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MP&T Director—File Reference 1082-200 Financial Accounting Standards Board 401 Morrit 7 P.O. Box 5116 Norwalk, CT 06856-5116

[VIA E-MAIL WITH COPY BY FEDERAL EXPRESS]

Re: File Reference No. 1082-200

Exposure Draft of the Proposed Interpretation—Consolidation of Certain Special Purpose Entities, an Interpretation of ARB No.51 (the "Interpretation")

Ladies and Gentlemen:

Thank you for the opportunity to participate in Monday's roundtable discussion. Regardless of how the board resolves the issues under consideration, it means a lot to have the opportunity to have one's ideas receive a fair hearing.

Having read the comment letters and listened to yesterday's discussions, this letter supplements the original comments of Atlantic Financial Group, Ltd ("AFG") in three important areas:

- The Interpretation should explicitly reject the concept of "virtual" SPEs.
- The Interpretation should retain the paragraph 8c scope exception.
- The Interpretation should eliminate conventional lenders from candidacy as Primary Beneficiary.

Section One: Why the Interpretation should explicitly reject the concept of a "virtual" SPE within a substantive entity.

A. Historically (including most recently in paragraph B18 of the Interpretation), the board has rejected the concept of proportional consolidation. If the board accepts the comments of PWC and others and permits consolidation (and/or deconsolidation) of a portion of an unrelated substantive entity's assets and liabilities under the theory that there is an embedded "virtual" SPE, then the board will be effectively issuing a Statement and not an Interpretation.

Unless the board explicitly rejects "virtual" SPEs, it is clear from the comment letters that many national firms will adopt the "virtual" SPE concept anyway (it is our experience in practice that firms have already begun adopting it on an inconsistent basis).

The concept of "virtual" SPEs would create a new class of SPEs, dramatically broaden the scope of the Interpretation, and create more opportunities for subjectivity, inconsistency and manipulation of balance sheets. Many (possibly a majority of) substantive entities "sequester" assets from time to time for the benefit of creditors by using secured financing (including non-recourse financing) in their day-to-day operations without forming a separate entity.

It makes no sense to widen an already broad scope to affect entities for which there have been no perceived problems in disclosure, consistency or accuracy of financial reporting. The potentially affected entities, though many, are unlikely to comment to the board, since they will have no reason to suspect that an Interpretation dealing with SPEs would draw them under its scope.

B. Partially "sequestering" assets by the use of secured debt (including non-recourse debt) in a substantive entity is significantly different from forming a SPE to accomplish this purpose.

From reading the comment letters of several of the national firms supporting the "virtual" SPE concept (most notably PWC and Grant Thornton, but also E&Y in their Appendix B), it is clear that the concept arises by analogy to Question 1 of EITF Bulletin 96-21. However, it is inappropriate and overreaching to draw this analogy.

EITF Bulletin 96-21 deals with "implementation issues in accounting for leasing transactions involving Special Purpose Entities", and question 1 follows a category header "multiple properties with a single SPE lessor". We fully agree with the logic of EITF Bulletin 96-21. If first, one determines that one is dealing with a SPE, and only then if one determines the assets and liabilities have been further segregated by the use of non-recourse debt with no cross collateral provisions, one is reasonable to conclude that multiple "silo" SPEs exist within the aggregate SPE entity.

However, the determination of whether one is dealing with a SPE must come first: the logic breaks down if the concept is transferred by analogy to groups of assets within a substantive entity. Such assets are not sufficiently isolated to be considered in a SPE in the first place. That is, creditors, equity participants, lessees and others are exposed to risks from the activities of the substantive entity unrelated to the "sequestered" assets. The most obvious of these risks is bankruptcy. For example, in the event of a bankruptcy unrelated to the activities of the "sequestered" assets, a lessee could find its lease rejected. Similarly, a lender, while admittedly secured, could be forced to endure the expense and risk of bankruptcy proceedings in order to recover its investment. An equity participant with an investment tied to the sequestered asset could suffer a loss of its investment through foreclosure unrelated to events tied to the sequestered assets and liabilities. The substantive entity itself is exposed to lawsuits related to the sequestered assets, as well as environmental and other similar risks.

As a side note, the concept of a SPE being bankruptcy-remote from the activities of its sponsor(s) is so pervasive and well understood in practice that it might be a useful inclusion when the board attempts to define and distinguish between SPEs and SOEs (and the desire to reduce ambiguity in this area seemed to be a frequent comment).

