Morgan Stanley

February 15, 2012

Technical Director
File Reference No. 2011-220
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Proposed Accounting Standards Update, Consolidation (Topic 810): Principal versus Agent Analysis

Dear Technical Director:

Morgan Stanley appreciates the opportunity to comment on the Proposed Accounting Standards Update, Consolidation (Topic 810): Principal versus Agent Analysis (the “Proposed Update”).

We have participated in the preparation of the responses to the Proposed Update submitted by the Securities Industry and Financial Markets Association Asset Management Group (“SIFMA AMG”) and the American Securitization Forum (“AFS”), and are generally supportive of the responses.

We are supportive of the FASB’s (the “Board”) efforts to develop a standard that requires a reporting entity to perform a qualitative evaluation of its power and economics to determine whether it should consolidate an entity. We agree with the fundamental principles in the Proposed Update and that the principal versus agent analysis should:

- Consider the decision maker’s overall relationship with the entity and the other parties involved with the entity
- Not consider the level of seniority of the decision maker’s fees when evaluating a decision maker’s capacity
- Place more emphasis on the decision maker’s exposure to negative returns than positive returns
- Not be performed if an entity’s fee arrangement does not meet the definition of a variable interest and the decision maker has no other variable interests
- Include the decision maker's direct and indirect interests held in an entity through its related parties
- Be required by a general partner of a limited partnership to determine whether it should consolidate the limited partnership

Although we support a number of the principles outlined in the Proposed Update, we do have reservations regarding some of the tentative conclusions reached by the Board. Our primary areas of concern are as follows:

- The principal versus agent analysis does not explicitly include the entity’s purpose and design as a specific factor for consideration.
- The examples provided appear to overemphasize the other interests held by the decision maker (e.g., equity interest) and underemphasize the role of rights held by others (e.g., removal rights) in the principal versus agent analysis. These examples could be interpreted to set unrealistically low bright lines for equity interests held in the funds, which could result in the consolidation of numerous funds by fund managers rendering their financial statements less meaningful to users.
Morgan Stanley

- There is insufficient illustrative guidance (i.e., examples) to demonstrate how to evaluate whether or not removal rights (or other substantive rights held by others) are determined to be substantive or to determine the impact of substantive rights in the context of the overall principal versus agent analysis.
- It is not explicitly clear that a reporting entity should be required or permitted to reconsider its consolidation conclusions when a change in any one of the key factors in the principal versus agent analysis (i.e., rights held by others, compensation to the decision maker and other interests held by the decision maker) occurs and when that change leads to a change in the purpose and design of the entity.
- It is not explicitly clear that money market funds that are required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7 of the Investment Company Act of 1940 should not be consolidated by their investment managers.
- Implementation of the guidance in the Proposed Update will require a significant effort as there are numerous evaluations and complex analyses that must be performed.

Further detail of these concerns and related suggestions to the Board are included in the responses to certain questions raised in the invitation to comment in the attached Appendix 1.

In addition to the issues outlined in our responses to specific questions in Appendix 1, we are also concerned that there is a lack of clarity with regards to the need for a distinction between variable interest entities and voting interest entities other than that they have significantly different disclosure requirements. We believe that the consolidation analysis could be simplified significantly if the distinction was not required. The elimination of this distinction would represent an additional step towards convergence. Therefore, we urge the Board to work towards a single consolidation model.

We applaud the Board’s efforts to develop a standard that requires a reporting entity to perform a qualitative evaluation of its power and economics to determine whether it should consolidate an entity and believe that this Proposed Update will provide comparability within entities and across industries after consideration of the feedback provided within this letter.

If there are any comments that are unclear, or you would like to discuss anything further please do not hesitate to contact me at (212) 761-1136 or Dave Bonnar (212) 276-7824.

Sincerely,

Peggy Capomaggi
Managing Director
Assistant Global Controller
Question 2: The evaluation of a decision maker’s capacity would consider the following factors:

a. The rights held by other parties
b. The compensation to which the decision maker is entitled in accordance with its compensation agreement(s)
c. The decision maker’s exposure to variability of returns from other interests that it holds in the entity.

