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A legal update from Dechert's Finance and Real Estate Group

Financial Accounting Standards Board Amends FAS 140 and FIN 46(R)

Authors' Note

We waited before preparing an update on FAS 166 and FAS 167 in order to let the full implications of these radical changes of accounting policy settle in. While these new rules don't go into effect until next year, much planning will be needed to address the added complexities and difficulties presented by these transformational changes in accounting policy. It is time to begin thinking about the impact these changes will have on your institution and transactions which may be in the pipeline.

While we will review the changes in a more dispassionate way below, let us editorialize at the beginning by saying that these changes will have a radical impact upon structured finance. The new rules will cause billions of dollars of assets and liabilities to be bolted onto the balance sheets of institutions which neither get practical economic benefit from the assets nor have contractual responsibility for the liabilities. It will be expensive and time-consuming to meet the new reporting and disclosure standards. Balance sheets will be more complex and harder to understand. Regulatory capital will be torqued and applicable regulatory constituencies will undoubtedly (we hope) adjust their rules to deal with the faux expansion of regulated balance sheets. All contractual arrangements containing financial covenants have to be attended to. Without change, many of these will be breached because of the accretion of new assets and liabilities onto balance sheets without attendant real world economic benefits and burdens.

To add to the misery, the analyses required by these standards are dynamic and ongoing. Consequently, in structured finance, assets and liabilities will become like the Okies of the Dustbowl and move from balance sheet to balance sheet as circumstances change over time. As realized losses change control in CMBS transactions, consolidated assets and liabilities will roll up the capital stack from unrated into investment grade bondholders' balance sheets.

Finally, henceforth, structuring transactions to receive sale treatment and to avoid the unintended consequences of consolidation will become a full time job for auditors and attorneys. This additional burden on achieving the legitimate business purposes of financial institutions is hard to swallow in a time of great financial distress.

The new standards can be seen as a product of a hasty rush to judgment by FASB and the harsh whip of the SEC to "get this resolved." They seem to reflect a certain insensitivity to the unintended consequences to an economy which, for the moment and for the foreseeable future, is in significant distress. The impact of these standards will be far-reaching and cannot help but result in a further drag on the prospects of economic recovery.

For these reasons, these changes to accounting policy remain "in play" as various regulatory constituencies and legislators continue to consider the wisdom of such radical changes at a time of economic disruption. Some, including the authors, hold a diminishing hope that some mitigation or delay of the draconian impact of these rules could be achieved before their effective date, but that's far from certain, or even likely. Stand by and be mindful that the debate goes on. And, in the mean time, prepare. With the editorial put aside for the moment, let us take you through these two important standards in some detail.

After many years of uncertainty regarding the treatment of financial assets transferred to and held by special purpose vehicles, on June 12, 2009, the Financial Accounting Standards Board ("FASB") issued two new standards that will materially impact the way reporting entities account for transfers of financial assets and off-balance sheet vehicles. The new standards – FASB Statement of Financial Accounting Standards No. 166, *Accounting for Transfers of*

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Financial Assets, an amendment of FASB Statement No. 140 ("FAS 166") and FASB Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)* ("FAS 167") – amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* ("FAS 140") and FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities* ("FIN 46R"), respectively.

In this update, we will summarize some of the significant changes to the accounting standards and will provide some commentary on these momentous changes, particularly with a focus on how the new standards will impact banks and other financial institutions that engage in securitizations and similar transactions that include the transfer of financial assets to special purpose entities ("SPEs"). Under the new standards, transferred financial assets (and liabilities) that would have previously been derecognized may no longer be eligible for derecognition. Absent careful planning and design, the assets and liabilities of SPEs with which the sponsor or transferor has retained a customary continuing relationship to these vehicles may be subject to consolidation. The new standards also will make it more difficult to structure securitized transactions as sales and will require financial institutions to consolidate many existing securitized structures that are currently accounted for as "off balance sheet" transactions.

