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United States Senate

COMMITTEE ON GOVERNMENTAL AFFAIRS

WASHINGTON, DC 20510-6250

June 30, 2003

Letter of Comment No: File Reference: 1200-001

Date Received: 6/30/03

Financial Accounting Standards Board 401 Merritt 7 Post Office Box 5116 Norwark, CT 06856-5116

Delivered by email to: director@fasb.org

Re: File Reference 1200-001: Exposure Draft on Qualifying Special Purpose Entities

To the Members of the Board:

Accounting issues related to special purpose entities (SPEs) became an issue of interest to the U.S. Senate Permanent Subcommittee on Investigations last year in connection with its extensive investigation into the collapse of Enron Corporation. I chaired this investigation and, last August, sent FASB a letter describing the key SPE abuses identified by the Subcommittee and supporting the accounting reforms included in what has become FASB's Interpretation No. 46, Consolidation of Variable Interest Entities.

The August 2002 letter expressed support for the proposed interpretation even though, at the time, an exception included in the proposal for Qualifying SPEs ("QSPEs") had raised concerns. FASB is to be commended for taking the next step on SPE accounting reform by issuing this new proposal to clarify the permitted activities of QSPEs. QSPEs have traditionally played an important role in securitizations which, in turn, have contributed to the availability of capital and management of risk in the U.S. economy. The exposure draft's proposed amendment to FASB Statement No. 140 appears to strike the right balance between limiting sham QSPE transactions undertaken to conceal debt or contingent liabilities, while allowing legitimate, risk-dispersing securitizations to continue.

The following comments, in addition to expressing general support for the proposed amendment strengthening QSPE accounting standards, seek to highlight two important provisions and offer two suggestions for further improvements.

SPE Abuses. The August 2002 letter outlines the major SPE abuses uncovered in the Subcommittee investigation of Enron. The magnitude of these abuses, and how Euron used them to manipulate its financial results, necessarily affect any informed effort to design specific accounting measures to prevent similar misconduct in the future. One internal Enron document indicates, for example, that as of June 30, 2001, six months before the company's collapse, Enron had added up all of the outstanding transactions it

Financial Accounting Standards Board June 30, 2003 Page Two

had accounted for under FASB Statement No.140 (FAS 140), or its predecessor, FAS 125, and determined they represented outstanding debt of over \$5 billion. Almost none of this debt, however, appeared on Enron's financial statements; it was instead carried off balance sheet on the books of unconsolidated SPEs sponsored by Enron or a financial institution engaged in business with Enron. In addition, in a report filed in federal bankruptey court, an Enron bankruptey examiner states that, in 2000 and 2001 alone, Enron recognized "[a]pproximately \$350 million of gain" from FAS 125/140 ransactions. The examiner also determines that at least \$1.1 billion of cash flow on Enron's financial statements related to these transactions had been improperly classified as eash flow from operations, when it should have been classified as cash flow from financings.

Excluding Equity Instruments. One key measure in the exposure draft to prevent the type of sham SPE transactions perpetrated by Enron is the proposed prohibition on QSPEs' holding equity instruments.

On a number of occasions, Enron claimed to have securitized under FAS 125/140 certain equity investments it held by transferring an interest in those investments through one or more SPEs, the last of which was financed with debt and equity supplied by one or more financial institutions. One such transaction, known as Bacchus, is detailed in a Subcommittee report issued in January 2003. In this transaction, Enron used several SPEs as well as a set of overvalued assets to "monetize" its equity investment in a pulp and paper trading business, and claim in its 2000 financial statements over \$100 million in income and \$200 million in cash flow from operations, or approximately 11% and 6% of its net income and operating cash flow respectively. In another transaction, known as Braveheart, Enron claimed over \$100 million in income from an alleged securitization of its interest in a joint venture with Blockbuster, even though that joint venture never generated more than \$1 million in revenue before its termination.

FAS 140 was never intended to be used to securitize equity investments, and FASB is taking the right course of action in making it clear that a company seeking to increase its reported income cannot use FAS 140 to transform an equity investment into instant earnings. By prohibiting QSPEs from holding equity instruments, the exposure draft would eliminate the ability of companies like Enron to misuse FAS 140 and QSPEs to manufacture earnings.

Banning Total Return Swaps. Another key measure in the exposure draft to prevent Enron-like sham transactions is the proposed prohibition on a transferor's using a total return swap or similar financial instrument to support a QSPE.

