

Project **Consolidation**Topic **Power to direct: Protective and participating rights**

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## Introduction

1. ED10 *Consolidated Financial Statements* (the ED) defines control of an entity as follows:

A reporting entity controls another entity when the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity.

2. The purpose of this paper is to discuss the power element of the control definition—power to direct the activities of an entity. In particular, the paper discusses the characteristics of power and what rights give a reporting entity the power to direct the activities of another entity.
3. The paper does not discuss power with less than a majority of voting rights, or options and convertible instruments. Those topics will be discussed in more detail at future meetings.
4. Appendix B to this paper includes some examples that illustrate the application of the staff recommendations.

## Staff recommendations

5. We recommend that the final consolidation standard:
  - (a) characterises power as follows:

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- (i) Power refers to a reporting entity's current ability to enforce its will in directing the activities of an entity that significantly affect the returns.
  - (ii) Power need not be exercised.
  - (iii) Power need not be absolute.
  - (iv) Power is assessed on the basis of current facts and circumstances.
- (b) includes guidance discussing participating rights as set out in paragraphs 16-32 of this paper as follows:
- (i) participating rights are rights that, if held by one party, are sufficient to give that party the ability to enforce its will in directing the activities of an entity that significantly affect the returns. If their exercise requires agreement by more than one party, participating rights prevent other parties from controlling the entity to which they relate.
  - (ii) participating rights must be substantive.
  - (iii) rights that are exercisable only when specified circumstances arise or events happen are participating rights in some circumstances and protective rights in others.
- (c) includes the guidance on protective rights in B1 and B2 of ED10.

**Comments from respondents on power, and participating and protective rights**

6. Many respondents noted that the principle behind the term 'power to direct' was not clearly articulated in the ED and could lead to inconsistent application. Indeed, some of those respondents believed that power was inconsistently applied within the ED—one paragraph stated that power did not need to be exercised while other paragraphs implied either that active direction of activities was required or that what appeared to be future rights would give a reporting entity power. Those respondents referred to the alternative views (paragraphs AV2 – AV7 of the ED) that address the same issue. Respondents urged the

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Board to clarify and to provide additional guidance as to what the control principle is and thus what would constitute power.

7. Respondents agreed that only one party should control an entity and that it is possible for no one to control an entity. Most respondents were also supportive of the concept that a passive majority shareholder generally has power; an entity would not have to exercise its power in order to control the entity in this situation.
8. Respondents were supportive of including guidance on protective rights and generally agreed with the guidance provided. Some commented that the definition of protective rights is circular. Many expressed the view that including guidance on protective rights alone was not enough; participating rights should also be defined and addressed in the final standard to better identify what rights might be considered substantive when assessing control.
9. Many respondents asked for clarity regarding situations in which different parties had decision making rights at different points in time when specific triggers occurred.

**Staff analysis regarding power, and participating and protective rights**

***Power to direct the activities of an entity***

10. In agenda paper 3A, we recommend that the final standard should clarify that, to control an entity, a reporting entity must have the power to direct the activities of the entity that significantly affect the returns. Such a recommendation provides guidance on the activities that matter when assessing control. However, respondents to ED10 have also asked for clarity regarding ‘power to direct’.
11. In July 2009, the Board discussed power in the context of two situations—power with less than a majority of the voting rights, and power from holding options or convertible instruments to obtain voting rights. When discussing power, we referred to the following characterisation of power in ED10:

