

Letter of Comment No: 97A  
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**Morgan Stanley**

November 5, 2002

Mr. Ronald W. Lott  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

Re: File Reference No. 1082-200  
Exposure Draft on Consolidation of Certain Special Purpose Entities, an interpretation of ARB No. 51  
(the "Exposure Draft")

Dear Mr. Lott:

I want to thank you for your decision to raise with the Board the proposal I made in my comment letter dated October 10, 2002, regarding the consolidation analysis for a third-party investor in a qualifying SPE (a "QSPE").

While I was disappointed in the decision of the Board to reject the proposal, I thought it unfair to characterize the proposal as without conceptual basis. I respectfully disagree and suggest that it is the Board's decision that lacks conceptual basis in that it will produce inconsistent accounting results in contrast to FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*.

As noted in paragraph 140 of FAS 140, in the Board's deliberations of FAS 125 (which were carried forward into FAS 140 without reconsideration), "[t]he considerations discussed in paragraphs 132-139 led the Board to seek an alternative to the risks-and-rewards approach." We want to highlight that paragraph 136 discusses the precise example we raised. "For example, if Entity A initially acquired an undivided subordinated interest in a pool of financial assets, it would recognize that subordinated interest as a single asset." The Board now has tentatively decided to reverse that accounting treatment in contradiction of the approach provided for in EITF 99-20<sup>1</sup>

<sup>1</sup> EITF 99-20 provides appropriate accounting guidance for these types of interests. Paragraphs 6 and 7 provide as follows:

6. The Task Force observes that a beneficial interest in securitized financial assets that are in equity form may meet the definition of a debt security in paragraph 137 of Statement 115. For example, some beneficial interests issued in the form of equity represent solely a right to receive a stream of future cash flows to be collected under preset terms and conditions (that is, a creditor relationship), while others, according to the terms of the special-purpose entity, must be redeemed by the issuing enterprise or must be redeemable at the option of the investor. Consequently, those beneficial interests would be within the scope of this Issue, since they are required to be accounted for as debt securities under Statement 115.

In addition, we want to highlight that the elimination of the analysis contained in paragraphs 22 and 23 of the Exposure Draft could have significant adverse effects on transactions in which a third party investor purchases beneficial interests issued by a QSPE representing the first loss position in the assets owned by the QSPE. The addition of the new set of three tests (control of any substantive decision-making, a majority of the risks of the assets and a majority of the rewards from the assets) does not provide the treatment afforded these transactions in the Exposure Draft.

FAS 140 paragraph 146 summarizes the concepts that provide the key to the application of a financial-components approach. We believe that paragraphs (e) and (f) in particular provide conceptual support for our proposal:

- “e. The recognition of financial assets and liabilities should not be affected by the sequence of transactions that led to their existence unless as a result of those transactions the transferor maintains effective control over a transferred asset.” [For example, a securitization transaction followed by the sale by the transferor to a third-party investor of the beneficial interest representing the first-loss position is identical to a sale of the loans to the third-party investor followed by the sale of the loans by the third-party investor in a securitization transaction, with the third-party investor retaining the first-loss position. No control is obtained as a result of either of these transactions.]
- “f. Transferees and transferees should account symmetrically for transfers of financial assets.” [For example, the transferor of a beneficial interest representing a first-loss position (which is a financial asset) and the transferee of such beneficial interest should have symmetrical accounting.]

Rather than a risks-and-rewards approach, FAS 140 focuses on transactions in which the transferor has surrendered control of the assets and what requirements must be met to ensure that a transferor has surrendered control. FAS 140 concludes that a transferor of assets to a QSPE that meets all of the other requirements of FAS 140 has surrendered control of the assets and thus should account for any interests that it has with the QSPE using a financial components approach. We do not believe that any transfer of these interests to a third party with no other rights and obligations provides the investor with the ability to exercise control of the QSPE or the assets the QSPE holds. If the beneficial interests did not provide the transferor with the ability to control the QSPE, they alone cannot provide another party with the ability to control the QSPE. Paragraph 173 states that “[h]olders of beneficial interests in the qualifying SPE...do not control the individual assets held by the qualifying SPE.”

This matter is particularly important in the commercial mortgage-backed securities (“CMBS”) market. Virtually all transactions in this market are structured to meet all of the sale requirements of FAS 140, and the issuing SPE is structured as a QSPE. In most transactions, securities representing the first loss position are sold to a third party investor. The third party investor typically serves as the special servicer and is responsible for servicing defaulted loans.

We recommend the Board reconsider the test we proposed in our letter dated October 10 to determine whether a third party investor in a QSPE would be required to consolidate the QSPE. We suggest once again that the Board consider a simple principle: If the third party investor had no rights or obligations that, in the hands of the transferor, would have prevented the transferor of the assets to the QSPE from accounting for the transaction as a sale of assets, then the third party investor would not be required to consolidate the QSPE. This principle results in identical accounting results for transactions with identical economic results. Examples of transactions involving QSPEs that would still be required to be consolidated under that principle include: Entering into arrangements that preclude the assets in the QSPE from being legally isolated in the event of the investor’s bankruptcy or receivership; call options held by the investor that do not meet the FAS 140 requirements; arrangements where the other holders of beneficial interests in the QSPE are not able to pledge or exchange their interests; and derivative instruments through which the investor obtains effective control over the assets.

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7. Beneficial interests issued in the form of equity that do not meet the above criteria should be accounted for under the applicable provisions of Opinion 18, the applicable consolidation guidance, or Statement 115.

We would be pleased to discuss our comments with the Board or the Staff. Please contact Staci Lublin at (212) 537-2456, Karen Dealey at (212) 537-2452 or me at (212) 761-1779 with questions or comments.

Sincerely,

/s/ J. Douglas Van Ness  
Executive Director,  
Securitized Products Group

cc: Members of the Board