



Project	Consolidation
Topic	Agency Relationships

Introduction

1. The purpose of this paper is to provide the boards with analyses and recommendations in determining whether a decision maker or a service provider is acting as an agent or a principal. A principal would be required to consolidate an entity while an agent would not as it is acting on behalf of a principal or principals. This paper will provide recommendations for guidance to be included in the final consolidation standard on this topic without considering whether kick-out or removal rights are considered substantive (agenda paper 3C addresses this issue). The staff believe that substantive kick-out and similar participating rights should be considered when assessing whether a decision maker acts as an agent or a principal. However, kick-out rights are discussed in agenda paper 3C and, therefore, we have not included a discussion of kick-out rights in this paper.
2. The objective of this paper is to obtain input from the boards regarding agency relationships and to assess which of the views included in the paper, or which aspects of those views, the staff should develop further. The staff believe that it would be beneficial to explore in somewhat more detail how they could better differentiate an agent from a principal, both by looking at the nature of the decision-making authority and at the returns received by the decision-maker.

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

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FASB's guidance in Statement No.167

3. The FASB's current guidance for determining whether a fee received by a decision maker or service provider represents a variable interest in a variable interest entity (VIE) is used to determine whether a decision-maker is acting as an agent or a principal. The guidance, included in paragraph B22 of Statement No. 167, *Amendments to Interpretation No.46(R)*, states:

Fees paid to an entity's decision maker(s) or service provider(s) are not variable interests if all of the conditions below are met:

- a. The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
- b. Substantially all of the fees are at or above the same level of seniority as other operating liabilities of the entity that arise in the normal course of the entity's activities, such as trade payables.
- c. The decision maker or service provider and its related parties,^{26a} if any, do not hold other interests in the variable interest entity that individually, or in the aggregate, would absorb more than an insignificant amount of the entity's expected losses or receive more than an insignificant amount of the entity's expected residual returns.
- d. The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.
- e. The total amount of anticipated fees is insignificant relative to the total amount of the variable interest entity's anticipated economic performance.
- f. The anticipated fees are expected to absorb an insignificant amount of the variability associated with the entity's anticipated economic performance.

^{26a}The term *related parties* refers to all parties identified in paragraph 16. However, for purposes of this condition, related parties do not include employees of the decision maker or service provider, unless the employees are used in an effort to circumvent the provisions of this Interpretation.

2. Additionally, the FASB provided the following guidance in paragraph A76 of the background information and basis for conclusions to Statement 167:

The Board also concluded that the revised guidance for determining whether decision maker fees and service provider fees represent a variable interest in a variable interest entity in paragraphs B22 and B23 of Interpretation 46(R), as amended by

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this Statement, is sufficient for determining whether an enterprise is acting in a fiduciary role in a variable interest entity, particularly because the Board removed the consideration of kick-out rights and cancellation provisions from those paragraphs. In other words, the Board expects that the fees paid to an enterprise that acts solely as a fiduciary or agent should typically not represent a variable interest in a variable interest entity because those fees would typically meet the conditions in paragraph B22 of Interpretation 46(R), as amended by this Statement. If an enterprise's fee did not meet those conditions, the Board reasoned that an enterprise is not solely acting in a fiduciary role. If the enterprise has (a) the power to direct the activities that most significantly impact the economic performance of the entity and (b) the obligation to absorb losses or the right to receive benefits of the entity that could potentially be significant to the variable interest entity, that enterprise would be the primary beneficiary of the entity. The Board observed that the conditions in paragraph B22 would allow an enterprise to hold another variable interest in the entity that would absorb an insignificant amount of the entity's expected losses or receive an insignificant amount of the entity's expected returns. The Board concluded that an enterprise holding such an interest would still be acting in a fiduciary role as long as the other conditions in paragraph B22 were met and that enterprise would not be the primary beneficiary of the entity.

4. At its November 11, 2009 board meeting, the FASB decided that the provisions of Statement 167 should be deferred for some investment funds so that the FASB and IASB could work jointly to develop guidance for determining the role of a decision maker. Although the FASB believes that the guidance in paragraph B22 is sufficient for evaluating most decision makers, it received consistent feedback from representatives of the asset management industry and its users that consolidating investment funds would distort the asset manager's financial statements as both the industry and its users believe that asset managers generally act in a fiduciary capacity. The FASB staff are aware that the IASB has received similar feedback.