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- (a) Power precludes others from controlling an entity.
  - (b) Power need not be absolute—protective rights of other parties do not preclude a parent from controlling a subsidiary.
  - (c) Power need not be exercised—power refers to what a reporting entity has the ability to do in directing the activities of an entity.
  - (d) Power can be obtained by different means, including voting rights, instruments to obtain rights, or rights within other contractual arrangements.
12. We also noted that:
- (a) power must be current—a reporting entity must have the current ability to direct the activities of an entity, rather than the ability in the past or in the future.
  - (b) power is assessed on the basis of current facts and circumstances.
13. Some respondents noted that the statement that power precludes others from controlling an entity was misleading because it implied that a reporting entity with less than a majority of the voting rights in an entity would never have power, which is not what was said in other parts of the exposure draft. In most cases, the holder of less than a majority of voting rights could not *preclude* another party from acquiring a majority of the voting rights and thus controlling an entity.
14. We believe that what the Board meant by ‘a parent’s power precludes others from controlling the subsidiary’ was that two different entities could not control an entity at the same time. If a reporting entity controls an entity, it has the current ability to direct the activities of the entity. Having power means that other parties cannot prevent the reporting entity from directing the activities that significantly affect the returns on the basis of current facts and circumstances.
15. Therefore we believe that it would be clearer to characterise power as follows in the final standard:

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- (a) Power refers to a reporting entity's current ability to enforce its will in directing the activities of an entity that significantly affect the returns. A reporting entity has that current ability if a mechanism is in place that ensures that the reporting entity has substantive decision-making rights that mean that it can enforce its will in directing the activities that matter as and when decisions are required to be taken or the reporting entity would like decisions to be taken.
- (b) Power need not be exercised.
- (c) Power need not be absolute.
- (d) Power is assessed on the basis of current facts and circumstances.

Question for the Board: the characteristics of power
<p>Does the Board agree that the final consolidation standard should clarify the characteristics of power as follows:</p> <ul style="list-style-type: none"> <li>(a) power refers to a reporting entity's current ability to enforce its will in directing the activities of an entity that significantly affect the returns.</li> <li>(b) power need not be exercised</li> <li>(c) power need not be absolute</li> <li>(d) power is assessed on the basis of current facts and circumstances?</li> </ul>

***Rights of a reporting entity***

- 16. One of our main objectives in this project is to provide clearer and more consistent requirements for identifying whether a reporting entity controls another entity than we currently have in IFRS. It is clear from the comments received that many respondents do not think that the exposure draft achieved that objective.
- 17. When considering all of the different means by which a reporting entity can have the power to direct the activities of an entity, we have noted that power, in all cases, comes from rights—either voting rights, rights to obtain voting rights, rights within other contractual arrangements or a combination of these.

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18. We believe that one way to clarify what power means and to demonstrate how to apply the control model consistently is to include a section in the application guidance that discusses rights, and whether a reporting entity's rights are sufficient to give the reporting entity power.
19. To clarify our intentions, we are not proposing a model in which a reporting entity must have *the right* to direct the activities of another entity. Rather, we wish to clarify that when a reporting entity has particular decision-making rights, it must assess whether those decision-making rights are sufficient to give the reporting entity the *ability* to enforce its will in directing the activities of the entity that significantly affect the returns.
20. Some might argue that, in some circumstances, a reporting entity might have the ability to enforce its will in directing the activities without having particular rights to do so. However, we cannot envisage a situation in which a reporting entity would have the ability to enforce its will in directing the activities of an entity that significantly affect the returns without *any* decision-making rights. Therefore, we believe that adding guidance relating to participating and protective rights would be helpful.

*Rights that are sufficient to give a reporting entity power*

21. A reporting entity has the power to direct the activities of another entity when it has rights that are sufficient to give the reporting entity the current ability to enforce its will in directing the activities of the entity that significantly affect the returns.
22. Depending on the circumstances, the following rights are examples of those that are sufficient to give a reporting entity that ability (either individually or in combination):
  - (a) Rights to determine or change the strategic operating and financing policies of an entity (those rights could be voting rights or rights to exercise or convert instruments into voting rights of an entity—both of those topics will be discussed in future meetings).

