August 29, 2002

Director of Major Products and Technical Activities
File Reference No. 1082-200
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
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RE: File Reference No. 1082-200
Exposure Draft on consolidation of Certain Special-Purpose Entities,
A Proposed Interpretation of ARB No. 51

Deerfield Capital Management (Deerfield) is a Chicago-based institutional investment advisor specializing in Collateralized Debt Obligations (CDOs) and hedge funds. We are a SEC-registered investment advisor and a commodity pool operator and trading advisor registered with the CFTC. We are pleased to have the opportunity to respond to the above referenced Exposure Draft, 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 special-purpose entities (SPEs) and fully support the Board's objective of improving financial reporting by enterprises involved with SPEs. 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 $6 billion of CDO assets. It is our 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. The current Exposure Draft does not provide for guidance in identifying SPEs that effectively disperse risks, and thus do not warrant consolidation.

The Board has stated that it believes that if a business enterprise has a controlling financial interest in an SPE, the assets, liabilities, and results of the activities of the SPE should be included in consolidated financial statements with those of the business enterprise. We cannot argue with this position, however, we feel that serious consideration needs to be given to the definition of "controlling financial interest". The proposed definition of "variable interest" is very broad and includes just about anyone who has conducted any sort of transaction with an SPE. That combined with the concepts of "risk of first loss" (i.e. what if a holder has risk of first loss, but total exposure is very small relative to others?), "expected future losses" (very subjective and volatile) and terms like "significant" and "significantly more" can lead to entities making consolidation decisions that are not reflective of economic reality and will result in financial statements that are anything but transparent. The proposed guidance will result in some cases in the Primary Beneficiary, as defined, consolidating assets that it has absolutely
no rights to and liabilities that it has no obligation for. Consolidating these assets and liabilities will in many cases lead to financial statements that will be confusing and misleading to the users. We have attempted to identify these situations and propose some suggested alternatives. There are certain situations where enhanced disclosure requirements would achieve the Board’s objective “to improve financial reporting by enterprises involved with SPEs”, which we will highlight below.

Our comments will focus on the criteria surrounding consolidation based on voting interests, determination of the primary beneficiary, financial SPEs and the effective date and transition.

**Consolidation Based on Voting Interests**

It is currently unclear how to apply the scope exception in paragraph 8c. for subsidiaries that are being consolidated by a substantive operating enterprise and the criteria in paragraph 9 that need to be present to qualify for consolidation based on voting interests. What is the definition of a “subsidiary” or a “portion of a substantive operating enterprise (SOE)” and how do you reach the conclusion to consolidate a subsidiary or portion of an SOE without first considering the criteria in paragraph 9?

Paragraph 9a. requires the nominal owner(s) to have voting rights or similar rights that convey the current ability to make decisions and manage the SPE’s activities. It is common in CDO structures for the equity owners to share voting rights with a senior debt class or insurance provider. The equity holders have all the residual risks and rewards of the assets and also participate in decisions. These two criteria together would seem to meet the definition of a controlling voting interest. Is it the Board’s intention to automatically require consolidation based on variable interests in these types of situations, even if all the other criteria of Paragraph 9 are met? It would seem appropriate for these types of structures to consolidate based on voting interests versus variable interests.

Paragraph 9b provides criteria for the sufficiency of the equity investment with a rebuttable 10% threshold. The current guidance leaves too much subjectivity to a very integral component of the consolidation conclusion. We would encourage the Board to provide for a bright-line threshold here, otherwise there will be widespread variability in its application and diversity in what is deemed to be sufficient evidence to support something less than or greater than 10%. Additionally, the implications of this point are magnified by the requirement to evaluate the sufficiency of the equity “at all times during the SPE’s existence”.

