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Ms. Suzanne Q. Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
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RE: File Reference No. 1082-200

Dear Ms. Bielstein:

We appreciate the opportunity to comment on the Proposed Interpretation, *Consolidation of Certain Special-Purpose Entities* (hereinafter, the "Proposal" or the "ED"). Merrill Lynch supports the Board's effort to improve financial reporting by clarifying consolidation rules for SPEs. As the Board has noted, the existing guidance on consolidation of SPEs is fragmented and incomplete, and as a result has been extended by analogy to a wide variety of transactions not specifically covered by the literature. We therefore support the development of an integrated and principle-based approach that will address a wide variety of SPEs and lead to greater consistency and transparency in financial reporting.

In general, we believe the Board has developed an appropriate conceptual approach to analyze certain risk diversification SPEs that hold financial assets. However, in developing this model we are concerned that this concept has not been fully adhered to, with the result that the model will not apply to many of the SPEs to which it was intended to apply. In addition, we have significant concerns regarding the practical application of the variable interest model that relies on determining whether an entity provides "significantly more" financial support to an SPE in comparison to any other party. We believe that a model that is based on a "controlling financial interest," which is usually evidenced by a majority variable interest but which may be evidenced by contract, agreement or otherwise, would be more in line with existing guidance and much more operational in practice.

We offer the following detailed comments for your consideration.

Comments on Certain SPEs That Hold Financial Assets

We echo the Board's acknowledgement that certain SPEs that hold financial assets are fundamentally different in nature, and therefore applaud the Board's effort to accommodate the unique nature of these SPEs with special provisions for evaluating them for consolidation. As stated by the Board in its Basis for Conclusions (paragraph B19), SPEs that hold exclusively financial assets (hereinafter referred to for convenience as Financial SPEs) serve to disaggregate the risks and rewards of such assets into separate components and recombine them to create different financial assets, with different risks and rewards, which are then purchased by third parties in accordance with their desired risk/reward profile. In these types of SPEs, no individual party controls the SPE's assets or is responsible for the SPE's liabilities. Accordingly, each party should account for its rights and obligations related to the assets of the SPE, but it is inappropriate for any party to consolidate the assets and liabilities of the SPE. Therefore, we believe that a consolidation model that is tailored to reflect the risk dispersion nature of Financial SPEs is entirely appropriate.

The Board has elected to define Financial SPEs via a modification of the QSPE rules as promulgated in FAS 140 and related guidance. However, we believe that it is inappropriate to base the definition of a Financial SPE on that of a QSPE, because the QSPE model is based on a different premise. Specifically, a QSPE is premised on the notion that it must be significantly limited in terms of both its activities as well as the assets it is permitted to hold. That is, it may hold only passive financial assets and passive derivatives that do not involve any decision making on the part of the SPE.

We understand that the reason for these restrictions is that the derecognition provisions of Statement 140 were based on the concept of **control** over transferred assets: in order for a transferred asset to be derecognized, the transferor had to relinquish control over the transferred assets and the transferee had to assume control over them. In the case of QSPEs, which were often unable to pledge or exchange the assets acquired, the ability of the beneficial interest holders of an SPE to pledge or exchange their beneficial interests was considered to be the counterpart of the ability of an ordinary transferee to pledge or exchange the assets themselves.

Thus, the fundamental notion underlying a QSPE is its **lack of control** over the assets it holds. (See, for example, various references in Statement 140 to a QSPE "simply acting like a custodian, passively holding assets on behalf of the BIHs" and acting as a "passive repository of assets on behalf of others."[1]) In contrast, the fundamental notion underlying the Financial SPE model appears to be that of **risk diversification**. Of course, this basic concept carries with it the concomitant notion of diversification of control: if the risks and rewards of financial assets held by an SPE are appropriately diversified, then no one party could be said to control the SPE's assets for its sole benefit or be solely responsible

[1] Statement 140, paragraphs 190-191

for its liabilities. However, the starting point seems to be risk diversification, which we believe is a sound basis for what is essentially a "financial components approach" to SPEs, wherein each party accounts for its separate rights and obligations related to the assets in the SPE.