Are the proposed factors for assessing whether a decision maker is a principal or an agent appropriate and operational? If not, why? Are there any other factors that the Board should consider including in this analysis?

We agree that proposed factors should be considered in assessing whether a decision maker is a principal or an agent. However, we believe that all relevant factors should be considered in conjunction with the purpose and design of the entity. Paragraph ASC 810-10-25-39C states, “This assessment also shall consider the entity’s purpose and design, including the risks that the entity was designed to create and pass through to its interest holders.” We are concerned that by not making the purpose and design of the entity a specific factor to consider in the evaluation of a decision maker’s capacity, some may interpret the guidance to suggest that this factor is not of equal importance in the principal versus agent assessment. Therefore, we suggest making the purpose and design of the entity an additional specific factor (i.e., criterion d) in the analysis. Additionally, the purpose and design of the entity should specifically consider the scope of the decision maker’s authority.

We are also concerned that the case examples provided in ASC 810-10-55-3B to ASC 810-10-55-3BK overemphasize criterion c (other interests held by the decision maker) and underemphasize criterion a. (rights held by other parties). This concern is further articulated in our responses to Questions 3 and 4 below.

Question 3: The proposed Update would require judgment in determining how to weigh each factor in the overall principal versus agent analysis. Do you agree that the proposed amendments, including the related implementation guidance and illustrative examples, will result in consistent conclusions? If not, what changes do you recommend?

We agree that the proposed factors (in conjunction with the purpose and design of the entity) should be weighted appropriately, which will require judgment. However, certain case examples lack transparency into the thought-process on how the purpose and design of the entity were considered in the overall assessment and how changes to the fact patterns presented could result in different conclusions. Specifically, we are concerned that case examples provided in ASC 810-10-55-3B to ASC 810-10-55-3AC overemphasize criterion c. and underemphasize criterion a. For example, Case B (Investment Fund—Performance Based Fees) and Case C (Investment Fund—Performance Based Fees and Other Interests) have the same fact pattern with the exception of the equity interest held by the manager, which increases from 0 percent equity in Case B to 20 percent equity in Case C, and thereby changes the conclusion from “agent” in Case B to “principal” in Case C. While we agree that the level of equity interest should be considered for purposes of determining control, we disagree that the extent of a decision maker’s equity involvement should be the only factor considered and therefore determinative by itself. We are concerned that some might interpret these Case Examples to place more emphasis on a manager’s equity interest in the entity than what was intended by the Board.
We are concerned that the principal versus agent analysis of Case C does not sufficiently illustrate how to weigh the various factors in the analysis and therefore believe that the conclusion reached could be misleading. We strongly believe that in most cases, when considering the 20 percent equity interest held by the decision maker (in Case C) when weighted with all the factors in conjunction with the purpose and design of the entity, an agent conclusion could be reached. Case C indicates that the purpose of the decision maker’s interest in the fund is to align its interests with the entity investors and not to give the decision maker significant exposure to the investment objectives of the entity for its own proprietary risk taking. Asset managers are required by fiduciary duty to make decisions in the best interest of the investors of the fund. In many scenarios, this fiduciary duty is not affected by the existence of an investment in the fund by the asset manager. Nonetheless, fiduciary duty should be one of the factors considered and weighted appropriately in the principal versus agent analysis. Additionally, the fees paid to the manager are market based and considered commensurate with the services provided. With the consideration of these factors in the aggregate, we believe a lower weight should be given to the equity interest of the decision maker to support an agent conclusion. As this fact pattern is not uncommon for fund managers, we are concerned that if the Case C example is not amended, it will set unrealistically low bright lines resulting in numerous consolidations of funds by fund managers that could render financial statements less meaningful to users.