IASB's proposals in ED 10

5. The IASB issued ED 10 *Consolidated Financial Statements* in December 2008, proposing guidance for consolidation of all entities (not just VIEs or structured entities as referred to in ED 10). The IASB included guidance for determining whether a party is an agent or a principal in paragraphs B3-B8 of ED 10.

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Paragraph B4 is specific to removal rights. As removal rights (kick-out rights) are discussed in agenda paper 3C, the guidance for these rights in ED 10 has not been reproduced in this paper.

6. ED10 developed criteria to identify an agency relationship on the basis of the following assumptions:

- (a) Both the principal and the agent will seek to maximise their own benefits. Therefore, the principal is likely to introduce additional measures that are intended to ensure that the agent does not act against the interest of the principal.
- (b) A principal has no incentive to remunerate an agent with more than what is commensurate for the services provided. Therefore, remuneration commensurate with the services provided is an indicator as to whether a party acts as an agent or a principal. Similarly, remuneration that is not commensurate with the services provided is an indicator that a party does not act as an agent of another party.

7. Paragraph B3 of ED 10 provides guidance on agency relationships and states:

B3. An agent is a party engaged to act on behalf of another party or parties (the principal(s)). An agent might have the ability to direct the activities of an entity, for example by making decisions concerning the operating and financing activities of the entity. However, that ability is governed by agreement, law or fiduciary responsibility that requires the agent to act in the best interests of the principal. The agent must use any decision-making ability delegated to it to generate returns primarily for the principal.

8. Paragraph B5-B8 of ED 10 provide the following guidance related to remuneration of an agent:

B5. An agent is remunerated for the services it performs by means of a fee that is commensurate with those services. Fees that are not commensurate with the services performed indicate involvement with an entity beyond that of an agent and, therefore, might indicate control.

B6. Any of the following factors might indicate that fees are not commensurate with the services performed:

- a. The fees are more than would be received for similar services negotiated on an arm's length basis.

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- b. The fees are large relative to the total expected returns of the entity to which the services are provided.
- c. The expected variability in the fees is large relative to the total expected variability of the returns of the entity to which the services are provided.

B7. The remuneration of an agent can be a fixed or performance-related fee. If the agent receives a performance-related fee, the agency relationship can be difficult to distinguish from a controlling relationship. This is because the agent can use its ability to direct the activities of the entity to affect its remuneration. However, if this ability is limited by the agent's responsibility to act in the best interests of the principal, the performance-related fee that the agent receives is remuneration for the services it performs and does not indicate involvement with the entity

B8. A performance-related fee of an agent is often distinguishable from the returns of the investors for whom the agent is acting. For example, an investor in a fund will benefit from increases in the value of the fund and suffer from decreases in the value of the fund. In contrast, an agent might be paid a performance-related fee for a specified period and the agent is unlikely to be required to contribute to the fund (i.e. refund fees already received) if the value of the fund decreases.

Dual role

- 9. Paragraph B11 of ED 10 proposed the following application guidance for a reporting entity that acts in a dual capacity:

Sometimes it can be difficult to identify whether a reporting entity that holds voting rights, both directly and on behalf of other parties as an agent, uses the voting rights of the other parties for its own benefit or for the benefit of those other parties. In such circumstances, in assessing whether it has voting rights sufficient to control another entity, the reporting entity excludes the voting rights it holds as an agent only if the reporting entity can demonstrate that it is obliged to act in the best interests of those other parties or has implemented policies and procedures that ensure the independence of the decision-making in its role as an agent from that as a holder of voting rights directly.

Respondents' comments to ED10

- 10. Most respondents to ED 10 agreed that the consolidation standard should provide application guidance to identify an agency relationship. However, some respondents believed that the ED was not clear on whether the Board intended the proposed application guidance to be limited to legal or contractual agency relationships or whether a reporting entity should also consider unwritten or implicit arrangements. Some suggested that this could be addressed by

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developing a principle from the wording in paragraphs BC89 and BC90 of ED10 as follows:

A reporting entity has power to direct the activities through the use of an agent where it controls the agent via an agreement or ongoing relationship where the agent must act in accordance with and where the reporting entity can exercise its powers to direct the activities by removing the agent. [CL 15 and CL 144]