As a result, these new standards are expected to cause the bulk of existing securitized assets to be transferred onto the balance sheets of sponsors, servicers or investors. Moreover, the new standards are also expected to have a negative impact on the future issuance of mortgage- and asset-backed securities, as one of the principle structural underpinnings of securitizations, the Qualified Special Purpose Entity ("QSPE" or a "Q") has been eliminated. According to the chairman of FASB, Robert Herz, in FASB's press release announcing the two new standards, "[t]hese changes were proposed and considered to improve existing standards and to address concerns about companies who were stretching the use of off-balance sheet entities to the detriment of investors ... [t]hey'll provide better transparency for investors about a company's activities and risks in these areas." Well, that's one view.

The principal changes to accounting resulting from the adoption of FAS 166 and 167 are:

- eliminate the concept of the QSPE and the corresponding consolidation exemption;
- modify the derecognition criteria for determining whether, for accounting purposes, a transfer of a financial asset should be accounted for as a sale or a secured borrowing;
- establish elaborate criteria for determining when a transfer of a portion of a financial asset should be accounted for as a sale for accounting purposes;
- revise the test to determine whether an enterprise is a variable interest entity ("VIE");
- revise the consolidation criteria to move from a quantitative risks and rewards analysis to a qualitative control-based analysis for determining who will be the "primary beneficiary" of a VIE and hence, who must consolidate;
- require an ongoing dynamic reassessment under FAS 167 to determine whether an enterprise is the primary beneficiary of a VIE; and
- lastly, expand the disclosure requirements for a reporting entity with respect to transferred financial assets and VIEs whether or not the reporting entity is a primary beneficiary.

Both FAS 166 and FAS 167 will be effective as of the beginning of the reporting entity's first annual reporting period that begins after November 15, 2009 and for interim periods within that first annual reporting period. The guidance in FAS 166 will apply to all transfers of financial assets occurring on or after the effective date, and the guidance in FAS 167 will be applied as of the effective date to all VIEs, including pre-existing VIE's and vehicles that were previously considered QSPEs.

Elimination of the QSPE

The marquee change to FAS 140 and FIN 46R relates to the elimination of the QSPE. The QSPE has played a central role in accounting for transfers of financial assets in securitization since the inception of structured finance. Entities that transferred financial assets to a vehicle that satisfied the requirements of a QSPE were typically able to derecognize the transferred asset and attendant liabilities (i.e., move these off of its balance sheet) in accordance with FAS 140. Likewise, assets and liabilities of a QSPE were exempt from the VIE consolidation analysis under FIN 46R which required the reporting entity with the preponderance of the risks and rewards of ownership to consolidate the VIE's assets and liabilities. Under the new standards, with no Q to

inoculate securitization vehicles from consolidation analysis, most securitization vehicles and other similar vehicles will be VIEs and subject to the new derecognition and consolidation criteria addressed below.

The elimination of the QSPE concept is applicable not only to new structures and transactions, but also to existing QSPEs. Therefore, all VIEs (including existing QSPEs) will need to be re-evaluated on the effective date for consolidation under FAS 167. As a result, previously unconsolidated VIEs may now become consolidated, substantially increasing the amount of assets and liabilities carried on balance sheets of securitizers and other transferors.

FAS 166 and the Amendments to FAS 140

FASB's articulated objective in issuing FAS 166 was to:

> "improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets."

In particular, FASB sought to address in FAS 166: (1) concerns with practices that had developed since the original issuance of FAS 140 that FASB viewed as inconsistent with the original intent and key requirements of FAS 140 and (2) perceived concerns of financial statement users that many financial assets that had been derecognized should continue to be reported in the financial statements of the related transferor.

While FAS 166 runs to well over 100 single-spaced pages and contains numerous provisions that may significantly change the accounting for transfers of financial assets, we will focus on the changes to the derecognition criteria in FAS 166. Paragraph 9 of FAS 166 sets forth the derecognition criteria for determining whether to account for a transfer of a financial asset as a sale or a secured borrowing, and applies to transfers of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset (i.e., a transfer of a portion of a financial asset) in which the transferor surrenders control over those financial assets.