The requirement to evaluate all of the criteria provided for in the Exposure Draft at each reporting date assumes availability of consistent information to each investor (different assumptions could lead to very different consolidation rationale and decisions between investors). Also, is it reasonable to impose the requirement that the SPE is not consolidated as long as its performance meets original expectations (and thus has sufficient capital) but if performance is below original expectations and future losses are greater than originally anticipated, at a time when performance is negative, someone then has to consolidate the SPE? Once the equity is gone, would the most subordinate debt holder have to consolidate (assuming no other variable interest holders)? In the absence of an ownership of a majority of the voting interests, fair value accounting by the debt and equity holders seems to be much more representative of the economics and risks to the investors. Consolidation of a failing CDO first by the primary equity holder and then later, if loss expectations increase, by the primary debt holder, does not seem to accomplish the intended objectives and will result in financial information that is not comparable (due to initial years not consolidated, then a year
of consolidation, only to be deconsolidated by someone if loss estimates increase...). Most
users of financial statements will not comprehend why these assets and liabilities were
consolidated/deconsolidated over the life of the investment. Also, if an investor's ultimate
exposure is limited to the amount of its original investment, introducing periods of
consolidation and or deconsolidation will confuse the true amount of risk involved.
Accounting for the investment at its estimated fair value would clearly demonstrate the
amount of risk involved and not unduly confuse the issue. We suggest the Board consider
providing guidance for making the sufficient equity determination at inception only (absent
some significant change in its capital structure) and requiring enhanced disclosure for all
variable interest holders with respect to the purpose of the SPE, the total assets and liabilities
of the SPE, the nature of its variable interest in the SPE and the risk involved, including
valuation assumptions and sensitivities (if applicable). This would provide a clearer picture of
the risks involved to the users of the financial statements versus future
consolidation/deconsolidation.

Paragraph 9e. prohibits the equity investment from being provided directly or indirectly by the
SPE or other parties with variable interests in the SPE. We do not understand the rationale
for this requirement. If any of the equity (regardless of significance) is owned by a variable
interest holder (i.e. a debt holder), would you automatically fail the criteria for consolidation
based on voting interests? We recommend for this requirement to be removed, as it does
not appear justified. Another suggested alternative would be to disregard any portion of
equity that is guaranteed, provided by or financed directly or indirectly by the SPE or other
parties with variable interests from the “sufficient equity” test.

**Determination of Primary Beneficiary – Variable Interest Approach**

We strongly support a risk/reward model for determining the Primary Beneficiary. The
proposed guidance states that the relative size of variable interests shall be determined by
comparing expected future losses from the interests. We feel it is also important to consider
the benefits and potential upside in quantifying variable interests. In most situations the risk
will be directly correlated to the benefits, but there are situations where an entity may be
subject to the risk of first loss without having the most significant portion of the benefits. We
believe that to warrant consolidation a party must have a significant portion of the benefits as
well as the risks involved. In Paragraph 7b, variable interests are defined as the means
through which financial support is provided to an SPE and through which the providers gain
or lose from activities and events that change the values of the SPE’s assets and liabilities.
By the very definition of variable interests, it would seem appropriate to evaluate the extent of
the gains as well as the losses.

**Size Requirement** - If more than one party has variable interests in the SPE, Paragraph 13c.
states that the party whose interest is significant and significantly more than any other party is
the Primary Beneficiary. This is a highly subjective criterion, which will lead to inconsistent
interpretation and practice. The complexity in applying this criterion is further magnified by
the types of interests that may be viewed as variable interests (i.e. derivative counterparties
and service providers) which are not easily quantified (see comment below regarding
quantifying the variable interest of a service provider). We recommend that the Board
consider requiring the Primary Beneficiary to hold a *majority* of the variable interests. This will
support and clarify the definition of a “controlling financial interest” and reduce the amount of
subjectivity involved. Without a majority requirement, the Board is imposing a more stringent
standard on SPEs than non-SPEs, when in reality a holder of a significant but non-majority
investment in a non-SPE will most likely have more influence and control than a holder with
the relatively same sized investment in an SPE. For example, consider a significant but non-majority investor in the most subordinated debt tranche of a CDO (Investor A). This investor really has no control or influence over the activities of the CDO and its return on its investment is capped at a stated return. However, the voting rights of a significant non-majority holder of voting stock in a SOF (Investor B) may very well have influence over the actions of the Board of Directors in addition to having unlimited upside. Under the proposed rules, Investor A may have to consolidate its investment whereas Investor B does not. It is difficult to see the justification for this result. Acknowledging that due to the nature of SPEs, the determination of a controlling financial interest should not be based on voting rights alone and that a variable interest approach is more appropriate, what is the justification for the more stringent standard applied to the level of variable interests vs. voting rights? For these reasons, we encourage the Board to consider defining the Primary Beneficiary to be the holder of the majority of the variable interests. If no one has a majority, then the risks and rewards should be assumed to have been effectively dispersed unless a de-facto controlling financial interest exists through other means (other than holding a majority of the variable interests), based on the specific facts and circumstances, which should be evaluated in all circumstances.

