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February14, 2012

Technical Director
Financial Accounting Standards Board
401 Merritt 7, PO Box 5116
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File Reference: No. 2011-220

Dear Ms. Cosper:

The Financial Reporting Executive Committee (FinREC) of the American Institute of Certified Public Accountants is pleased to offer comments on proposed FASB Accounting Standards Update (the proposed ASU), "Consolidation (Topic 810) - *Principal versus Agent Analysis*." FinREC supports the efforts of the FASB and the International Accounting Standards Board (IASB) to develop consistent guidance for a reporting entity to determine whether a reporting entity (or an entity's decision maker) is an agent or a principal when performing its consolidation analysis. FinREC believes that this will help to improve the comparability of financial statements and disclosures prepared in accordance with U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRSs). FinREC also supports the proposed ASU's objective to alleviate the inconsistency for evaluating kick-out and participating rights that resulted from the issuance of FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R).*

While FinREC generally supports inclusion of an assessment of whether a decision-maker is using its decision-making authority in a principal or an agent capacity based on the factors articulated in the proposed ASU and believes that a qualitative analysis would be superior to the current list of required criteria contained in the U.S. GAAP consolidation guidance for variable interest entities (VIEs), FinREC is concerned that the proposed guidance has some operational challenges, which are discussed below.

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 all of these factors should be considered when evaluating a decision maker's capacity. However, we believe that the rights held by other parties should be considered first and independently of the decision maker's economics, that is, the decision maker's compensation and the exposure to variability. We believe that it is a more operational approach to first determine whether the rights held by other parties (such as kick-out or

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participating rights; see our response to Question 4) are substantive, and then consider economics, rather than considering all of these factors simultaneously.

If the Board agrees with our recommendation to change the principal versus agent analysis as described above, we believe that the flowchart in paragraph 810-10-05-6 of the proposed ASU should also be changed to reflect our recommendations. Furthermore, we believe that the flowchart should be expanded to provide more detail on how to perform the principal versus agent analysis.

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 believe that substantive kick-out and participating rights should be considered when evaluating whether a reporting entity should consolidate another entity and that such rights should be determinative. Furthermore, we believe that these rights can be substantive if they are held by more than a single party, which seems to be consistent with the view expressed by the Board in paragraph BC19 of the proposed ASU: "The Board concluded that kick-out rights and participating rights held by a small number of parties could overcome the decision maker's economic interest in the principal versus agent analysis." As such, we recommend that the Board modify paragraph 810-10-25-39E of the proposed ASU as follows:

> When ~~a single party (including its related parties) holds~~ there are substantive kick-out rights (or other rights that have a similar effect on the decision maker's ability to exercise its power), whether held by a single party or a small number of parties, that allow the holders of such rights to ~~and can~~ remove the decision maker without cause, this, in isolation, is sufficient to conclude that the decision maker is an agent rather than a principal.

We also believe that it would be helpful to provide guidance about how the dispersion of these rights would factor into the analysis of whether the rights are substantive. We believe that in order to be substantive, these rights should be held by a small number of parties. However, it would be helpful to provide an example to demonstrate what would be considered "widely-dispersed".

If the Board decides not to amend the proposed model to independently evaluate the rights held by others, we are concerned that the guidance and implementation examples illustrating how a reporting entity should consider rights held by a large number of unrelated parties in its analysis are not sufficiently clear. Specifically, in Case E: Asset-Backed Collateralized Debt Obligation, it was concluded that the fund manager was acting as a principal and the kick-out rights held by debt-holders would not overcome this conclusion. In this example, several factors resulted in this conclusion, including the fact that the fund sponsor, through its equity interest, had a different economic exposure than debt holders. The fee arrangements further support the conclusion that the fund manager is acting as a principal. Paragraph 810-10-55-3AX of the proposed ASU states that "The level of economic variability that the fund manager is exposed to through its equity interests and fees relative to the

returns expected from the activities of the entity indicates that the fund manager is using its decision-making authority to direct the relevant activities of the fund in a principal capacity…. The widely dispersed kick-out rights held by the AAA-rated debt holders would not overcome this conclusion based on the dispersion of the rights and the disproportionate economic interest of the right holders and the fund manager."

