



**Eaton Vance Corp.**  
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**Letter of Comment No:** 67  
**File Reference:** 1082-200  
**Date Received:** 08/29/02

August 29, 2002

Ms. Suzanne Bielstein  
Director of Major Projects and Technical Activities  
Financial Accounting Standards Board  
401 Merrit 7  
P.O. Box 5116  
Norwalk, CT 06851-5116

Re: File Reference No. 1082-200; Exposure Draft dated June 28, 2002,  
“Consolidation of Certain Special-Purpose Entities, a proposed  
interpretation of ARB No.51”

Dear Ms. Bielstein:

Eaton Vance Corp. (“Eaton Vance”) appreciates the opportunity to comment on the captioned exposure draft (the “Exposure Draft”). Eaton Vance is an investment advisory firm based in Boston with approximately \$59.2 billion in assets under management. We are a public company whose stock is listed on the New York Stock Exchange (EV). We are one of the largest managers of floating rate bank loan funds in the country, with approximately \$8.8 billion in bank loan fund assets under management.

Eaton Vance agrees with the FASB’s intent to create greater financial transparency and disclosure. However, we are concerned that the Exposure Draft may have significant unintended consequences if it does not exclude the consolidation of collateralized debt obligation (“CDO”) assets and liabilities in the financial statements of companies like Eaton Vance that act as investment advisers for CDOs. Financial special-purpose entities (“FSPEs”) that issue CDOs function in the marketplace as risk-dispersing financial vehicles with bankruptcy-remote structures that isolate and limit financial risk. The following characteristics of such FSPEs make it clear why it would not be appropriate to consolidate them with the CDO investment adviser:

- The FSPE is a conduit formed solely to distribute the risks and rewards of the asset pool among investors.
- The assets that are collateral for the CDOs are acquired by the investment adviser for the FSPE in the open market pursuant to restrictive rules and standards.
- The investment adviser’s investment decisions are subject to the approval of an independent trustee.

- The investors in the CDOs can remove the investment adviser; the investment adviser cannot vote on this matter.
- The assets of the FSPE were not previously owned by the investment adviser.
- The investment adviser is not required to provide any financial support to the FSPE after it is formed.
- The CDOs and the FSPE have no recourse to the investment adviser.
- If the investment adviser has purchased a minority equity position in the FSPE, it did so at the formation of the FSPE on the same terms as other equity investors and gives the investment adviser no control over the FSPE.

The consolidation of these entities on the books of an investment adviser would impair financial transparency and create misleading financial statements. As shown in detail below, Eaton Vance's financial statements would be dramatically misleading if we were forced to consolidate the FSPEs of CDO asset pools for which we provide investment advisory services.

In our view, paragraphs 22 and 23 of the Exposure Draft do not clearly and unambiguously exclude such FSPEs from consolidation with investment advisers of CDOs that have only a minor equity interest in the FSPEs. Interpretations of paragraphs 22 and 23, although not our own, could lead to "false positives" that could ultimately result in consolidation for investment advisers. We recommend that the FASB adopt a clear, simple carve-out for investment advisers of CDOs that hold only a minority equity position in the FSPE issuer of the CDOs.

**Consolidation With CDO FSPEs Would Make Eaton Vance's Financial Statements Misleading.**

To capitalize on our expertise in managing both bank loan and high yield debt investment companies, in 1999 Eaton Vance began acting as an investment adviser for the assets that are collateral for CDOs. We manage approximately \$1.6 billion of CDO assets out of the total \$59.2 billion in assets under our management<sup>1</sup>. Eaton Vance has a condensed balance sheet as follows:

|              |               |
|--------------|---------------|
| Assets:      | \$674 million |
| Liabilities: | \$329 million |
| Equity:      | \$345 million |

Our debt to equity ratio is approximately 0.6 to 1.

To act as investment adviser for CDOs, we are required by the underwriters in some but not all cases to purchase a minority portion of the equity of the FSPE that issues the CDOs. Please note that this is a marketing requirement, not a structural requirement. Accordingly, included in the assets on our balance sheet are \$13 million in minority equity investments in FSPEs that issue CDOs for which we act as investment adviser.

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<sup>1</sup> Because Eaton Vance is a public company, the financial information about the company in this letter is that which was publicly disclosed in our last report on Form 10-Q, for the quarter ended April 30, 2002.

Our minority equity interests have limited voting rights. For example, the contracts Eaton Vance has entered into with these FSPEs can be terminated without cause at any time by a two-thirds vote of the other CDO investors. This ability of the CDO investors not affiliated with Eaton Vance to discharge Eaton Vance as investment adviser puts them in a position similar to that of investors in mutual funds managed by Eaton Vance and its affiliates.