11. Most respondents agreed that the form of remuneration can be an indicator of an agency relationship. However, respondents argued that the application guidance should not specify that “large fees” or a “large variability of fees” would be indicators that an agency relationship does not exist.
12. Most respondents agreed that the final consolidation standard should not require a reporting entity that acts in dual capacity always to assess in aggregate its rights as an agent and a principal. Neither, should the reporting entity automatically exclude its rights as an agent from the control assessment. However, most respondents disagreed with the rebuttable presumption in ED 10 and were concerned that it established a bias towards consolidation.
13. Most respondents expressed concerns about the rebuttable criteria. Many noted that most reporting entities could argue that they had implemented policies and procedures that ensure the independence of the decision-making in their role as an agent from that as a holder of voting rights directly. Therefore, they argued that the presumption ED 10 could be rebutted by most entities.
14. Others noted that the requirement to act in the best interest of other parties is implicit in the definition of an agent and usually already incorporated in the law or regulation that governs the agency relationship. Therefore, they asked the Board to clarify what evidence would rebut the presumption in ED 10. Some suggested that the final consolidation standard should clarify that a fund manager acts in the best interest of other parties when the agent cannot favour its own interest as an investor over that of the other investors if there is a conflict of interest (ie all investors must be treated equally).
15. In light of those concerns some respondents suggested that the final consolidation standard should include a quantitative threshold when the fund manager is presumed to use the rights from its role as an agent for its own

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benefit. However, respondents generally disagreed as to where this threshold should be. For example, respondents suggested that a reporting entity should only be presumed to use power for its own benefit (ie acting as a principal) when it receives (a) more than insignificant returns, (b) significant returns or (c) a majority of the returns of the other entity.

16. Some respondents were confused about the list of related parties in paragraph B12 of ED 10. In their view, those examples were not helpful because, depending on a particular set of facts and circumstances, every party in the examples could be an agent, or not.

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17. A reporting entity controls another entity when it has the power to direct the activities of that entity to generate returns for itself (the definition of control of an entity in ED10). A reporting entity can have that power by delegating decision-making authority over the activities of an entity to another party. The party to which that decision-making power has been delegated does not have power in its own right; it is an agent of the real holder of that power.
18. In most cases, a party that exercises decision-making power over the activities of an entity that significantly affect the returns is the controlling party. However, in some cases that party is simply servicing the entity on behalf of the real power holder or holders. It would not be appropriate to have a service provider consolidate an entity if it is simply an agent of another party. Similarly, the party that really does hold that power should not avoid consolidating an entity by delegating its power over that entity to another party. Consequently, the final consolidation standard should include guidance to help assess whether:
 - (a) a reporting entity controls another entity through its agent; and
 - (b) a reporting entity only holds power as an agent of another party.
19. The following sections in the paper discuss:
 - (a) what an agency relationship is;
 - (b) how an agent or a principal can be identified.

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What is an agency relationship?

20. We note that “agent”, “fiduciary” and “trustee” are legal terms and that the meaning of those terms is different depending on the legal environment. In our view, the application guidance in the final standard should not refer to a particular legal environment and its terminology.
21. We believe that a more promising approach is to base our definition on the thinking developed in agency theory. Jensen and Meckling define an agency relationship as “a contractual relationship in which one or more persons (the principal) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent”.
22. We believe that there can be a difference between being obliged to act in the best interests of all investors or shareholders and acting as an agent when assessing control of an entity. Although this is a factor to consider when assessing whether a party acts as an agent or a principal, we do not think that it would be appropriate to conclude that every party that is obliged, by law or contract, to act in the best interests of all investors or shareholders would be an agent when assessing control of an entity.
23. For example, some respondents to ED10 suggest that, in a dual role situation particularly involving mutual funds, a fund manager that holds anything other than 100% of the units in the fund should not be deemed to control the entity. They argue that the fund manager is legally obliged (and regulated as such) to act in the best interests of all investors in the fund. It, therefore, cannot act in its own interest to the detriment of the other investors. The fund manager’s decision-making powers are exactly the same, irrespective of whether it holds 0% or 99% of the fund.
24. This suggestion, in effect, assumes that a reporting entity that is legally or contractually obliged to act in the best interests of others will always do so, even if that reporting entity receives the vast majority of the returns that are influenced by its decision-making. Although this view might be considered appropriate for mutual funds that are highly regulated, it is difficult to see how this approach could be applied to all entities, including variable interest or structured entities. Virtually every servicer or investment manager could argue

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that they act in the best interests of others. The result might be that virtually every structured entity would not be consolidated by any party. The staff have not, therefore, developed this view further.

