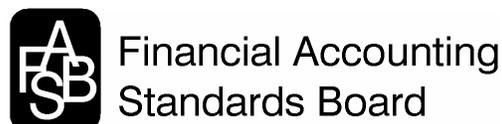


## MINUTES



**To:** Board Members

**From:** Miller (ext. 276)

**Subject:** Minutes of the November 11, 2003  
CON VIE Board Meeting

**Date:** November 11, 2003

**cc:** Bielstein, Smith, Petrone, Leisenring, Project Team, Thompson, Sutay, Gabriele, Swift, Polley, FASB Intranet, Allen, Bean

Topic: Discussion of an FSP on Exclusion of Certain Decision Maker Fees from Paragraph 8(c) of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*

Basis for Discussion: Board memorandums dated November 6, 2003

Length of Discussion: 9:00 a.m. to 9:50 a.m.

Attendance:

Board members present:	Herz, Crooch, Batavick, Schipper, Schieneman, Seidman, and Trott
Board members absent:	None
Staff in charge of topic:	McIntosh, Lott
Other staff at Board table:	Smith, Miller
Outside participants:	None

**Summary for ACTION ALERT:**

The Board discussed the nature of a decision maker's fee arrangement that should be excluded from paragraph 8(c) of FASB Interpretation 46, *Consolidation of Variable Interest Entities*, in the calculation of an entity's expected residual returns. The Board directed the staff to revise a draft FSP that would exclude a decision maker's fees from paragraph 8(c) if all of the following conditions are met:

1. The fees are compensation for services provided commensurate with the level of effort required to provide those services. The determination of whether fees are commensurate compensation should be based on all relevant facts and circumstances.
2. The decision maker's fees:
  - a. Have no more than a trivial amount of variability; for example, a fee that is fixed in terms of amount and timing with no more than a remote probability of nonpayment, or
  - b. Are calculated based on a fixed rate, such as, a fixed percentage of assets managed or a fixed dollar amount per unit of service.
3. The decision maker's fees are not linked primarily to the net income of the variable interest entity. Although net income may affect the level of assets managed, a fee based on a fixed percentage of assets managed would not necessarily be linked primarily to net income.
4. The payment of the decision maker's fees is not subordinated to other cash flows of the variable interest entity; that is, the fees are at the same level of seniority as other operating liabilities of the entity.
5. Except for the fees for services, the decision maker and the decision maker's related parties do not hold interests in the variable interest entity that provide more than a trivial amount of subordinated financial support to the entity or the right to receive more than a trivial amount of the entity's expected residual returns.
6. The decision maker is subject to substantive kick-out rights. The rights to remove a decision maker (kick-out rights) are substantive if (i) the decision

maker can be removed by the vote of a simple majority of the voting interests held by parties other than the decision maker and the decision maker's related parties, and (ii) the parties holding the kick-out rights have the ability to exercise those rights if they choose to do so; that is, there are no significant barriers to the exercise of the rights. Barriers include, but are not limited to:

- a. Kick-out rights subject to conditions that make it unlikely they will be exercisable, for example, conditions that narrowly limit the timing of the exercise
- b. Financial or operational penalties associated with replacing the decision maker that would act as a more than insignificant disincentive for removal
- c. The absence of an adequate number of qualified replacement decision makers or inadequate compensation to attract a qualified replacement
- d. The inability of parties holding the rights to obtain information necessary to exercise them
- e. The absence of an explicit, reasonable mechanism in the contractual arrangement or in the applicable law or regulations by which the parties holding the rights can call for and conduct a vote to exercise those rights.

Substantive kick-out rights alone are not sufficient to allow a decision maker's fees to be excluded from paragraph 8(c) in the calculation of an entity's expected residual returns.

**Matters Discussed and Decisions Reached:**

The Board discussed the nature of fees paid to a decision maker that should be excluded from paragraph 8(c) of Interpretation 46, including the nature and impact of substantive kick-out rights. These issues were previously discussed at the October 15, 2003 Board meeting and in proposed FSPs FIN 46-b, "Effective Date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*,

for Certain Decision Makers," and FIN 46-c, "Impact of Kick-Out Rights Associated with the Decision Maker on the Computation of Expected Residual Returns under Paragraph 8(c) of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*."