Limitations on Derivatives Held by Financial SPEs
If the concept of risk diversification is in fact the starting point, it follows that many of the limitations on buying and selling of assets imposed on QSPEs in Statement 140 would not be relevant to Financial SPEs, and this is indeed accomplished by the provisions in paragraphs 22.b.2. and 22.b.3 (and further alluded to in 23.a.) in the Proposal, which permit purchasing and selling activity. However, by building the definition of a Financial SPE on the foundation of a QSPE, we are concerned that many other limitations that were originally imposed for purposes of the control-based model of Statement 140 will be unnecessarily carried over to this risk-diversification model.

Specifically, paragraph 22(b) of the ED incorporates by reference the derivative guidance from FAS 140 as it relates to QSPEs. Therefore, Financial SPEs would only be able to enter into *passive* derivatives that pertain to beneficial interests issued to third parties that relate to, and that partly or fully, but do not excessively, counteract some risk associated those beneficial interests or the transferred assets. In addition, if the amendment to FAS 133 is finalized as proposed, both QSPEs and, by extension, Financial SPEs will face additional limitations arising from the bifurcation requirements and the prohibition that such SPEs may not hold derivatives that pertain to other derivatives.

While these limitations on derivatives may make sense in the context of a QSPE, we do not believe they are relevant to the concept of a Financial SPE. We understand that Statement 140 set out such limitations on the types of derivatives a QSPE may enter into for two basic reasons:

- because there were no requirements at the time to bifurcate derivatives embedded in a beneficial interest issued by a QSPE, there was a concern that derivatives could effectively be hidden by placing them into a QSPE

- many derivatives, such as purchased options, would require the holder to make a decision, and such decision-making was deemed inconsistent with the entirely passive nature of a QSPE.

As noted above, we believe the starting point for the definition of a Financial SPE, that of risk diversification, is fundamentally different from the control-based framework that gave rise to the idea of a QSPE, and appropriately so. Thus, the limitations on derivatives held by a QSPE would not seem to be consistent with the notion of a risk diversification vehicle, for the following reasons:

- assuming that the proposed Amendment to Statement 133 is finalized, any derivatives held by an SPE would be required to be bifurcated and accounted for by the holder of the beneficial interests, thereby eliminating the first objection to derivatives held by Financial SPEs.

- often, the main reason for entering into a derivative is to diversify or otherwise transform the risk of a financial instrument, and thus the use of derivatives would seem to be uniquely suited to Financial SPEs.

Furthermore, the Financial SPE model seems to recognize that an SPE does not have to be entirely passive, by virtue of the fact that is permitted to purchase and sell assets. This makes sense to us, as decision-making authority over assets is not necessarily inconsistent with the risk diversification nature of an SPE. Presumably, then, any limitations on so-called "active" derivatives that require decision-making on the part of a Financial SPE would also be irrelevant to the Financial SPE model.

Our concern is that, in carrying over these limitations on derivatives, the Financial SPE model will not capture the very types of SPEs it was intended to encompass, thereby substantially reducing the applicability and relevance of the Financial SPE model. In particular, there are a number of non-QSPEs that appropriately disperse risks such that no one party controls, for example, Collateralized Debt Obligation SPEs and SPEs that issue credit-linked notes.

Take as an example a "credit-linked note" SPE which:

a) issues notes to beneficial interest holders which gives them exposure to a specific reference credit
b) uses the proceeds to purchase an asset such as a Treasury security, and
c) enters into a credit-default swap with a derivative counterparty to increase the yield of the beneficial interest by transforming the risk and return of the Treasury into the higher yielding credit risk desired by the beneficial interest holders.

This type of SPE would seem to be a classic risk diversification vehicle, as both the derivative counterparty and the SPE noteholders share in the risks of the SPE. However, this type of SPE would likely not qualify as a Financial SPE once the proposed Amendment to Statement 133 is finalized. The reason being that the credit-default swap would pertain to the derivative embedded in the beneficial interests issued by the SPE. Therefore, application of the model as currently proposed would result in the counter-intuitive result of a risk-dispersing SPE being analyzed not under the Financial SPE model but instead under the variable interest model.