The best proof that there is a material difference between a SPE and a "virtual" SPE, and that it is inappropriate to draw an analogy to EITF Bulletin 96-21, is the very proliferation of SPEs. If a "virtual" SPE accomplished the same purpose as a SPE, there would be no need for companies to undergo the additional legal complexity and expense of forming a separate entity. This was confirmed by the comments of the American Securitization Forum in the morning roundtable discussion, and any securities lawyer or lender's counsel would also echo this view.

C. The desire to establish "virtual" SPEs may be rooted in a concern that without such a concept, transaction structures that some of the national accounting firms (and perhaps the board) find "undesirable", such as synthetic leases, may potentially continue within substantive entities. However, the benefit of eliminating these transactions in their entirety (assuming one perceives a benefit) is not outweighed by the risk of inadvertently bringing an enormous number of other transactions under the scope of the Interpretation as "SPEs".

See our previous comment letter regarding other recent board measures that have already dealt effectively with any perceived abuses related to synthetic leases.

Using synthetic leases as the example, if the board explicitly rejects the "virtual" SPE concept, then after the Interpretation is issued it is possible some substantive entities could elect to originate transactions directly as lessor and not in a SPE, but many others would find this approach unattractive due to regulatory issues, a perception of inadequate sequestering of risks vis a vis their overall enterprises, and/or the effects of reporting the assets and liabilities on the substantive entities' balance sheets. Lessees using substantive lessors would also be required to make judgments regarding the nature of the lessors and whether the lessees wished to be exposed to bankruptcy risks.

With respect to the more general risks of "renting balance sheets", substantive entities and structured finance professionals already have the opportunity to pursue this approach. It is rare in practice that they do so, for the reasons noted above, and related to the general difficulty in moving assets off-balance sheet absent appropriate substance to accompany the form. For example, in the instance the U.S. Senate referenced regarding "renting a balance sheet" to "park" assets (the Enron barges), the Senate noted correctly that the transaction probably wouldn't have been removed from the seller's balance sheet if details of certain verbal agreements had been known

To summarize, unless the "virtual" SPE concept is explicitly rejected in the Interpretation, practitioners may choose to use the concept; potentially promoting inconsistency in reporting and/or dragging large numbers of non-controversial transactions under the scope with all the related potential for adverse unforeseen and unintended consequences (such as the potential for new structured finance transactions of a type similar to the example described in Section 2B below).

D. Assuming paragraph 8c is retained, the wording could be modified so that the "virtual" SPE concept is clearly rejected.

We would suggest revising the first sentence of paragraph 8C as follows:

"No enterprise shall be deemed to be the primary beneficiary of a subsidiary that is consolidated by a substantive operating enterprise, and no division, department, branch or other non-subsidiary (i.e. directly-owned) assets and/or liabilities of a substantive operating enterprise shall be considered a SPE, even if such subsidiary or portion of a substantive operating enterprise is otherwise similar to a SPE that would be subject to the requirements of this Interpretation."

Section Two: Why the Interpretation should retain the scope exception set forth in Paragraph 8c, and how to deal with the legitimate concerns expressed by those who have suggested deleting the exception.

A. Without the 8c scope exception, numerous (many thousands in number and billions in dollar volume) of legitimate, non-controversial SPEs currently being reported by their owners with transparency, accuracy and consistency will fall within the scope. At a minimum, the costs to all the variable interest holders of applying the Interpretation to these SPEs will outweigh any benefits, and reporting consistency and transparency will likely also suffer.

For example, consider all the comment letters the board received from the credit tenant lease ("CTL") industry. While lenders to the industry are also concerned about the definition of a substantive entity (e.g. can it be an individual?), many of the transactions would be excluded if the scope exception were retained. A board member conceded in yesterday afternoon's conversation that having a traditional lender consolidate another's SPE in a normal CTL transaction was a less than desirable outcome, and retaining the 8c exception for substantive entities would partially address the CTL industry's concerns.

While only a few of the original comment letters directly supported the 8c exception (e.g. the KPMG letter), now that some have asked the board to consider removing the 8c exception, we suspect additional letters will be received from traditional equipment lessors, REITs etc. highlighting the adverse consequences for existing substantive entities if the exception is removed. Accordingly, our remaining remarks in this section will be confined to highlighting the potential for new, problematic structured finance transactions if the scope exception is removed, and to suggesting an alternative to mitigate the concerns of those advocating removal of the exception.