Paragraph 9 is sufficiently important that we thought it useful to summarize it in its entirety. Under paragraph 9, a transferor will surrender control over a transferred financial asset, and thus account for the transfer as a sale, if and only if, the following conditions are satisfied:

1. the transferred financial asset is isolated from the transferor;

2. each transferee (or, if the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities and that entity is constrained from pledging or exchanging the assets it receives, each third-party holder of its beneficial interests) has the right to pledge or exchange the transferred asset (or beneficial interests) it received, and no condition both constrains the transferee (or third-party holder of its beneficial interests) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor; and

3. the transferor, its consolidated affiliates or agents do not maintain effective control over the transferred financial asset or third-party beneficial interest related to the transferred asset.

If the transfer of a financial asset fails to satisfy any of the criteria set forth above, or if the transfer of a portion of an entire financial asset does not satisfy the definition of a "participating interest" (as discussed below) or otherwise satisfy the criteria set forth above, then the transferor and transferee are required to account for the transfer as a secured borrowing. Of the three criteria, "effective control" is the most interesting and important.

Control

In accordance with FAS 166, the preparer must determine whether a transferor and its consolidated affiliates and agents have surrendered effective control over the transferred financial asset or, as applicable, third-party beneficial interests related to the transferred financial asset. If effective control is found to exist, a sale did not occur. In making this determination, the preparer of financial statements must first assess the transferor's (its consolidated affiliates' and its agents') continuing involvement with the transferred financial asset. Continuing involvement, according to the guidance, means any involvement with the transferred financial asset that permits the transferor to receive cash flows or other benefits that arise from the transferred financial asset or that obligates the transferor to provide additional cash flows or other

assets to any party related to the transfer. According to the guidance, examples of continuing involvement include, but are not limited to, servicing arrangements, recourse or guarantee arrangements, agreements to purchase or redeem transferred financial assets, options written or held, derivative financial instruments that are entered into contemporaneously with, or in contemplation of, the transfer, arrangements to provide financial support, pledges of collateral, and the transferor's beneficial interests in the transferred financial asset.

In assessing whether continuing involvement exists, the preparer is required to use judgment in considering all arrangements or agreements made contemporaneously with or in contemplation of the transfer, even arrangements or agreements that were not entered into at the time of transfer. All available evidence must be considered, including, but not limited to, explicit written arrangements, communications between the transferor and the transferee or its beneficial interest holders, and unwritten arrangements customary to similar transfers. This broad notion of continuing involvement considers the idea that transferor control could be "baked in" by the designer of a structure to create something of a bias towards a conclusion that effective control exists.

If continued involvement is present, the analysis turns to whether effective control exists. Consistent with the guidance in FAS 140, an agreement that both entitles and obligates the transferor to repurchase or redeem the transferred asset before its maturity will give the transferor effective control over the transferred financial asset. Likewise, an agreement that provides the transferor with the unilaterally ability to cause the holder of a transferred asset (except through a clean-up call) to return a specific transferred asset may give the transferor effective control over the transferred financial asset (i.e., repo agreements). The unilateral ability to cause the holder of a transferred asset to return a specific transferred asset must provide more-than-a-trivial-benefit to the transferor. In addition to these two examples, FASB provided an additional example of effective control—an agreement that permits the transferee to require the transferor to repurchase the transferred asset at a price that is so favorable to the transferee that it is probable that the transferee will require the transferor to repurchase the transferred financial asset.

FASB noted in FAS 166 that the above list of examples is not an exhaustive list of situations where the transferor maintains effective control over the transferred financial asset. The preparer of financial statements must use judgment to assess whether the transferor maintains effective control over a transferred financial asset, including through multiple arrangements. As discussed above, all direct or indirect continuing involvement in the transferred financial asset by the transferor, its consolidated affiliates and its agents must be considered. There is more than a hint of FASB's underlying suspicion of banker creativity in this open-ended invitation to find effective control. It seems to encourage a fair amount of "creativity" in a preparer's analysis of structures when effective control might be inferred from the design or structural features of the deal.