This criterion also poses major operational challenges because it may be difficult or impossible to ascertain the investments of other parties involved in an SPE in order to make the "significant" or "significantly more" assessment. Additionally, we believe that there is little conceptual basis for one enterprise to change its consolidation conclusion based on the actions of an unrelated enterprise. This is explained more fully in the Continuous Assessment section below.

If the Board is not comfortable with consolidation by the majority variable interest holder (absent a de-facto controlling financial interest), we recommend that the Board consider whether equity-method accounting would be an acceptable alternative where the investor is at or near a defined consolidation threshold.

Continuous Assessment – The Exposure Draft states, "All factors shall be reconsidered at each reporting date using all evidence that the enterprise possesses or would reasonably be expected to possess." Building on the previous comment regarding Paragraph 9 and sufficient equity, variable interest holders in CDO's may not have access to the information necessary to continually assess who the primary beneficiary is. Identification of the primary beneficiary may be possible at the inception of a deal, but as equity holders transfer their interests and develop their own loss assumptions, this will become more difficult to determine and monitor. Consider a CDO with three equity holders, each with equal interests. Holder A who believed they had equal variable interests with Holders B and C would not be privy to what Holders B and C choose to do with their investment. If Holders B and C each sell 50% of their investment, Holder A would unknowingly be the primary beneficiary (assuming A would have significantly more variable interests than other parties). What has changed in the structure or risk profile of the SPE to cause Holder A to suddenly acquire a controlling financial interest? They do not have any more control than they previously had and there was no change in the amount of support they provide to the CDO. Additionally, Holder A most likely would have no knowledge of the transfers. For privacy reasons, Trustees and Share Registrars do not share information concerning other equity holders. Additionally, Paragraph 16a states that only a party that is a substantive operating enterprise can be a primary beneficiary. It is not uncommon for high net worth individuals to invest in CDO equity through trusts. No one is in the position of continuously evaluating whether the equity holders are substantive operating enterprises. If high-worth individual A owns 70% of the variable
interests, does this mean that a corporate investor who owns 30% would have to consolidate (assuming its 30% equity ownership was significantly more than any other variable interests)? If we are basing the consolidation decision on who has a controlling financial interest, whether or not that party is a SOE or an individual should not impact the conclusion. The proposed guidance is reliant on information regarding ownership as well as other relationships of unaffiliated parties being readily available. What if one party becomes privy to information not available to others, allowing them to arrive at a more informed conclusion different from the conclusions reached by other parties? Such a significant determination cannot be dependent on the preparer's knowledge of the identity, investments, agreements, assumptions and actions of independent third parties involved with the same SPE.

