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Mr. Timothy S. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

File Reference 194-B

Dear Mr. Lucas:

The Bond Market Association (the "Association")* appreciates the opportunity to comment on the Revised Exposure Draft, *Consolidated Financial Statements: Purpose and Policy* (ED).

In general, we question whether the ED will result in an improvement in financial reporting. We believe that the definition of control, combined with the rebuttable presumptions and implementation guidance, create a model which is subjective, difficult to apply in practice, and might create greater diversity, rather than consistency, in practice. We believe that the ED fails to adequately resolve many of the issues associated with the consolidation of special purpose entities, while at the same time raises new questions regarding what have previously been relatively straightforward transactions.

We note that this project was intended in part to address the consolidation issues surrounding trusts and other special purpose entities. We believe that critical issues have been addressed separately for special purpose vehicles as part of Statement 125 and the Amendment process thereof, as well as by the EITF, via the guidance regarding Qualifying Special Purpose Entities. We acknowledge the fact that the Statement 125 guidance does not address the issues associated with nonqualifying SPEs; however, due to the difficulty in understanding how to apply the definition of control noted below, we do not believe that the proposed guidance represents a substantial conceptual improvement or clarification over the existing literature.

* The Bond Market Association represents securities firms and banks that underwrite, distribute and trade debt securities, both domestically and internationally. This letter was prepared with the participation of the Association's Accounting Policy Committee, which is comprised of in-house accounting and financial management professionals at the Association's member firms. More information about the Association and its members may be found at its internet website, located at <http://www.bondmarkets.com>.

Mr. Timothy S. Lucas

May 24, 1999

2



At the same time, we believe that the proposed guidance raises many additional questions regarding "plain-vanilla" types of investments such as investments in corporate entities. The ED replaces the current approach, which relies in part on certain objective criteria, with a broader, more abstract approach. Although the ED approach may be more compelling from the standpoint of pure theory, we note that its practical application highlights many of the flaws with such an approach. More specifically, although the current distinctions such as ownership of greater than 50% of voting stock, or ownership of greater than 20% and less than 50%, may be considered arbitrary or overly simplistic, its very simplicity is the feature that leads to both consistency and comparability in consolidation financial reporting. Accordingly, we do not believe there is a compelling need to replace this model.

In light of the above, we do not support the ED. If, however, FASB does decide to proceed with this project, we strongly encourage the Board to consider the specific points we have noted below. We have also provided comments on certain of the "close-call" case studies which we feel are relevant to the financial services industry.

Definition of Control/Rebuttable Presumptions (Issues 1 and 2)

As noted above, we believe that the ED's approach to assessing control is too general, and therefore open to a number of different interpretations. In particular, we believe that many of the factors that an investor is required to take into consideration are overly subjective in nature. We are concerned that this will lead to inconsistency in application and therefore detract from the comparability of financial statements.

We are also concerned that the proposed guidance is not evenhanded, in that there appears to be a higher hurdle for deconsolidation than there is for consolidation. We believe that the ED is therefore biased towards consolidation, and we do not agree with this approach. Furthermore, we note that the ED *suggests*, through some of the examples, that control over some entities may be shared by several parties, and that therefore no one party would be required to consolidate the entity. We recommend that the ED state this explicitly in the standard itself so that there is not a further bias towards consolidation in practice.

Focus on Probable or Potential Events

One area of particular concern is that the ED requires investors to make assessments regarding the probable behavior of unrelated third parties in order to determine whether the investor has control over an entity. We believe such predictions are not sufficiently objective or reliable, and that they should therefore not be used as a basis for determining control.

For example, in the case of an investor who has a large minority voting interest in the election of a corporation's governing body, and no other party or organized group of parties has a significant voting interest, the ED requires the investor to make predictions regarding the percentage of votes expected to be cast at the election (paragraph 18b). While some information for making this determination could be derived from past voting patterns, this

Mr. Timothy S. Lucas

May 24, 1999

3



hardly seems reliable enough for purposes of making a consolidation decision. The ED also suggests that investors should factor in whether other groups are attempting to mobilize existing shareholders to vote against the investor's board nominees. In our view, such a determination borders on speculation. Additional complexities in making a determination about whether control has been attained could also arise if the terms of board members are staggered, so that control of the board can only be achieved over several years. For example, a large institutional investor may have a significant percentage ownership interest in an entity, yet may not be able to exert control if board elections are held on a staggered basis.