In short, we do not understand why the use of derivatives to disperse risk should cause an SPE to fail the Financial SPE determination. The use of derivatives by a risk diversification vehicle should not be relevant unless the derivative results in the recombining of risks and rewards or provides some unilateral discretion over the SPE.

Additionally, this limitation on derivatives is particularly irrelevant for financial institutions that mark to market both derivatives and securities, where all interests are appropriately reflected on the financial statements.

Recommended Alternative Approach
For all of these reasons, we believe it is inappropriate to base the definition of a Financial SPE on that of a QSPE.[2] We therefore propose replacing paragraph 22 with a more conceptual basis for determining whether an SPE is a risk diversification vehicle. An SPE subject to this model would be one that holds financial assets and that serves to disperse the risks and rewards of the financial assets to several (two or more) participants, either by allocating cash flows of financial assets and/or modifying or providing for risks to such participants. No participant to such an SPE would be required to consolidate the SPE; participants would instead account for their respective interests, *i.e.*, apply the financial components approach. We believe this accounting and financial statement presentation is more transparent to financial statement users and represents the risk diversification nature of the SPE, rather than searching for a single participant that would be required to consolidate all the SPE assets and liabilities.

We also believe that paragraph 23, which provides criteria for determining whether a participant may otherwise be required to consolidate the SPE, should be revised with a more conceptually consistent approach. Specifically, paragraph 23 as written seems to be designed to capture those instances where a participant is providing significant financial support to the SPE. We believe the more relevant test is whether a participant in a Financial SPE holds an interest (or multiple interests) that either:

1) effectively reconstitutes or recombines the risks and rewards of the financial assets held by the SPE, or

2) otherwise gives the participant effective control over the SPE that enables it to unilaterally benefit from that control.

An example of the former would be an entity that enters into a total return swap with an SPE, such that it is exposed to all of the risks and rewards of the assets held by the SPE. In these and other similar instances, the SPE would not be considered a risk diversification vehicle and the variable interest model would instead be applied.

We acknowledge that some level of judgment will be required by the participants to the vehicle in reviewing the substance of the SPE to ensure that it has in fact dispersed the risks and rewards of the financial assets among various participants. However, we believe that this is a conceptually superior approach that will result in the most

[2] We would also like to point out that if the FASB does start with the definition of a QSPE, fairly extensive revisions will need to be made to the QSPE rules, given that they are all written from the perspective of the transferor; and such revisions will likely result in some fairly cumbersome and potentially quite confusing guidance.

appropriate and transparent reporting and that will prove to be adaptable to a wide variety of different structures.

We strongly recommend the Board consider either of these approaches. However, if the Board elects to continue to base the definition of a Financial SPE on that of a QSPE, we urge the Board to reconsider the proposed limitations on derivatives held by Financial SPEs, including the limitations that will arise as a result of application of the proposed Amendment to Statement 133 and related guidance.

Comments on Variable Interest Model

Under the variable interest model, the entity that holds variable interests that are significantly more than another party to the SPE is required to consolidate the SPE. We believe this model is different than the model that is applied to non-SPEs that is based upon a "controlling financial interest."

Although we understand the rationale for this requirement, we are concerned that it may not be operational in practice, as much of the information required to perform this analysis is not readily available. In many SPE transactions, the interests are widely dispersed, and the various parties are not known to one another (nor are the terms and conditions of their respective interests). In addition, once a deal is closed, there is no mechanism to provide this type of information to investors; providing it would be quite expensive, as it would involve detailed tracking of all purchases and sales of interests that occur over the life of the SPE.

The "significantly more" approach will likely result in periodic deconsolidation and reconsolidation of an entity due to the actions of third parties, and we are also concerned that financial statement users may find this confusing and the information less useful, as it may not be apparent why, for example, in one period a vehicle is consolidated and in the next period, through no action of the entity itself, it is deconsolidated.

For these reasons, we believe that the determination of whether a variable interest is sufficiently significant so as to result in consolidation should be based on the same concept as Statement 94, that of a "controlling financial interest." The usual condition for a controlling financial interest would be ownership of a **majority** of the variable interests. However, a controlling financial interest could also arise by contract or agreement with other variable interest holders, or otherwise. Such an approach would necessarily require the use of judgment to determine whether an interest is deemed to be controlling. However, not only would this model prove eminently more operational and sustainable, as an entity can readily determine if it holds the majority of the variable interests, it would also be more consistent with the existing consolidation guidance which this proposal is meant to interpret.