The Board discussed the exclusion from paragraph 8(c) of fees that represent compensation for services commensurate with the level of effort required to provide those services in accordance with the conditions described in the staff draft of the FSP.

Mr. Trott asked if the determination of whether a decision maker's fees can be excluded from the paragraph 8(c) component of an entity's expected residual returns was intended to be a two part determination consisting of (1) the satisfaction of the requirement that compensation for services provided be commensurate with the level of effort required to provide those services and (2) satisfaction of specified conditions.

Ms. McIntosh responded that the staff suggested that all conditions would need to be met to qualify for the exclusion from paragraph 8(c) and agreed to clarify the draft FSP accordingly.

The Board decided to discuss the nature of substantive kick-out rights in conjunction with the discussion of the exclusion of certain decision maker rights from paragraph 8(c). The staff recommended the kick-out rights meet both of the following conditions to be considered substantive:

1. The decision maker subject to the kick-out rights can be removed by a vote of no more than a simple majority of the voting interests held by parties other than the decision maker and the decision maker's related parties.

2. The parties holding the kick-out rights have the ability to exercise those rights if they chose to do so, that is, there are no barriers to the exercise of the rights. Barriers include, but are not limited to:
  - a. Kick-out rights subject to conditions that make it unlikely they will be exercisable, for example, conditions that narrowly limit the timing of the exercise
  - b. Financial penalties associated with replacing the decision maker that would act as a more than insignificant disincentive for removal
  - c. The absence of an adequate number of qualified replacement decision makers or inadequate compensation to attract a qualified replacement
  - d. The inability of parties holding the rights to obtain information necessary to exercise them
  - e. The absence of an explicit, reasonable mechanism in the contractual arrangement or in the applicable law or regulations by which the parties holding the rights can call for and conduct a vote to exercise those rights.

Mr. Trott observed that the objective of the FSP is to identify fees paid to a decision maker who is acting as an employee of a variable interest entity, rather than to a decision maker with a controlling financial interest in the entity. Mr. Trott recommended that the existence of substantive kick-out rights be included as one of the conditions required for a decision maker's fees that are compensation commensurate with the level of services to be excluded from paragraph 8(c). Since employees have exposure to replacement by their employers, requiring the decision maker to be subject to substantive kick-out rights would be consistent with the objective of the FSP. Although substantive kick-out rights alone would not permit a decision maker's fees to be excluded from paragraph 8(c), such rights are one of the characteristics of an employment arrangement. Mr. Trott suggested that the staff return to the Board after drafting a single approach that combined the two ideas presented in the draft FSP for determining whether a decision maker's fee could be excluded for purposes of

applying paragraph 8(c). Mr. Trott also recommended that because an employee relationship could include performance incentives, conditions required for the exclusion of the fees from paragraph 8(c) not include a prohibition for fees that are contingently receivable upon attainment of predetermined performance criteria.

Mr. Schieneman asked whether this approach was targeted at a specific type of entity, such as conduits. Mr. Trott responded that he tried to avoid targeting any specific entity, but acknowledged that fee arrangements for conduits and CDOs are intended to be captured if such an arrangement provides a decision maker with a fee that exceeds the compensation commensurate with the level of services provided.

Mr. Schieneman said that if a purely market-based fee was paid to a decision maker without the existence of substantive kick-out rights, then that decision maker could be viewed as having a variable interest. He commented that it seemed as though the existence of kick-out rights trumped the existence of a market-based fee. Mr. Trott responded that earlier attempts at defining “market-based fee” had been met with resistance.

Mr. Crooch agreed with Mr. Trott’s recommendations.