A similar concern regarding the requirement to predict investor behavior exists with respect to the guidance on investments in partnerships. Paragraph 65 of the ED states that veto rights held by limited partners may overcome the presumption that the general partner controls the partnership, but a careful assessment of the relevant facts is still required, as "the ability of the limited partners to participate by exercising their veto as a group may depend on the size and dispersion of the limited partners. The larger the number of limited partners and the more dispersed they are, the more likely that the sole general partner can exercise control." This suggests that in order to overcome the presumption of control by the general partner, the limited partners must have not only the *legal right* to veto decisions, but an evaluation must be made as to whether they have the ability to organize and exercise those veto rights. Again, such a determination would be subjective, and two different investors could arrive at two different conclusions given the same set of circumstances. Furthermore, we note that under partnership law in many jurisdictions, limited partners are entitled to obtain from the general partner a list of the names and addresses of all other partners, and therefore have the ability to organize themselves if they so wish. In fact, if limited partners were dissatisfied with the performance of a general partner, we think they would often be sufficiently motivated to organize the limited partners and exercise their veto rights. Therefore, we believe that sufficient evidence is present to conclude that control is shared between a general and limited partners if the limited partners have the legal right to veto decisions of the general partner or remove the general partner at will. A further assessment of whether the limited partners are likely to exercise those rights is unnecessary.

A third instance where the determination of control rests on possible, rather than actual, events is the ED's presumption that control exists if an investor has the unilateral ability to obtain either a majority voting interest or the right to appoint a majority of the governing body through the ownership of convertible securities or similar rights whose expected benefits exceed the cost of conversion. This presumption shifts the focus of the ED to potential control, rather than actual control, and may well result in situations where an investor is required to consolidate an entity over which he never acquires actual control. We do not believe this should be the basis for consolidation. For example, an investor may choose not to exercise the option to acquire additional securities or rights, even if they are "in-the-money," if, for example, he does not have the funds available to do so, or if there are other, more attractive investment opportunities available to him. We believe that the ED should focus on situations where actual control exists, and therefore, that this presumption be eliminated.

Mr. Timothy S. Lucas

May 24, 1999

4



Given the large number of factors that must be taken into consideration in determining whether control exists, the ED would make it extremely burdensome to make a determination of control regarding a single investee, let alone for a more realistic scenario in which there are a large number of investees. Moreover, since so much of the determination of control is based on predictions regarding future events, we are concerned that should such predictions prove incorrect, an investor may be unnecessarily required to restate previously issued financial statements. The Board's lack of resolution on this point, as noted in paragraph 252 of the ED, causes us serious concern. A restatement of financial statements resulting from subjective factors points out the potential lack of reliability that would result from the proposed guidance.

Level of Economic Benefits

The ED is also unclear to what extent the notion of economic benefits should be taken into consideration in determining the existence of control. The formal definition starts with the non-shared ability to make decisions that guide the activities of an entity so as to benefit from those activities. Taken as a whole, however, the ED suggests that even though control may not in fact exist, the ownership of a majority of the risks and rewards of an entity (e.g., via a total return swap executed with an entity) could be tantamount to control. We do not support an approach whereby a preponderance of economic benefit alone leads to a presumption of control.

Although the ED contends that the level of economic benefits has no effect on the determination of consolidation, the absence of any minimum thresholds for either legal or economic ownership also creates the potential for misleading financial statements. This would especially be the case in situations where a "controlling" entity does not have a majority legal ownership of an investee, nor a significant economic interest in the entity. For example, we note that under the proposed guidance, a management company could be determined to have control over an entity via a management contract and performance fees that it charges under the contract, even though it does not own any voting shares of the entity. As a result, the management company would be required to consolidate the entity, including in its consolidated financial statements 100% of the assets and cash flows of the entity, to which the company has no legal right above and beyond its management fee. We do not believe this will result in more meaningful financial statements to investors.