To further emphasize our point, we believe that in most cases, the equity interest percentage in Case C could be increased to 35 percent and agent conclusion could still be reached given the weighting of the various factors in the analysis. The exposure to downside side risk is only 35 percent, which is solely attributable to the decision maker’s equity interest. The potential upside exposure is a combination of 35 percent equity interest, the 2 percent fixed fee and the 20 percent performance fee, a maximum total of 49 percent, which holds less weight than the downside exposure. Additionally, the total upside exposure could actually be a lesser amount as the performance fee should be evaluated to determine whether there is a reasonable expectation of receiving payment to determine how much weight it should hold in the analysis. The purpose and design of the entity further explains why less weight should be attributed to the upside exposure as the entity is designed to align its interests with the entity investors and not to give the decision maker significant exposure to the investment objectives of the entity for its own proprietary risk taking. All factors considered together are generally indicative of a decision maker that acts in an agent capacity.

We understand and support the Board’s anti-abuse concerns regarding consolidation. That said, if the equity interest in Case C increases to an extent that there is a clear majority of the economics held by the decision maker, that might be more reflective (but not conclusive) of a decision maker that is controlling the entity (i.e., acting as a principal) with no substantive rights held by others to overcome the presumption of control. However, the equity interest should still be considered in conjunction with the other factors in the analysis to determine the appropriate weight to apply to the upside risk and other factors in determining whether the decision maker is acting as a principal or an agent.

We recommend amending Case C to increase the equity interest held by the fund manager (decision maker) to 35 percent, add additional discussion of the purpose and design of the entity (including the

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1 Decision maker’s exposure to upside risk 49% = 2% (fixed fee) + 20% (performance fee) + 27% (remaining economics*)

* Remaining economics paid after fixed and performance fees are paid out. As such, remaining economics = 78% (100% - (2% + 20%)). The decision maker’s 35% interest is applied to the 78% to come to a total of 27% exposure related to the remaining economics.

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manager’s fiduciary duty) and change the conclusion to that of agent. While the intention is not to draw bright lines, we intend to illustrate how equity interest can be increased but with less weight applied to that factor to reach an agent conclusion. We believe that in most cases, a 35 percent equity interest combined with a 2 percent fixed fee and 20 percent performance fee (with no substantive rights held by others) represents a decision maker acting as an agent and therefore, amending the Case example would result in more appropriate conclusions for fund managers.

**Question 4:** Should substantive kick-out and participating rights held by multiple unrelated parties be considered when evaluating whether a reporting entity should consolidate another entity? If so, do you agree that when those rights are held by multiple unrelated parties, they should not in and of themselves be determinative? If not, why? Are the guidance and implementation examples illustrating how a reporting entity should consider rights held by multiple unrelated parties in its analysis sufficiently clear and operational?

We agree that substantive kick-out and participating rights should be considered when evaluating whether a reporting entity should consolidate another entity. However, we disagree that when those rights are held by multiple unrelated parties they should not, in and of themselves, be determinative. We believe that this determination should be made on a case-by-case basis. We also agree with the Proposed Update in that potential barriers to exercise these rights as well as the number and/or dispersion of unrelated parties that need to act together to exercise these rights should be considered in the evaluation of whether or not these rights are substantive. However, we are concerned that rights held by others are underemphasized as they are excluded from the Case Examples.

As noted in our response to Question 3 above, we believe that a 35 percent equity interest combined with a 2 percent fixed fee and 20 percent performance fee (with no substantive rights held by others) provides for an interest that is generally reflective of an agent. Therefore, we suggest that the Board include a Case Example to illustrate how the number and dispersion of kick-out, participating or dissolution rights impact the assessment of whether the rights are deemed substantive and the impact that those substantive rights would have on the overall principal versus agent analysis if the equity interest increased. Please refer to Appendix 2 for a suggested example to illustrate these points.

Additionally, there appears to be disparity between the guidance in paragraph ASC 810-10-25-41D, which states that “the likelihood that the participating rights will be exercised by the interest holder shall not be considered when assessing whether a participating right is substantive” and the Board’s belief, as noted in the basis for conclusions paragraph BC18, that “kick-out and participation rights should affect only the consolidation analysis when there is a realistic possibility that the other interest holders may exercise those rights.” We believe that the Board’s intent is that consideration of the likelihood that either kick-out or participating rights will be exercised is irrelevant to determining whether the rights themselves are substantive. Therefore, we encourage the Board to update the basis for conclusion to clarify that the likelihood of rights being exercised does not impact the assessment of whether or not there is a realistic possibility that the rights will be exercised.