Our \$13 million investment in the equity of these FSPEs represents our total maximum balance sheet exposure to these vehicles. Other than our investment management responsibilities, we have no access to the assets held in the collateral pool and no current or future obligation to any other investor within the structure. We bear first risk of loss only to the extent of our original equity investment. Our maximum exposure is fully disclosed in our financial statements.

If Eaton Vance were required to consolidate the approximately \$1.6 billion in CDO assets and liabilities for which we act only as investment adviser (because we are unable to either meet the requirement of an FSPE as described in paragraph 22 of the Exposure Draft or fail the three-part test described in paragraph 23), our balance sheet would be completely distorted and misleading. The \$1.6 billion of CDO assets and liabilities that we manage are assets against which our creditors have no claim and liabilities for which we have no current or future obligation. If consolidation were required, our debt to equity ratio would increase from a healthy 0.6 to 1 as described above to over 5.0 to 1 without any change in the true financial condition of our company. Our balance sheet would change as follows:

|                 | <u>Current</u> | <u>Consolidated</u> |
|-----------------|----------------|---------------------|
| Assets:         | \$674 million  | \$2,274 million     |
| Liabilities:    | \$329 million  | \$1,929 million     |
| Equity:         | \$345 million  | \$ 345 million      |
| Debt to Equity: | 0.6 to 1       | 5.0 to 1            |

**There Is No Recourse to the Investment Adviser for Obligations of FSPEs That Only Issue CDOs.**

Our views on the correct application of FSPE consolidation are based primarily on the concept of recourse. We believe that if there is recourse to a company for the liabilities of an FSPE, that company should consolidate the FSPE on its balance sheet. If there is no possibility of recourse, there should be no consolidation.

As discussed above, Eaton Vance's principal business is providing investment advisory services to mutual funds, institutions and individuals. Our revenues are derived primarily from fees for such services. As part of our institutional business, we provide investment management services for several arbitrage cash flow CDOs. The CDO assets that we manage are a newly purchased pool of sub-investment grade assets that serves as collateral for the CDOs, which are issued by the FSPE in various classes with different rights to payment from the proceeds generated by the assets. The CDOs, which are sold to sophisticated institutional investors by an underwriter, thus provide a mechanism to reapportion the risks and returns of their investments among these investors. In some

CDO programs the underwriter requires Eaton Vance, as a condition to serving as investment manager, to purchase at the market price a minority portion of the equity issued by the FSPE. The equity is the most risky portion of the CDO program, and the purchase of equity by the investment adviser is sometimes used by the underwriter for marketing purposes. Identical equity interests are typically sold to unaffiliated, independent entities whose investment decision is driven exclusively by market forces.

The FSPE structure is used to ensure that CDO investors can look only to the pool of assets that are collateral for the CDOs. Neither the investment adviser, the underwriter, nor any CDO investor provides any guaranty or other recourse to insure the asset pool against losses. The maximum loss to any investor is its investment and nothing more. CDOs are attractive to investors largely because of their non-recourse nature. The FSPE provides a “bankruptcy-remote” entity, so that each investor is protected from, and does not rely upon, the financial condition of either the investment adviser or any other investor. Thus, if either the investment adviser or any investor were to file for bankruptcy, the CDO program would continue its operations without any economic disruption. The FSPE structure is also attractive to CDO investors, because it insulates the pool of assets from the control of any one party.

Investment advisory services that Eaton Vance provides for a CDO program are not significantly different than the investment advisory services that we provide to other institutional investment accounts or to mutual funds, except that we generally have much less discretion in advising a CDO structure. Basically, a CDO investment adviser is given a mandate to buy or sell a particular class of security for the CDO collateral asset pool according to strict rules set forth in a legally binding indenture. Generally, the CDO assets must be purchased in the open market on an arm’s length basis. Except in the case of “Balance Sheet” CDOs (which we do not advise and are not discussed here), the investment adviser has never owned the assets in the collateral pool and the CDOs do not represent any form of securitization of assets from the investment adviser’s balance sheet. Requiring Eaton Vance to consolidate the assets and liabilities of FSPEs that only issue CDOs would not be much different from requiring Eaton Vance to consolidate the assets and liabilities of mutual funds for which it serves as investment adviser.

#### **The Exposure Draft Would Not Unambiguously Exclude FSPEs That Issue CDOs from Consolidation with the Investment Adviser**

The issue of control is suggested in the Introduction of the Exposure Draft to be a defining concept of ARB 51. The Exposure Draft explains that in an FSPE voting rights alone may not be sufficient to determine control either because of the lack of voting rights or the severe limitations on any voting rights by governing documents of the FSPE. Assuming that voting rights are not a sufficient method of control, the Exposure Draft looks to entities that provide financial support, the “variable interests”, to determine the controlling entity.