Distinctions Based on Legal Form

Although the ED purports to advance a notion of effective control that applies uniformly regardless of the legal form of the investee, we believe that the implementation guidance in Appendix A suggests otherwise in certain cases. In particular, paragraphs 69-70 explain why entities governed by the Investment Advisers Act and the Investment Company Act of 1940 ("40 Act Funds") are not considered to be controlled by their fund manager. Emphasis is placed on the fact that the fund manager has a fiduciary responsibility to protect the interests of the investors of the fund, and related restrictions placed on fund managers' activities and discretionary decision-making authority that preclude them from exercising control over the fund. We note that there are a large number of private investment funds that operate with

Mr. Timothy S. Lucas

May 24, 1999

5



legal and contractual restrictions that are similar to those imposed on 40 Act Funds, but which are not exempt from the scope of the proposal. For example, many private investment funds are formed as limited partnerships. Under partnership law, the general partner has a fiduciary duty to act in the best interests of the limited partners. In addition, private investment fund limited partnership agreements often impose restrictions on the activities, entitlements and discretionary decision-making authority of general partners that are analogous to similar restrictions applicable to fund managers of 40 Act Funds. These similarities seem to be ignored, however, when evaluating the type of control that a general partner has over a limited partnership, which is to presume that the general partner controls the partnership despite its fiduciary and other responsibilities to the partnership and its limited partners.

Other Issues

Scope

The scope of the ED provides an exemption for entities that carry substantially all of their assets at fair value with all changes in value reported in a statement of net income. This exemption has raised several questions among our members.

- (1) We are not clear as to how paragraphs 5 and 232 interrelate with respect to the scope exemption, and we interpret the guidance as follows. Assume the existence of the following tier of investments:
- Parent Company A, which does not carry substantially all of its assets at fair value, invests in
 - Venture Capital Company B, which does carry substantially all of its assets at fair value, which in turn invests in
 - Operating Company C, which does not carry substantially all of its assets at fair value.

Assume further that each investor controls the investee using the definition in the ED.

Applying the scope exemption, Venture Capital Company B would not consolidate Operating Company C, as Company B qualifies for the scope exemption. Parent Company A would consolidate Venture Capital Company B, as A does not qualify for the scope exemption. Are we correct in concluding that the specialized accounting principles applied by B to its investment in C results in non-consolidation of C's individual assets and liabilities in the consolidated financial statements of A, as is consistent with current GAAP (EITF Issue No. 85-12)?

Mr. Timothy S. Lucas

May 24, 1999

6



- (2) We note that the scope exemption in paragraph 5 applies to “mutual funds and other investment companies that apply the provisions of the AICPA Audit and Accounting Guide, *Audits of Investment Companies*.” However, we understand that AcSEC currently has a project on its agenda to clarify what entities fall under the scope of the Investment Company Guide. Given the interrelationship of these two projects, we strongly encourage the Board to consider the timing of the AcSEC project before finalizing the ED and selecting an effective date for the standard.
- (3) We note that once the FASB completes its fair value project, many entities will carry substantially all of their assets at fair value. Presumably many of these entities would then be exempt from the standard and would not be required to consolidate any of its controlled entities, including operating subsidiaries. We suggest that the Board re-evaluate how this exemption will be applied once the Board completes its fair value project.
- (4) We note that many entities may carry all or substantially all of their assets at fair value; however, a portion of those assets may be classified as available-for-sale under Statement 115. Accordingly, the change in fair value of those investments is recorded in comprehensive income, rather than in the statement of net income, and thus these entities would not qualify for the scope exemption. We find no meaningful difference, for purposes of the scope exemption, between reporting changes in fair value through net income versus reporting such changes through comprehensive income. We therefore suggest that the scope exemption in the ED be expanded to include changes in value that are reported in a statement of net income *or* comprehensive income.
- (5) We believe that merchant banking activities should be specifically exempted from consolidation requirements. “Merchant banking” generally describes an investment management activity that is entered into for the purpose of producing significant returns through the subsequent sale of the investment. The basic intent of merchant banking is to pool money to achieve stated business objectives, and to profit from the ultimate disposal of the investment, rather than from the ongoing “operations” of the investee. Merchant banking is almost always a discrete, readily identifiable activity that is carried out through a separate subsidiary with a relatively limited number of investments at any one time. The operation of merchant banking funds is subject to specific investment criteria, with ongoing management oversight to ensure conformity with those criteria.