Financial Accounting Standards Board June 30, 2003 Page Three

Enron used total return swaps in many of its FAS 125/140 transactions. These swaps were constructed to transfer substantially all of the financial risks and rewards associated with the transaction to Enron and functioned, in essence, as guarantees to financial institutions that Enron would repay any debt that an SPE failed to make good. In Bacchus, for example, an Enron-backed total return swap was used to protect the bank that agreed to loan the key SPE funds equal to 97% of the purported value of the interest in the pulp and paper trading business being securitized. This total return swap protected the bank from any drop in the value of the assets and from any failure of the SPE to repay the loan by enabling the bank to turn to Enron to make up any deficiency. In several other FAS 125/140 transactions with Enron-backed total return swaps, the Subcommittee inquiry found that the financial institution providing the financing for the deal did not even bother to perform a due diligence review of the assets being securitized, because its debt exposure was protected from fluctuations in the value of those assets. The end result was a transaction in which Enron purported to sell an overvalued asset to an allegedly independent SPE but simultaneously took back more than 90% of the risk and rewards associated with the asset by using a financial instrument - the total return swap that was never recorded on Enron's books.

The exposure draft's proposed prohibition on total return swaps to support QSPEs would put an end to these sham transactions, and would do so without hurting legitimate securitizations since, as industry representatives informed the Subcommittee staff, total return swaps are rarely, if ever, used in traditional securitization transactions.

The proposed provision would be further strengthened, however, if re-worded to make it clear that the prohibition extends not only to financial instruments between a QSPE and transferor, but also to financial instruments between a QSPE transferor and a financial institution or other party supporting a related QSPE securitization.

Establishing "Effective Control," A final important issue involves the issue of control. FAS 140 requires transferors to "surrender control" of assets transferred to a QSPE and identifies a range of factors to consider to determine whether control has been surrendered. While these provisions provide useful guidance, one issue that is not directly addressed is the situation in which a transferor or other party exercises effective control of a QSPE's decisionmaking process.

Again, Enron is instructive. A key part of the Subcommittee's Enron investigation examined a series of prepaid forward transactions or "prepays" that Enron used to claim more than \$8 billion in cash flow from operations on its financial statements over a six year period, when those funds should have been characterized as cash flow from financings. Each prepay transaction consisted of an orchestrated series of bilateral commodity trades involving Enron, a bank, and an SPE, the net effect of which was to cancel out all of the trades other than a transfer of funds from the bank to Enron

Financial Accounting Standards Board June 30, 2003 Page Four

followed by Enron's repayment of the funds to the bank with the equivalent of an interest payment. To create the appearance of commodity trades generating operational income, the transactions required the participation of an SPE trading partner that was supposedly independent from Enron and the bank. However, the investigation discovered that, while no legal documents established a direct ownership interest, the SPE involved in the deals was not at all independent of the bank. Instead, the evidence showed that, for example, the bank had caused the SPE to be formed; provided instructions to the SPE's trustees and agents on how the SPE should operate; provided the financial support, bank accounts, and financial services needed for the SPE to function; determined the business deals the SPE participated in; and negotiated the contracts into which the SPE entered.

After holding a hearing on the prepay transactions in July 2002, the Subcommittee sent letters to two key financial institutions requesting them to attest to whether they "effectively controlled" the SPBs that had participated in the prepay transactions. One institution, J.P. Morgan Chase, maintained that it did not "effectively control" the relevant SPE, known as Mahonia, despite acknowledging that Mahonia had been formed at its request, Mahonia had no employees of its own, Mahonia had participated in the prepays identified by the bank, and Mahonia was dependent upon the bank for finances, legal advice, contract negotiations, and execution of its business operations. One letter by J.P. Morgan Chase even acknowledges the following:

"[E]ach transaction arranged by JPMorgan Chase in which Mahonia participated contained a negative pledge clause, in which Mahonia could not, without JPMorgan Chase's consent, "assign, charge, hedge, dispose of or otherwise encumber any or all of Mahonia's rights, title and interest in the Collateral." Effectively, it would have been necessary for Mahonia to obtain JPMorgan Chase's consent before entering into any transaction not involving JPMorgan Chase."

To a fair and independent observer, these facts would seem to establish that the SPE was under the "effective control" of its sponsor. It is not clear, however, what significance, if any, these facts would be accorded under FAS 140, as amended. For example, paragraph (9) as amended by the exposure draft is the key provision requiring a transferror to "surrender control" over assets transferred to a QSPE, yet none of the listed factors appears to address the situation in which a transferror maintains effective control over the transferred assets by dominating the SPE's decisionmaking process. To address this situation, the proposal could perhaps be strengthened by adding new language at the end of subparagraph (9)(c), such as the language suggested here in bold type: "The transferor has surrendered control over transferred assets if ... the transferor does not

Financial Accounting Standards Board June 30, 2003 Page Five

maintain effective control over the transferred assets through ... or (3) an arrangement that allows the transferor to exercise decision making authority, either directly or indirectly, over the QSPE."

The accounting practices exposed in the Enron debacle and other corporate scandals demonstrate the extent of SPE abuse at some companies and the need for stronger SPE accounting standards. FASB Interpretation No. 46 began the SPE reform process, and the proposed amendment to FAS 140 will further advance it. Thank you for this opportunity to comment on the proposal.

Sincerely,

Carl Levin

Ranking Democrat
Permanent Subcommittee on Investigations

CL:ejb