DEERFIELD
CAPITAL MANAGEMENT LLC

October 1, 2003

Director, TA&I-FSP
File Reference No. FIN46-c
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

RE: File Reference No. FIN 46-c
Proposed FSP on The 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*

Deerfield Capital Management LLC (Deerfield) is a Chicago-based institutional investment advisor focused on the management of Collateralized Debt Obligations (CDOs) and hedge funds. We are a SEC-registered investment advisor as well as a commodity pool operator and trading advisor registered with the CFTC. We are pleased to have the opportunity to respond to the above referenced Proposed FSP, as it will have a significant impact on our business and the investing community.

We have a strong understanding of the complexities involved with accounting for activities conducted through Variable Interest Entities (VIEs) and fully support the Board's objective of improving financial reporting by enterprises involved with these structures. Our views in this area are concentrated on the potential impact to CDOs, as we are actively involved in this industry. We currently serve as collateral manager for approximately $7 billion of CDO assets. We continue to have the view that while there may be certain unique CDO structures where consolidation is warranted, a large majority of CDOs serve valid business purposes that provide alternative investment opportunities to a large population of investors and effectively disperse risks among the parties involved. We feel that the guidance provided for in FIN 46 and the proposed FSPs do not adequately address VIEs that effectively disperse risks and thus do not warrant consolidation.

FIN 46-c addresses the impact of the existence of kick-out rights on the treatment of "the" decision maker's fees in the computation of expected residual returns. The FSP states, "The existence of kick-out rights does not affect the status of a decision maker in the application of paragraph 8(c)." It would seem that if a service provider can be terminated without cause, that there must be a higher decision-making power. How can somebody that can be fired be "the" decision maker? We understand that the Staff

8700 WEST BRYN MAWR 12TH FLOOR CHICAGO, ILLINOIS 60631 USA
TELEPHONE: 773.380.1600 FACSIMILE: 773.380.1601

may be applying a broader definition of "decision-maker" in this instance, but perhaps some additional definitive guidance is needed in further defining a decision-maker for the purposes of applying paragraph 8(c). The existence of kick-out rights may be only one consideration of many in determining the identity of the decision maker. If the definition or determining factors of a decision maker are too broad, the end result may be one that results in consolidated financial statements that are confusing and misleading to the users.

Deeming a party to be the decision maker implies that this party has substantive control over the VIE. What attributes must be present to establish control? We refer to the arguments presented in EITF 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* (EITF 97-2). This consensus states that "The Task Force observed that there may be industries other than the health care industry in which a contractual management arrangement is established under circumstances similar to those addressed in this Issue. Accordingly, the Task Force observed that use of the guidance in this Issue is appropriate when the circumstances are similar to those described in this Issue." As the permitted activities of a collateral manager are subject to strict contractual arrangements and the collateral manager may or may not also have an equity interest in the VIE, we feel an analogy to physician practice management described in EITF 97-2 is appropriate under the circumstances. In the context of FIN 46, the Board has stated that it believes that if a business enterprise has a controlling financial interest in an SPE (VIE), the assets, liabilities, and results of the activities of the SPE (VIE) should be included in consolidated financial statements with those of the business enterprise. If the Staff intends for the definition of a decision maker for purposes of FIN 46 to be broader than that of the controlling financial interest described in EITF 97-2, then the applicable guidelines should be established with explanation of the appropriate rationale. However, it would seem that the end objective is the same: an entity that controls another by means of a contract should consolidate the assets, liabilities and results of operations of the second entity into its own financial statements in order to make them more meaningful by presenting the true risks and rewards of the business. We feel more guidance is necessary in order to achieve this objective within the confines of FIN 46.

EITF 97-2 states that "a controlling financial interest exists if, for a requisite period of time, the PPM has 'control' over the physician practice and has a 'financial interest' in the physician practice that meets all six of the requirements listed below (for reference purposes):

1. Contract has a term that is either (a) the entire remaining legal life of the practice or (b) a period of 10 years or more.
2. Contract is not terminable except in the case of gross negligence, fraud, or other illegal acts or bankruptcy of manager.
3. Manager has exclusive authority over all decision making regarding ongoing, major, or central operations.
4. Manager has exclusive authority over total practice compensation of professionals as well as the ability to establish and implement guidelines for the selection, hiring and firing of them.

5. The manager must have a significant financial interest in the entity that is unilaterally salable or transferable by the Manager and
6. provides the Manager with the right to receive income, both as ongoing fees and as proceeds from the sale of its interest in the entity, in an amount that fluctuates based upon the performance of the operations of the entity and the change in the fair value thereof.

It is clear that if the manager has *ALL* of the above attributes that there is an element of substantial control established by means of the contract. However, it would seem that different standards are being applied in determining a decision maker of a VIE and it is not clear why that is when the objective is the same. We would like to explore some typical attributes of a collateral management agreement for the types of CDO's we manage in order to demonstrate that the collateral manager has very limited discretion/control. We encourage the Staff to consider some or all of these attributes in debating the determination of a decision maker and hopefully issuing further guidance:

- The permitted activities of a collateral manager are explicitly provided for in the collateral management agreement and the CDO indenture. Numerous strict investment guidelines are imposed. For example, the manager can only sell collateral if it poses additional credit risk, is credit improved or has defaulted. Otherwise, trading is limited to a small allowable discretionary trading bucket (usually 15-20%). Purchases must comply with strict reinvestment criteria.
- The established reinvestment period ranges from approximately three to five years and after that period, the collateral becomes similar to a static pool where the collateral manager has very limited to no ability to sell collateral.
- Upon an event of default under the indenture, the controlling party (i.e. a monoline insurance provider or the most senior class of securities issued by the CDO) effectively directs all actions of the CDO.
- Optional redemption of notes/equity issued by the CDO can only occur by 2/3 vote of the equity holders. If there is a redemption due to a tax event, it must be approved by the affected class of securities.
- The collateral manager typically has no say/vote in amending the deal documents or restructuring the deal. Minor amendments usually require approval by the rating agencies and/or monoline insurance provider. Major amendments need approval of a majority of each class of investors as well as the rating agencies and insurance provider. Some significant amendments may require a 100% vote of each party.
- The collateral manager has no power to remove service providers (i.e. trustees, accountants).
- Many substantive decisions require the approval/consent of the rating agencies, swap provider and or insurance provider (i.e. replacement of service providers, purchase of certain types of securities such as synthetics and structured finance securities).
- Collateral manager cannot assign its rights under the collateral management agreement without the consent of investors, rating agencies and/or insurance provider. Collateral manager can resign, but resignation is not effective until the replacement is approved.

- The collateral manager can commonly be removed without cause.

The collateral manager clearly has some decision-making authority, but that power is significantly limited by the terms of its contract. The collateral manager is a service provider whose activities are governed by the terms of the collateral management agreement and CDO indenture. The collateral manager clearly does not control the VIE under the guidance provided in EITF 97-2.

Including the fair value of the collateral manager's fees in the computation of expected residual returns will in many cases result in the collateral manager receiving a majority of the "returns". However, there is inconsistency in the application/use of the term "return". Investors originally made an investment of cash and if the investment is profitable, they will receive their investment back plus a return on that investment. CDO managers are providing a service in exchange for a market-based fee. It is not practical to label that fee as a return in the same way it is applied to investors. The manager has invested resources in order to receive the fee – it is not all "return" to the manager. Ignoring the impact of discounting, the return to the investor equals its total cash distributions received less its initial investment (assume total investor returns = net income of VIE). This return falls to the bottom line of the investor. For the collateral manager, in the examples and guidance provided by the FASB, assuming no other financial interest in the VIE, the return equals total gross cash distributions received in the form of fees (ignoring the impact of discounting) without the deduction for the cost of its investment. The total fees received do not fall to the bottom line of the manager because there are significant costs involved with earning that fee. It would seem that if the fee received is fair, market-based compensation for the services provided that the fees should not be considered as a "return". Additionally, the term "residual" implies that this is the residual cash/return remaining after the payment of contractual obligations and expenses. An argument can be made that since the fee is a contractual expense of the CDO, the fees should not be considered a component of the "residual returns". The end result seems unjustly skewed towards the collateral manager ending up with the majority of the "residual returns", as defined. This result does not seem to be practical and will cause undue confusion and misleading financial statements in many cases.

Consider for example a collateral manager that is a service provider with a relatively small balance sheet consisting of cash, fee receivables and fixed assets totaling $15 million in assets. The manager's income statement presents the results of its operations – the fees it has earned from the services provided offset by the costs of those providing those fees. Assume that the collateral manager does not have any investments in the CDO's it manages. When the manager applies the current guidance in FIN 46, due to the requirement to include its fees in the return analysis, it is deemed to have a majority of the rewards of the CDOs it manages and must add $7 billion of CDO assets to its balance sheet, to which it has no legal rights to, offset primarily by debt that it will never have any obligation for and absolutely none of related risks. Total assets will increase to almost 500 times that of the assets it actually owns and has rights to. This presentation will be difficult to explain to the users of the financial statements. Further, the collateral manager will be required to report substantial amounts of "investment income" on its income statement from investments it does not own and interest expense on debt it is not responsible for – all to be removed net in one line item by what used to be referred to as "minority interest". In this example, the minority interest actually represents 100% of the ownership of the CDO's and the related net income, which adds to the confusion. This presentation does not seem to meet the objective of improving transparency and the user's understanding of the financial statements. A reader will not be able to ascertain what business this entity is in or how it makes its profit. The true risk of the business will be unclear. In this situation, full disclosure of the types of CDOs it manages and the risks involved would seem to be a more favorable alternative.

We do not mean to imply that there are not certain situations where it makes sense for a collateral manager to consolidate the financial statements of the CDOs its manages. However, the guidance needs to distinguish what those situations are so as not to mandate consolidation in absence of a true controlling interest. The current end result seems unjustly skewed toward the collateral manager consolidating in most cases without adequate rationale. The right answer may be achievable with further consideration being given to the definition of a decision maker and the subsequent treatment of the related fees. Many VIEs effectively disperse risks among the parties involved and appropriately do not warrant consolidation. Unfortunately, these VIEs are getting lost in some very complex rules where the full impact is not yet completely understood.

In regards to the effective date of FSP 46-c, like many others in the CDO community, we and our accountants have been operating under the belief that a service provider who can be terminated/replaced without cause would not be deemed to be the decision-maker. The proposed guidance has taken many by surprise and the implications are significant. Enormous amounts of data must be collected and analyzed in order to reach the necessary conclusions. These conclusions and resulting financial statements will then need to be audited. With definitive guidance coming out in October, depending on the final position of the Staff, there is not sufficient time to collect the data and complete the required forecasts and calculations of expected losses and residual returns before year-end. For this reason, we are asking the Staff and Board to consider deferring the effective date for deals entered into in 2003 to be consistent with that for the earlier deals.

We thank the Board for the opportunity to comment on this Proposed FASB Staff Position and fully appreciate the effort involved.

Sincerely,

Danielle T Valkner

Danielle T. Valkner, CPA
Vice President of Finance
Deerfield Capital Management LLC

Marvin Shrear
Chief Financial Officer
Deerfield Capital Management LLC