**Question 7:** A reporting entity would be required to evaluate whether there has been a change in the decision maker’s capacity by considering whether there has been a change in the purpose and design of the entity. For example, the purpose and design of the entity may change if the entity issues additional equity investment that is at risk to the decision maker. Do you agree with this proposed requirement? If not, please specify when this relationship should be reassessed and why.

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The Proposed Update states that the determination of whether the decision maker is using its authority in a principal or an agent capacity shall be reconsidered if there has been a change in the purpose and design of the entity. While we agree that reconsideration should occur when there is a change in the purpose and design of the entity, we are concerned that the Proposed Update is not explicitly clear that a reporting entity should reevaluate whether it acts as principal or agent when there has been a change in its overall relationship with the entity (e.g., a change in equity or other interests held by the decision maker). For example, if a decision maker sells all of its interests in an entity, the decision maker’s relationship with that entity has changed and we believe that reconsideration would be appropriate. However, it is not clear whether this change would represent a change in the purpose or design of the entity in the Proposed Update. Therefore, we recommend that the Board provide explicit guidance stating that reconsideration should occur when there is a change in the reporting entity’s overall relationship with the entity which includes consideration of all of the factors in the principal versus agent analysis (i.e., rights held by other parties, compensation to the decision maker, decision maker’s other interests held and purpose and design of the entity). This guidance should remain principles-based therefore we do not believe that the Board should attempt to list all specific changes that require reconsideration.

Question 10: Update 2010-10 was issued to address concerns that some believe that the consolidation requirements resulting from Statement 167 would have required certain funds (for example, money market funds that are required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7 of the Investment Company Act of 1940) to be consolidated by their investment managers. The amendments in this proposed Update would rescind the indefinite deferral in Update 2010-10 and would require money market funds to be evaluated for consolidation under the revised guidance. The Board does not intend the application of the proposed Update to result in money market funds being consolidated. Do you agree that the application of the proposed Update will meet this objective? If not, why and what amendments would you recommend to address this issue?

We agree that certain funds (for example, money market funds that are required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7 of the Investment Company Act of 1940) should not be consolidated by their investment managers, however, it is not clear that the application of the Proposed Update will meet this objective. We are concerned that this view could be misinterpreted absent explicit language in the guidance that would exclude these funds from the scope. Therefore, similar to the deferral in ASU 2010-10, 810: Amendments for Certain Investment Funds, we recommend that the Board explicitly state that a reporting entity’s interest in an entity that is required to comply or operate in accordance with requirements similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds are excluded from the scope of this guidance.

Question 13: Do you agree with the proposed transition requirements in paragraph 810-10-65-4? If not, how would you propose to amend those requirements, and why? Please provide an estimate of how long it would reasonably take to implement the proposed requirements.

We believe the Proposed Update should be required to be effective at the beginning of the first calendar year at least one year after the final standard has been issued. Implementation of the Proposed Update will require a detailed, comprehensive assessment of an entity’s relationship with VIEs and limited partnerships. This will necessitate a significant amount of evaluation and analysis by the entity,
particularly for an asset manager that may require complex and thoughtful analyses for a large number of investment funds it manages.

Question 14: Should early adoption be permitted? If not, why?

We believe that institutions that are able to implement the Proposed Updated prior to the effective date should be permitted to do so to which would address any concerns with the lack of comparability within a reporting entity as the entities being evaluated would no longer be subject to different consolidation guidance (i.e., FIN 46R versus FAS 167). The effective date, and permission for early adoption, should be consistent with the FASB’s investment property and investment companies proposals due to their interrelationship.
Case Example: Investment Fund—Performance-Based Fees, Additional Interests and Rights Held by Others

A fund manager creates and sells securities in an investment fund to external investors. The securities were marketed to the investors as an opportunity to generate significant returns by allowing the fund manager broad decision-making authority, including how to invest the fund’s capital.