We believe that the issue of control should be based on the true ability of an entity to direct the activities of the FSPE. As mentioned above, and discussed in greater detail below, the investment adviser is constrained in its ability to actively manage the collateral

for CDOs. The investment adviser manages the collateral pool within the constraints of the indenture and an independent Trustee must approve all transactions. The fact that investors in the pool of assets collateralizing CDOs delegate investment advisory decisions to a fiduciary investment adviser does not mean that the investment adviser has “control” over the FSPE that issues the CDOs or over the asset pool. Also, the rules of the CDO are static and inflexible, so that even the equity holders of the FSPE could not exercise any true control.

However, assuming that control is only based on the concept of financial support, as defined in Paragraph 7(b), we still do not believe that either the investment adviser or CDO equity investor would qualify as a true variable interest. First, the investment adviser earns a market fee for services rendered and the adviser does not guarantee investment performance or contribute resources to a non-performing CDO. Second, while the equity holders of the FSPE participate in the gains and losses of the CDO asset pool, there are reasonable limits to either the gains that can be achieved or losses incurred. CDO investors do not seek to control an FSPE or the assets collateralizing its CDOs, but rather to capture returns within a specified risk tolerance. The existence of classes of CDOs with varying payment priorities is designed to increase the probability of achieving targeted returns for all portions of the capital structure, but there are no financial guarantees for any portion of the capital structure. The equity investment in an FSPE issuing CDOs is a limited loss, non-recourse investment, and not a variable or controlling interest.

Accordingly, we suggest that the FASB clarify and define financial support as a guarantee of performance or subsequent funding requirement, rather than as an investment.

The Exposure Draft references FASB Concepts Statement No. 6, *Elements of Financial Statements*, in its description of assets and liabilities as follows: “[CON 6] defines *assets*, in part, as probable future economic benefits obtained or controlled by a particular entity and defines *liabilities*, in part, as obligations of a particular entity to make probable future sacrifices of economic benefits”. We agree with these definitions. However, the Exposure Draft appears to suggest that even though the primary beneficiary may not be able to make decisions about such assets or liabilities, and the creditors of the FSPE may have no recourse against the primary beneficiary, the primary beneficiary should consolidate such assets and liabilities in its financial statements. In our opinion, this logic does not follow and contradicts the intent of CON 6.

As discussed above, if Eaton Vance, either because it is the investment adviser or is also a minority owner were named as the primary beneficiary and forced to consolidate CDO assets and liabilities, our financial statements would confuse and mislead shareholders. Therefore, we suggest that the Board clarify the standard to exclude from consolidation on the investment adviser’s financial statements all FSPE assets which the investment adviser does not own and all FSPE debt for which the investment adviser is not liable.

## **Additional Recommendations**

**Paragraph 22.** We recommend that Paragraph 22 of the Exposure Draft, in addition to excluding Qualifying SPEs (QSPEs), completely exclude FSPEs that only issue CDOs (“CDO FSPEs”). We believe that such exclusion would be logical, given that CDO FSPEs are not conceptually different from QSPEs. Both QSPEs and CDO FSPEs attempt to reapportion risk and return among investors and capture a perceived arbitrage opportunity. The primary differences between QSPEs and CDO FSPEs are the ability of CDOs to have some limited trading and that collateral for CDOs is purchased in the open market. The trading of CDOs is very limited and we believe that there is no primary beneficiary of the CDO FSPE (i.e. no equity investor exercises control over the FSPE). Specifically, CDO FSPEs that disperse risk and do not require either ongoing financial support or performance guarantees should be excluded from any consolidation requirements.

The limited use of derivatives should not disqualify CDO FSPEs from any carve-out under Paragraph 22. Derivatives have a logical and necessary role in CDO programs. Typically, some limited amount of derivatives may be used in CDO programs to hedge interest rate risk or gain exposure to assets, as explicitly stated in the indenture. In all cases, the rating agencies of the CDOs are required to approve all such derivative transactions.

**Paragraph 23(a).** If the FASB does not exclude CDO FSPEs under Paragraph 22, then we suggest that Paragraph 23 be clarified to adequately address CDO issues. Paragraph 23 (a) focuses on the concept of “significant discretion” in managing the assets. In the case of CDO FSPEs, the investment adviser exercises very limited control, and that limited control is conditional on performance of the collateral assets. We believe that the investment adviser would not meet this significant discretion standard for many reasons including the following:

- Investment asset classes are strictly limited to one or two asset classes.
- There are numerous criteria that must be met before an asset can be purchased or sold and all trades must be approved by an independent trustee
- Any limited discretionary trading would be prohibited when the program becomes stressed or if the rated CDOs are downgraded by the rating agencies.
- The investment adviser cannot make any change to the trading rules. Any modification to trading rules must typically be consented to by a majority of the investors (and some cases require 100% investor approval).
- The investment adviser can be terminated without cause by a vote of investors, and all investments owned by the adviser are excluded from any such vote.

