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October 1, 2003

Director, TA&I-FSP
Financial Accounting Standards Board
401 Merritt 7
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Norwalk, CT 06856-5116

Re: Proposed FASB Staff Positions (FSP FIN 46-c and 46-d) - 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* ("FIN 46") and Treatment of Fees Paid to Decision Makers and Guarantors as Described in Paragraph 8 in Determining Expected Losses and Expected Residual Returns of a Variable Interest Entity under FIN 46.

We appreciate the opportunity to comment on the Proposed FSPs. The company previously commented on Proposed FSP FIN 46-d before its reissuance and believe the same critical issues raised in that comment letter continue to exist in the Proposed FSP's FIN 46-c and 46-d. More specifically, despite the strong urging from practitioners, the Financial Accounting Standards Board (FASB) has yet to address and resolve the following two critical issues that, if the Proposed FSP's were applied, would result in certain entities designated as decision makers (DM's) of asset management variable interest entities (VIE's), inappropriately consolidating VIE's in which they do not have a controlling financial interest (CFI) [1]:

(a) The definition of a DM and how an asset manager (AM) associated with an asset management VIE (AMVIE) that owns no variable interests in the VIE and otherwise has no ability to make independent operating decisions (as a result of its potential to be removed without cause) can be judged to have a controlling financial interest in the VIE, and
(b) Why fees paid to a DM should receive unique treatment in the computation of expected residual returns.

The company understands and fully supports the FASB's objective in issuing FIN 46 and the related FSP's of adopting an accounting standard that requires reporting entities to

[1] Controlling financial interest is defined and otherwise described in the following authoritative literature:
- ARB No. 51, *Consolidated Financial Statements* (ARB 51)
- FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries* (SFAS 94)
- AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Joint Ventures* (SOP 78-9)
- EITF Issue No. 96-16, *Investors Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights* (EITF 96-16), and
- EITF Issue No. 97-2, *Application of FASB Statement No. 94 and ABP Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements* (EITF 97-2)

consolidate all entities in which they have a CFI. Moreover, we believe the consolidation model constructed in FIN 46 is a significant improvement over the previous guidance contained in EITF 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions* and EITF Topic D-14, *Transactions Involving Special Purpose Entities*, however, certain modifications must be made to the FIN 46 model to ensure that reporting entities are not required to consolidate VIE's in which they do not have a CFI.

Our first issue is the identification of a DM, which is very difficult given the lack of clear definitive guidance in FIN 46. Given the lack of guidance, the company analyzed other existing authoritative guidance such as EITF 96-16 and EITF 97-2, which we believe define the attributes of a DM. As a result of our analysis, we do not believe AM's associated with AMVIE's should be considered DM's as they have no ability to make independent operating decisions (as evidenced by the fact that they generally can be removed without cause; i.e. at any time for any reason). In contrast to our position, it is our understanding that the FASB believes AM's associated with AMVIE's are DM's as a consequence of their ability to execute tightly circumscribed asset management decisions in accordance with the relevant asset management agreement and the fact that they are rarely, if ever, removed. Our belief is that the ability to execute tightly circumscribed asset management decisions does not constitute "decision-making" ability as contemplated by paragraph 5(b)1 of FIN 46 or the relevant provisions of EITF 96-16 and EITF 97-2. Moreover, we believe the fact that AM's are rarely removed provides clear substantive support for their lack of independent decision-making ability. More specifically, if AM's did possess and exercise real independent decision-making abilities of the type described in the above referenced accounting guidance there would be regular conflicts arising between AM's and debt and equity investors who would be directly economically affected by the decisions of the AM which may not be aligned with the interests of the debt and equity investors.

