed above under 'Scope'. Following those amendments, deconsolidation will occur when and where necessary and appropriate, be it at adoption of the interpretation or in subsequent periods, leading to consistent treatment for interests in SPEs, regardless of their inception dates.
24. A large number of existing SPEs will likely require consolidation under the Interpretation. We believe it would be appropriate for the effective date of the Interpretation, as applied to existing SPEs, to provide a reasonable amount of time to allow the market participants most affected by these rules to restructure or resell their ownership levels in existing SPEs, without causing market dislocation. We do not believe that an April 1, 2003 deadline would meet this criteria.

Overall structure

25. As an additional comment, which we hope may assist the Board to improve the exposure process, we feel the Board should make every attempt to make its guidance as easy to read as possible, even given the technical nature of some topics. To that end, we suggest the Board try to reduce the number of cross references within this and future documents.
26. We believe the readability of proposals for new guidance issued by the Board would be further improved by the inclusion of a decision tree, where appropriate.

We have included as an attachment to this letter a decision tree we prepared to facilitate discussions with Senior Management.

27. As an additional suggestion as to how the readability of the Interpretation could be improved, we recommend that the FSPE criteria should be written out, rather than presented as a series of modifications to the QSPE rules in SFAS 140. The description currently in the ED can be used as a helpful introduction to the Board's discussion in the Basis for Conclusions, but we found the differences to be significant enough that the current wording is more confusing than it needs to be.

Conclusion

We appreciate the opportunity to share our views with you. If you have any questions regarding our comments, please feel free to contact Frank Reda on 973 802 2443.

Sincerely,

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Senior Vice President & Controller