

MINUTES



To: Board Members

From: Statement 140 Amendment Team
(Gagon, Ext. 322)

Subject: Minutes of the October 27, 2004 Board Meeting **Date:** November 3, 2004

cc: Bielstein, Smith, Petrone, Leisenring, Project Team, Mahoney, Thompson, Vincent, Sutay, Gabriele, Swift, Polley, Getz, FASB Intranet (e-mail)

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.

Topic: Isolation and the Need for Custodial Arrangements

Basis for Discussion: Memorandum 35
dated October 15, 2004

Length of Discussion: 9:30 a.m. to 11:10 a.m.

Attendance:

Board members present: Herz, Trott, Schipper, Batavick, Crooch, and Seidman

Board members absent: Schieneman

Staff in charge of topic: Donoghue and Lott

Other staff at Board table: Smith, Lusniak, and Gagon

Outside participants: None

Summary of Decisions Reached

The Board's discussion focused on whether to strengthen the implementation guidance on isolation. The Board discussed whether to require certain conditions that an attorney would be expected to require to render a true sale at law opinion, instead of including those conditions as examples; in particular, the condition that the transferred financial asset be adequately segregated from the transferor and placed, at a minimum, in a custodial arrangement.

The Board also discussed whether the decision to require that any benefit that a transferor receives from setoff related to transferred assets must be shared with other interest holders should be included in the amendment to 140 as an effective control issue or simply as a stand-alone exception. No decisions were made at this Board meeting.

Objectives of the Board Meeting

The objectives of the meeting were for the Board to decide whether to (1) amend the requirements of paragraph 9(b) of Statement 140 for transfers of a portion of a financial asset such as a loan participation that do not involve the use of a qualifying special-purpose entity (SPE), (2) retain the Board's decision to require a qualifying SPE for all transfers of portions of financial assets, (3) retain the parenthetical phrase in the introduction to paragraph 9, and (4) retain its decision to require that any benefit that a transferor receives from setoff related to transferred assets must be shared with other interest holders as an effective control issue. The objectives were not met.

Matters Discussed and Decisions Reached:

The following paragraphs summarize the Board's views on the major issues discussed at the meeting. The views and matters presented in these minutes may not be in the specific order in which they were discussed at the meeting.

Background

Ms. Donoghue began the meeting by providing a brief background of prior Board decisions relating to the isolation criteria in paragraph 9(a) of Statement 140 (refer to the Board minutes from the October 1, 2003, February 11, 2004, and September 22, 2004 meetings). She stated that the purpose of the meeting was to address issues concerning the application of paragraph 9(b) of Statement 140 to transfers of portions of financial assets, including transactions such as loan participations, that may or may not include a custodial arrangement.

However, before the Board addressed how paragraph 9(b) should be applied to transfers of portions of financial assets, the Board and staff agreed that it was important to address the threshold issue of whether it is possible to transfer a portion of a financial asset without first segregating the entire asset in a custodial arrangement or other entity. As a result, the Board spent most of the meeting discussing whether a custodial arrangement should be required in all instances for transfers of portions of financial assets.

At the end of the meeting, the Board briefly considered but did not vote on whether the decision to require that any benefit that a transferor receives from setoff related to transferred assets must be shared with other interest holders should be discussed in the amendment to 140 as an effective control issue or simply as a stand-alone exception. The issues are discussed more fully below.

Should a Custodial Arrangement Be Required?

Mr. Lott described the alternative staff view. He stated that the introduction to paragraph 9 uses the phrase *a transfer of financial assets* and the fundamental premise of Statement 140 is that a transfer has occurred. Mr. Lott asked Board members what they think is being transferred in transactions similar to loan participations. That is, whether a portion of a financial asset can be transferred or whether the entire asset must be transferred to meet the requirements of paragraph 9. He stated that he believes the whole asset must be transferred and that it is not possible to transfer a portion of a financial asset without using a custodial arrangement or other entity.

In addition, Mr. Lott stated that he does not believe that all the conditions¹ of a true sale need to be required—only the fourth condition, which states that a custodial arrangement be used when the transferor continues to act as a servicer of the financial assets or if the interest holder does not obtain the right to directly enforce the underlying financial contracts. He stated that he and Ms. Lusniak believe that a custodial arrangement or similar arrangement should be required to segregate the cash flows as they are received.

The Board was divided between requiring a custodial arrangement in all cases and not requiring a custodial arrangement unless it is deemed necessary to receive a true-sale-at-law opinion. Those views are discussed below.

Require a Custodial Arrangement

Ms. Schipper and Messrs. Crooch and Trott support requiring a custodial arrangement for transfers of portions of financial assets such as loan participations.

Mr. Trott stated that he believes that some form of isolation must exist for transfers of portions of financial assets—whether it be in a qualifying SPE or another entity—to be considered sales. He believes that the entire asset must be isolated and that the true-sale-at-law opinion must say that only the rights to cash flows retained by the transferor would be included in a transferor's bankruptcy estate. He believes this requirement may be difficult to enforce when there is a jurisdiction that says that an entire asset can be isolated without the use of a custodial arrangement. He is not aware of how an entity can sell a portion of an asset without having a custodian.