If the Board believes it is more appropriate to retain the "significantly more" criterion, then we would encourage the Board to develop various indicators or triggering events for when consolidation should be re-evaluated in order to make the Interpretation more operational.

Status of Derivative Counterparty

For SPEs that enter into derivative transactions with a counterparty, paragraph 18 of the Proposal identifies the entity that "bears the risk of losing a variable interest in the SPE" as being the probable primary beneficiary. We are uncertain as to the meaning of this guidance. Is a premium received or paid considered to be a variable interest in the SPE? If a derivative dealer enters into a derivative with an SPE at market value, but the derivative subsequently moves out of the money from the dealer's perspective (results in a liability), is the dealer suddenly at risk of consolidating the SPE because funds will have to be transferred to the SPE that are now at risk of loss?

As a dealer in derivatives, Merrill Lynch enters into thousands of derivative transactions with numerous counterparties, many of which could be SPEs. However, we do not specifically identify whether a counterparty is an SPE, as that is not particularly relevant to us from a risk perspective. What is relevant is the level of our market and credit risk and the extent to which we have evaluated, monitored, and mitigated these risks.

As a derivative counterparty with no other involvement with the SPE, we have not been provided transaction specific details or participants. In many instances where the deal is privately placed we would not have access to this information or have the ability to request any transaction specific details. Additionally, we have no mechanism to monitor changes in the participant holdings, concentrations of interests, and when the interests may be bought and sold. And, depending on how the guidance referenced above is intended to be applied, this analysis may have to be performed on an almost continual basis as derivatives move in and out of the money.

While we recognize that certain derivatives can include terms that would expose the dealer to all of the risks and rewards of the assets held by an SPE, for many typical derivatives (interest rate swaps and foreign currency forwards), consolidation of the SPE by the derivative counterparty would appear to be inappropriate. The derivative dealer is already applying the financial components approach by accounting for the derivative on a mark-to-market basis. Accordingly, we recommend the use of indicators to identify situations when a derivative would **not** be considered a variable interest. These could include the following:

- other variable interests of the SPE are subordinated to the derivative and have an initial cash investment greater than the derivative that is at risk of loss,
- the derivative does not convey substantially all of the risks and rewards of the underlying assets held by the SPE,
- the derivative does not otherwise convey control over the SPE,
- the derivative counterparty has no other form of variable interest in the SPE,
- and the derivative is marked to market.

Other Comments

Computation of Expected Loss
We are not entirely clear how the quantitative analysis to compare different variable interests as described in paragraph 20 is intended to be performed. The guidance refers to the computation of expected future losses, which is defined as the probability-weighted estimate of losses without considering possible gains. By excluding the consideration of possible gains, this approach would suggest that the concept of losing one's investment is considered to be the most important factor in determining who is the Primary Beneficiary. However, the term "Variable Interest" suggests that the approach also incorporates some notion of *variability* of return or expected future outcome. If variability of return were also a factor to be considered, however, the computation should take into account any possible future gains as well. In any event, we feel that this concept is sufficiently important that it merits a more expanded discussion in the Proposal than is currently included in footnote 3. In particular, it would be helpful for the Board to provide examples of this computation as it would be applied to some real-life transactions.

In addition, we assume that in the context of derivatives, the computation of expected future loss would take into account all expected future cash flows, both positive and negative (that is, the reference to excluding gains would not extend to excluding interim positive cash flows).

Consolidation Based on Voting Interests

The Interpretation includes a number of different criteria to be applied in evaluating whether the voting interests of an SPE are appropriate so that the determination for consolidation can be based upon ownership of voting interests. We have the following comments.

The criteria for evaluation of an SPE based on voting interests does not include a requirement that equity must be issued in the legal form of equity in order for it to be considered sufficient. We believe this is appropriate for a model that is based on analyzing the substance of a transaction, as many SPEs do not issue equity in legal form but instead issue subordinated notes that function effectively the same as equity and that are sufficient to allow the SPE to finance its activities. We believe that the Board should avoid adding any requirement that equity be issued in legal form to be considered a sufficient and substantive equity investment for purposes of applying this model.