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- (b) Rights to determine or change the restrictions on an entity's activities.
  - (c) Rights to manage the amount of economic benefits derived from use or disposal of the assets of an entity (eg managing defaulting receivables or the leasing and operation of investment property).
  - (d) Rights to manage the selection, acquisition or disposal of assets of an entity.
  - (e) In some entities, rights to manage the funding of an entity.
  - (f) Rights to appoint or remove the party that directs the activities of an entity that significantly affect the returns.
  - (g) Rights to appoint, reassign or remove an entity's key management personnel.
23. Rights that are sufficient to give a reporting entity the ability to enforce its will in directing the activities of an entity that significantly affect the returns usually relate to activities that are expected to happen in the ordinary course of an entity's business. Those decisions are described as participating rights in US GAAP.<sup>1</sup>
24. We are of the view that we should characterise rights as participating rights if they are held by one party and are sufficient to give that party the ability to enforce its will in directing the activities of an entity that significantly affect the returns.
25. If their exercise requires agreement by more than one party, participating rights prevent other parties from controlling the entity to which they relate.

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<sup>1</sup> EITF Issue No. 96-16 *Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights* describe participating rights as those that provide for the manager to effectively participate in significant decisions that would be expected to be made in the ordinary course of the limited partnership's business. Decisions made in the ordinary course of business are defined as decisions about matters of a type consistent with those normally expected to be addressed in directing and carrying out the limited partnership's current business activities, regardless of whether the events or transactions that would necessitate such decisions are expected to occur in the near term. However, it must be at least reasonably possible that those events or transactions that would necessitate such decisions occur.

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Participating rights exercisable on agreement by more than one party do not require the holders to have the ability to initiate decisions. Rather, participating rights might only give the holders the ability to approve or block decisions that relate to the activities of an entity that significantly affect the returns.

Participating rights must be substantive

26. To be sufficient to give a reporting entity power or prevent other parties from controlling an entity, participating rights must be substantive. Paragraph 25 of ED10 noted an example of a situation in which the holder of a majority of the voting rights of an entity would not have the power to direct the activities of that entity because those voting rights were not substantive:

For example, if an entity in which a reporting entity has more than half of the voting rights is placed under legal supervision, the reporting entity is prevented from having the power to direct that entity.

27. Determining whether participating rights are substantive and give the holder the current ability to enforce its will requires judgement, considering all relevant facts and circumstances. We think that it would be useful to include in the application guidance some factors to consider when making that determination as follows:

- (a) Whether there are any barriers (either economic or otherwise) to exercising the rights that, in effect, mean that the holder (or holders) of those rights does not have the current ability to enforce its will in directing the activities of an entity that significantly affect the returns. The example included in paragraph 25 of ED10 (and reproduced above in paragraph 26 of this paper) is an example of such a barrier to exercise. Other examples include:
- (i) financial penalties that would prevent the holder from exercising its rights,
  - (ii) other conditions attached to the exercise of the rights that prevent the holder from having the ability to enforce its



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will in directing the activities that matter (eg timing restrictions), or

- (iii) operational barriers that would prevent the holder from exercising its rights (eg the absence of other managers willing or able to provide all of the specialised services, or provide all of the services and financial support provided by the incumbent manager).
- (b) When the exercise of participating rights requires the agreement of more than one party, whether a mechanism is in place that facilitates those parties collectively exercising their rights if they choose to do so. If the holders of participating rights have the ability to act together to prevent the body or party that currently directs the activities of an entity to take decisions that are contrary to their wishes, their participating rights are substantive.

Can rights that are exercisable only when specified circumstances arise or events happen give a reporting entity the current ability to direct the activities of an entity?

28. Paragraph 34 of ED10 states (within the section on assessing control of a structured entity):

A reporting entity identifies what activities cause the returns to vary and assesses whether it has power to direct those activities. A reporting entity's ability to act when circumstances arise or events happen constitutes power if that ability relates to the activities that cause the reporting entity's returns to vary.

The exposure draft illustrates this guidance with an asset securitisation example that notes that the power to direct how any defaulting receivables are managed would constitute power if managing defaulting receivables is the only activity that causes the returns to vary.