Also, the ongoing consideration of the Primary Beneficiary can be complex and require judgment, which may produce different answers among the variable interest holders, who will not be in communication with one another. Different investors may have different assumptions surrounding "expected future losses," which can lead to dramatically different answers. Assume a $500 million CDO has $10 million in equity (Equity A=$6 million/Equity B $4 million) and $490 in debt, including a $25 million bottom debt tranche (Debt A=$20 million and Debt B=$5 million). These investors do not communicate and assume no changes to the original beneficial interest holders. Consider a simplified example where Equity A estimates losses at $20 million, resulting in the following exposures: Equity A=$6 million; Equity B=$4 million; Debt A=$8 million; Debt B=$2 million. Equity A says Debt A should be consolidating. However, Debt A estimates losses at $16 million, resulting in the following exposures: Equity A=$6 million; Equity B=$4 million; Debt A=$4.8 million; Debt B=$1.2 million, resulting in Equity A consolidating. Each investor can point to someone else and no one consolidates. (It is not clear whether once expected future losses exceed the level of equity, the Primary Beneficiary determination excludes the equity holders and is made between the subordinate debt holders. We have come across this interpretation but do not believe this was the Board's intent). The proposed interpretation may lead to no consolidation or double-consolidation due to the level of judgment involved in the consolidation conclusion. Additionally, under the proposed guidance, the Primary Beneficiary may change simply due to the level of expected losses, which seems to lead to an undesirable result (consolidation and deconsolidation by multiple parties) which will actually reduce the transparency the Board is trying to achieve. The determination of who has a controlling financial interest and the consolidation conclusion should not change due to the level of losses incurred by the SPE. Again, we encourage the Board to consider making the determination of the primary beneficiary at inception and requiring enhanced disclosure by all variable interest holders throughout the life of the variable interest. If the disclosures include a description of the purpose of the SPE, total assets and liabilities of the SPE, the nature of the variable interest, the risk involved, and valuation assumptions and sensitivity tests (if applicable) this would provide a framework for users of financial statements to understand the true risk involved. Another suggestion would be to only require reassessment of the Primary Beneficiary if there has been a significant change in the quality or quantity of the variable interests, excluding GAAP losses.

Market-Based Fees - Due to the many different fee structures common in the CDO industry, the market based fee determination will be difficult to apply. If a collateral manager subordinates its fee, it may negotiate additional upside potential. Each fee structure is unique based on the effort involved (investment strategy), experience and reputation of the manager, and the risks undertaken. It will be difficult to demonstrate that a fee is comparable to other fees in similar observable arrangements, due to the uniqueness of fee structures. However, we would argue that by their very nature the fees are competitive in that investors are not
going to invest if they do not believe that they are paying competitive fees commensurate with the services provided and the risks involved. Fees are contractual and disclosed in the offering memorandum, thereby being negotiated between the manager, investment banker and investors.

The guidance in determining whether a fee is market based seems contradictory. Paragraph 18 defines variable interests as interests that are "generally subject the holder to a risk of losing an investment in the SPE or incurring a loss as a result of a contingent obligation to transfer assets or issue securities to the SPE." Paragraph 19 further states that a market-based fee is not a variable interest unless the holder has an investment at risk or can be required in certain circumstances to transfer assets or issue its own equity or debt instruments to the SPE or a party with an interest in the SPE. Paragraph 19 first defines market-based fees as being negotiated at arm's length under competitive conditions but then in another sentence says the fee shall be presumed to be not market-based unless it can be demonstrated to be comparable to fees in similar observable arm's length transactions or arrangements. These two sentences say two completely different things. Other comparable fees in the marketplace should be one method of assessing whether a fee is market-based, but it seems unreasonable to make that an absolute standard. Assuming that a comparable fee structure does not exist in the marketplace, why would a fee that fails to meet the market-based standard (as defined) earned by a holder who does not have an investment at risk or can not be required to transfer assets or issue its own equity or debt instruments to the SPE result in a variable interest (as defined in paragraph 18)? It would seem that the determining factor in identifying a variable interest should be based on whether the holder is at risk of losing an investment in the SPE or incurring a loss as a result of a contingent obligation to transfer assets or issue securities to the SPE. The non-market based fee concept unduly complicates the consolidation issue. EITF Issue No. 97-2 already provides useful guidance for determining when a manager may control another entity by contract and should consolidate the entity. We suggest referring to this guidance in determining whether a service provider has a variable interest. The proposed guidance surrounding market-based fees will have anti-competitive results in the marketplace and may result in inappropriate consolidation by an entity that is not at risk of losing an investment or incurring a loss. Additionally, whether or not a fee is market-based should be determined only at the inception of the deal, as the market is likely to change, which should not have an impact on the consolidation conclusion.