The fund manager is paid an annual fixed fee equal to 2 percent of the assets under management and a performance-based fee of 20 percent of the fund’s profits if a specified annual profit level is achieved. The fees are considered commensurate with the services provided. The fund manager also holds a 40 percent pro rata investment in the fund. The fund manager does not have any obligation to compensate the fund for losses beyond its 40 percent investment.

The fund is not required to and does not establish an independent board of directors. However, the individual investors hold rights that might affect the decision maker’s ability to direct the activities that most significantly impact an entity’s economic performance. At any time after the initial closing, the fund manager may be removed by the written consent of the individual investors holding not less than a simple majority in interest excluding the fund manager and any affiliated persons of the fund manager. The fund has 50 investors, including its own 40 percent equity investment:

<table>
<thead>
<tr>
<th>Investor</th>
<th>Equity Ownership in Fund (percent)</th>
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<tbody>
<tr>
<td>1 Fund Manager</td>
<td>40.0%</td>
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<tr>
<td>2 Non-affiliated Investor1</td>
<td>20.0%</td>
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<tr>
<td>3 Non-affiliated Investor2</td>
<td>11.0%</td>
</tr>
<tr>
<td>4 Non-affiliated Investor3</td>
<td>11.0%</td>
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<tr>
<td>5 Non-affiliated Investor4</td>
<td>11.0%</td>
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<tr>
<td>6 Remaining 45 Non-affiliated Investors</td>
<td>7% in aggregate (0.1% to 1.0% for each investor)</td>
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<td>Total</td>
<td>100.00%</td>
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If a simple majority of the unaffiliated investors (on a percentage ownership basis) decided to remove the fund manager, a new manager would have to be selected to perform these services. There are no financial penalties or operational barriers associated with replacing the decision maker that would act as a significant disincentive to do so. Additionally, there are an adequate number of qualified replacement decision makers as well as adequate compensation to attract a qualified replacement. While there are no explicit provisions in the entity’s governing documents that specify the manner in which the parties holding the rights can call for and conduct a vote to exercise those rights, the governing documents do specify that quarterly shareholder meetings will be held and will be open to all investors. These quarterly meetings would provide for a forum for the investors to get together to vote on removal of the manager if they choose. Generally speaking, the larger investors are expected to attend this meeting, as well as representatives of multiple, smaller investors in the fund. It is not expected that all investors will attend

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every meeting; though they all have the option to do so. Additionally, the address, location and contact information of the fund manager are made known to each investor, thereby allowing them the right to obtain a list of investors and contact information if they choose to call a meeting outside of the standard quarterly meetings.

>>> Design of the Entity

To determine whether the fund manager uses its decision-making authority in a principal or an agent capacity, a reporting entity is required to evaluate the purpose and design of the fund, including the risks the fund was designed to create and pass through to its interest holders. In making this assessment, the reporting entity determined the following:

a. The fund is designed to provide investors with exposure to the risks and returns of the fund that depend on the fund manager’s performance. The investors have granted the fund manager broad decision-making authority over their invested capital on the basis of the prior performance demonstrated by the fund manager.

b. The fee structure is designed to provide greater compensation to the fund manager if the fund generates returns for the third-party investors above the specified profit level. The specified profit level that needs to be achieved by fund is based on the activities of the fund, the nature of the fund’s assets, and the decision maker’s authority. While the fund manager’s fee structure may provide an incentive for the fund manager to take additional risk in order to realize its performance-based fee, the performance-based fee is designed to:
   1. Align the interests of the fund manager with those of the third-party investors
   2. Provide compensation to the fund manager that is commensurate with its services
   3. Include only customary terms and conditions.

c. The fund manager’s 40 percent pro rata investment exposes the fund manager to gains, as well as losses, of the fund and is designed to align the fund manager’s interests with those of the third-party investors.

