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Frank T. Vayda
First Vice President
Director
Financial Reporting

Finance

World Financial Center North Tower New York, New York 10281-1331 212 449 3308 FAX 212 449 8720

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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

Re: File Reference 154-D

Dear Mr. Lucas:

Merrill Lynch

Thank you for the opportunity to comment on the Board's proposed statement, Consolidated Financial Statements: Policy and Procedures. We support the Board's efforts to establish standards for consolidated financial statements to make them more consistent and meaningful. Comments on the exposure draft for your consideration follow.

Scope (paragraph 4)

This paragraph provides an exception to this proposed standard for "...entities that...carry substantially all of their assets...and liabilities at fair value...". We believe that the term "substantially all" lacks the necessary precision to prevent inconsistent interpretation. Accordingly, we suggest that the final standard include clarification of this term. For instance, a broker/dealer carries essentially all of its financial assets at fair value or amounts approximating fair value, but is not specifically mentioned as being exempt from this statement. We believe that the final statement should include an exemption which encompasses entities which carry substantially all of their <u>financial</u> assets and liabilities, <u>except long-term debt</u>, at fair value <u>or amounts approximating fair value</u>. This would provide the exemption for entities which carry their financial assets and liabilities at fair value or amounts approximating fair value but continue to report their property, plant and equipment and long-term debt at historical cost in accordance with GAAP.

In addition, we believe that clarification is needed for instances in which a reporting entity has an investment in another entity that is exempt under this paragraph, and that exempt entity has an investment in a controlled entity. The final statement should clarify whether the reporting entity must "look through" the exempt entity and consolidate the exempt entity's controlled entity.



Special Purpose Entities (paragraph 14d)

This paragraph seems to only address special purpose entities that do not have voting rights. Some special purpose entities have voting rights for limited management matters that are only invoked under special or non-recurring circumstances, such as removing a sponsor or vendor for cause, or to deal with other unforeseen matters. Since typically these voting rights are limited in nature and rarely invoked, the final statement should provide guidance on the applicability of this paragraph to those types of situations.

Asset securitization vehicles, by their nature, are limited to activities scheduled by its sponsor, often the seller of the assets to the vehicle. Typically investors in the vehicle are given voting rights only for limited management matters since active management of the vehicle is not necessary. We find the terms of paragraph 14(d) difficult to apply to asset securitization vehicles for several reasons. First, we believe that the term "substantially all future net cash inflows or other future economic benefits" can be interpreted differently and, as such, should be clarified in the final statement (see Attachment I for further detail). Second, we believe that the <u>ongoing</u> power to direct the use of the assets of the securitization vehicle must be considered in the final statement, in addition to the receipt of a certain amount of net cash inflow or economic benefit.

Notwithstanding the criteria in paragraph 14(d), we are unclear as to the interplay between paragraph 14(d) and paragraph 9(a) of the exposure draft on Transfers and Servicing of Financial Assets and Extinguishment of Liabilities for either the seller of assets or the sponsor of an asset securitization special purpose vehicle. For instance, a conservative interpretation of paragraph 14(d) of the consolidations exposure draft would require consolidation of a special purpose vehicle in which the sale of assets to the vehicle may have met the sale requirements of paragraph 9(a). Such consolidation would negate the sale. Each of the final statements should provide guidance that is consistent.

General Partners in Limited Partnerships (paragraph 14f)

It appears that a presumption has been made that a general partner automatically has "control" over the assets of a limited partnership. There are instances, particularly in a facilitation to customers, where the general partner acts solely as an administrator, investment manager, or trustee. The general partner, for example, may "control" the assets of the limited partnership, but not control them in the same way that it can use its own assets or to achieve substantial economic benefits beyond what is contractually determined at the origination of the transaction. Fiduciary responsibilities and contractual obligations compel general partners in limited partnerships to act in the best interests of



the limited partners. If the general partner were to act in its own self-interest, it would violate these duties.

In many instances, in accordance with the partnership agreement, the general partner only receives its proportionate share of the economic benefits/risks. The general partner is also unable to change the partnership agreement to increase its level of control or economic benefit. Very often, the general partner's potential loss is limited to its capital by the partnership agreement. In addition, the partnership's creditors only have recourse to the underlying assets of the partnership. As such, in these types of situations, not consolidating the investee entity more clearly reflects the economic reality and substance of these types of transactions and recognizes how this type of business is actually done.