29. Many respondents disagreed with what that wording and example implied—that rights that are not exercisable today could give the holder current power. In their view, such rights were contingent rights and represented contingent power, rather than current power.

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30. We believe that rights that are available only when specified circumstances arise or events happen are protective rights in some situations (see paragraph 34 of this paper) and participating rights in other situations. They are participating rights in situations in which the day-to-day activities of an entity are administrative in nature and the reporting entity's rights give it the ability to direct the activities of the entity that significantly affect the returns. They are also current because the reporting entity has the right to make decisions about and, therefore, direct the activities of the entity as and when decision-making is required; the entity is set up so that decision-making is required only when specified circumstances arise or events happen.
31. So, for example, in the asset securitisation example referred to in ED10, the asset securitisation entity is set up so that the only activity that significantly affect its returns is managing defaulting receivables. The ongoing activity—to collect cash flows from counterparties to the receivables and allocate those cash flows to investors according to predetermined policies—does not affect the returns of the entity and does not require any decision-making. The reporting entity that has the right to manage defaulting receivables is the party that has decision-making rights when those rights are needed.
32. In such a situation, the so-called contingent rights are really the mechanism that ensures that the party with those rights has the current ability to direct the activities of the entity when those rights are needed. This is no different to an operating entity for which a majority shareholder exercises its power when it needs to.

*Rights that are not sufficient to give a reporting entity power*

33. Protective rights are those that are designed to protect the interests of the party holding those rights without giving that party power, nor do they prevent other parties from controlling an entity. Protective rights often relate to activities that are *not* expected to happen in the normal course of an entity's business. Rather, they relate to fundamental changes in the activities of an entity (those outside the normal course of an entity's business) or apply only in exceptional

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circumstances. B1 and B2 of ED10 include examples of protective rights and are set out in Appendix A to this paper.

34. A reporting entity has protective rights in situations in which the rights relate to circumstances and events that are expected to happen only in exceptional circumstances. In that situation, there are ongoing activities of the entity that significantly affect the returns, which the reporting entity has no current ability to direct. For example, a financial institution's ability to seize assets if a borrower fails to meet specified loan repayment conditions would usually be a protective right.

*Consistency with US GAAP requirements*

35. Our recommendations regarding participating and protective rights are similar to some US GAAP requirements and dissimilar to others.
36. EITF Issue No.96-16 *Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights* and EITF Issue No. 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* apply to voting interest entities. They describe participating rights in a similar manner to how they are described in this paper. EITF Issue No. 04-5 also describes factors to consider when assessing whether participating rights are substantive. Again, the factors mentioned in EITF Issue No. 04-5 are similar to those described in this paper with one exception. The US GAAP requirements note that substantive kick-out rights (which we refer to as removal rights) are exercisable by a single limited partner or a vote of a simple majority (or a lower percentage) of the limited partners voting interests. We prefer not to define 'substantive' in terms of a quantitative measure such as a simple majority.
37. In contrast, FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R) Consolidation of Variable Interest Entities*, states that an enterprise's determination of whether it has the power to direct the activities of a variable

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interest entity that most significantly impact the entity's economic performance shall not be affected by the existence of kick-out rights or participating rights unless a single enterprise has the unilateral ability to exercise those kick-out rights or participating rights.

38. Agenda paper 3F *Agency relationships* discusses the reasons that support the FASB's conclusions in SFAS 167 regarding kick-out rights and other participating rights, and the reasons why we do not recommend replicating those requirements.

**Question for the Board: participating and protective rights**

Does the Board agree with the staff recommendation that the final consolidation standard should:

(a) add guidance discussing participating rights as set out in paragraphs 16-32 of this paper as follows:

- participating rights are rights that, if held by one party, are sufficient to give that party the ability to enforce its will in directing the activities of an entity that significantly affect the returns. If their exercise requires agreement by more than one party, participating rights prevent other parties from controlling the entity to which they relate.
- participating rights must be substantive
- rights that are exercisable only when specified circumstances arise or events happen are participating rights in some circumstances and protective rights in others;

(b) include the guidance on protective rights in B1 and B2 of ED10?

