



Staff Paper

Project	Consolidation
Topic	Agency relationships—regulated funds

Introduction

1. At the March 2009 joint board meeting, the IASB and FASB tentatively decided that when assessing whether a decision-maker is an agent or a principal, the assessment should be made on the basis of the overall relationship between the decision maker, the entity being managed and the other interest holders, and should consider all of the following factors:
 - (a) Scope of decision-making authority
 - (b) Rights held by other parties
 - (c) Remuneration of the decision-maker
 - (d) The decision-maker's exposure to variability of returns because of other interests that it holds in the entity.
2. None of these factors should be considered in isolation—all factors should be considered when assessing the overall relationship. However, depending on the circumstances, one or some of those factors could be a strong indicator of an agent or principal relationship and would receive more weighting when assessing whether the decision maker is an agent or a principal.
3. This paper discusses the appropriate consolidation conclusions when a fund being managed is strictly governed by law or regulation to ensure that the fund is operated in the best interests of all investors.

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.

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4. Our intentions are *not* to ask the boards to reconsider their tentative decisions regarding how to assess agency relationships. Rather, the staff wish to clarify how those tentative decisions should be applied when the fund being managed is strictly governed by law or regulation.

Staff analysis

Reporting entity acts as a fund manager of a mutual fund and invests in the fund

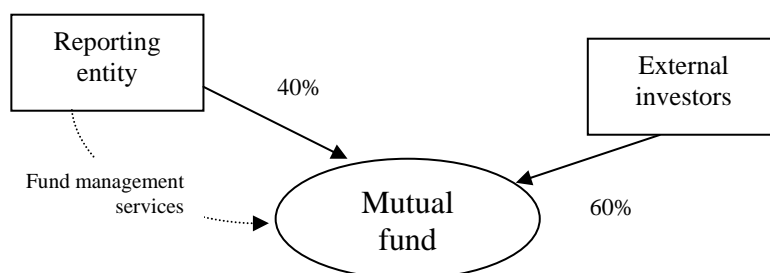
5. Consider the following fact pattern:

A reporting entity sets up a mutual fund and acts as the fund manager, marketing the fund to external investors. The fund manager determines the type of fund, however, the parameters of the fund within which the fund manager operates are determined by regulation. [ie the fund manager has discretion in choosing the type of fund. However, having chosen a particular type of fund, the operating and financing policies of the fund and the fund manager's fee structure must adhere to requirements that have been set out by regulation and are governed by the regulator. Those policies and fees are included in the investment mandate and fund constitution and cannot be changed by the fund manager, nor any individual investor (irrespective of the size of the investor's holding in the fund). The fund manager's decision-making is strictly limited to implementing the fund's investment strategy that, in particular, limits the level of risk that may be taken (eg the policies of the fund will, for example, state the types of investments that can be made). The fund manager's fee represents market-based compensation for the services being provided.] The fund is subject to strict regulatory supervision to ensure that the fund manager operates the fund in accordance with the regulatory requirements.

Numerous investors invest in the mutual fund, including the reporting entity that takes a 40% pro-rata investment in the fund (the reporting entity is not exposed to losses of the fund beyond its 40% investment, nor is it entitled to

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anything other than the return on its 40% investment and its fund management fee set out in the fund prospectus).¹ The investors have some protective rights (eg a super-majority of the investors can collectively decide to change the investment mandate or liquidate the fund in particular circumstances). However, they do not have any participating rights.



6. When assessing whether the reporting entity (as the decision-maker) acts as an agent or principal, the reporting entity considers:
- (a) *The scope of its decision-making authority*: the reporting entity operates within narrowly defined parameters. The reporting entity's decision-making is governed by the regulator, with the objective of ensuring that the reporting entity acts in the interests of all investors. Nonetheless, within those parameters, the reporting entity is the only party with decision-making authority that can affect the returns generated by the fund and those decisions could have a significant effect on the performance of the fund (other than funds such as pure tracker funds for which the fund manager may have very limited discretion in making investment decisions).
 - (b) *The rights of the other investors*: the other investors do not hold participating rights that would prevent the reporting entity from

¹ The analysis in this paper does not take into account any possible consequences of the proposed derecognition model that the IASB is deliberating. Therefore, the paper assumes that returns from the 40% investment flow to the reporting entity and that the reporting entity does not simply 'pass through' those returns to other parties, acting as an agent on behalf of those other parties. It is also assumed that the mutual fund, when issuing units/securities to investors, is not considered to simply 'pass through' the cash flows of the assets of the mutual fund to the investors. If that were the case, the mutual fund would not have any assets and liabilities to be consolidated.

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directing the activities of the fund, provided those activities remain within the confines of the investment mandate.

- (c) *Remuneration of the reporting entity*: the reporting entity is paid a market-based fee that is commensurate with the fund management services that it provides.
- (d) *The reporting entity's exposure to variability of returns because of its 40% investment*: the reporting entity's 40% investment in the fund creates significant exposure to variability of returns of the fund.