However, based on this example we are unclear how widely dispersed kick-out rights should be evaluated and what impact they would have in the context of a pro-rata equity ownership. Specifically, when using a fact pattern that is similar to the one described in case E but assuming that kick-out rights are held not by debt holders but by pro-rata equity holders and are also widely dispersed, it is unclear whether that would be considered enough of a right to overcome the presumption that the fund sponsor is acting as a principal. We believe it would be helpful to provide an example which isolates the feature of kick-out rights and demonstrates how those rights would impact the analysis.

Furthermore, we recommend the Board reconsider its position that redemption rights would not be considered in the principal versus agent analysis. We believe that if redemption rights function in a manner that is substantively the same as liquidation rights, then those redemption rights should be evaluated similarly to liquidation rights. In other words, if circumstances are such that if a redemption right were exercised, it would result in the liquidation of an entity, then it should be evaluated as a liquidation right. We believe that for a redemption right to be similar to a liquidation right, it has to be concentrated in the hands of a very small number of significant investors.

We understand that the guidance in the proposed ASU (paragraphs 810-10-25-40B and 810-10-25-98) is consistent with the current guidance in FASB ASC 820-20-25-9, which, in turn, represents a carry-forward from paragraph 8 of 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." Paragraph BC21 of the proposed ASU indicates that "While redemption rights do not provide an investor with the power to remove a decision maker, investors could theoretically withdraw 100 percent of an entity's capital (assuming there are no restrictions in place) and effectively "kick out" the decision maker. While this scenario may be rare in circumstances with many investors, it might be plausible for an entity that has few investors and, thus, could be seen as increasing the possibility that a decision maker is not a principal in those situations." We do not believe that this scenario is "rare," but believe that it is encountered in practice often enough for it to be addressed in the standard, particularly in the institutional asset management and hedge fund spaces. In fact, it is common for investment funds to liquidate solely because of the magnitude of redemptions, because it becomes increasingly more difficult for a fund manager to obtain additional investors for the entity and it may become more difficult to effectively manage the investment fund due to lack of appropriate scale. As a result, in some cases, a redemption right can be in substance the same as a liquidation right

In most of the examples in the implementation guidance, there is specific mention of redemption rights within the background of the examples, but no mention of how these rights factor into the conclusion and the principal versus agent analysis. We recommend that the examples be amended to include the discussion on how redemption rights would impact the analysis.

We also recommend providing examples on the implementation of the guidance for significant barriers to exercising participating and kick-out rights. For example, many investment funds have "lock-ups" and other provisions in which certain rights of investors may not be effective until a certain period of time. These lockups may create a temporary barrier. Also, certain of the barriers are less relevant when a single party holds a substantive kick-out right. For example, an explicit, reasonable mechanism in the entity's governing documents is more likely necessary when multiple unrelated parties are required to act together.

Finally, we recommend that the Board add language to the Codification to indicate that "for the purpose of the principal versus agent analysis, liquidation rights should be considered equivalent to kick-out rights." Currently, this language is included on paragraph BC20 of the proposed ASU which will not be codified. Furthermore, paragraph 810-10-25-10 of the proposed ASU indicates that liquidation of the investee is deemed a "protective right," which seems to imply that it is not substantive. We believe that currently liquidation rights are not treated consistently in practice and that moving guidance from paragraph BC20 into the Codification will help to reduce that inconsistency in practice.