How can an agent be identified?

25. It is easy to identify an agent when a party performs a service on behalf of another party and has no discretion in how that service must be performed. In this case, the agent clearly lacks power and thus cannot have control. However, sometimes an agency relationship is less clear because of the extent of the discretion of the decision-making authority delegated to it by the principal or principals. In those situations it can be more difficult to distinguish decision-making authority that has been delegated to an agent from genuine decision-making power.
26. To illustrate, assume that a group of investors invests in a fund and engages a fund manager to manage their investment. The investors task the fund manager with maximising the returns on their investment. However, the fund manager is free to decide which investments it makes to accomplish that objective. The investors remunerate the fund manager for its services with 10% of the returns generated by the fund. In this example, how do we distinguish the actions that the fund manager takes on behalf of the investors from actions that it takes for its own benefit? The fund manager's decision-making authority might be sufficient to meet the power element of the control definition. Additionally, the investors may have insisted that the returns that the fund manager receives for its services are aligned with those of the investors. Those returns, therefore, may look similar to those of a controller. Some staff question how this situation is different than one in which a minority shareholder that holds less than a majority of the voting rights but is considered the party with the controlling interest consolidates. The decisions made by the controlling minority shareholder benefit the other shareholders as well as the controlling shareholder itself.
27. ED10 defines control of an entity as the power to direct the activities of an entity *to generate returns for the reporting entity*. To have control, a reporting entity must have power and be able to use that power for its own benefit. For

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traditional operating entities, the link between power and returns is usually straightforward. Generally, the more voting rights that a reporting entity holds (and therefore the greater the power that it has), the more returns that it receives from its involvement with that other entity.

28. However, when the investors do not retain any ongoing means of influencing the party with decision-making authority (by retaining substantive kick-out or other participating rights), and that party is remunerated via a performance-related fee or its returns are disproportionate to its direct investment in the entity, the analysis is more difficult.
29. If the party receives a return that is insignificant or varies insignificantly, most would feel comfortable concluding that the party uses any decision-making authority delegated to it to generate returns for others—this is because the party would not have power *so as to benefit*. In contrast, if the party held a very significant investment in the entity (say, a 95% investment), we would conclude that the party uses any decision-making authority delegated to it to generate returns for itself—the party would have power so as to benefit. **But at what point between insignificant and very significant does such a party change from using any decision-making authority to generate returns for others to using that authority to generate returns for itself?**
30. The following paragraphs in the paper explore a number of different approaches that the Board could follow when assessing whether a party that has been delegated decision-making authority acts as an agent or a principal:
 - (a) **View 1:** an approach that considers all facts and circumstances, including a party's decision-making authority, the returns that it receives both the form of fees and from other involvement with an entity, and kick-out and similar participating rights.
 - (b) **Views 2 and 3:** approaches that focus on the returns of the party (both in the form of fees and from other involvement with an entity), as well as kick-out and similar participating rights.
31. You should note that all of the following views would consider substantive kick-out and other similar participating rights when assessing whether a party acts as an agent or a principal, as well as considering the other factors noted in this

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paper. Agenda paper 3C addresses kick-out rights and therefore we have not included a discussion of kick-out rights in this paper. Agenda paper 3C includes views as to whether kick-out rights are required to be exercisable by a single party or whether multiple parties may agree to evoke a kick-out right in order for the right to be considered substantive.

32. You should also note that it is assumed that the party in question has been delegated decision-making authority over the activities of an entity that significantly affect the returns. If the party does not have such decision-making authority, it could not meet the power element of the control definition.