In addition to the clarifications noted above, FAS 166 specifically requires an inquiry of whether the transferor retains effective control over the transferred financial asset through its control over the third-party beneficial interests in the transferred financial asset issued by the transferee. Furthermore, FAS 166 specifically requires that the transferor consider whether the transferor's consolidated affiliates and agents (but only to the extent the agent acts for and on behalf of the transferor) maintain effective control over the transferred financial asset or third-party beneficial interests.

Isolation

Another condition for sale treatment under paragraph 9 is the determination that the transferred financial assets are isolated from the transferor. In other words, the transferred financial asset must be presumptively beyond the reach of the transferor, its consolidated affiliates (that are not entities designed to make remote the possibility that they would enter bankruptcy or other receivership) and its creditors, including in bankruptcy or other receivership. This analysis will depend on the facts and circumstances with respect to the related transaction or series of transactions taken as a whole.

FASB carried forward most of the existing guidance relating to analyzing this condition under FAS 140. For example, the preparer of financial statements must continue to consider all available information that either supports or questions isolation, including, whether the contract or circumstance permits the transferor to revoke the transfer, whether the transfer would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee and other factors pertinent under applicable law. (It is uncertain what might be the impact of the recent raft of bankruptcy cases which may test the whole notion of legal isolation around SPEs.)

Constraints on Pledging or Exchanging the Transferred Financial Asset

The final condition for sale treatment under paragraph 9 is the determination that there are no constraints on the transferee's ability to pledge or transfer the transferred financial asset. The guidance in FAS 166 is similar to the existing guidance under FAS 140. Having eliminated the QSPE, however, FASB had to confront the reality that the *sine qua non* is that, with respect to transfers to entities whose sole purpose is to engage in securitization or asset-backed financing activities, the transferee is constrained from pledging or exchanging the transferred financial assets to protect the rights of beneficial interest holders in the financial assets. Consequently, under such circumstances the restraint on the ability to pledge/transfer test was moved to the beneficiary level so that the preparer of financial statements must look through the securitization vehicle and assess whether there are any restraints on the entity's beneficial holders to pledge or exchange their beneficial interests. Note that, in another nod to practicality, this test can be satisfied even if the transferor, as a beneficial interest holder in the vehicle, is restrained from freely transferring its interest.

In any case, the preparer of financial statements must use judgment to assess whether a condition on pledging or exchanging a financial asset (or third-party beneficial interests) results in a constraint and whether the particular constraint provides more-than-a-trivial benefit to the transferor. For example, a provision that prohibits or significantly limits (e.g., provisions that narrowly limit timing or terms of a transfer) a transferee from selling or pledging the transferred asset may presumptively provide the transferor with more-than-a-trivial benefit, such as knowing who holds the financial asset and of being able to block the financial asset from being sold to a competitor. FASB clarified in FAS 166 that under some circumstances sale accounting will be allowed even if the transferee is significantly limited in its ability to pledge or exchange the transferred financial asset if the transferor, its consolidated affiliates and its agents have no continuing involvement with the transferred financial asset.

Participating Interests

FAS 140 did not contain any specific guidance on the treatment of transfers of a portion, or component, of a financial asset. FASB attempted to address this issue in FAS 166 by defining, albeit narrowly, when a transfer of a portion of an entire financial asset may be accounted for as a sale. This new standard, however, focuses more on the form of the transfer (i.e., a participation that meets the definition of a "participating interest" as discussed below), rather than its substance. If a financial asset is subdivided using a multi-note structure, each note is considered a separate financial asset; no problem here. Not so as to participations. FASB has had an unnatural fascination with participating interests for many years.