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 have concerns that the application of the proposed ASU will not meet the Board's intention and the proposed guidance may be interpreted to require money market funds and similar funds to be consolidated in certain situations. The Board provided two examples in the proposal (Case F: *Commercial Paper Conduit*, and Case C: *Structured Investment Vehicle*) that indicate that having an "implicit financial responsibility to ensure that the entity operates as designed" may affect the consolidation analysis. In both of these examples it was determined that the sponsor had an implicit financial responsibility and "[t]his determination was influenced by the sponsor's concern regarding the risk to its reputation in the marketplace if the VIE did not operate as designed" (see paragraphs 810-10-55-3BJ and 810-10-55-132 of the proposed ASU). In the past, when several money market funds reached or approached the point of "breaking the buck," money market managers provided or considered providing financial support to those funds through capital infusions or capital support agreements. It may be argued that this was done to "ensure that the entity operates as designed" (that is, the money market fund's shares continue to trade at a $1.00 NAV) and to "manage the risk to its [money market manager's] reputation in the marketplace." As a result of this experience, many believe that money market managers have a non-binding, but implicit guarantee to fund credit losses of a money market fund in situations where the fund's NAV decreases to a value less than $1.00.

As a result, we are concerned that when the proposed guidance is considered in conjunction with the financial crisis experience, some may conclude that money market funds should be consolidated. To avoid this interpretation of the proposed guidance we recommend that a reporting entity's interest in an entity that complies with or operates in accordance with requirements that are similar to those included in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds be explicitly scoped out of the proposal. This language is consistent with the language in FASB ASC 810-10-65-2(aa)(2) which was added to FASB ASC 810 by ASU 2010-10, *Consolidation (Topic 810) - Amendments for Certain Investment Funds*, to defer, for certain investment funds, the consolidation requirements of FASB ASC 810 resulting from the issuance of Statement 167. We believe that providing such an exemption would be consistent with the position taken by the Board in ASU 2010-10 in which it acknowledged that "the Statement 167 amendments to the Topic 810 consolidation requirements should not result in investment managers having to consolidate money market funds that operate in accordance with the requirements of the Act" (see paragraph BC16 of ASU 2010-10). The Board also acknowledged in that ASU "that the deferral should not be limited to registered money market funds that are required to comply with the Act, but that it also should apply to all funds that operate in a manner similar to registered money market funds that are required to apply the Act" (see paragraph BC17 of ASU 2010-10).

If our recommendation above is not accepted, we request clarification about the impact of the proposed guidance on situations in which an investment manager actually does provide funding to a money market fund. This could be in the form of a voluntary contribution, an explicit or implicit guarantee or required by regulation or legislation.

Question 11: *For purposes of applying the proposed principal versus agent guidance, the proposed amendments would require a reporting entity to include the decision maker's direct and indirect interests held in an entity through its related parties. Do you agree with the requirement that a decision maker should include its proportionate indirect interest held through its related parties for purposes of applying the principal versus agent analysis? Why or why not?*

Paragraphs 810-10-25-42 and 810-10-25-96 of the proposed ASU indicate that for purposes of determining whether the decision maker/general partner is a principal or an agent, a decision maker/the general partner shall include its direct economic interests in the entity/partnership and its indirect economic interest held through a related party. We are concerned that the examples provided in those paragraphs imply a false sense of precision. Furthermore, related-party interests may have different rights associated with them and it is unclear to us whether those rights should also be considered in this analysis and, if so, how. We are concerned that the proposed guidance may have unintended consequences and may be challenging to apply.

In addition, in the case of a limited partnership, the evaluation of whether a general partner is a principal would include the general partner's interests in the limited partnership held through its related parties. While we do not disagree with this approach, it is unclear to us whether the decision making authority of a general partner should ever be attributed to the limited partners in a related party group, specifically, whether interests held by a related party should also be considered if the reporting entity is a limited partner and an unconsolidated related entity is the general partner. The following example is presented for consideration:

An entity is a limited partner in a limited partnership and its unconsolidated related party (for example, a board member, or a de-facto agent, or an equity-method investee) is the general partner. If the limited partner is required to include its related party's interest in its consolidation analysis, the limited partner may determine that it should consolidate the partnership.