View 1: consider the overall relationship including the range and latitude in decision-making

33. Staff supporting **view 1** believe that when evaluating whether a decision maker is an agent or a principal, the overall relationship should be evaluated on a qualitative basis to determine if the decision maker is acting as a principal or an agent. Factors that should be considered in the evaluation include (1) the range of a decision maker's ability and the latitude by which they can enforce their will; (2) whether substantive kick out rights exist (discussed in agenda paper 3C); (3) the decision maker's fee structure and (4) other interests held by the decision maker including investments in the entity or guarantees provided by the decision maker.
34. When evaluating a relationship, the determination of whether a party is acting as an agent or a principal should not be evaluated solely on the basis of any one factor, but rather should take into consideration the overall nature of the arrangement. Accordingly, the staff does not believe that any relative weighting of each of the factors should be provided, as the arrangement should be evaluated in its totality.
35. It is inevitable, in the absence of a decision maker having a 100% ownership interest in another entity (principal) or a decision-maker only receiving a nominal fee for services (agent), that significant judgment and consideration of all facts and circumstances must be considered when determining whether a decision maker is a principal or an agent.

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Range of decisions made and latitude by which a party can make those decisions

36. Staff supporting **view 1** believe that the range of decisions and/or activities that a reporting entity can execute and the level of latitude and discretion that it has in directing the entity should be considered in evaluating the decision makers capacity. These staff expect that the greater the range of a decision maker's abilities and the latitude and discretion it has in executing those activities, the higher the probability that the decision maker is a principal.
37. When evaluating the range of the decisions that the decision maker can make, the entity should consider the design of the entity. For example, staff supporting **view 1** believe that, regardless of the evaluation of the other factors, practitioners should be able to reasonably conclude that traditional money market mutual funds should not be consolidated by an asset manager. However, asset managers of alternative investment funds, depending on their fee structures, other interests in the fund, and the range of activities that the reporting entity directs and its latitude and discretion in managing the fund, may be required to consolidate these alternative funds.
38. When performing the analysis, the reporting entity should consider whether the decision maker is responsible for imposing any of the restrictions on the range of activities that it will perform i.e. if the decision maker were to create an entity and through the incorporation documents limits the range of activities that may be performed, the decision maker should consider the decisions that are embedded in the documents of incorporation as part of the range of decisions.
39. When evaluating the level of latitude of the decision maker, the entity should consider if any other parties hold participating or veto rights that would require the decision maker to obtain approval for any decisions that it makes. A decision maker that is required to obtain approval for its actions, regardless of whether the entity has a wide range of activities, would generally be acting as an agent.

The decision maker's fee structure

40. Staff supporting **View 1** believe that the decision maker's fee also needs to be analysed to determine the nature of the arrangement. Paragraph B22 of Statement No.167 provided a number of requirements used to evaluate whether a

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decision maker's fee represents a principal or agent relationship. The staff believe that the requirements to evaluate whether the fee is (1) commensurate with the level of effort required and (2) negotiated at arm's length, should be considered under this view. In addition, the amount of variability related to the entity's economic performance that will be absorbed by the decision maker should also be considered. The staff believes that a decision maker that does not receive returns in the form of performance fees or from a direct investment in the entity may be acting as an agent.

41. Paragraph B22 of Statement No.167 included a requirement to evaluate whether the decision maker's fees absorb more than "an insignificant amount" of the variability associated with the entity's economic performance. Based on the fact that constituents are interpreting the guidance in paragraph B22 at an extremely low threshold (for example, 5-10%), the staff believe that the threshold for evaluating this criterion should be modified. But at what point between insignificant and very significant does a party change from using any decision-making authority to generate returns for others to using that authority to generate returns for itself? The staff believes that the threshold should be based on facts and circumstances; however, the staff would expect the threshold would be higher than the range currently being used in practice under Statement No.167.
42. Based on discussions with both preparers and users of financial statements, some believe that when assessing the decision maker's exposure to the variability, the decision maker should only consider its exposure to "downside" risk. Accordingly, the decision maker would be required to hold an investment in the entity or provide a guarantee to the entity in order to impact whether the decision maker is acting as an agent or a principal. The staff believe that variability captures both upside and downside and should be considered in the analysis of the fee. Many fee arrangements that include a performance based arrangement are structured with the expectation that both the fixed fee and the performance based fee will be received. Accordingly, the decision maker will act in a manner to attempt to earn and receive the performance based fee.