Typically, a general partner (GP) has a 1% interest in the limited partnerships. Applying the provisions of paragraph 14(f) in this circumstance would require grossing up the balance sheet with assets which bear no resemblance to those of the GP and with liabilities (probably of a much different credit quality) for which the GP has no responsibility. The stockholders' equity section of the balance sheet would increase, containing a minority interest equal to 99% of the net assets consolidated. The investor's key ratios, such as return on assets, return on equity, and leverage ratios, would be distorted. Finally, incorporating the investee's cash flows would also create confusion because the GP has neither the intention or the ability to use them.

Accordingly, we strongly believe that the final statement should provide exemptive provisions that would not require the consolidation of an investment as a general partner in a limited partnership where the general partner's:

- position and profits are determined by an agreement which it may not change unilaterally.
- potential loss is limited to its investment.
- ability to use cash flows or assets for non-partnership purposes is precluded.
- liability for partnership debt is limited because the creditors only have recourse to the underlying assets of the partnership.

Merchant Banking Investments (paragraphs 10, 14 and 16)

Merchant banking or venture capital investments are those in which an investor (individual or fund) makes a substantive investment (through debt and/or equity) in an entity, often a start-up or rapidly expanding business, to finance its new or expanding business. The primary investment objective is to achieve capital gains. This investment approach is specifically designed to provide the investee entity the opportunity to plan and effect a



strategy that maximizes value. The merchant bank or venture capital investor typically has a role on the Board of Directors, but generally only monitors the direction that the entity's management has taken in order to protect its investment. The investor's own business is typically very different from the entity's business such that the investor has no expertise in the entity's business, and thus the monitoring of management is merely an oversight function to protect its investment.

Although the technical control requirements of paragraph 14 may have been met, the "controlled" investment is primarily passive (there is no intention to operate or manage the business on a day-to-day basis. While paragraph 10 specifically states that electing not to exercise control does not reduce the investor's status as a controlling entity, we disagree because the investor's stated business is to be a passive investor, not an operator. To prepare its financial statements as if it were an operating entity is misleading. While the investor may have this power, the investor makes the deliberate, conscious decision not to exercise this power since it does not intend to operate or manage that entity but rather intends to divest the investment at a later date.

Paragraph 16 would consider an investment "temporary" if there is a plan to divest within one year with certain limited exceptions. The merchant bank or venture capital investor typically intends to divest its investment at the point in time which would maximize its investment return. This would normally exceed one year because the investee entity is either in a "start-up" or "turnaround" phase. Thus, the one-year time frame proposed in the exposure draft completely ignores the normal operating or life cycle of the merchant banking business.

Accordingly, we strongly believe that the final statement should provide exemptive provisions that would not require a merchant banker or venture capitalist to consolidate a "controlled" investment when the investor:

- has the unequivocal and demonstrable intention to divest after some elapsed time, even if greater than one year from date of investment.
- has no intention of operating or managing the investee's business or using the investee's cash flows or assets.
- will rely on investee management to prepare the business plans and strategies and operate and develop the business.
- has as its primary objective capital appreciation.
- limits its participation to capital infusion(s).
- will only exercise general, senior-level oversight and supervision.

We do not believe that it is appropriate to fair value these investments through income or directly through equity. To do so would subject the financial statements to volatile and



temporary earnings or equity fluctuations that are typical in these cases. Using fair values for these investments would require the use in the financial statements of highly subjective "market" values caused by, among other things, the illiquidity of or restrictions on the disposal of many of these investments. Fair value disclosures in the footnotes contains sufficient information for financial statement users who are interested.

We further believe that consolidation is inappropriate for merchant banking investments because of the significant period-to-period and/or investment-to-investment inconsistencies it would create. These types of "controlled" investments would have to be consolidated when bought and deconsolidated when sold in the next few years. Additionally, since some merchant banking investments may not be "controlled" while others are "controlled", some would be consolidated while others would not. This situation certainly would not be helpful to understanding the comparability of the financial statements.

