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Ms. Suzanne Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
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Letter of Comment No: 92
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By e-mail to director@fasb.org

Subject: **Exposure Draft of "Consolidation of Certain Special-Purpose Entities, an Interpretation of ARB No. 51"**

Dear Ms. Bielstein,

Marsh & McLennan Companies, Inc. and its subsidiary Putnam Investments, (collectively referred to as, "MMC") appreciates the opportunity to comment to the Financial Accounting Standards Board's June 28, 2002 Exposure Draft of its Proposed Interpretation "Consolidation of Certain Special-Purpose Entities, an interpretation of ARB No. 51" (the "Exposure Draft"). MMC has decided to comment because of our concerns regarding the potential impact the Exposure Draft could have on collateralized debt obligation transactions ("CDOs"). MMC through its subsidiary, Putnam Investments, is as an investment advisor or an investment manager to several CDOs. MMC supports the need to improve current U.S. GAAP guidance on consolidation of special-purpose entities ("SPEs"). However, there are certain aspects of the current Exposure Draft that we believe could have unintended adverse effects on companies involved in CDO structures.

CDOs take financial assets purchased in the open market (e.g. corporate bonds or bank loan participations), distill the resulting portfolio's risks and rewards characteristics into two or more distinct classes (represented by bonds entitled to different tranches of cash flows), and allocate those distinct classes of risks and rewards to different investors according to their particular desired investment objectives. CDOs have an investment manager who manages the CDO's asset portfolio in accordance with guidelines agreed to by all the investors at the outset. The investment manager's fees for this service are usually a small fixed percentage of the portfolio under management (e.g. 0.10% to 0.15% per annum) and may also include a similarly sized incentive fee paid only if portfolio performance meets a set standard. Both the portfolio management activities and the overall management fee structure are similar to those for the portfolio management of other investment products, such as certain investment companies and funds. Various other parties participate in a CDO transaction as arrangers, as debt placement

agents and as derivative counterparties, among others. Each of these participants receives fees or compensation for their role also.

Securitization transactions generally, and CDOs in particular, rearrange the risks and rewards relating to their assets into new, distinct components held by multiple parties. The activities of the SPEs in these transactions are governed by consensus. Initially, all the participants agree on the nature and scope of the SPEs' activities and the instructions given to the agent entrusted with their execution. Each new participant "votes with their wallet" and ratifies that consensus when they choose to invest in a security or otherwise join the transaction. The nature and scope of activities can be changed, based on a new consensus of the participants (which may require unanimous consent or at a minimum, consent of more than a simple majority of a single class of participants). In addition, control of such SPEs is predetermined based on the creation of managing agreements and generally, no one entity has the ability to direct all or a majority of the significant activities of such SPEs.

We agree with the Board's stated belief in "Summary – Differences between this Proposed Interpretation and Current Practice":

> "The Board believes that this proposed Interpretation would require existing unconsolidated SPEs to be consolidated by primary beneficiaries if they do not effectively disperse risks among parties involved. SPEs that effectively disperse risks would not be consolidated unless a single party holds an interest or combination of interests that effectively recombines risks that were previously dispersed."

We believe that the interpretation as proposed in the Exposure Draft does not reflect this principle. To require the consolidation of the assets and liabilities of such an SPE with an agent or other holder of less than a majority risks and rewards of a portfolio will not accomplish the goal of improving financial reporting. While even the holder of a majority of the risks and rewards may not have a controlling interest (because of the requirement for consensus management), we would support consolidation of an SPE in that case because of the significance of that party's economic interests. Consolidation in other cases, including many resulting from application of the interpretation as proposed in the Exposure Draft, would, in fact, create misleading financial statements.

Below are three primary issues that we believe warrant revisions or clarifications of the Exposure Draft to ensure that participants in SPEs used in risk-dispersing activities with non-recourse transactions, such as CDOs, will clearly be excluded from potential consolidation under the proposed standard.

Issue 1: *Limited Purchase and Sale Authority.*

As noted above, in a typical CDO transaction, the investment manager's responsibilities include managing the collateral or asset in the CDO based on the rules or guidelines established initially. We are concerned that some would consider this function performed by the investment manager to meet the current definition in Paragraph 23(a) of the Exposure Draft relating an entity's ability to have purchase and sale authority of assets on behalf of the CDO SPE. We believe that limited discretion exercised under detailed instructions does not provide the unilateral control that Paragraph 23(a) should address. Therefore, that criterion should be clarified to distinguish between situations with broad discretion and limited discretion. The focus on revenues, expenses, gains and losses is not useful in this regard, since it focuses on the subsequent outcome of the decision.