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43. The entity should consider if it has any “other interests” that could absorb any of the entities variability. The staff believe that a decision maker may structure a decision making arrangement by including terms that would absorb variability of returns of the entity in a separate interest. Accordingly, any other interests should be considered in the analysis.
44. The staff also believes that any guarantees will impact whether the decision maker of an entity is acting in the capacity of a principal versus an agent. Paragraphs BC13-BC16 of the FASB’s Exposure Draft, Amendments to Statement 167 issued in December 2009, expressed a necessity for a party to assess whether it could be required to fund the losses that could potentially be significant to an entity. The Board emphasized that determining whether a party has the obligation to fund losses requires significant judgement and the consideration of all facts and circumstances surrounding the terms and characteristics of a decision maker’s interest or interest in the entity along with the design and characteristics of that entity. The staff believes that any potentially significant guarantees could impact the capacity in which the entity acts regardless of the probability of the guaranteed event occurring. The staff believes that the impact of other interests held should be scrutinised when determining in what capacity a decision-maker acts.

Views 2 and 3: stronger focus on the returns of the decision-maker

45. Some staff believe that it is difficult to distinguish an agent from a principal when looking at the range and latitude of a party’s decision-making authority, although those staff agree that the greater the range of decisions that a party can make and the greater the latitude that it has in making those decisions, the more likely it is that the party is a principal.
46. Often, a party that has been delegated decision-making authority is the only party that has any ongoing ability to make decisions about the activities of an entity that significant affect the returns. In the absence of another party or parties having substantive kick-out or similar participating rights, it is difficult to

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assess whether such a party is an agent or a principal on the basis of the extent of its decision-making authority.

47. Therefore, those staff would consider an approach focussing more on the returns received by a party that has been delegated decision-making authority. Those staff also believe that a decision maker's exposure to the variability of returns of the entity either through its fee or other interests will inherently be significant if the decision maker performs a wide range of activities and has significant latitude.
48. Those staff acknowledge that **views 2** and **3** place more emphasis on the returns received by a decision-maker and, therefore, place more pressure on determining what level of returns would result in consolidation. This is not ideal because it puts more emphasis on determining a threshold of returns at which a reporting entity would be considered to control another entity.

View 2

49. Some staff would apply the definition of control to conclude that a reporting entity controls another entity when it has decision-making authority to direct the activities, and receives a variable return from its involvement with the entity. When a reporting entity receives a variable return, any power that the reporting entity has affects that return. The reporting entity, therefore, has both power and the ability to benefit from that power, irrespective of whether it must act in the best interests of other investors.
50. Staff supporting **view 2** emphasise that a reporting entity will usually seek to maximise its own benefits and not necessarily those of its principal or principals. As a consequence, they do not believe that a reporting entity would necessarily use its decision-making authority in accordance with the wishes of the principal. Rather, they assume that the party with decision-making authority will always act in its own best interest.
51. Without any further guidance, staff supporting **view 2** acknowledge that this interpretation implies that many fund managers of mutual funds or money market funds should consolidate the fund even though they might receive a small fee for their services. Therefore, they would propose that it is necessary to

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look at the significance of the returns received by the decision-maker when assessing control. **View 2** would clarify that, to meet the definition of control, a reporting entity must have the power to generate significant returns for the reporting entity.

52. In Statement No.167 published in June 2009, the FASB provided guidance that is consistent with **view 2** in the context of variable interest entities but phrased the wording from the agent's standpoint. The FASB decided that the return received by a decision-maker is not a variable interest (and therefore that the decision-maker acts as an agent) when, among other factors, the decision-maker's fee is (a) at the same level of seniority as other operating liabilities of the variable interest entity, (b) is commensurate with the level of effort required and negotiated at arm's length, and (c) is not more than insignificant (in monetary terms) and (d) does not absorb an amount of variability that is more than insignificant related to the anticipated economic performance of the variable interest entity. In addition, a decision-maker would have a variable interest in situations in which, along with its fee, it holds another variable interest that absorbs more than an insignificant amount of the variable interest entity's expected returns.
53. **View 2** would result in more fund managers, investment managers and service providers consolidating the entities that they manage than **view 3**, and potentially **view 1**. **View 2** is also relatively straightforward to apply although there are likely to be questions about what 'significant' means—3%, 5%, 10%, 20% of the returns generated by the activities of an entity. Judgement needs to be applied to assess what is significant.
54. If the boards supports **view 2**, we would need to explain what we mean by 'significant'. The staff would propose that a reporting entity should assess significance from the controlled entity's perspective (rather than from the reporting entity's perspective) and significance should relate to variability of expected returns. Staff supporting **view 2** believe that the only approach that would avoid judgement when assessing significance would be to define significant in terms of a number. They do not recommend such an approach.