Under FAS 166, the transfer of a portion of a financial asset may only be accounted for as a sale if it meets the definition of a "participating interest" and otherwise satisfies the derecognition criteria in paragraph 9. Each component of an entire financial asset must satisfy the definition of a "participating interest" if sale accounting treatment is desired. According to FASB, a "participation interest" has the following characteristics:

1. it represents a proportionate (pro rata) ownership interest in an entire financial asset;

2. all cash flows (other than certain compensation for services performed[1] and certain proceeds of the transfer[2]) from the entire financial asset must be proportionately distributed to the participants in proportion to their share of ownership;

3. the rights of each participating interest holder must have the same priority and no participating interest holder may be subordinate to another;

4. the participating interest holders must not have any recourse to the transferor (or its consolidated affiliates or agents) or to each other, other than standard representations and warranties, servicing obligations and contractual obligations to share in any setoff benefits received by any participating interest holder; and

5. no party has the right to pledge or exchange the entire financial asset, unless all participating interest holders agree.

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[1] Compensation for services performed will be excluded from this consideration if (a) it is not subordinate to the proportional cash flows and (b) it is not significantly above fair compensation for the services rendered.

[2] Proceeds will be excluded from this consideration if the transfer does not result in the transferor receiving an ownership interest in the financial asset that permits it to receive disproportionate cash flows.

FASB's narrow definition of a "participation interest" will impact how banks and other financial institutions structure participation interests in the future. Under this criteria, the flexibility of a participation structure is greatly limited if the transferor of a participation interest hopes to achieve sale treatment under FAS 166. For example, a transferor cannot participate an entire financial asset into a senior and junior portion and transfer the junior (or riskier) portion and achieve sale treatment under FAS 166. In such case, the transferor will have to account for the sale of the junior (or riskier) participation interest as a secured borrowing for its senior position.

It is difficult to understand FASB's position that a portion of an individual financial asset can not be sold (and derecognized under FAS 166) in any manner other than through a pro rata participation interest with equal priority. This conclusion ignores the important business purposes that participation structures serve for banks and other financial institutions. Nonetheless, that's now the rule. Under FASB's new guidance, banks and other financial institutions will need to engage in the costly, and often burdensome, process of obtaining the underlying obligor's consent to restructure an entire financial asset into multiple financial assets if sale treatment is desired for transfers that do not satisfy the criteria for a participating interest, even though a participation structure, in substance, would achieve the same result.

FAS 167 and the Amendments to FIN 46R

Of the two new standards, FAS 167 is the more far reaching in terms of its immediate impact on financial institutions. FAS 167 will cause banks and other financial institutions to consolidate the assets and liabilities of many existing securitization vehicles (including assets and liabilities of existing QSPEs) onto their balance sheets. These, of course, are assets which they do not really own, in any practical sense, and liabilities for which they have no actual legal liability. Among other things, this will adversely impact capital reserves for certain financial institutions, cause companies to breach GAAP based financial covenants and render balance sheets vastly more complex, all at substantially greater cost to reporting companies.

The primary amendments to FIN 46R relate to the elimination of the QSPE and the criteria for determining when a holder of a variable interest in a variable interest entity (a "VIE") – an entity that is deemed insufficiently capitalized or is not controlled through voting or similar rights – must consolidate the assets and liabilities of the VIE on its financial statements (i.e., it is the primary beneficiary of the VIE). As discussed above, FAS 167 will apply to existing entities. Therefore, a reporting entity must carefully reconsider whether a pre-existing entity is a VIE and, if such entity is a VIE, whether that entity is the primary beneficiary.

FASB's objective in issuing FAS 167, as stated in FAS 167, was to "improve financial reporting by enterprises involved with variable interest entities." In particular, FASB sought to address in FAS 167 (1) the effects on certain provisions in FIN 46R as a result of the elimination of the QSPE concept and (2) concerns about the application of certain key provisions of FIN 46R in which the accounting and disclosures did not always provide timely and useful information about an enterprise's involvement in a VIE. The scope of FAS 167 remains unchanged from the scope of FIN 46R with the addition of entities previously considered QSPEs.

As with FAS 166, the breadth of 167 is large. Here, we will primarily focus on the revisions to the criteria relating to determining whether an entity is a VIE and to determining whether or not an entity is a primary beneficiary of a VIE (and thus, must consolidate the assets and liabilities of a VIE on its financial statements).