Another complexity surrounding management contracts viewed as variable interests is how to quantify the amount of the variable interest. Paragraph 20 states, "The relative size of variable interests shall be determined by comparing expected future losses from the interests." For a collateral manager, what is the basis for quantifying its variable interest? Is it the upfront incremental investment referenced in Paragraph 19? Do you consider the ongoing investment made in the services provided to the CDO (time/salaries)? Should you consider potential future fees that may never be earned due to their subordination? Assume the following facts surrounding a collateral manager:

A) Allocated incremental investment in systems and support: $.5 million
B) Annual Allocation of Portfolio Manager Salaries: $.75 million
C) Annual Senior Fees: $1 million
D) Annual Estimated Subordinated fees: $1 million
E) Estimated Incentive fees: $.5 - $1 million (estimate of min/max)
For simplicity sake, let's assume this is a one-year CDO, because multiple years greatly add to the complexity. Is the collateral manager's variable interest:

A) $.5 million of incremental investment in its business
B) $1.25 million of incremental investment and salaries
C) $0.25 million, net of incremental investment, salaries and senior fees (net loss).
D) $2.0 million of potential subordinated and incentive fees that it is at risk of not earning
E) $.5 million – collateral manager's estimate of potential incentive fees it will not earn
F) ???

There are too many variables, some known and some contingent, to make a logical assessment as to the relative size of the collateral manager's variable interest. Additional guidance will be necessary to ensure consistent application.

Financial SPEs (FSPEs)

Paragraphs 22 and 23 provide criteria for certain SPEs that hold financial assets. It is hard to determine what types of SPEs the Board is targeting here. Paragraph B19 of the Appendix states, "In SPEs that diversify risks, a portfolio of assets is held by an administrator, trustee, or servicer and the various rights and obligations that arise from those assets and any liabilities incurred to hold those assets are allocated to various parties in accordance with their tolerance for risk. No individual party controls the SPE's assets or is responsible for the SPE's liabilities. Each party should account for its rights and obligations related to the assets in the SPE, but it is inappropriate for any party to consolidate the assets and liabilities of the SPE." This sounds like the definition of a CDO, but the restrictions of paragraph 22 will eliminate most CDO's because of the derivative restrictions. We do not see why the fact that a CDO holds derivatives should impact the SPE's ability to diversify and allocate the risks involved. It is not clear why the starting point for financial SPEs is QSPEs with various carve-outs. It would seem more appropriate to focus on the risk-dispersing characteristics rather than QSPE criteria, which were derived for a different purpose. Also, EITF 02-12 introduces additional complexities regarding the QSPE criteria. We encourage the Board to consider establishing new criteria for identifying risk-dispersing SPEs (i.e. number of investors, assessment of concentration of risk in one entity, etc.). As long as risks are dispersed and no party has an interest that effectively recombines substantially all of the risks, then no one should consolidate.

Paragraph 23 identifies certain criteria for identifying variable interests of an FSPE. These criteria seem to be more restrictive than the straight variable interest model due to the lack of a provision to measure the size or extent of the variable interest (assuming only one entity meets 2 of the 3 criteria). Without some consideration of the amount at risk, this criteria may lead to consolidation where no consolidation would have been required if the general variable interest approach was applied. For example, a collateral manager obviously meets the first criteria of having authority to purchase and sell assets. What if they also have a very insignificant equity investment or receive a fee that is not comparable to fees in similar observable arm's length transactions, but was negotiated at the inception of the deal? These scenarios can lead the collateral manager consolidating a CDO where they do not have a
significant risk of losing an investment in the SPE or incurring a loss as result of a contingent obligation to transfer assets or issue securities to the SPE.