If this is the Board's intent, we believe that the evaluation should consider the nature of the related party. For example, a reporting entity typically cannot control a board member or a de-facto agent in the same manner in which an employee can be controlled. Further, if the reporting entity were a not-for-profit entity, because those entities typically do not compensate board members and are prevented by private inurement and intermediate sanctions laws from benefitting the board member, the conclusion may be different.

For reasons cited above, we believe it will be very challenging to capture and evaluate indirect/implicit interests, especially in situations in which indirect interests are diluted by proportionate ownership rights or there are no ownership rights. If the Board decides to move forward with the requirement for an entity to consider both its direct and indirect economic interests when determining whether it is a principal or an agent, we recommend that the Board provide additional examples. The example currently included in the proposed ASU demonstrates a situation when a related party owns an equity interest. We recommend providing additional examples in the final standard to illustrate how to apply the guidance in the proposed ASU in situations when the related party is a debt- or guarantee-holder in the entity being evaluated.

Question 12: *The amendments in this proposed Update would require a general partner to evaluate its relationship with a limited partnership (or similar entity) by applying the same principal versus agent analysis required for evaluating variable interest entities to determine whether it controls the limited partnership. Do you agree that the evaluation of whether a general partner should consolidate a partnership should be based on whether the general partner is using its decision-making authority as a principal or an agent?*

While we agree that the principal versus agent analysis should be used to evaluate whether a general partner should consolidate a limited partnership, we have concerns about how this guidance would be applied for certain investment funds. Paragraph 810-10-25-95(d) of the proposed ASU indicates that when evaluating its exposure to variable returns from other interests in the limited partnership, a general partner should consider, among other things, "the general partner's maximum exposure to losses of the limited partnership. Although the general partner's exposure is evaluated primarily on the basis of returns expected from the activities of the limited partnership, that evaluation also shall consider its maximum exposure to losses of the limited partnership, which would include guarantees of the partnership's obligations (through a contract or a legal requirement) that may be inherent in a general partner's ownership interest."

While a general partner may have unlimited liability with respect to the overall operations of the entity, by purpose and design, many partnerships are structured in such a way so that general partners would not incur significant losses above and beyond their partner capital balances invested in the limited partnership. However, we are concerned that a literal interpretation of the above guidance will result in substantially all general

partners being considered principals solely because of the legal structure of these types of entities. We do not believe this was the Board's intent and we recommend that the final standard includes additional guidance to clarify this. Specifically, we recommend including language similar to that in paragraph BC7 of ASU 2010-10, which states that "a general partner's unlimited liability with respect to its interest in a limited partnership that has general recourse debt obligations would not be deemed to expose the reporting entity (general partner's investor) to losses of the partnership that could potentially be significant to the partnership, if the general partner has no assets other than its interest in the limited partnership and the partnership's creditors have no recourse to assets of the financial reporting entity (general partner's investor)."

We also recommend revising the proposed ASU to emphasize that the general partner analysis, as laid out in the proposed ASU, would now include not only the review of the rights given to the limited partners but also the economics that the general partner has. Otherwise, we are concerned that some practitioners will reach inappropriate consolidation conclusions by focusing only on the changes related to kick-out and participating rights. At a minimum, an example illustrating whether a 1% general partner interest results in consolidation would be helpful in conveying the Board's intent.

Furthermore, we believe that an examination of the overall purpose and design of the entity, coupled with an analysis of the expected returns of the general partner should be weighed in the determination and that a traditional general partner interest, taken by itself, should not automatically create principal relationship. In this context, we encourage that, prior to finalizing the standard, the Board reach out to various industries to understand the impact of the proposed guidance, for example real estate and energy-related industries.