B. If the 8c scope exception is removed, the board will increase the opportunity to "rent balance sheets" by manipulating SPE and transaction characteristics. That is, the board will inadvertently create a powerful new deconsolidation tool, allowing entities to bypass detailed authoritative literature on leasing and securitizations developed over decades of deliberation.

To illustrate this point, consider a substantive entity (DataCo) with a contract to build, own and run a data center for 10 years on behalf of an unrelated creditworthy substantive entity (BusinessCo). As part of the contract negotiations, BusinessCo agrees to lease the underlying real estate from DataCo pursuant to an operating lease upon completion of construction.

DataCo builds the data center, and upon completion of construction, forms a wholly-owned LLC with nominal equity (SPE1). Due to its nature, the entity is disregarded for tax purposes, and DataCo retains full voting control of SPE1. The formation documents bar SPE1 from entering into any transactions other than as described below.

At completion of construction, the fair value of the real estate, as encumbered by the lease, is determined to be \$50 million. DataCo transfers the real estate and the lease to SPE1 in return for \$50 million in cash. SPE1 borrows the \$50 million using a 10 year loan, secured by the lease (i.e. the rent stream from BusinessCo) and the real estate, plus a \$20 million residual insurance policy purchased by lender from an unrelated insurance company. The lease is sufficient to repay \$30 million in principal plus interest over 10 years.

<u>Analysis</u>: Even though DataCo originally owned the real estate and continues to wholly-own SPEI, unless the 8c scope exception is retained, DataCo would deconsolidate the real estate and the debt.

After first determining that SPE1 is in fact a SPE, the voting interests model would be evaluated. SPE1 will fail condition 9(b) of the Interpretation by virtue of having no equity, and so DataCo will evaluate consolidation based upon variable interests.

The variable interest holders include DataCo (due to its voting rights), the lender to SPE1 and the residual insurer. Based upon the Interpretation, DataCo will determine that either the lender or the residual insurer should consolidate the entity, and DataCo will report no assets or liabilities related to SPE1. FAS 98 and other similar provisions will not apply to DataCo, because DataCo will have no sale/leaseback with SPE1.

This is a single example, developed in the past few days (i.e. after we became aware the board was considering eliminating the 8c exception). If the board agrees the example is at a minimum plausible, it may wish to consider what more creative structures and permutations might be developed over a longer period of time by the large existing community of sophisticated structured finance specialists.

C. What is the underlying reason several of the national accounting firms have suggested eliminating the 8c exception?

In reading the comment letters from a number of national firms, we were struggling to see how the exception would result in <u>less</u> consolidation than currently exists. We reasoned that the exception would simply leave existing GAAP unchanged for substantive entities, and therefore any SPEs that were currently being consolidated by substantive entities would maintain the status quo.

After clarifying comments were made in the roundtable discussion, we now understand that the advocates for eliminating the exception have two reasonable and significant concerns:

- 1) With the exception retained, any SPE currently consolidated by a lessee due to failure to meet the substantive equity provisions of EITF Bulletins 90-15 and 96-21 would become unconsolidated if the SPE was owned by a substantive entity, since the Interpretation nullifies those Bulletins. Since the Bulletins were applied by analogy to transactions other than leases, presumably the same consequences would occur in connection with other SPEs. This concern is presumably further exacerbated if the substantive entity does not currently consolidate the SPE (i.e. the Interpretation's 8c exception says that all "subsidiaries" of substantive entities are excluded from the scone, not just "consolidated subsidiaries").
- 2) The exception as drafted might allow proliferation of new "non-substantive" SPEs owned by substantive entities. That is, not only would substantive entities be able to "rent" their balance sheets, they could do so without providing any equity.

Unfortunately, the proposed solution of eliminating the exception and relying on paragraph 9 is equally unattractive. Many, if not most, of the conventional, non-controversial SPEs owned by substantive entities or individuals for legitimate purposes (i.e. SPEs that should rightly be excluded from the scope), will not meet the self-sufficiency equity requirements set forth in paragraph 9, and the variable interest model will often give the "wrong" result (e.g. a lender being required to consolidate a traditional CTL lessor SPE).

D. Is there an alternative that could mitigate the concerns about retaining paragraph 8C short of eliminating the exception?

Replacing the second sentence of paragraph 8c with the following wording could eliminate the concerns related to the issue of non-substantive equity in leasing transactions:

"Notwithstanding the above, a lessee shall consolidate a SPE lessor if the lessee has provided a significant residual value guarantee unless such SPE lessor has provided an initial substantive residual equity capital investment equal to at least 10% and maintains such investment over the life of the lease."