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View 3

55. **View 3** would interpret the control definition differently from **view 2**. Staff supporting this view believe that there are situations in which a reporting entity's returns might be more than insignificant and yet that reporting entity would still use the decision-making authority delegated to it to generate returns for other parties. These staff believe that a party that has been delegated decision-making authority should not be deemed to control simply because it receives a remuneration that varies along with the returns received by the investors.
56. It is normal business practice in many industries that a service provider's remuneration is structured so that it varies along with the returns of investors to ensure that the service provider acts in the best interests of those investors. That remuneration could be in the form of a performance-related fee or in the form of a direct investment in the entity that holds the investments (i.e. dual role). Indeed, there are proposals both in Europe and in the US to legally require all servicers of securitisation entities to hold a 5% or 10% pro rata direct investment in any securitised assets that they service.
57. Nevertheless, staff supporting **view 3** acknowledge that every party involved with some entities (particularly structured entities) might argue that it acts in the best interests of other parties and therefore should not consolidate an entity. Those staff would not wish to create an opportunity to avoid consolidation when it would be inappropriate to do so.
58. **The crucial question is how to distinguish between situations in which a party uses decision-making authority delegated to it to generate returns for itself, and situations in which it uses that authority to generate returns for others, ie whether it is (or would be expected to be) using its power so as to benefit.**
59. In order to answer this question, **view 3** distinguishes between returns that vary in the same way as and those that vary differently from, those of the investors. [You should note that a party should consider the total returns that it receives or is exposed to from its involvement with an entity, including returns in the form of fees, and returns from any other interests that it has in the entity.]

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60. Staff supporting **view 3** would propose that a party uses decision-making authority delegated to it to generate returns for itself when it has any disproportionate exposure to losses below the most senior investors. In that situation, the party with decision-making authority has an incentive to make decisions that are potentially different from those that it might make if its returns were not affected by those decisions, or if its returns varied in the same way as those received by the investors. Therefore, a party with decision-making authority over the activities of an entity that significantly affect the returns would control the entity when, for example,
- (a) it holds any mezzanine or junior notes in the entity,
 - (b) provides a guarantee or other forms of credit enhancement to an entity,
 - (c) provides liquidity support that exposes the reporting entity to risk, or
 - (d) it is the counterparty to a derivative that absorbs losses of the entity or losses of the investors from their involvement with the entity.
61. In contrast, when the returns of the party with decision-making authority vary in the same way as those received by the other senior investors, it is virtually impossible to be certain of whether that party uses that authority to generate returns for itself or for others. In that situation, the party makes decisions in same way as it would if its returns were unaffected by those decisions. This would be the case, for example, when that party receives a performance-related fee calculated as a percentage of the returns received by the investors or has a direct pro rata investment in an entity.
62. **View 3** proposes guidance that describes when a party is more likely to use decision-making authority delegated to it for its own benefit rather than for the benefit of other investors as follows. When a party receives returns that vary in the same way as those received by other senior investors, it uses decision-making authority delegated to it to generate returns for itself when it receives or is exposed to a *majority* of the variable returns. Such a party has power so as to benefit because its decision-making powers are used *primarily* for its own benefit rather than for the benefit of other parties.

Staff paper

- 63.** Therefore, in addition to the situations described in paragraph 60, a party with decision-making authority over the activities that significantly affect the returns would control another entity when, for example, it receives returns (both in the form of fees and from any direct investment) that have the potential to be more than those received by other parties involved with the entity (eg fixed and performance related fees that are more than 50% of the returns that are reasonably possible; fees and returns from holding units in a fund (in which all investors are treated equally) that result in the party receiving more than 50% of the returns generated from the activities of the fund).

Question for the boards

The staff are keen to obtain input from the boards on which of the views, or which aspects of any of the views, the boards believe should be developed further. The staff believe that it would be beneficial to conduct some further work to explore whether they can better differentiate the decision-making of an agent and that of a principal, that would perhaps compliment looking at the fee structure and other interests of the decision-maker. The staff would propose to bring back a paper on agency relationships to the February joint board meeting that would include examples illustrating the application of the approaches developed.