In addition to the preceding, we believe the unequal weighting of fees paid to AM's that are deemed DM's (i.e. evaluating their fees in terms of their probability weighted present value as opposed to their standard deviation) is unwarranted and likely to result in AM's inappropriately consolidating asset management VIE's in which they do not have a CFI. To reduce the possibility of inappropriate consolidation we recommend that fees attributable to AM's/DM's be evaluated in connection with paragraph 8(c) of FIN 46 and Proposed FSP FIN 46-d in terms of their **variability and not their probability weighted present value**, in recognition of the fact that each dollar of expected residual returns is of equivalent value.

The final issue we believe should be addressed is the relative treatment of the interests of a Guarantor with those of an AM that is deemed to be a DM. More specifically, in situations where the guarantee relates to a majority of the VIE's assets, we believe that consolidation by the Guarantor should be an **automatic requirement with no further analysis required**. In contrast, if the guarantee relates to less than a majority of the VIE's assets we believe an analysis prepared in the manner described in Proposed FSP FIN 46-d would be appropriate. The theory supporting our recommendation is that the interests of DM's and Guarantors are fundamentally different and should be treated differently in the FIN 46 consolidation model.

More specifically, through the provision of a guarantee, a Guarantor has intentionally acquired, for a fee, exposure to the expected losses inherent in the VIE. Accordingly, we would urge the FASB to amend its existing guidance in Proposed FSP FIN 46-d and **automatically require** Guarantors to consolidate any VIE to which they provide a performance guarantee on "a majority" (based on the market value of the assets at the inception of the guarantee) of the VIE's assets. This simple recommendation recognizes that any provider of a guarantee of the performance of a majority of a VIE's assets is, by definition, exposed to a majority of the expected losses associated with the VIE and therefore should be required to consolidate the VIE, **without any additional analysis**. In contrast, fees paid to AM's should be evaluated in terms of their variability as described above.

To provide a more comprehensive framework against which to evaluate our recommendations, a description of the nature of AMVIE's is provided below.

Description of Asset Management VIE's

The principal elements and objectives of AMVIE transactions are as follows:

- AMVIE transactions attempt to leverage a sponsor's unique asset management skills (i.e. the asset classes included in the transactions are typically higher risk fixed income securities that require specialized asset management skills).
- The assets under management in the structure are purchased by the AMVIE from unrelated third parties and are not transferred from or sold by the AM/sponsor to the AMVIE.
- The AM/sponsor does not have legal ownership of the assets in the VIE. Rather, the VIE owns the assets, which are not available to settle the general corporate obligations of either the AM or the sponsor. Equivalently, the liabilities are not obligations of the AM/sponsor.
- The AM can, in the case of most AMVIE's, be removed without cause by a majority vote of the equity holders (or a combination of debt and equity holders) of the VIE and therefore has no ability to make independent operating decisions of the nature described in EITF's 96-16 and 97-2 that are a pre-requisite for consolidation in those statements.
- The AM possesses no authority to make any decisions other than investment management decisions tightly circumscribed in the legal documents governing the transactions.
- In addition to their involvement as AM, in most typical asset management transactions the AM also maintains an equity interest (or "financial interest" as that term is used in EITF 97-2) in the VIE, which is generally not considered significant (again as that term is used in EITF 97-2).

Impact of Applying FIN 46 and Related FSPs to AMVIE Transactions

Pursuant to the guidance in paragraph 14 of FIN 46, it is our understanding that the FASB believes an AM meets the definition of a DM as it has the "direct or indirect ability to make decisions that significantly affect the results of the activities of a variable interest entity".

This conclusion, together with the disproportional weighting of fees paid to a DM in the evaluation of rights to expected residual returns makes it very possible, as a result of applying the FIN 46 consolidation paradigm, that an AM could be designated as a primary beneficiary of a VIE (thereby requiring it to consolidate the VIE) even if it holds no variable interests, has no independent decision-making ability, and possesses no CFI in the VIE, which is a direct contradiction to not only FIN 46 but also to all other authoritative accounting guidance that addresses consolidation. The remainder of this letter sets forth our specific recommendations and the underlying support for those recommendations aimed at reducing the possibility of inappropriate consolidation which we believe is critical as it could result in reporting entities preparing inappropriate and misleading financial statements inasmuch as they would include assets that are not available to settle general corporate obligations and liabilities whose discharge is not an obligation of the reporting entity.