Variable Interest Entities

Under FAS 167, a VIE is generally an entity in which either: (1) the equity investors are not deemed to have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support or (2) the equity investors lack any one of the following three characteristics:

1. the power, through voting rights or similar rights, to direct the activities of an entity that most significantly impact the entity's economic performance;

2. the obligation to absorb the expected losses of the entity; and

3. the right to receive the expected residual returns of the entity.

For the most part, these criteria are consistent with the criteria under FIN 46R. However, FASB clarified in FAS 167 that the presence of kick-out rights (as discussed below) or participating rights will not be considered (for

purposes of the first characteristic above) unless a single enterprise has the unilateral ability to exercise these rights. It is apparent that, absent the Q, this test will cause most securitization vehicles and many fund vehicles to be viewed as a VIE, thus kicking off the search for the primary beneficiary.

Consolidating VIEs

Under FIN 46R, the determination of whether a holder of a variable interest in a VIE must consolidate the assets and liabilities of the VIE was based on a quantitative analysis which required the enterprise that held a variable interest that absorbed a majority of the entity's expected losses, received a majority of the entity's expected residual returns, or both, to consolidate the assets and liabilities of the VIE on its financial statements. FAS 167 eliminated this quantitative analysis in favor of a more qualitative approach.

Under FAS 167, an enterprise must consolidate a VIE when that enterprise has a variable interest (or combination of variable interests) that provides the enterprise with a controlling financial interest (i.e., the enterprise is the primary beneficiary of the VIE). The assessment of whether the holder of a variable interest is the primary beneficiary will include: (1) an assessment of the characteristics of the enterprise's variable interest(s) and other involvements (including involvements of related parties and de facto agents) as well as the involvement of other variable interest holders and (2) an assessment of the VIEs purpose and design, including the risks that the VIE was designed to create and pass through to its variable interest holders.

The primary beneficiary of a VIE will be the enterprise that has both of the following characteristics:

1. the power to direct the activities of a VIE that most significantly impact the entity's economic performance; and

2. the obligation to absorb losses of the entity that could potentially be significant to the VIE or the right to receive benefits from the entity that could potentially be significant to the VIE.

Each VIE is expected to have only one primary beneficiary. FAS 167 requires an enterprise to continuously reevaluate whether or not it is the primary beneficiary of a VIE, not just *ab initio* when certain trigger events occur as required under FIN 46R.

FAS 167 also provides specific guidance on several points of controversy in the structure of the typical securitization that will either impact the determination of whether an enterprise has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance or whether an enterprise holds a variable interest in a variable interest entity. Most notably, the treatment of kick-out rights, when fees paid to service providers constitute variable interests for purposes of the primary beneficiary analysis and when power is shared. These points are discussed in more detail below.

Kick-out Rights

In securitizations, "kick-out" rights refer to the ability of a class of certificate holders to remove a special servicer or collateral manager. Under FAS 167, the existence of kick-out rights or participating rights will not affect the determination of whether the holder of a variable interest has the power to direct the activities of a VIE that most significantly impact the entity's economic performance unless a single enterprise (including its related parties and de facto agents) has the unilateral ability to exercise those kick-out rights or participating rights. This "unilateral" standard will affect many entities that currently hold variable interests, especially in this current economic downturn as operating losses for VIEs continue to rise. For example, a CMBS servicer who owns (directly or indirectly through an affiliate) a senior variable interest may become the primary beneficiary of the related VIE solely because the kick-out rights have shifted from a single enterprise in the equity tranche to multiple enterprises (within a single debt tranche) due to operating losses for the related VIE.

Protective rights held by other parties, on the other hand, do not preclude an enterprise from having the power to direct the activities of a VIE that most significantly impact the entity's economic performance. Protective rights include approval or veto rights that do not affect the activities that most significantly impact the entity's economic performance, the ability to remove the enterprise that has a controlling financial interest for bankruptcy or covenant breach and limitations on the operating activities of the enterprise.

Shared Power

Under certain circumstances, the power to direct the activities that most significantly impact the entity's economic performance may be shared by multiple entities and it may be difficult, or impossible to determine which single entity is the primary beneficiary.