Issue 2: *Financial Support Provided to an SPE*

Paragraph B15 of the Exposure Draft states:

> "The Board reasoned that providers of financial support to an SPE would be expected to have risks and opportunities to benefit (risks and rewards) that are of the same character as those of an equity investor. At the same time, they arrange to protect their investment through means other than ownership of voting shares. Effectively, the providers of financial support are in the same position as parents in a conventional parent-subsidiary relationship, except that the mechanism that establishes the relationship is different. The Board concluded that the assets, liabilities, and results of activities of an SPE and its financial support provider (primary beneficiary) should be included in consolidated financial statements."

We believe that the conventional parent-subsidiary relationship involves both significant, unilateral control, including the discretion to invest more resources in the subsidiary or to withdraw resources from the subsidiary. These characteristics are not present in the typical relationship between a participant and an SPE, and certainly not in an investment in or management agreement with a CDO. A contingent obligation to an SPE, such as in the form of a

credit guarantee or derivative, might involve a non-discretionary provision of additional assets to an SPE. While we believe that even this represents a fundamentally different relationship than that of parent and subsidiary, we would support considering these situations in the consolidation framework for SPEs, including risk dispersing ones. However, we do not believe that a fixed and fully funded financial investment, even a subordinated one, in a risk dispersing SPE is similar to an equity investment by a parent in a subsidiary. Rather, it is a separate asset with its own distinct characteristics that should be accounted for by the holder based on those characteristics (i.e. as a security classified as appropriate under SFAS 115). Therefore we believe that Paragraph 23(b) should be revised to clearly indicate that an SPE participant should consider consolidation only for positions where the participant's maximum risk of loss exceeds amounts recorded on its balance sheet.

***Issue 3**. Evidence of Market Based Fees*

The Exposure Draft proposes a presumption that fees for services to an SPE be considered non-market based fees unless such fees can be demonstrated to be comparable to fees in similar observable arm's length transactions or arrangements. We believe that this presumption is inconsistent with the basic notion of what constitutes a market based fee – that is, those that are negotiated at arm's length by two independent principals acting for their own account under competitive conditions. The Exposure Draft's proposed basic standard is entirely consistent with other common accounting definitions of fair value and market value, such as expressed in Paragraph 540 of SFAS 133 as "amounts at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale." We cannot understand why the Board would specifically reject an actual transaction that is both more current and more relevant in favor of less relevant and elusive evidence elsewhere. We think that this is a particular problem for SPE transactions, including CDOs, because by their very nature, they are often private and "similar observable transactions" may be difficult to find and verify, because among other reasons, market conditions may change from time to time. We believe the current draft could cause a person to conclude that fees received by an innovator providing a new service, one that by definition lacks a comparable, be considered non-market based.

We believe that the interaction of Paragraph 19 with Paragraph 23(c) is confusing, because Paragraph 19 also deals with that subset of market-based fees that are also variable interests. Paragraph 23(c) should be revised to make clear that all market-based fees, whether or not they are variable interests, are excluded.

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MMC supports the issuance of a final interpretation to improve financial reporting around SPEs. We believe that the Exposure Draft, if adopted in its current form, would not be an improvement. Among other things, it would require many SPEs used in typical CDOs to be consolidated with a large minority investor and/or the collateral manager. We believe that those results would be misleading and distort information reported in the consolidated financial statements. For example, creditors of an entity consolidating a CDO SPE would have no claim to the assets of the CDO SPE and the consolidating entity has no current or future obligation with respect to the liabilities or equity instruments issued by the CDO SPE. The effect of such a consolidation would have a corollary adverse effect on certain key ratios of the consolidating entity. The consolidator's debt to equity ratio would be adversely affected without any true change in the entity's financial condition or risk profile.

We thank the FASB for the opportunity to comment on the Exposure Draft. We would also like to participate in the planned round-table discussion scheduled for September 30, 2002. If you have any questions on our comments before then, please feel free to contact James Mench, Assistant Controller, Financial Reporting at (212) 345-5877 or James.Mench@mmc.com.

Sincerely,

Signed by Robert J. Rapport

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