Ms. Schipper stated that she does not support relying solely on a legal analysis. She does not believe lawyers accord the same value that accountants do to consistency and comparability. She believes that if the FASB wants comparable and consistent accounting, the Board should describe precisely what it intends

¹ Refer to the minutes of the September 22, 2004 Board meeting for the conditions of a true sale discussed at this meeting.

for the transfer to meet the isolation requirement in paragraph 9(a). She stated that a custodial arrangement should be required and that the Board ought to provide a description of what it means to act in a custodial capacity. She also stated that, in her opinion, to act in a custodial capacity means that the arrangement would be extremely passive (like a qualifying SPE), but it would not necessarily have to be as costly or formal an arrangement as a qualifying SPE. The custodial arrangement would be for safekeeping of the assets and segregating the assets from the transferor. The arrangement could be something as simple as a lock box that would segregate the cash flows and prevent commingling of cash. The issue is not just participations; there are other transactions that are involved that are more complex and should use some sort of arrangement to segregate the assets transferred.

Mr. Crooch stated that he believes that for accounting purposes the entire asset should be isolated. He believes that in order to do that, the entire asset must be transferred to a custodial arrangement. He stated that the FASB has relied on attorney opinions in the past, and he would prefer that the Board create safeguards in addition to relying on a true-sale opinion. He would also like to clarify what the differences are between a secured borrowing and a sale of a portion of financial assets.

Do Not Require a Custodial Arrangement

Ms. Seidman and Messrs. Herz and Batavick do not support requiring a custodial arrangement for transfers of portions of financial assets such as loan participations.

Mr. Batavick stated that he believes that because a true sale involves several legal issues, whether or not something has been isolated should be considered in the legal analysis done by lawyers and accountants. He believes that in the case of a loan participation, a bankruptcy court would look at the participation documents and if the documents were well written, the court would conclude that any funds received by the lead bank on the participated loan would be passed along to the participating bank.

Ms. Seidman stated that she continues to support the Board's conclusion reached at the September 22 Board meeting to rely on a true-sale opinion and leave the clarification of the conditions for a true sale in the implementation guidance. She is concerned about imposing a requirement to use a custodian because it is her understanding that recent changes in the Uniform Commercial Code do not require mechanics or a trustee to effect a sale of a portion of a financial asset. She fully supports the notion of relying on a true sale opinion that considers the facts and circumstances and the rulings in each jurisdiction, and she stated that requiring a custodian would be introducing costs and complexity to the standard that is not currently required by the courts or the marketplace. Ms. Seidman also stated that she believes that the ultimate transferee is the beneficial interest holder and that if a custodian is used, the guidance should be clear that one looks through the custodian, similar to a qualifying SPE, to determine who applies paragraph 9(b).

Mr. Herz stated that he believes a portion can be created by agreement but that in many cases, a custodian may be necessary because the legal analysis will require one in order to consider the assets isolated. However, he is hesitant to prescribe that a custodian be used in all instances or jurisdictions. He stated that he has always interpreted paragraph 9 to allow a transfer of a portion of a financial asset. He firmly believes that Statement 140 allows transfers of a portion of an asset if it meets all three criteria in paragraph 9 and that isolation should be left to a legal analysis based on the facts and circumstances in each jurisdiction. He also stated that he believes that the need for segregation of assets should not be the FASB's determination.

Other Comments Relevant to the Discussion on Custodial Arrangements

Mr. Smith stated that he believes that requiring a custodial arrangement, which may only involve an establishment of a separate account (or lock box) to segregate the asset, seems like a simple fix that would meet the basic tenants of Statement 140 (paragraph 9, in particular).

In response to Mr. Smith's comments, Mr. Herz said that he would be willing to have the staff explore the need for a separate account, the costs of setting up that account, and any practical issues, but he is hesitant to require a custodian in all instances at this time. Again, he reiterated that he believes it is possible to transfer a portion of a financial asset.

Additionally, Ms. Donoghue stated that it is her understanding that a custodial arrangement would not necessarily involve the transfer of the entire asset. She stated her belief that it is possible for a portion of an asset to be segregated in a custodial arrangement. Furthermore, she stated her understanding that U.S. courts recognize portions of financial assets if those portions have been properly segregated.

Decisions Reached on the Issue

The Board did not make any decisions on this issue. The Board was split evenly (3 to 3) with Mr. Schieneman not being in attendance or providing the Chair with his preference on this issue. The decision was deferred until Mr. Schieneman could express his views and cast his vote.

Should Setoff Be an Effective Control Issue

The Board briefly discussed whether the decision to require that any benefit that a transferor receives from setoff related to transferred assets must be shared with other interest holders should be discussed in the amendment to 140 as an effective control issue or simply as a stand-alone exception.

Mr. Lott stated that at the last Board meeting on September 22, the Board decided that setoff should be viewed as an effective control issue under paragraph 9(c). He stated that he believes that setoff is not an effective control issue and that it may be more appropriate to address setoff as a stand-alone exception in Statement 140.

The Board deferred a decision on this issue until the staff could conduct additional research on the similarities between setoff and other types of dilutive

rights and provide a recommendation to the Board on how setoff should be addressed in Statement 140.

Follow-up Items:

Mr. Herz asked the staff to perform additional research on the pros and cons of establishing a custodial arrangement for transfers of portions of financial assets, including its costs and practicability. Ms. Seidman also asked the staff to research the consequences of imposing a requirement for a custodian on transfers of portions of financial assets, not just participations.

The Board also asked the staff to conduct further research on how setoff is similar to other dilutive rights and whether setoff should be addressed in Statement 140 as an effective control issue or as a stand-alone exception.

General Announcements:

None.