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LETTER OF COMMENT NO. 27

Mr. Russell G. Golden
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

File Reference No. 1610-100 and No. 1620-100

Dear Mr. Golden:

We appreciate the opportunity to comment on the proposed amendments to SFAS No. 140, *Accounting for Transfers of Financial Assets* (the "FAS 140 ED") and FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities* (the "FIN 46(R) ED"). For Merrill Lynch, a large financial services institution, this guidance affects many of our transactions, and therefore we are very interested in the progress of this important project.

While we agree that some of the suggested amendments would improve the current reporting framework, we are concerned about the Board issuing new guidance without a thorough consideration of convergence to IFRS. By the time this guidance is implemented, firms will already be considering the implementation requirements for similar guidance under IFRS. Implementing two sets of rules over such a short time frame will be both costly and operationally risky to reporting firms and may be confusing to users of financial statements as they seek to make comparisons in the changing reporting environment.

Below are our specific comments on the FAS 140 ED and the FIN 46(R) ED. Please refer to our comments related to the disclosure requirements in our response submitted on October 15, 2008 for the proposed FSP FIN 46(R) – e and FAS 140 – e.

FAS 140 ED

Restrictions on asset sales
In general we support the proposed changes in the FAS 140 ED. In our opinion, the rule-based QSPE approach for securitizations has always been operationally challenging,

therefore the elimination of QSPEs is a welcome revision. That being said, we are still concerned that the proposed sale criterion in paragraph 9c(3) does not satisfactorily address transfers to entities that are restricted by governing documentation from selling their assets. Under paragraph 9c(3), in order to achieve a sale where the transferee has selling restrictions, a transferor must determine that the transferee *primarily* benefits from these restrictions. Paragraph 54A provides additional guidance, indicating that for securitization vehicles the constraint may primarily benefit the transferee because it enhances the transferee's ability to issue securities. It is our view that although paragraph 54A provides examples for securitizations, there are other entities that are restricted from selling assets that may not be considered securitization entities. For these types of entities, it is not always clear who primarily benefits from the restrictions because by their nature, the transferees are simply investment vehicles that hold assets on behalf of investors.

Take, for example, credit-linked note issuers. These entities sell credit protection in the form of credit default swaps (CDS), issue notes that are linked to the underlying credit that is referenced by the CDS, and are collateralized by low-risk assets transferred to the entity. The transferor is typically the CDS counterparty, and the investors are unrelated third parties (often there is only one investor). In these transactions, the investors benefit from the selling restrictions because the transferred assets 1) provide a portion of the interest income that the investors receive from the credit-linked note and 2) provide the source for principal repayment (assuming no default in the CDS reference). As a result, it is important for the investors to be satisfied that the assets held by the special purpose entity (SPE) will meet certain criteria. By selecting low-risk assets at the inception of the transaction and prohibiting those assets from being changed, the investors' interests are protected. The transferor will also benefit from the selling restrictions because the transferred assets serve as collateral for the purchased CDS.

Applying the proposed guidance to this situation, we are likely to conclude that the investors primarily benefit from the selling restrictions, which under a paragraph 54A analysis would correspond to the transferee benefiting. We would argue that because the transferred assets provide the return and principal repayment to the investors, the investors primarily benefit from the selling restrictions. However, there is a significant level of judgment involved in this determination because the transferor also requires the SPE to hold low-risk assets to serve as collateral for the CDS.

In order to make the guidance more clear and in our view, more principles-based, we recommend basing the effective control test on whether the transferor, rather than the transferee, primarily benefits from the selling restrictions/constraints. We believe that this is more consistent with the effective control principle because under this approach the focus is on whether the transferor has relinquished control rather than whether the transferee has obtained control. If the transferor does not primarily benefit from the restrictions, then it should not be considered to have retained effective control over the assets and should be able to account for the transfer as a sale (assuming that the other criteria in paragraph 9 are satisfied). When using this approach to analyze the credit-linked note transaction above, it would be reasonably simple for the transferor to conclude that it does not **primarily** benefit from the selling restrictions placed on the transferred assets.