Paragraph 9(e) does not seem to allow an equity owner of a SPE to hold any other interest in the SPE. We support a notion that an equity owner must provide capital from a source outside of the SPE and cannot use fees or other payments from the SPE to fund the equity. We do not understand the rational for restricting an equity owner from holding other interests in the SPE. An equity owner that holds other SPE interests would need to evaluate if a controlling financial interest exists without holding a majority of voting interests.

Definition of Related Party
The variable interest model also requires a variable interest holder to consider variable interests held by related parties as its own interests for determining if they are the primary beneficiary. The ED expands the current definition of "related parties" as defined by Statement 57 to include "a party that has a *de facto* agency relationship with the entity as a result of providing significant amounts of professional services or similar business arrangements."

We agree with the Board that all related parties need to be identified and all variable interests should be evaluated as a single holding. However, as a participant in the financial services industry, we frequently transact business with a number of counterparties who might also hold variable interests in an SPE in which we invest, and do not agree with the implication that this type of ordinary business relationship could be construed to fall within the Interpretation's expanded definition of a related party relationship. We also question the validity of expanding related party to entities that provide significant amounts of professional services. For example, under this expanded definition of related parties a company's independent auditor could more than likely fall within this definition due to the level and significance of audit services provided.

Therefore, we recommend eliminating this aspect of the definition. We understand the Board's concern about related party relationships, but as an overall matter, we believe the Statement 57 definition appropriately identifies all related parties. If the Board believes that Statement 57 is not sufficient, we strongly recommend the Board identify any abuses or issues and appropriately address them as an amendment to Statement 57.

Market-Based Fees
Under the financial SPE consolidation model, contracts to provide services to a SPE are presumed *not* to be market-based, and it must be demonstrated that the fees are comparable to similar observable arm's length transactions or arrangements. If the fees cannot be demonstrated to be market-based, then an entity must evaluate the two other conditions specified in paragraph 23 to determine if it is required to consolidate the SPE.

We find it curious that the Board should establish a presumption. This would only appear to make sense if there was an underlying assumption that the fees were negotiated by and among related parties. Assuming the parties are not related, however, this presumption would seem to be invalid. For example, in the CDO market, a collateral manager negotiates its fees with independent investors who decide either to invest or not to invest in the SPE taking into account the amount of the fees charged by the collateral manager. How can this type of arm's-length negotiation between unrelated third parties be considered anything other than market-based?

In addition, many service providers can be removed by other participants in the SPE without cause. We believe that this provides a strong indication that the relationship between the service provider and other participants to the SPE is at arm's-length. A service provider that can be removed at any time without cause could hardly be said to have a controlling financial interest in an SPE. Accordingly, we recommend that the final Interpretation include this practice as one way of rebutting the presumption that fees are not market-based.

We also note that under the variable interest model, if the amount of a service provider's fee is variable and it can be demonstrated that the service provider "made a significant incremental investment in its own business in order to earn the fee, that investment also should be considered in determining if the enterprise has a variable interest." From a conceptual standpoint it is unclear why making an investment in infrastructure to generate revenue results in a variable interest in the SPE. We suggest that the Board provide either an example of what it intended or a rationale for this approach so that practitioners will be able to understand this requirement and apply it appropriately.

Application to Entities Subject to the Investment Company Act of 1940
As a participant in the mutual fund industry that provides investment management services to funds, it is not clear to us whether mutual funds registered under the Investment Company Act of 1940 ("40 Act Mutual Funds") are within the scope of the Proposal. Most mutual funds and many closed-end investment companies have no employees and their activities are generally performed by organizations other than the investment company itself, *i.e.*, an investment manager, transfer agent, administrator, custodian, and underwriter. Investment managers are typically compensated for services

based on a specified percentage of average net assets; compensation may also include a performance fee.

Under the current consolidation guidance, investment managers do not consolidate 40 Act Mutual Funds. We believe this is appropriate as investment managers manage the fund for the benefit of the investors and have a fiduciary responsibility to protect the interests of the investors. Additionally, the investment manager must be re-approved annually and continuation of an agreement beyond two years requires Board approval and potentially a shareholder vote.