7. This situation is viewed very differently from, for example, a servicer (or special servicer) that operates a securitisation vehicle within narrow parameters set out in contract, for which there is no regulatory supervision. If that servicer also has other interests in the securitisation vehicle, it is likely that the servicer would have been involved in determining the parameters within which it operates. Through that involvement in the design and its ongoing involvement in managing any defaulting assets of the vehicle, that servicer is likely to have the ability to direct the activities that significantly affect the returns (in the absence of other parties having participating rights that could prevent the servicer from directing those activities). In addition, if such a servicer has other interests in the securitisation vehicle, particularly if those interests are subordinate to interests held by other investors, it is likely that the servicer's decision-making would be influenced by its own interests such that the servicer would be focused on maximising its own return. Its decision-making could be different from what it would be if it did not have any other interests in the vehicle. It can use its power 'so as to benefit itself'.

View 1

8. The discussions at the March 2010 board meeting regarding agency relationships indicated that having considered all of the factors above, some board members would conclude that the reporting entity would be deemed to control the fund (and therefore would have to consolidate the fund). Some staff also support this view. This is because the reporting entity is the only party with any decision-making authority that could significantly affect the returns of the

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fund (ie it has ‘power to direct the activities’), and it has significant exposure to variability of returns (ie it can use its power ‘to generate returns’ for itself).

9. Those staff would argue that the fund manager meets the power element of the control definition because it has discretion both in deciding to set up the fund and is the only party that can affect the returns of the fund through its fund management activities. Whether such a fund manager controls the fund depends on the extent of any other interests that it has in the entity. Without any other interest in the fund, the fund manager would *not* be deemed to control the entity because it would be viewed as using any power that it has to generate returns for external investors. However, if the fund manager has other interests in the fund that it manages, this increases the likelihood that it would be deemed to control the fund.
10. The staff supporting view 1 are also be concerned that an asset manager with a subordinated interest in certain types of structured entities, such as CDOs, may avoid consolidation by arguing that their decision-making authority is narrowly defined and the procedures they are required to follow for managing delinquent assets (mortgages owned by the fund) are governed by law and subject to regulatory supervision.
11. View 1 would also result in a consolidation conclusion that is consistent with the conclusion for those entities that are not governed by regulation, but their incorporation documents require the decision-maker to operate within the narrowly defined parameters required by the regulatory requirements (and the decision-maker is unable to modifying these requirements). According to View 2, the consolidation conclusion for the two entities could, potentially, be different even though the decision maker operates within identical decision-making parameters as those for a regulated entity.
12. The staff supporting view 1 believe that if the boards deem that the nature of how some funds operate mean that they should not be considered controlled, these funds should be specifically identified in the final standard rather than modifying the agent/principal guidance. For example, in the recent amendments to defer the Statement 167 amendments to Subtopic 810-10 for certain interests,

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the FASB also deferred the effective date for interests in funds with the following characteristics:

A reporting entity's interest in an entity that is required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds.

View 2

13. Other staff question whether the fund manager of a fund that is subject to strict regulation meets the power element of the control definition, in particular, considering the restrictions on the fund manager's decision-making authority. This is because the fund manager is operating the fund on behalf of the investors under strict regulatory supervision—the regulator imposes restrictions on the fund manager's decision-making authority, on behalf of the investors. Although the fund manager has some discretion both in choosing the type of fund, and in making investment decisions, it does so within narrow parameters that have been determined and are governed by regulation. Irrespective of its direct investment, the fund manager cannot use its decision-making powers 'so as to benefit itself' due to the regulatory oversight. The fund manager acts in exactly the same manner, regardless of whether it holds 0%, 40% or 80% of the mutual fund. Therefore, the 'power' that the fund manager has is unaffected by any other interests that it might have in the fund and, as noted above, the fund manager does not have power that can be used for its own benefit.
14. Those staff supporting view 2 also note the following regarding the example in paragraph 5 of the paper:
 - (a) The fact pattern being discussed includes a narrow set of circumstances. The decision-maker must operate within narrowly defined parameters, and the strict governance and enforcement of the regulator is critical in ensuring that the decision-maker is unable to use any decision-making powers that it has for its own benefit. For this reason, those staff do not think that the concern regarding some structured entities, such as CDOs, discussed in paragraph 10 of this paper is likely to happen. It is

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difficult to understand how it could be argued that a decision-maker is acting the best interests of all investors if it holds subordinated interests in an entity that it manages.

- (b) There is usually no leverage in such regulated funds (the fund is usually prevented from financing its investments in ways other than from investments made by investors in the fund). The risks and rewards attributable to the reporting entity are limited strictly to its investment. We understand that users find it difficult to understand how it is useful for the reporting entity to consolidate such an investment fund and believe that there is a loss of information when the reporting entity must consolidate, and ‘gross-up’ its statement of financial position.
15. If the boards agree with view 2 in the paper, we would recommend including a paragraph within the agency guidance in the consolidation standard to the effect that a decision-maker is an agent when its decision-making authority is restricted as follows:
- (a) The decision-maker must operate an entity according to narrowly defined operating and financing policies, that are enforced by law or regulation, to ensure that the entity is operated in the best interests of all investors.
- (b) The decision-maker is unable to change the parameters within which it operates.

Question for the boards

(1) Do the boards agree with view 1 (that the restrictions placed on a fund manager’s decision-making authority by law or regulation would *not* prevent the fund manager from controlling the fund) or with view 2 (that the restrictions placed on a fund manager’s decision-making authority by law or regulation could prevent the fund manager from controlling the fund) in the example set out in paragraph 5 of this paper?