Accordingly, we believe, and strongly recommend, that the final statement should require reporting merchant banking or venture capital investments that meet the above criteria at historical cost, adjusted downward through income for any other than temporary impairment in value, rather than consolidating them. It should also require the disclosure of the investments' fair value, where determinable. For these types of investments, this solution would reflect the investor's objectives of acting as a passive holder and divesting in the foreseeable future.

Conforming Accounting Methods (paragraph 31)

This paragraph requires that accounting methods which are acceptable GAAP for a subsidiary (due to specialized industry practices) but not acceptable for the reporting entity be conformed to the accounting methods of the reporting entity. This proposal seems to vastly oversimplify and minimize the potential impact of a series of highly complex concepts, and we would urge the FASB not to include such a requirement in the final statement without a thorough analysis of its implications across all industries.

An example of such impact is a broker/dealer owned by another type of entity. A broker/dealer is specifically exempt from SFAS 115 since it carries its investments at fair value with changes in fair value reflected in income, while other entities account for investments in accordance with SFAS 115. The classification of trading inventory for a broker/dealer is not necessarily analogous to investments held for trading purposes under SFAS 115, and thus conformance of accounting methods is not a simple task and does not appear to serve a valid purpose.



Leasing Transactions

As an arranger of and/or investor in many complex leasing transactions, we are concerned with the guidance in Example 5 of Appendix B. Due to time constraints, we have not completed our analysis of the related issues. Shortly, we will forward to you, as Attachment II to this letter, a comprehensive summary of those issues and our specific concerns.

Nevertheless, the following is a brief summary of the matters we have identified to date:

- The proposed guidance appears to rest on a premise that lessees create special purpose leasing entities and are their primary beneficiaries.
- The proposed guidance contradicts the well-reasoned guidance of paragraph 82 of SFAS 13.
- The scope of transactions covered by the proposed guidance should be clarified since all lease agreements, by definition, provide the lessee with "control".
- The proposed retroactive transition requirements would impose a significant burden on lessees.

We look forward to discussing these and other matters with you further at the public hearings on February 20 and 21. In the meantime, if you have any questions please contact Sharyn Handelsman at (212) 236-6356 or me.

Frank T. Vayda

Yours truly,

Director, Corporate Reporting

Frank O. Vayde

EXAMPLES OF ASSET SECURITIZATIONS

Example 1

A special purpose entity, created and administered by a financial institution (the "administrator"), is established to finance financial assets originated by a third party (the "originator") and transferred to the special purpose entity. The special purpose entity incurs finance charges and pays fees to the administrator; all excess cash flows from the financial assets (to the extent not required by the financing) flow back to the originator of the assets. In this instance, the originator should not be required to consolidate the special purpose entity. Nevertheless, we do not believe that paragraph 14(d) should be interpreted as all excess cash flows should be considered "substantially all net cash inflows".

Example 2

A special purpose trust is formed where all the effective control over the trust's operations rests with noteholders. These trusts are typically administered by a trustee and custodian who transact trust activities pursuant to the trust agreement. The trustee and custodian can only be replaced by a vote of the noteholders, which is one measure of control. These types of transactions may also have a residual interest that will receive all excess cash flows. While the holder of the "residual" or "collateral" interest may be classified as the legal owner of the trust, "effective control" rests with the noteholders. Nevertheless, similar to example 1, we do not believe that paragraph 14(d) clearly relieves the residual interest holder of a requirement to consolidate.

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Some variations in asset securitizations that should be considered in developing guidance for the final statement include:

- The seller of the assets, the servicer of the assets, and the sponsor of the special purpose vehicle may be the same entity or different entities. There may also be multiple sellers in a given structure.
- Excess cash flows, as described above, may be comprised of a normal servicing fee and/or all excess servicing income after payment of a normal servicing fee and/or excess collateral after noteholders have been repaid at maturity. Excess servicing income may not exist in some securitizations, and the holder of the residual or excess collateral interest may be a third party who is being compensated for its credit enhancement of the structure.
- Noteholders often have voting rights in limited management matters, as discussed in the body of the response.
- A special purpose entity or trust may issue certificates of beneficial interest in the underlying assets (an equity instrument) rather than notes or other debt instruments.
- A bankruptcy-remote entity may be either the special purpose entity financing the assets or the seller of the financial assets.