Definition of a Decision Maker

To eliminate the possibility of inappropriate consolidation, which we believe is highly probable under the Proposed FSP's, the FASB should more adequately define the attributes of a DM. FIN 46 and Proposed FSP FIN 46-d discuss the attributes of a DM as follows:

> **FIN 46 Paragraph 14:** "A direct or indirect ability to make decisions that significantly affect the results of the activities of a variable interest entity is a strong indication that an enterprise has one or both of the characteristics that would require consolidation of the variable interest entity."
>
> **FIN 46 Paragraph C31:** "The 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 and for that reason, decision making is an indicator of the primary beneficiary of a variable interest entity."
>
> **Proposed FSP FIN 46-d:** "Guarantors of the values of all or substantially all of the entity's assets and guarantors of all or substantially all of the entity's liabilities are also likely to have the ability to make significant decisions for the entity. Because decision making is an indicator of the primary beneficiary, fees paid to decision makers and guarantors are added to the variability components of expected residual returns, increasing the likelihood that the decision maker or guarantor will be identified as the primary beneficiary. Expected residual returns allocated to a decision maker or guarantor receiving paragraph 8 fees would include (1) the decision maker's or guarantor's allocated share of the variability components (paragraphs 8(a) and (b)), if any, plus (2) the fair value of the decision maker's or guarantor's paragraph 8 fees.

The above passages from FIN 46 and the Proposed FSP's illustrate the inadequacy of the definition of a DM. Moreover, we believe the FASB added to the general confusion about what constitutes a DM by indicating that an AM in a AMVIE transaction is a DM; and thereby granting equivalent status to AM's and "Guarantors of the values of all or substantially all of the entity's assets". While the company is in full agreement with the FASB that a Guarantor of all or substantially all of a VIE's assets is also likely to have the ability to make significant decisions for the VIE, and therefore should be granted special treatment in the FIN 46 consolidation paradigm, extending this treatment to AM's is inappropriate.

In defining the attributes of a DM we urge the FASB to more comprehensively analyze the authoritative guidance provided in EITF's 96-16 and 97-2 and incorporate the elements discussed below into a list of DM attributes. All of these elements include the basic simplifying assumption that true decision-making ability is not granted to any party that does not possess a significant or controlling financial interest in the VIE. Stated differently, the existence of a DM without a significant or CFI in a VIE would render the variable interests of the VIE un-saleable as the variable interest holders would be exposed to an undue amount of risk as there wouldn't necessarily be any alignment between their interests and the interests of the DM. The following excerpts from EITF's 96-16 and 97-2 describe attributes an entity should possess before it should be considered a DM:

EITF 96-16:

- The exclusive ability to make significant decisions that would be expected to be made in the ordinary course of business that cannot be blocked or vetoed by a minority shareholder
- Control by a majority shareholder is supported by the absence of minority "participative" rights such as (a) selecting , terminating, and setting the compensation of management responsible for implementing the investee's policies and procedures, and (b) establishing operating and capital decisions of the investee, including budgets, in the ordinary course of business.

EITF 97-2:

- The right to receive income, **both** [emphasis added] as ongoing fees and as proceeds from the sale of its interest, in an amount that fluctuates based upon the performance of the operations and the change in the fair value thereof.
- Possession of a **significant financial interest** [emphasis added] that is both (a) unilaterally salable or transferable, and (b) provides the holder with the right to receive income, both as ongoing fees and as proceeds from the sale of its interest in an amount that fluctuates based upon the performance of the operations and the change in the fair value thereof.
- Exclusive authority over all decision making related to both of the following (a) ongoing, major, or central operations including the exclusive decision-making authority over scope of services, negotiation and execution of contracts, and establishment and approval of operating and capital budgets. This authority also must include exclusive decision-making authority over issuance of debt if debt financing is an ongoing, major, or central source of

financing, and (b) compensation as well as the ability to establish and implement guidelines for the selection, hiring, and firing of employees.