We believe that this approach can be consistently applied to both operating entities and SPEs. For operating entities, transferor imposed selling restrictions would presumptively result in the transferor retaining effective control - it is difficult to argue that these selling restrictions would not primarily benefit the transferor. Non-transferor imposed restrictions would presumptively *not* primarily benefit the transferor even though the transferor may have some benefits. For SPEs, where the determination of who benefits is more challenging because of an SPE's pass-through nature, focusing on whether the transferor primarily benefits provides a reasonable principle for determining when the transferor has relinquished control.

Sales to consolidated subsidiaries
The FAS 140 ED does not clearly permit sale or purchase treatment for intercompany transfers from a parent to a consolidated subsidiary in stand alone financial statements. Specifically, paragraph 9c requires that in order for a transferor to record a sale, "the transferor, its consolidated affiliates included in the financial statements being presented, or its agents do not maintain effective control over the transferred financial assets..." Additionally, paragraph 46A states "to assess whether the transferor maintains effective control...all involvement by the transferor, its consolidated affiliates...shall be considered..."

If it is the Board's intention to disallow intercompany transfers of assets to be recorded as sales and purchases in stand alone financial statements, we request that the Board discuss the rationale for this in the basis for conclusions. If the Board did not intend to prohibit intercompany sales of assets, we recommend that the Board specifically address the treatment of these transactions in the FAS 140 ED. We believe that this is warranted because the guidance otherwise seems to prohibit sale and purchase accounting in these circumstances and is therefore likely to require further implementation guidance.

Rights to reclaim specific transferred assets
Paragraph 53 of the FAS 140 ED, as proposed, indicates that the right to reclaim specific assets at fair value "may" result in the transferor maintaining effective control if it also holds "*a* residual interest" in the financial assets "...because it can pay any price it chooses ...and recover *any* excess paid over fair value through its residual interest..." [*emphasis added*]. Although this paragraph is not new and has always been subject to what is, in our view, an overly conservative interpretation, we believe that the proposed changes have made the paragraph even less clear.

Currently, certain audit firms apply the guidance found in paragraph 53 to situations where the transferor holds a small portion of the residual interest in the transferred assets. For example, certain audit firms are concluding that if the transferor owns 15% of a residual interest in transferred assets and can bid at auction when assets are sold, then that transferor has effective control over the assets. We do not believe that this interpretation is in the spirit of the rule because the transferor in this situation would not be able to bid any price and recover <u>all</u> of (or even most of) the excess through its residual interest because it holds only 15% of the residual interest (i.e., a third party would receive 85% of the excess). In contrast, if a transferor holds no residual interest, that transferor could bid any price at auction to ensure that it obtains the assets without being considered to have maintained effective control. Though in this case, 100% of the excess would be paid to

third parties, in either instance, the transferor is unable to recover "*any* excess" paid above fair value.

We recommend changing this guidance from "a transferor may maintain effective control if it has such a right and also holds *a* residual interest in the transferred financial assets" to "a transferor may maintain effective control if it has such a right and also holds *substantially all* of the residual interests in the transferred financial assets." It is our view that from an economic perspective the transferor would only be willing to pay an excess above fair value if it was able to recover substantially all of that excess through its residual interest, and it is only in this case that the transferor has the ability to choose whether to buy the assets without regard to the economics. If the transferor is not able to recover substantially all of the excess through its residual interest, the transferor will be subject to the same economic considerations as any other purchaser and therefore should not be deemed to effectively control the transferred assets.

Participating interests
In general, we support the Board's approach to the long-standing issues associated with sale accounting for participating interests. However, we believe that under the proposed approach the accounting result can be changed simply by adding a variable interest entity (VIE). Consider the following: Entity A retains a senior participating interest in a loan and sells the junior participating interest in that loan to Entity B. Under the proposed guidance, because the loan has been tranched (i.e., it is not a pari passu participation), Entity A would not be able to treat the participation as a sale and would continue to reflect the entire loan on its balance sheet.