If not, what do you recommend and why?

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**Appendix A – Extracts from the application guidance to ED10****Protective rights**

- B1 A reporting entity can control another entity even though other parties have protective rights relating to the activities of that other entity.
- B2 Protective rights are designed to protect the interests of the party holding those rights without giving that party control of the entity to which they relate. They include, for example:
- (a) approval or vote rights granted to other parties that do not affect the strategic operating and financing policies of the entity. Protective rights often apply to fundamental changes in the activities of an entity, or apply only in exceptional circumstances. For example:
    - (i) a lender might have rights that protect the lender from the risk that the entity will change its activities to the detriment of the lender, such as selling important assets or undertaking activities that change the credit risk of the entity.
    - (ii) Non-controlling interests might have the right to approve capital expenditure greater than a particular amount, or the right to approve the issue of equity or debt instruments.
  - (b) the ability to remove the party that directs the activities of the entity in circumstances such as bankruptcy or on breach of contract by that party.
  - (c) Limitations on the operating activities of an entity. For example, a franchise agreement for which the entity is the franchisee might restrict the pricing, advertising or other operating activities of the entity but would not give the franchisor control of the franchisee. Such rights usually protect the brand of the franchisor.

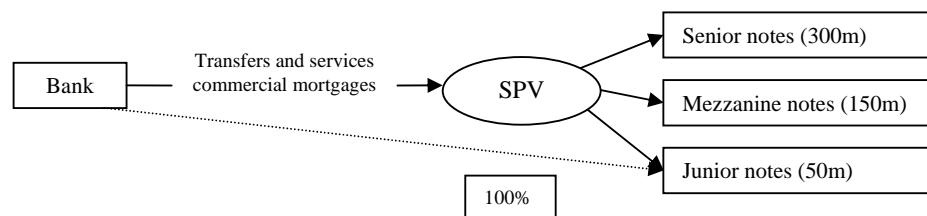
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Appendix B—Illustrative examples

Example 1: asset securitisation

**Facts—situation (a)**

39. Bank transfers commercial mortgage loans (with a value of CU500 million) into a securitisation vehicle, SPV, which issues senior, mezzanine and junior notes to investors. Bank holds all of the junior notes, which means that Bank is entitled to any excess spread, takes the prepayment risk and the junior notes are expected to cover the majority of the expected losses of SPV. Bank is the servicer of the loans, making all decisions regarding the collection of the cash flows, including dealing with delinquent and defaulted loans. The activities of the SPV are restricted and cannot be changed, nor can the terms of the servicing agreement be changed without the consent of a majority of the other noteholders. Bank receives a market-based servicing fee commensurate with the services performed (paid senior to any payments made to noteholders) and can be removed for cause by the other noteholders. Bank holds a clean-up call, which gives it the right to purchase the loans from SPV when less than 10% of the notional amount of the loans is outstanding.



**Staff view—situation (a)**

40. The only activity of SPV that significantly affects the returns is the servicing of the loans, which includes managing defaulting loans. Therefore, Bank directs

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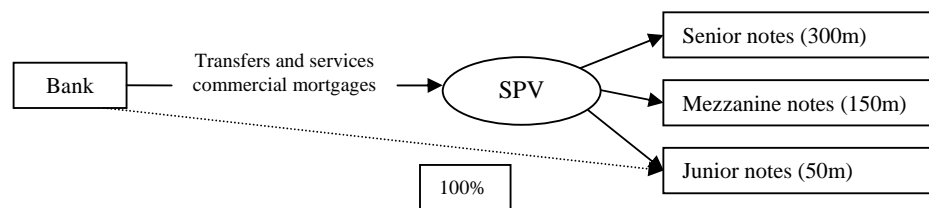
the activities of SPV that significantly affect the returns. The noteholders' right to remove Bank for cause is a protective right, which does not prevent Bank from having the ability to direct the activities of SPV. Although Bank is paid a market fee for the servicing activities performed, Bank also receives all of potential upside (the excess spread) and the majority of the potential downside through its holding of junior notes. Consequently, Bank controls SPV because it has the ability to direct the activities of SPV that significantly affect the returns, and it can use that ability to generate returns for itself.