The company believes that including the above attributes in a list of indicators of a DM in the Proposed FSP FIN 46-d would be appropriate as a DM, if it is to possess true decision-making ability, should possess all the rights referred to above including exclusive independent "operational" decision-making authority. Moreover, the rights of the DM should not be subject to the approval or veto of any party similar to the consolidation guidance in EITF 96-16. Accordingly, the presence of substantive kick-out rights (i.e. those that can be exercised at any time, for any reason, and with no dis-incentives to the parties exercising the rights; financial or otherwise) would appear to provide prima facie evidence that an AM is not a DM. As a consequence of the preceding, we do not believe that AM's in typical AMVIE's meet what should be the requirements of a DM and therefore should not have their fees included in the analysis of rights to expected residual returns pursuant to paragraph 8 of FIN 46 and Proposed FSP FIN 46-d.

Treatment of Fees Paid to a Decision Maker

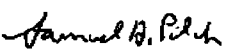
As stated above, the company does not believe an AM meets the definition of a DM. We also believe that fees paid to a DM should not be disproportionately weighted as that only serves to increase the risk that a VIE may be inappropriately consolidated by an entity that does not possess a CFI in the VIE (and possibly the non-consolidation of the VIE by a reporting entity that does possess rights to a majority of the expected residual returns exclusive of the disproportionate treatment of fees paid to a DM). Moreover, disproportionately weighting the fees paid to a DM in the manner described in Proposed FSP FIN 46-d renders the calculated amount of "expected residual returns" invalid as it assigns different economic utility to fungible dollars of residual returns where no economic differences exist. Stated differently, for each VIE evaluated under FIN 46 and the related FSP's there is a finite amount of expected residual returns and each dollar of return possess an equivalent amount of economic value. Accordingly, to achieve the goal of identifying the party, if any, that possess the right to a majority of the expected residual returns it is absolutely necessary to weight each dollar of expected returns equally. Moreover, if the FASB is correct in its assumption that the presence of decision-making ability that can significantly affect the value of the variable interests will likely be associated with a holder of a significant variable interest there would be no need for the disproportional weighting; rather, the weighting should be equivalent and if a DM, after analyzing and aggregating all of its variable interests, is determined to be entitled to a majority of the expected residual returns of the VIE then it should be required to consolidate the VIE. In contrast, inappropriately dis-proportionately weighting the fees paid to an AM (that is arbitrarily deemed to be a DM) would only increase the likelihood that the AM may be forced to inappropriately consolidate a VIE in which it does not have a CFI and thereby be required to prepare financial statements that could be considered inappropriate and misleading.

In the Event FIN 46 and the Proposed FSP's are not Amended

In the event the FASB does not agree with the views set forth in this letter and chooses not to amend the authoritative guidance in the manner described we ask that the following actions, listed in order of importance, be taken. First, we ask that the FASB develop new balance sheet captions for assets it requires reporting entities to consolidate that are not owned by the consolidating reporting entity and are not available to satisfy the general corporate obligations of the entity. We would also ask the FASB to identify new balance sheet captions for liabilities that are not general obligations of the company and whose payment is dependent upon the liquidation of assets not owned by the company. In addition, appropriate guidance should be set forth regarding appropriate footnote disclosures describing the impact of consolidating VIE's in which a reporting entity does not have a CFI to allow investors and creditors to more appropriately assess the resources, obligations, and financial condition of reporting entities that are required to consolidate VIE's in which they do not have a CFI.

If you would like to discuss the contents of this letter in more detail I can be reached at (847) 402-2213.

Sincerely,



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