Under the proposed guidance in the FAS 140 ED and the FIN 46(R) ED, Entity A could achieve a sale by selling the entire loan to a trust that is a VIE and purchasing the senior interest issued by the trust. As long as Entity A does not have power over the trust, it would not consolidate it. Thus, based on our understanding of the guidance, it seems that if the transfer is done through a participation, sale accounting would not be achieved. However, if instead Entity A simply transfers the entire loan to a trust first, a sale could be achieved. Given that the economics of both transactions are the same, we believe both examples should result in the same accounting treatment. As such, we recommend that the Board consider permitting sale treatment for participations where the transferor retains a senior participating interest in the loan.

FIN 46(R) ED

Qualitative versus quantitative determinations
We agree with the Board's conclusion that consolidation of VIEs should be based on a qualitative analysis rather than a quantitative analysis, and therefore we strongly encourage the Board to remove the quantitative analysis from the guidance. Modeling cash flows and determining relative probabilities has proven to be extremely subjective even for relatively simple VIEs. We do not believe that the quantitative analysis should be used as a "tie breaker" in instances where qualitative factors are deemed indeterminate because this could result in firms being encouraged by auditors to use a "belt and suspenders" approach (i.e., not consolidating only when both the qualitative and quantitative approach indicate that consolidation is not required) or could result in

auditors requiring a quantitative approach in instances where they do not agree with their client's judgment on the qualitative factors. If the Board truly intends for the consolidation determination to be based on a qualitative assessment, including the quantitative analysis as a tie-breaker undermines the principles of the guidance.

Continuous reassessment
Based on the proposed consolidation approach for VIEs, we believe that continuous reassessment for voting rights entities (VREs), especially operating entities, would be overly burdensome and would not provide significant benefits. Under the FIN 46(R) ED, a firm will be required to continuously reassess whether an entity is a VIE or VRE simply based on losses or gains recorded by that entity. For instance, if an operating company suffers losses such that the equity is no longer sufficient to absorb losses, the entity would become a VIE.

We believe that this reassessment for losses would only affect disclosures and would not result in consolidation because under the proposed guidance in paragraph 14A, an investor must have both power and economics in order to consolidate the VIE. Economic losses alone are unlikely to result in a non-equity investor in a VRE obtaining power. Instead, power would be transferred based on contractual triggers such as breaches of debt covenants, events of default and/or foreclosures. Until power is transferred, the owners of the voting equity would have the consolidating interest under both a VRE model and the VIE model proposed in the FIN 46(R) ED.

We are concerned that implementing this requirement would be extremely burdensome for financial services companies given the number of affected entities and the calculations required to determine whether equity is sufficient to absorb losses. We believe that the cost of implementation would outweigh the benefits associated with the information provided by the additional disclosures, and therefore request that the Board reconsider this requirement.

Definition and importance of power/control
The Board seems to have reversed its view on the importance of control in VIEs from not particularly significant under FIN 46(R) (i.e., FIN 46(R) in its current form is based on an expected loss approach) to one of the two essential consolidation factors in the FIN 46(R) ED. While we agree that the ability to control the important decisions of an entity should always be considered critical in determining whether an entity should be consolidated, we believe that the FIN 46(R) ED can yield counterintuitive results, especially for largely static entities where the governing documents, rather than an on-going controlling entity, direct the matters that most significantly impact the activities of the VIE.