IAS 27/SIC-12

41. Bank controls SPV because it is exposed to the majority of the risks and rewards of SPV, and has the decision making powers to obtain the majority of the benefits of the activities of SPV.

**Facts—situation (b)**

42. Similar fact pattern to situation (a) in paragraph 39 except that Bank can be removed without cause by the vote of a simple majority of the senior and mezzanine noteholders. If Bank is removed before the losses of SPV exceed CU50 million, the noteholders agree to purchase the junior notes from Bank at a fixed price (that compensates Bank for any losses already incurred). If Bank is removed without cause at any time, Bank also receives a termination fee equal to two years servicing fees.



**Staff view—situation (b)**

43. Bank controls SPV. The removal rights granted to the mezzanine and senior noteholders are not considered to be substantive because of the terms and

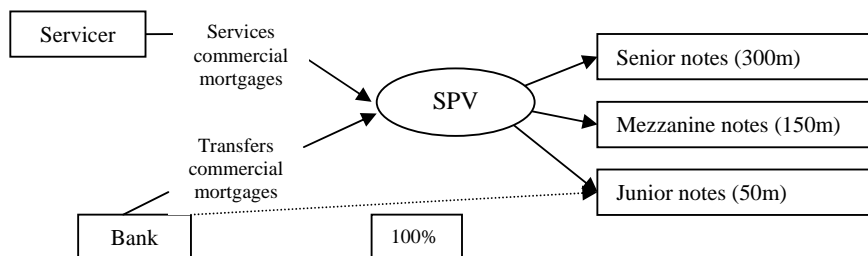
conditions attached to those rights—the termination fees and the obligation to purchase the junior notes means that there are significant barriers that would prevent the noteholders from exercising their right to remove Bank.

IAS 27/SIC-12

44. Bank controls SPV because it is exposed to the majority of the risks and rewards of SPV, and has the decision making powers to obtain the majority of the benefits of the activities of SPV. We think that the removal rights would also be ignored given the terms and conditions attached to those rights (although IAS 27 and SIC-12 do not discuss such rights).

**Facts—situation (c)**

45. Similar fact pattern to situation (a) in paragraph 39 except that Bank appoints a third party as the servicer of the loans. That third party servicer makes all decisions regarding the collection of the cash flows, including dealing with delinquent and defaulted loans. The activities of the SPV are restricted and cannot be changed, nor can the terms of the servicing agreement be changed without the consent of a majority of the noteholders. The servicer receives a market-based fee commensurate with the services performed (paid senior to any payments made to noteholders) that is insignificant relative to the returns of the entity. The servicer can be removed for cause by the noteholders. Bank cannot remove the servicer and has no influence over how delinquent or defaulted loans are directed until the outstanding amount of the loans is less than 10% of the notional. Bank holds a clean-up call, which gives it the right to purchase the loans from SPV when less than 10% of the notional amount of the loans is outstanding.