We believe 40 Act Mutual Funds should be excluded from the scope of the Proposal. Mutual funds do not seem to be the type of entity with which the Board was concerned in describing the objective of the Proposal in paragraph B2 of the Proposal. These funds are not used to avoid reporting assets and liabilities or their related gains and losses; and while the investment manager has the responsibility for the management of the assets, its actions are pursuant to a specified investment policy and are for the benefit of the investors, the manager cannot gain access to the assets for its own use, and the manager can be replaced periodically. Accordingly, we recommend that the final Interpretation explicitly exclude these entities from the scope of its application.

Definition of Terms

Paragraph 7(a) of the Interpretation defines a substantive operating enterprise as an enterprise that conducts business operations other than those performed by the SPE, as having employees, and having sufficient equity to finance its operations without support from any other enterprise other than its owners. We are uncertain why the Board defined the enterprise as only having sufficient equity to finance operations. Sufficiently capitalized companies typically obtain operating capital through the appropriate mix of both equity and debt issuances. We believe the Board's concern is that the substantive enterprise have the ability to fund its operations and what they meant was it needed sufficient capital and did not intend to limit the evaluation to only equity. We would recommend that the Board change the requirement to *sufficient capital* and that this would encompass both debt and equity.

Disclosure Requirements

The Proposal would require non-primary beneficiaries that provide significant administrative services to SPEs, such as placing securities issued by an SPE, to disclose both qualitative and quantitative information regarding these SPEs (specifically, the purpose of the SPEs and the amount of assets and liabilities of the SPEs). We have significant concerns regarding this proposed requirement. We do not believe this information will be in any way meaningful to readers of financial statements in instances where an entity provides purely administrative services such as placing securities.

Placing securities is a service that is provided to the SPE at its inception and the placement agent typically has no continuing involvement with the SPE. The corollary of this requirement would be to require financial institutions to disclose similar information for all clients whose securities they either underwrite or privately place, information that surely would not be of interest to investors. Investors are concerned about any risks that arise in connection with an institution's business activities, and disclosures are already required pursuant to SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties,* if an entity's business is concentrated either with a particular customer or in a specific service or market, such that the entity may be exposed to significant risks as a result of these concentrations. Adding disclosures that do not provide relevant information to financial statement users unduly increases the amount of time and effort needed to prepare the financial statements and, more importantly, detracts from other, more useful information included in the financial statements. Accordingly, we urge the Board to eliminate this requirement.

Transition Provisions

We recognize that the issuance of new consolidation guidance for SPEs is considered by many to be a matter of the utmost urgency, and we therefore agree that the new guidance should be immediately effective for newly created SPEs upon issuance of a final Interpretation. However, we believe the implementation effort could prove to be quite extensive, in light of the large number of existing SPEs that must be analyzed, as well as the implementation requirements of a number of other related proposals which will likely go into effect early next year (Amendment of FAS 133 and related guidance, and Measurement and Disclosure regarding Guarantees by Guarantors). Accordingly, we urge the Board to consider delaying the effective date of the proposal for pre-existing SPEs to one year after the date a final Interpretation is issued. Assuming a final Interpretation is issued prior to the end of this year, we believe that the combination of an immediate effective date for newly created SPEs and an implementation date for existing SPEs by next year-end should strike an appropriate balance between the benefits of the new standard and the time required for implementation. A delay in the adoption of the Interpretation for existing SPEs should not trouble the Board, as public registrants are required under SAB 74 to report in MD&A the impact of adopting new accounting standards.

Roundtable Participation
Merrill Lynch has notified the Board of its interest in participating in the public roundtable discussions to discuss the Proposal. Our comment letter addresses the issues that are of greatest concern to us and which we believe should be addressed in order to produce a conceptually sound and practical model. We are very interested in participating in the roundtable, as we believe this would be an effective and productive forum for further elaborating on our comments on the proposal as well as exchanging views with the Board and with other interested constituents.

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We thank you for the opportunity to comment on this Proposal. Please do not hesitate to contact me at 212-449-2048 with any questions on our comments.

Sincerely,

/s/ Esther Mills

First Vice President