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Morgan Stanley

August 30, 2002

Ms. Suzanne Q. Bielstein Director of Major Projects and Technical Activities Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

File Reference No. 1082-200 Re:

Exposure Draft on Consolidation of Certain Special Purpose Entities, an interpretation of ARB No. 51

(the "Exposure Draft")

Dear Ms. Bielstein:

Morgan Stanley appreciates the opportunity to provide comments on the Exposure Draft. Morgan Stanley is a member of the American Securitization Forum and has participated in the comment letter submitted to the Financial Accounting Standards Board (the "Board") by that organization. We support the positions and recommendations reached therein.

Executive Summary

We share the Board's objective of improving the transparency and comparability of financial statements and we agree that too narrow a standard can result in the omission of assets and liabilities and revenues and expenses that should comprise an enterprise's financial statements. On the other hand, too expansive a consolidation standard can also result in less meaningful financial statements by including assets that are not available to an enterprise and liabilities that are non-recourse to an enterprise. In addition, the inclusion of these assets and liabilities can result in significant distortions in the income statement due to mixed attribute accounting (i.e., fair value accounting for assets and accrual accounting for liabilities). As a result, we believe that an excessively broad consolidation standard will create a new set of problems. It will not accomplish the Board's stated purpose to "achieve more consistent application of consolidation policies to SPEs and, thus, improve comparability between enterprises engaged in similar activities even if some of those activities are conducted through SPEs."

Most importantly, we are concerned that an overly broad standard will result in less efficient markets for the securitization of financial assets. In particular, the markets for credit-linked notes ("CLNs"), collateralized debt obligations ("CDOs") and multi-seller asset-backed commercial paper facilities ("ABCP") will be directly affected, as many parties will be unwilling to engage in otherwise economically beneficial transactions that may inappropriately distort their financial statements. Other markets will suffer as well. CDO vehicles and ABCP are

significant investors in asset-backed securities, commercial mortgage-backed securities ("CMBS") and other fixed income securities including beneficial interests issued by other SPEs.

As a result of the Board's earlier discussions, we had believed that the Exposure Draft would accommodate many transactions designed to diversify and allocate risks to interested parties. In paragraph B19, "the Board acknowledged that...some SPEs effectively diversify risks...No individual party controls the SPE's assets or is responsible for the SPE's liabilities. Each party should account for its rights and obligations related to the assets in the SPE, but it is inappropriate for any party to consolidate the assets and liabilities of the SPE." We do not believe that the results of applying the guidance in the Exposure Draft to many CDO, CLN and ABCP structures will be consistent with this objective.

In particular, CDOs and CLNs represent transaction structures that are designed in most cases to diversify risks and are not established to benefit a particular party. We are concerned that the Exposure Draft would inappropriately require many risk-diversification SPEs to be consolidated by a party to the transaction. We believe that the framework for analyzing SPEs that hold certain financial assets ("Financial SPEs") is not consistent with its objective of identifying risk-dispersing SPEs and determining whether a party to the SPE exercises financial control. The following discusses our concerns in more detail.

SPEs That Hold Certain Financial Assets

We have significant concerns with the framework for analyzing Financial SPEs described in paragraphs 22 and 23 and further discussed in paragraphs B19 through B25 of the Exposure Draft. As the Board has recognized, "[n]o individual party controls the SPE's assets or is responsible for the SPE's liabilities" in those SPEs that "effectively diversify risks." "The Board believes that appropriate application of the provisions of this Interpretation would not result in consolidation of SPEs that effectively disperse risks." The framework provided in paragraphs 22 and 23 is intended as "more specific guidance on how to analyze one class of risk-dispersing SPEs" in order to "simplify implementation and improve consistency." We do not believe that the framework for analyzing Financial SPEs achieves this objective; but rather, we believe that this framework will result in the consolidation of Financial SPEs in many circumstances in which consolidation would not be required under the more general variable interests approach.

Modifications to the Financial SPE framework should ensure that it is consistent with the overall premises of the Exposure Draft and the general variable interests approach. The conditions for the consolidation of Financial SPEs should not be more stringent than the premises for consolidation under the general variable interests approach. While the general variable interests approach requires consolidation when a party holds a significant variable interest that is significantly larger than any other, the requirements in paragraph 23 do not appear to take this principle into consideration. Further, we continue to believe, consistent with our comments in following sections of this letter, that consolidation should generally be based on a majority of the variable interests.

The provisions of paragraph 23 should therefore be modified to require consolidation only if 1) a party holds a majority of the variables interests (or interests that meet the significant and significantly larger tests if those conditions are not amended) and 2) a party also meets two out of the three conditions in paragraph 23. In addition, the provisions of paragraph 23 should be further modified in order to ensure the Board's objective that "appropriate application of the provisions of this Interpretation would not result in consolidation of SPEs that effectively disperse risks."