For example, based on our understanding of the guidance, it appears that when analyzing whether someone has *power* over a VIE as defined in paragraph 14A(a), the *power* of a portfolio manager in Example 2 of the FIN 46(R) ED is considered equal to the *power* of a servicer in Example 6 of the FIN 46(R) ED. We do not believe that this is appropriate given the portfolio manager's broad decision-making ability as compared to the servicer's limited decision-making ability. In our view, the distinguishing component is the amount of decision-making that has already been made through the initial governing documents. Although the servicer is the only party with the power to direct matters after

the entity is established, it can be argued that the decisions that most significantly impact the activities of the VIE are pre-determined by its governing documents. While the servicer's powers are important, they are largely contingent on the occurrence of events outside of its control, typically required as a result of the governing documents and primarily in place to protect investors when assets default. In our view this is very different from the power of a portfolio manager whose day-to-day decisions are made to maximize the returns of investors.

Further, there are fairly common entities that are largely static in nature. Take, for example, simple asset repackaging VIEs. These VIEs typically hold one fixed-income asset and enter into a derivative to modify the interest rate or currency of the asset held by the VIE. Generally there is only one investor. Neither the investor nor the derivative counterparty has any power over the entity. In fact, based on experience in the current market place, although the derivative counterparty (typically the transferor/structurer) is likely to try to accommodate the investor if the investor wants to restructure the transaction, it is under no obligation to do so.

Given that no party is considered to have power, the economic assessment in paragraph 14A(b) is not relevant even though there is only one investor. Although paragraph B24 in the basis for conclusions discusses the interaction between economics and power, it does not specifically acknowledge that if an entity has substantially all of the economics it is likely to have the power, too; so it is possible that no party would consolidate this structure as no party has power (i.e., meets the requirements in paragraph 14A(a)). We find this conclusion somewhat surprising as a single investor owns 100% of the issuance but does not consolidate and question whether this is the Board's intent. If it is not the Board's intent, additional information that incorporates some of the concepts in FIN 46(R) paragraph 5c may be helpful.

Kick-out rights

The qualitative discussion on power in FIN 46(R) ED paragraph 14A(a) considers "kick-out rights" to be substantive only when those rights can be unilaterally exercised by a single investor. We fundamentally disagree with this conclusion because, as written, an entity is considered to have power even if it can substantively be removed by a simple majority of investors.

The Board acknowledges that this is inconsistent with other guidance, including the guidance in paragraph B20 of FIN 46(R) and EITF 04-5, *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights* (EITF 04-5). In the basis for conclusions, the Board argues that considering kick-out rights when analyzing power in VIEs would provide enterprises with structuring opportunities. We feel that this argument is neither theoretically supportable nor principles-based. It is our view that other guidance has established the principle that if a decision-maker can be terminated at will by a simple majority, then that decision-maker acts as agent/employee for the entity. We believe that this proposal undermines that principle. The Board also argues that because the rights are rarely used in practice, they may not be meaningful. Based on our experience with the application of EITF 04-5, we disagree with this assertion. It is our experience that regardless of the fact that these rights are not frequently exercised, the

business considers the inclusion of substantive kick-out rights in a transaction to be a true transaction risk.

Further, requiring continuous reassessment of VREs for operating losses highlights a potential unexpected outcome associated with the inconsistent treatment of kick-out rights. Consider an asset manager/general partner that had determined that it was not required to consolidate a VRE because limited partners had substantive kick-out rights. Under the proposed guidance, those kick-out rights would no longer be considered relevant simply because the entity has become a VIE as a result of operating losses. Therefore, upon reassessment, the general partner could be required to consolidate under the FIN 46(R) ED even though its power over the entity has not changed.

We strongly encourage the Board to reconsider this decision. We believe that moving away from an established principle simply to avoid what are perceived to be potential abuses establishes a troubling precedent. Currently, there is considerable guidance to help firms and auditors evaluate when kick-out rights are substantive, and we have found that as a result of this guidance substantive kick-outs rights are working as intended.

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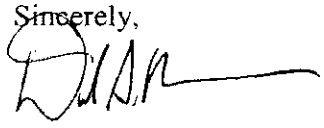
Thank you again for the opportunity to comment on this important project. We are available to provide further input on this draft or on future proposals that are developed as this project progresses. If you have any questions regarding our comments, please do not hesitate to contact me at (212) 449-2048.

Sincerely,



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