Therefore, we respectfully suggest clarification to Paragraph 23 (a) that would unambiguously exclude such limited authority from the concept of sufficient discretion.

**Paragraph 23(b).** Our interpretation of the intent of Paragraph 23 (b) is that if the investment adviser or other party involved with an FSPE provides some form of ongoing credit support for the transaction, then that party may be the primary beneficiary.

We believe that an initial investment in any subordinated tranche of a CDO should be viewed purely as an investment decision and not as ongoing credit support. Investors in subordinated tranches of CDOs (including in the equity of the CDO FSPE) are attracted to the risk-return profile of the investment and have a maximum loss position equal to their initial investment. No CDO investor is required to inject additional capital into a non-performing CDO, and that is the attraction to the limited recourse structure. Therefore, we respectfully suggest that the language of Paragraph 23 (b) be modified to more clearly define the concept of an ongoing credit support for non-performing CDO programs and specifically exclude subordinated tranches (including equity) where there is no recourse.

**Paragraph 23 (c).** Paragraph 23 (c) implies that if a fee is not market based, then the service provider may be a primary beneficiary and refers the reader to Paragraph 19. Conceptually, we agree with this theory. However, Paragraph 19 does not adequately differentiate between a service provider who makes a separate investment decision to invest, without recourse, in a CDO from a service provider who has an obligation to transfer assets or its own equity in times of non-performance. An investment adviser's investment in a CDO program is truly distinct from its investment advisory contract for the following reasons:

- The investment advisory contract is distinct from any investment in the CDO, and is not a structural requirement of a program.
- The investment adviser does not gain any preferential treatment in either the initial purchase of its investment or in the periodic returns earned. All investments by the investment adviser are made on an arm's length basis in negotiation with the placement agent.
- The investment adviser's investment would be *pari passu* with all other investors in the same tranche and is non-recourse in nature.

Therefore, we respectfully request that either Paragraph 23 (c) or paragraph 19 be modified to differentiate cases where a service provider invests, on an arm's length basis, in a CDO from those cases where the service provider holds some form of interest that contains some form of contingent liability or financial guarantee.

### **Conclusion**

Eaton Vance reports its investment in CDOs in its financial statements in accordance with EITF 99-20, and discloses all relevant information in the footnotes to those financial statements. We believe that such reporting and disclosure present a fair and accurate description of our investment.

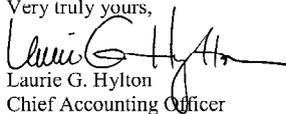
If Eaton Vance, in its role as investment adviser, were deemed to be the primary beneficiary of the CDOs, we would be forced to consolidate approximately \$1.6 billion of assets that we do not own and liabilities we do not owe with our existing \$674 million balance sheet, and gross up our income statement for the related CDO revenue and

expenses. Given that Eaton Vance has no ownership interest in or control over the CDO assets, nor any recourse for the CDO liabilities, such consolidation would be, in our opinion, both misleading and confusing for investors. We believe that such consolidation would be in conflict with the FASB's objectives relative to the Conceptual Framework as follows:

- Consolidation of the CDO FSPEs by Eaton Vance would violate FASB Concepts Statement No. 1. Consolidation would not provide information that is useful in making investment decisions, but rather would distort such information.
- Consolidation of the CDO FSPEs by Eaton Vance would violate several key elements of FASB Concepts Statement No. 2. Most importantly, the understandability of the Company's financial statements would diminish and decision usefulness would decrease, as there would be neither relevance nor representational faithfulness in including assets over which the Company has no control and liabilities for which the Company has no obligation.
- Consolidation of the CDO FSPEs by Eaton Vance would violate FASB Concepts Statement No. 6. We believe that an entity should not consolidate assets over which it has no control or liabilities for which it has no obligation. As confusing as financial contracts can be, we believe a common sense interpretation of control is most appropriate and useful for users of financial statements.

Thank you for the opportunity to comment on the Exposure Draft. Please contact the undersigned with any questions that you have.

Very truly yours,

A handwritten signature in black ink, appearing to read "Laurie G. Hylton", with a long horizontal flourish extending to the right.

Laurie G. Hylton  
Chief Accounting Officer