**Staff view—situation (c)**

46. Bank is exposed to the majority of the variability of returns of SPV through its holding of junior notes. Bank, however, has no means of influencing that exposure (until the outstanding amount is less than 10% of the notional) and, as such, does not have the power to direct the activities of SPV. Although Bank was involved in setting up the SPV, after inception it has no decision-making authority that affects the returns of SPV. Bank is no different from any of the other investors in terms of its ability to control SPV. Similar to the other investors, it has exposure to variability of returns (albeit, greater exposure to variability) but cannot influence that variability. The noteholders' right to remove the servicer for cause is a protective right.
47. The clean-up call held by Bank gives it the right to purchase the loans when less than 10% of the notional amount of the loans is outstanding. Until the outstanding amount of the loans reaches that specified level, Bank has no means of directing the activities of SPV. The clean-up call is considered to be a protective right.
48. The only activity of SPV that affects the returns is the servicing of the loans, which includes managing defaulting loans. Therefore, the servicer directs the activities of SPV that affect the returns, but is paid an insignificant market fee commensurate with the services performed. The servicer acts as an agent because it uses its decision-making powers to generate returns for the noteholders. Consequently, SPV would not be consolidated by any party.

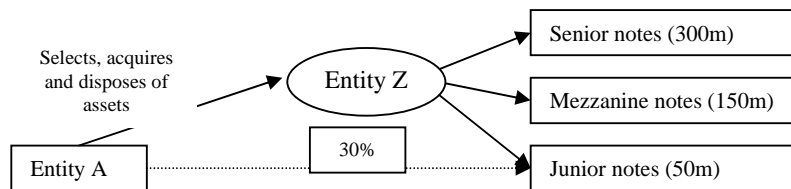
*IAS 27/SIC-12*

49. Bank controls SPV because it is exposed to the majority of the risks and rewards of SPV. It could be argued that SPV was set up both for the benefit of Bank (for financing purposes) and for the investors (investment opportunity in specific loans with substantial credit enhancement). However, according to SIC-12, Bank would be deemed to control SPV because of its exposure to the majority of the risks and rewards.

## Example 2—CLO type structure

### Facts

50. Entity A is the collateral manager of a CLO-type structure, Entity Z. Entity A is responsible for the selection, acquisition and disposal of the assets of Entity Z within portfolio guidelines, set by a rating agency and agreed to by the noteholders (investors). Entity A also takes decisions about hedging currency and interest rate risk. Entity A receives a market-based fixed fee (which is senior) and a market-based performance fee (which is paid after payments are made to the senior and mezzanine noteholders). Entity A also holds 30% of the junior notes issued by Entity Z.
51. The other notes are held by unrelated third party investors (the remaining 70% of the junior notes are held by 12 investors, none of which hold more than 50% of the junior notes). The noteholders can remove Entity A for cause.
52. The mezzanine notes are held by two unrelated investors, and the senior notes are held by four unrelated investors. In the event that defaulting assets exceed a specified proportion of the portfolio (ie when defaulting assets exceed expected levels), a third party note trustee takes control of the asset portfolio, and acts according to the instructions of the mezzanine and senior noteholders.



### Staff view

53. Entity A controls Entity Z. Entity A has the power to direct the activities of Entity Z that significantly affect the returns by having decision-making authority about the selection, acquisition and disposal of the assets of Entity Z as well as hedging decisions. The noteholders' rights to remove Entity A for cause are protective rights. Entity A also has exposure to variability of returns because of

its 30% holding of junior notes and its performance-related fee that ranks junior to the senior and mezzanine notes. Therefore we would conclude that Entity A controls Entity Z.

54. The mezzanine and senior noteholders have rights that ensure that they obtain control of the assets of Entity Z when defaulting assets exceed a specified proportion of the asset portfolio. That specified proportion is not expected to occur in the normal course of Entity Z's business. In addition, those noteholders have no ability to direct the activities of Entity Z until such unexpected events occur. Until those events occur, Entity A has decision making discretion in managing the assets, which significantly affects the returns of Entity Z. Consequently, the rights of the noteholders are considered to be protective rights.
55. Entity A would cease to control Entity Z if the specified events occur.

*IAS 27/SIC-12*

56. Entity Z is not controlled by any party. No one party is exposed to a majority of risks or benefits of the entity, and the entity was set up, arguably, for the benefit of both Entity A and all of the investors.