>>> Principal versus Agent Analysis

To determine whether it is using its decision-making authority in a principal or an agent capacity, a decision maker must analyze all of the following:

a. The rights held by others
b. Its compensation
c. Its other economic interests
d. The purpose and design of the entity

The third-party investors have substantive removal rights. While these rights appear widely dispersed amongst 49 unaffiliated investors, only 2 of the unaffiliated investors actually need to get together to make up the simple majority of unaffiliated parties needed to remove the decision maker. The combination of the largest unaffiliated investor holding 20 percent equity in addition to any one of the three investors holding 11 percent equity, results in a combined equity interest of 31 percent, which is a majority of the total unaffiliated equity interests of 60 percent. Additionally, a combination of all three unaffiliated investors that each hold 11 percent equity (excluding the largest 20 percent unaffiliated holder) results in a combined total of 33 percent, which is also a simple majority of the unaffiliated interests of 60 percent needed to remove the decision maker.

Further, there is a mechanism for the investors to get together to exercise those rights—there is a quarterly meeting that is open to all investors and for which the larger investors generally attend. Additionally,
there are no financial penalties or operational barriers associated with replacing the decision maker that would act as a significant disincentive from exercising those rights. Lastly, there are an adequate number of qualified replacement decision makers as well as adequate compensation to attract a qualified replacement. Therefore, these rights are deemed to be substantive. These substantive rights, in isolation, are not sufficient to conclude that the decision maker is acting as an agent. As such, they must be considered in conjunction with the purpose and design of the entity, other interests held by the decision maker and compensation to the decision maker.

As compensation for its services, the fund manager receives fixed and performance-based fees that provide it with the right to receive benefits from the fund. The fees received are commensurate with the services provided and include only customary terms and conditions. Although not meeting these conditions would be a strong indicator that the decision maker is a principal, meeting these conditions is not sufficient to conclude that the decision maker is not a principal. The fund manager also must consider the purpose and design of its compensation arrangement, including the magnitude of, and variability associated with, its fees. Although the nonreceipt of a performance-based fee does not represent an exposure to negative returns, a decision maker’s compensation might influence its actions, as it attempts to earn the fee. When evaluating the annual fee equal to 2 percent of the fund’s net asset value and the performance-based fee of 20 percent of the fund’s profit if a specified annual profit level is achieved, the evaluation would consider the fund’s total anticipated economic performance.

The fund manager, 40 percent equity holder, has the obligation to absorb losses and the right to receive benefits of the fund. The fund manager’s investment aligns its economic exposure to positive and negative returns with the other third-party investors because all the equity investors share proportionately in the gains or losses of the funds. The fund manager’s 40 percent investment does not provide any credit or other enhancements to the third-party investors. Because the fund manager’s interest is pro rata, it is aligned with that of the third-party investors.

The level of economic variability that the fund manager is exposed to through equity interests, relative to the returns expected from the activities of the entity, indicates that the fund manager could be using its decision-making authority to direct the relevant activities of the fund in a principal capacity. However, because the fund manager can be removed at any point in time by investors through a simple majority vote of unaffiliated parties, we believe this fact overcomes the presumption that the fund manager is acting in a principal capacity. Only two or three of the larger investors are needed to make up a simple majority and those investors could consider removal of the fund manager at least on a quarterly basis.

The exposure to downside risk is only 40 percent, which is solely attributable to the decision maker’s equity interest. The potential upside exposure is a combination of 40 percent equity interest, the 2 percent fixed fee and the 20 percent performance fee, a maximum total of 53 percent\(^2\), which holds less weight than the downside exposure. Additionally, the total upside exposure could actually be a lesser amount as the performance fee should be evaluated to determine whether there is a reasonable expectation of receiving payment to determine how much weight it should hold in the analysis. The purpose and design of the entity further explains why less weight should be attributed to the upside exposure as the entity is

\(^2\) Decision maker’s exposure to upside risk \(53\% = 2\% \text{ (fixed fee)} + 20\% \text{ (performance fee)} + 31\% \text{ (remaining economics)*}\)

* Remaining economics paid after fixed and performance fees are paid out. As such, remaining economics = 78\% \((100\% - (2\% + 20\%))\). The decision maker’s 40\% interest is applied to the 78\% to come to a total of 31\% exposure related to the remaining economics.
designed to align its interests with the entity investors and not to give the decision maker significant exposure to the investment objectives of the entity for its own proprietary risk taking. All factors considered together, specifically the substantive removal rights, are indicative of a decision maker that acts in an agent capacity.