Other Matters

Definition of a Variable Interest Entity. Paragraph 810-10-15-14(b)(1) of the proposed ASU states that "The holders of the equity investment at risk may delegate this power to a decision maker that is an agent of the equity holders. In such situations, the decision maker shall not prevent the holders of the equity investment at risk from having this characteristic if the decision maker is determined to be an agent of the equity holders. Paragraphs 810-10-25-39A through 25-39L provide guidance on the assessment of a decision maker's capacity."

Our interpretation of the proposed ASU is that in applying the provisions of paragraph 810-10-15-14(b)(1), if in the principal/agent analysis it is determined that the decision maker (who is not considered part of the equity holder group) is an agent of the equity investor group, the entity would not meet this criterion. Provided the entity does not meet the other criteria in paragraphs 810-10-15-14, then the entity would *not* be a VIE but rather a voting interest entity. Consequently, the entity would need to be analyzed under the voting interest model of consolidation and would not be subject to the VIE disclosure requirements in FASB ASC 810-10-50-3 through 810-10-50-16.

If our interpretation is correct, we note that the proposed ASU has numerous examples of the application of the principal/agent analysis but it is not sufficiently clear as to the interrelationship between the determination that a decision maker is an agent and the definition of a VIE in paragraph 810-10-15-14. In order to clarify this point,

we recommend including an example of the application of an agency relationship to the definition of a VIE. For example, an alternative fund where the decision maker holds no equity interest, receives a base management fee and a market-based performance fee, and holds no other interests in the fund is determined to be an agent and would apply the voting interest model.

Common control entity example. We believe that related party guidance may be needed with respect to the following potential structuring opportunity. The following example is presented for consideration:

> An entity is owned by two affiliates under common control. One of the affiliates owns all of the economic interest in the entity, the other one holds all of the decision making rights. Neither affiliate owns any portion of the other affiliate. As discussed in the "Definition of a Variable Interest Entity" section above, the entity would not meet the criterion in paragraph 810-10-15-14(b)(1) of the proposed ASU. Provided the entity does not meet the other criteria in paragraphs 810-10-15-14, then the entity would *not* be a VIE but rather a voting interest entity. Because the voting interest model does not have a related party tie-breaker test (which is present in the VIE model – see paragraph 810-10-25-44 of the propose ASU), it is possible that in the fact pattern described above, neither of the affiliates would consolidate the entity if they were required to produce financial statements.

We recommend that prior to finalizing the proposed ASU, the Board consider how to address situations similar to the one described above.

How to apply revised Topic 810 guidance to investments by one investment company in another investment company. If the guidance in the proposed ASU, "Financial Services—Investment Companies (Topic 946): *Amendments to the Scope, Measurement, and Disclosure Requirements,"* is finalized in its current form, an investment company will be required to consolidate its interest in other investment companies. As discussed in our comment letter on the Topic 946 proposal, investment companies often do not invest in the other investment vehicles in order to control them; rather, they seek an efficient mechanism to gain exposure to expertise within a specific sector or asset class or as a mechanism to efficiently develop an asset allocation strategy. As such, we believe that in most instances consolidation of one investment company by another would not be appropriate and would not provide users of financial statements with meaningful information. We believe the Board should consider providing additional implementation guidance on how limited partners and similar structures should assess whether they should consolidate a limited partnership. This will be particularly necessary if the Topic 946 proposal is finalized in its current form, and an investment company is required to consolidate its interests in other investment companies.