Admittedly, this still doesn't fully restrict the ability of substantive entities to "rent the balance sheet", but it resolves the issue with respect to leases and has the added merit of preventing the creation of a new class of opportunities to "rent the balance sheet" as described in Section C above. Finally, there would be a clear understanding of how to apply a sentence like the final one above in practice in connection with leasing transactions.

Perhaps the "exception to the exception" proposed above could be further expanded to cover other "troublesome" structures. For example:

"Further, any SPE engaged in hedging or commodities trading transactions, or in transactions in which any obligations may be settled in securities in lieu of cash, shall be subject to the provisions of this Interpretation."

We are most familiar with leasing transactions; the board could undoubtedly improve on our wording, but hopefully the example illustrates the point.

Section Three: Why the Interpretation should eliminate traditional lenders from candidacy as Primary Beneficiaries

A. We agree with the Fed's letter that traditional lenders do not control borrowers so much as constrain them, and eliminating such lenders from consideration as Primary Beneficiaries would go a long way toward improving consistency and accuracy in applying the Interpretation.

As noted by one board member in the morning roundtable, distinguishing between debt interests versus equity interests can sometimes be difficult. This is certainly true at the margins, but we believe a paragraph such as the following would not be subject to much ambiguity:

"Notwithstanding anything to the contrary, the variable interests of a lender holding no other variable interests in a SPE shall be disregarded for the purposes of determining a Primary Beneficiary. The foregoing sentence shall only apply if the lender is advancing funds pursuant to a conventional and non-convertible loan agreement with a stated maturity and a debt-appropriate fixed interest rate, or a debt-appropriate floating interest rate variable solely due to conventional market indices associated with floating-rate debt."

The rationale is that a conventional lender uses a SPE to protect its interests, but that the loan also advances the interests of the other parties involved in the SPE, one of whom is the Primary Beneficiary.

By eliminating conventional lenders from consideration, the potential for "wrong" answers in applying the Interpretation will be greatly reduced. For example, SPE's owned by individuals (versus "substantive entities") in conventional CTL transactions would likely be evaluated based upon the variable interests model, but application of the model would probably determine correctly that the individual is the Primary Beneficiary.

We believe this fact pattern would hold for most traditional, non-controversial SPEs. However, in more "exotic" SPEs, if the lender has anything other than a "conventional" loan, including any other additional variable interests, the model would apply "as is". Thinking through what the Interpretation's effect might have been on the Senate's examples of "problem" Enron SPEs, adopting this approach in those instances would have at a minimum been neutral versus the current drafting, and might have increased the chances that Enron would have been deemed to be the Primary Beneficiary, particularly if the board also amended the approach to allow one to look at the potential for gains as well as losses in identifying a Primary Beneficiary (a concept we also support).

Lastly, with this approach and the other changes described herein, we believe the percentage in paragraph 12 could be amended to be a "bright line" versus a presumption that could potentially be overcome. A new, higher "bright line" for equity in SPEs would be perceived positively by the general public, and yet with these changes, a "bright line" would not be detrimental to the heneficiaries of the vast majority of SPEs used for legitimate purposes.

Concluding Remarks

Given the many significant and well-reasoned comments the board has received both "pro" and "con" related to consolidation issues raised by the Interpretation, including the issue of whether to retain paragraph 8c, the board might be well-advised to move with greater deliberation. It is notable that most of the national accounting firms were very concerned about applying the Interpretation in its current form. Unfortunately, the board is simultaneously under significant public pressure to move quickly to complete the project. Considering the tension created by these two opposing circumstances, we believe the board is best served by narrowing the scope of the project to the extent possible and "first doing no harm", rather than by moving quickly AND with a sweeping scope.

Both of our comment letters, particularly our remarks regarding "virtual" SPEs, have been drafted from this point of view. Similar thoughts were probably behind KPMG's suggestion to carve-out leasing from the scope (we are fully supportive of KPMG's letter in its entirety) and E&Y's suggestion that its second preference (behind a financial components approach but ahead of the Interpretation) was to codify and elaborate on existing ETTF Bulletins and SEC announcements, coupled with greater disclosure.

The board has a challenging task ahead in its intent to finalize the Interpretation by year-end. We wish you the best of success in the process, and if our firm may be of assistance in any way please don't hesitate to call me at 214-720-9237. Again, thank you for the opportunity to express our views.

Very truly yours,

ATLANTIC FINANCIAL GROUP, LTD.

By: Atlantic Financial Managers, Inc its sole general partner

Stephen Brookshire

President