Consider a realistic example of a collateral manager who under the proposed guidance would be required to consolidate $3 billion of COO assets which it has no future rights to and liabilities for which it is under no obligation, neither of which the collateral manager is deemed to control by contract under EITF 97-2. The collateral manager would add $3 billion of these assets to its current balance sheet of approximately $20 million in assets consisting of cash, receivables and fixed assets. The $20 million in assets currently owned by the collateral manager are not at risk in any way due to the COO assets it manages, but its balance sheet would increase by 150 times once these proposed rules were to become effective. This is one example where consolidation is not the most transparent accounting for these transactions.

Effective Date and Transition

Due to the complexities involved, it does not seem practical to mandate immediate implementation of the rules for transactions that have been in process but will close after the interpretation is issued in its final form. The impact is magnified due to the issuance being planned for the fourth quarter of 2002. This does not allow enough time to consider all the variables and moving pieces and implement by year-end. Additionally, this will have a significant impact on market activity in the fourth quarter, as these rules will have a far-reaching impact on market participants. As for deals that have closed and are in existence prior to the issue date, it will take some entities a significant amount of time to evaluate all the SPEs it may be deemed to have a variable interest in. The required implementation date of the beginning of the second quarter of 2003 for previous deals will not allow enough time to properly analyze the impact of the rules on existing transactions. For these reasons, we urge the Board to consider extending the effective date and transition period.

Conclusion

Currently, most parties involved with SPE’s primarily look to EITF 90-15 and related guidance to determine whether or not the Sponsor should consolidate the SPE. Application of this guidance has been inconsistently applied due to lack of guidance available in determining who the Sponsor was in addition to the SPE having to meet all three of the following criteria:

1. Substantially all of the activities of the SPE involve business activities with a single entity;

2. The expected substantive residual risks and substantially all the residual rewards of the asset(s) and the obligation imposed by the underlying debt of the SPE reside directly or indirectly with the reporting entity as sponsor; and

3. The owner(s) of record of the SPE has not made an initial substantive residual equity capital investment that is at risk during the entire term of the SPE (the 3% test). Note that an investor’s capital investment in a SPE that is financed by the Investor with nonrecourse debt or where the investor has hedged its risk does not qualify as being equity at risk.

It was not difficult to structure a transaction that would fail 1 or 2 of the above criteria (usually the first or third). However, the second requirement above seems to be more significant than the others. This should be the determining factor – who has the majority
of the risks and rewards? Emphasis on the second requirement most likely would have prevented the Enron financial reporting issue and others that may be out there. The idea of a primary beneficiary focuses on this issue. However, the definition of "variable interest" holder attempts to pull in too many players and unduly complicates the issue. Additionally, the concept of future expected losses is a rough moving target and due to its volatility and subjective nature, is going to lead to inconsistent results and further confuse the consolidation issue. We do not believe that the level of losses should have an impact on the consolidation conclusion.

If the Board will take into consideration some of the suggestions provided regarding the determination of sufficient equity or the primary beneficiary at inception of the SPE and mandate enhanced disclosure for all variable interest holders, it would seem that the Board's objective of more consistent application of consolidation policies to SPE's and improved comparability between enterprises engaged in similar activities even if some of those activities are conducted through SPE's, would be achieved.

In its current form, the proposed interpretation is far too complex for preparers to implement and for users to understand. The convoluted, subjective standards will be difficult to apply and give rise to unrealistic and impractical compliance burdens without commensurate benefits. Consolidation in absence of a true controlling interest will diminish transparency by pulling assets and liabilities into consolidated financial statements in circumstances where they make the financial statements less meaningful.

We thank the Board for the opportunity to comment on this Exposure Draft and fully appreciate the effort involved.

Sincerely,

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