For example, when analyzing the limited partnership investment company structure under the proposed ASU, the general partner often will be considered to be an agent. Limited partners in such investment companies often have no substantive rights and are limited in their decisions to those that pertain only to their own partnership interest (that is, they can either decide to make an additional investment or choose to redeem all or a portion of their interest). However, because in a typical fund the level of equity is considered sufficient, there are no single investors that constitute substantially all of the capital, and the decision maker is determined to be

an agent, based on guidance in paragraph 810-10-15-14 of the proposed ASU, the investment company would not be a VIE and would be determined to be a voting interest entity. In such situations, it is unclear how a limited partner, given its lack of explicit rights, would evaluate its interest to determine whether to consolidate the limited partnership. Currently, there is limited guidance on how limited partners should evaluate their interests and this guidance is included in the real estate Topic in FASB ASC 970-323-25-8, which is as follows:

> If the substance of the partnership arrangement is such that the general partners are not in control of the ~~major operating and financial policies of the partnership~~ activities that most significantly impact the limited partnership's economic performance, a limited partner may be in control. An example could be a limited partner holding over 50 percent of the total partnership interest. A controlling limited partner shall be guided in accounting for its investment by the principles for investments in subsidiaries in Topic 810. Noncontrolling limited partners shall account for their investments by the equity method and shall be guided by the provisions of Topic 323, as discussed in the guidance beginning in paragraph 970-323-25-2, or by the cost method, as discussed in the guidance beginning in paragraph 970-323-25-5, as appropriate.

Since this guidance is relevant not only to the real estate industry, we recommend moving this guidance out of Topic 970 into Topic 810. It should be noted that the question of whether to consolidate a limited partnership with only limited partnership interests currently exists, and will continue to exist, regardless of the Board's decision about whether an investment company is required to consolidate another investment company. Furthermore, we understand that while some industries have been following this guidance by analogy, others have not. Therefore, moving this guidance into Topic 810 will make it applicable to all entities, thus, eliminating diversity in practice. We also recommend revising the example to include a more qualitative assessment, which focuses not only on the level of ownership held by the limited partner but also on its relationship with the general partner, because we are concerned that the current example may be viewed by many as creating a bright-line threshold.

Change in exposure to variability. We believe it would be helpful to include examples on the application of the principal versus agent analysis where the general partner receives an equity-based performance fee (allocation). Many general partners of investment funds organized as limited partnerships receive their performance fees in the form of an equity interest (as opposed to cash). Accordingly, at a particular point in time during the life of the fund, this may increase the general partner's exposure to variability of the investment fund. Although the purpose and design of the fund at formation has not changed, we are concerned that some may interpret the general partner's exposure to variability as a result of the allocation that has not been withdrawn by the general partner, to change the nature of their relationship. The examples provided in the implementation guidance section of the proposed ASU seem to focus on fixed equity interests, but not on those that, by design, would change over time. It is unclear whether the fund manager's receipt of the performance allocation would be considered a change in the purpose and design of the entity that would require a reconsideration of the principal versus agent analysis (as an "additional equity investment that is at risk to the decision maker" as described in paragraphs 810-10-25-85 and 810-10-35-6 of the proposed ASU). If it is the Board's intent that this should result in a reconsideration of the relationship, we recommend that the Board clarify this point. That clarification should include the ability of the general partner to redeem its interest in the investment fund as it receives the

performance allocation is an important factor to consider in determining whether it is acting in a principal or agent capacity. Many fund managers receive their performance allocation on an annual basis and, in some cases, more frequently.

Series funds. We understand there are some concerns about the impact of the proposed ASU on mutual funds registered under the Investment Company Act of 1940 which are organized as individual series within an overall trust (series funds). Specifically, there are questions regarding whether series funds are considered VIEs and, if so, how does one determine who the primary beneficiary is. If series funds are considered to be VIEs, we recommend that the Board consider whether the disclosure requirements that are relevant for all other entities that have a variable interest in a VIE are also relevant and useful for series funds.

Employee benefit plans. We understand that the proposal has caused concerns with certain types of employee benefit plans, for example, multiemployer plans. Accordingly, we recommend that the Board reach out to constituents that may be impacted.

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We appreciate the opportunity to comment on the proposed ASU. We are available to discuss our comments with Board members or staff at their convenience.

Sincerely,

Richard Paul
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