Ms. Schipper said that she viewed the guidance being discussed as consistent with the Board’s description of the characteristics of a controlling financial interest in paragraph C30 of the Basis for Conclusions of Interpretation 46. She said that in paragraph C31, the Board described how decision making in a VIE could be separated from the exposure to expected losses or the right to receive expected residual returns, or both. Ms. Schipper stated that the Board intended to separate decision making associated with controlling financial interests and decision making not associated with a controlling financial interest. She went on to say that paragraph 14 describes the kind of decisions that may be involved

with a variable interest, which then requires analysis of an entity again under paragraph C30.

Ms. Schipper agreed with analyzing a decision maker to see if it is subject to the conditions of employment. She said that if a decision maker is subject to conditions of an employee, or that of a hired agent, then the decision maker will have the characteristic in paragraph C30(a) for decision making ability, but not the characteristics in paragraphs C30(b) and C30(c) for exposure to expected losses or rights to receive expected residual returns. Ms. Schipper said that the guidance in the FSP described the relationship of the decision maker to the entity rather than the kinds of decisions that may be required of a decision maker.

Ms. Schipper agreed with Mr. Trott's recommendations. She stated that the objective of the FSP as described by Mr. Trott elaborated on the guidance in paragraphs C30 and C31 of Interpretation 46. She requested that the objective be incorporated into the final FSP.

Ms. Seidman agreed with Mr. Trott's recommendations. She suggested that the FSP state that the objective of paragraph 8(c) is not intended to capture decision maker fees that compensate a decision maker who is acting in an employed agent capacity in an entity, but instead to capture fees paid to a decision maker who has a controlling financial interest.

Ms. Seidman further commented that she was concerned with the transition provisions of the draft FSP. As drafted, the guidance on substantive kick-out rights would be effective immediately, with a cumulative effect entry required. She said that this would not give an entity that may have had an implied hired agency relationship with its decision maker time to formalize such an arrangement. She preferred that this proposed FSP have an effective date that coincides with the ultimate effective date of the Interpretation to Modify Interpretation 46.

Mr. Batavick agreed with Mr. Trott's recommendations and Ms. Seidman's concern about the effective date and transition for the drafted guidance.

The Board decided to consider the appropriate transition and effective date of the FSP when the revised FSP draft is discussed at the next Board meeting.

Mr. Herz agreed with Mr. Trott's recommendations. He also agreed with Ms. Schipper that this guidance was an extension of the Board's existing thoughts in the Basis for Conclusions in paragraphs C30 and C31. He also agreed that a condition for exclusion of a fee with reference to the attainment of a performance condition was unnecessary.

Mr. Herz questioned the use of the terms "trivial" and "insignificant" in the document. The Board agreed that to qualify for the paragraph 8(c) exception, the decision maker and the decision maker's related parties could not hold interests in the variable interest entity that provide more than a trivial amount of subordinated financial support to the entity or the right to receive more than a trivial amount of the entity's expected residual returns.

The Board agreed that one of the barriers to the exercise of kick-out rights be the existence of operational penalties that would act as a more than insignificant disincentive for removal of a decision maker.

Mr. Schieneman questioned whether it is appropriate to consider the size of a decision maker fee in considering whether such a fee is commensurate with the level of services the decision maker provides.

Ms. McIntosh pointed out that the relative size of a fee could be an indicator of whether a fee included embedded returns in excess of compensation commensurate with the services provided. The size of the fee would be one factor to consider but might not be determinative by itself.

Mr. Herz requested that the staff should solicit feed-back on the FSP from knowledgeable outside parties before the Board discussed the document again at the November 19, 2003 meeting.

**Follow-up Items:**

The Board will discuss the revised draft FSP, including its effective date provisions, at the meeting on November 19, 2003.

**General Announcements:**

The staff announced that proposed FSP FIN 46-f, "Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*," will be posted to the FASB website by November 14, 2003, for a 30 day comment period ending December 14, 2003.

The staff announced that a proposed FSP providing guidance on the computation of expected losses under Interpretation 46 is still being reviewed by Board members and other knowledgeable parties; therefore, it is not ready to be posted for comment.