FASB, through FAS 167, recognized this dilemma and attempted to provide some guidance to help the preparer of financial statements determine which entity, if any, has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance. Pursuant to the guidance, if power to direct the activities that most significantly impact the entity's economic performance is shared among multiple parties and if decisions relating to those activities require the consent of each of the parties sharing power, then there is no primary beneficiary to the VIE (and no variable interest holder will consolidate the assets and liabilities of the VIE). If, however, the preparer of financial statements determines that power is not shared (because consent is not required for either party to exercise its powers or otherwise) but multiple parties direct the activities that most significantly impact the entity's economic performance and the nature of those activities is the same, then the preparer of financial statements must determine which party, if any, has the power over the majority of those activities. The party, if any, with the power over a majority of those activities will be the primary beneficiary of the VIE, assuming it meets the other criteria for consolidation. Likewise, if multiple parties direct the activities that impact the entity's economic performance but the nature of those activities is not the same, then the preparer of financial statements must determine which party has the power to direct the activities that most significantly impact the entity's economic performance. In such case, the party that has the power to direct the activities that most significantly impact the entity's economic performance will be the primary beneficiary of the VIE, assuming it meets the other criteria for consolidation.

Clear, right? This analysis will require judgment on the part of the preparer of financial statements. We think this complexity of considerations is likely to result in many disparate outcomes in the real world. Since multiple preparers are likely to assess these real world situations independently, it may often occur that multiple parties are deemed the primary beneficiary or none at all. Confusion will ensue.

Fees Paid to Service Providers

FAS 167 amends the criteria related to determining whether fees paid to an entity's decision maker(s) or service provider(s) are variable interests in a VIE and thus subject to the analysis described above relating to which holders of variable interests must consolidate the assets and liabilities of the VIE.

Under the revised standard, fees paid to an entity's decision maker(s) or service provider(s) are not variable interests only if all of the conditions set forth below are met:

1. the fees are commensurate with the services provided and the level of effort required to provide those services;

2. substantially all of the fees are at or above the same level of seniority as other operating liabilities in the normal course of the entity's activities;

3. the decision maker or service provider and its related parties do not hold other interests in the VIE that individually, or in the aggregate, absorb or receive, as applicable, more than an insignificant amount of the entities expected losses or expected residual returns, respectively;

4. the service arrangements contain only terms, conditions or amounts that are customarily present in arrangements for similar services negotiated at arm's length;

5. the total amount of anticipated fees are insignificant relative to the total amount of the variable interest entity's anticipated economic performance; and

6. the anticipated fees are expected to absorb an insignificant amount of the variability associated with the entity's anticipated economic performance.

If fees paid to decision makers or service providers fail to meet all of the conditions, then these fees will constitute variable interests in a VIE and will be subject to the consolidation analysis described above. As a common sense reading of these criteria suggests (and the examples don't help here at all), it's hard to determine whether a service provider which has another interest in a VIE might become the primary beneficiary. Does a servicer whose affiliate owns a small slice of AAA bonds become a primary beneficiary? Probably not (one hopes). However, a servicer whose affiliate owns a substantial portion of an investment grade tranche or perhaps even a smaller percentage of a non-investment grade tranche may, indeed, become the primary beneficiary. It's in the eyes of the preparer. The guidance is not comforting. Spend a moment to just consider the difficulty of applying these rules. Consider your typical 100 basis point CMBS resolution fee. Typical? Certainly. Consistent with the "level of effort

required to provide these services"? Perhaps. If, however, in the eyes of a particular preparer it is not, then the servicer may be deemed the holder of a variable interest and, indeed, the primary beneficiary.

Conclusion

As we said at the outset, these rules are tectonic. They shift the plates of the business of structured finance substantially. They reflect a bias against sale treatment and towards the consolidation of the assets and liabilities of all SPEs. They fail to recognize the legitimate business purposes of many structured finance transactions and create enormous traps for the unwary and areas of uncertainty, which, in the hands of preparers acting with the best of faith, will often come to disparate conclusions. Stand by, this will be quite a ride.

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