In our view it is important to draw a distinction between an entity that buys and sells companies for a profit, and an entity that controls and operates a business. In such circumstances, we strongly believe that the current accounting treatment is most appropriate, whereby investments of the former type are carried at fair market value, with changes in value reported in the income statement. We believe that such accounting will result in the most meaningful information to readers of financial statements. In the case of an entity that is held strictly for the profit expected on a future sale, the relevance of the entity’s assets, liabilities, revenues and expenses in consolidating financial statements

Mr. Timothy S. Lucas

May 24, 1999

7



is greatly diminished. The economic benefit that inures to the investor is the value of the investee, not the value of its individual assets and liabilities. We do not believe that such information provides relevant insights above and beyond what is provided by the estimated value of the investment, and therefore do not believe that moving away from fair value reporting to historical cost-based consolidated reporting would be an improvement in financial reporting.

Applicability to SPEs

The proposed standard addresses the consolidation of limited purposes entities such as partnerships and trusts. EITF Issue No. 96-20 and the proposed Amendment to Statement 125 addresses instances relating to consolidation of qualifying special purpose entities ("QSPEs") by the transferor, servicer, and creator. It is unclear how the current guidance would interrelate with the ED. We believe that the current guidance has evolved to a point where it is well-understood in practice and should not be superseded by the ED. In addition, we believe that it should be extended to apply to the transferor, servicer, or sponsor of the QSPE (as proposed in the draft Amendment to Statement 125 dated March 22, 1999), as well as to any beneficial interest holder of the QSPE. The presumption regarding QSPEs has been that they are, by their very nature, unable to be controlled, and therefore, we do not believe they should be consolidated by any of the parties involved. Situations where a party to a QSPE held 100% of the beneficial interests would, however, have to be addressed.

In addition, it is also unclear whether EITF Appendix Topic D-14, Issue No. 90-15, and other SEC pronouncements, which are currently applied to non-qualifying SPEs, would still apply and, if they do, how they would interrelate with the ED.

Effective Date and Transition (Issue 3)

The ED, if issued, would be effective for fiscal years beginning after December 15, 1999, including interim periods in that year. Since there is much interplay between a standard on consolidations and the amendment of SFAS 125, we recommend that the Board change the effective date to a date no earlier than the effective date for the Amendment to Statement 125.

In addition, the Board has asked whether there are circumstances that justify delaying the application to interim periods. We strongly believe that the standard should not be applied to interim periods in the year of adoption. Since a final standard on consolidation will not likely be issued before the fourth quarter of 1999, requiring application in the first quarter of 2000 would be impracticable. Entities would not have enough time to (i) make control assessments for all potential consolidatees and (ii) to collect all financial statement and footnote data on consolidatees necessary to issue interim financial statements.

Furthermore, we believe the benefits of restating prior periods presented do not outweigh the costs of doing so, in that retroactively making control assessments and obtaining necessary

Mr. Timothy S. Lucas

May 24, 1999

8



prior period financial statement and footnote data would be difficult. However, if the Board decides to retain the requirement for restatement, we would suggest a delay in the effective date in order to give firms enough time to review the many investments they have for compliance with the new standard.

Comments on "Close-Call" Case Studies

Case 2

We believe that more information is required to assess whether A has control over Corporation B. For example, if under the terms of the management contract A had little or no discretion regarding what assets should be acquired or what actions should be taken once assets were acquired, we would question whether A controlled B.

Case 8

Based on the facts presented, we believe that Trust Z would be considered a Qualifying Special Purpose Entity and would therefore fall under the scope of Statement 125 and the consolidation guidance related thereto (i.e., EITF Issue No. 96-20). Under this guidance, we do not believe that Bank X would be required to consolidate Trust Z. We do not believe this case study should be analyzed under the ED.

* * *

Again, the Association appreciates the opportunity to provide input on the foregoing issues associated with the ED. Should you have any questions or desire any clarification of the matters discussed herein, please do not hesitate to contact me at 212.357.8437, or George Miller, Deputy General Counsel of the Association and Co-Staff Advisor to the Accounting Policy Committee, at 212.440.9403.

Sincerely,

Esther Mills, *Goldman, Sachs & Co.*
Chair, Accounting Policy Committee of
The Bond Market Association

cc: George Miller, Andy Waskow—*The Bond Market Association*
James Johnson—*Deloitte & Touche*, Special Accounting Advisors to
The Bond Market Association