First, the Board should clarify the condition contained in paragraph 23(a). We urge the Board to clarify the condition to make clear that an enterprise must have the "authority [both] to purchase and sell assets for the SPE" and to benefit from the use of that authority in order to meet the condition. We believe that this condition was established in order to address the resulting control that may occur when the administrator or collateral manager has significant authority to engage in trading decisions and can benefit from those trading decisions. We also note that the conditions contained in paragraphs 23(b) and 23(c) appear to be duplicative. Paragraph 23(b) describes ways in which an enterprise owns a variable interest through a guarantee, a back up lending facility, or another form of

support. Paragraph 23(c) describes an enterprise that owns a variable interest through a non-market-based fee. Both simply describe variable interests.

Second, we are concerned that the provisions in the last sentence of paragraph 23 are inconsistent with the general variable interests model. A party to an SPE "that meets at least two of those conditions shall follow the guidance in items (b) and (c) of paragraph 13 (because two enterprises could meet two of those conditions)." It is unclear whether the subsequent analysis in paragraph 13 includes all parties that provide financial support through a variable interest or just the parties that meet two of the three conditions in paragraph 23 and, thus, provide "significant financial support through a variable interest." We believe that paragraph 13 should be clarified to note that all parties to the SPE that provide support through a variable interest are included in the analysis of variable interests.

Many of our concerns giving rise to our above comments can be illustrated by the following example: Consider a situation in which the collateral manager in a CDO (which meets the paragraph 23(a) condition) owns a small percentage of the total variable interests, either through ownership of a small percentage of the equity and/or a small non-market-based fee. Virtually all of the total variable interests are owned by a small number of third-party investors, such that each third-party investor owns a significant variable interest. (For example, the collateral manager owns 2% of the variable interests and two third-party investors each own 49%.) In this case, the collateral manager would be required to consolidate the CDO because it is the only party that meets two or more of the paragraph 23 conditions, even though third-party investors each owned a significantly greater share of the total variable interests than the collateral manager. This result is significantly different than the result from the general variable interests approach. Collateral managers in most CDO transactions purchase a minority of the equity interests, generally on the same terms as the investment of third-party investors. Investors recognize that coinvestment by the collateral manager best insures that the interests of the collateral manager are properly aligned with the interests of investors. The provisions of the Exposure Draft would discourage this co-investment. We do not agree with a requirement that is inconsistent with the needs of the market.

Limitations on Derivatives Owned by Financial SPEs

We believe that most of the limitations on derivatives contained in FAS 140 and carried over in paragraph 22 are not necessary in the context of Financial SPEs as we do not find these restrictions necessarily consistent with the concept of risk-dispersing SPEs. Given the provisions in the proposed amendment to Statement No. 133 ("FAS 133") requiring the bifurcation of embedded derivatives in beneficial interests issued by SPEs, we anticipate that these limitations will preclude the use of paragraphs 22 and 23 in order to evaluate SPEs that issue CLNs or CDOs that have "synthetic" collateral (i.e., they are exposed to credit risk through credit default swaps that are written by the SPE instead of owning securities with the same credit risk). Financial SPEs are also precluded from purchasing beneficial interests issued by SPEs that contain derivatives resulting from bifurcation under certain accounting requirements. This includes beneficial interests issued by former qualifying SPEs ("QSPEs") that have lost their qualifying status solely as a result of the application of the proposed amendment to FAS 133.

CLNs are created solely to disperse credit risk to investors. Synthetic CDOs provide the same economic risk as do "cash" CDOs (those CDOs that own securities). CDOs frequently invest in such beneficial interests, further excluding additional CDOs from qualifying as Financial SPEs. As such, the restrictions on derivatives contained in paragraph 22 severely limit the capacity for many risk-dispersing SPEs to be evaluated under the Financial SPE framework.

The Board's basis for limiting derivative activity in QSPEs does not appear relevant for risk-dispersing SPEs. In FAS 140, the Board noted that it placed limits on derivatives held by QSPEs for two reasons. First, the Board was concerned that QSPEs could be used to circumvent the application of FAS 133. Second, QSPEs are not permitted to exercise discretion with respect to its activities and the Board was concerned that there may be decision-making aspects associated with certain derivatives that are beyond the scope of a QSPE's permitted activities. The proposed guidance in the amendment to FAS 133 and related Implementation Issue No. D2 alleviates the Board's concerns regarding the circumvention of FAS 133 and the decision-making activity that would occur as a derivative counterparty does not appear to be any greater than that already afforded to a Financial SPE under paragraph 23(a).

Therefore, we suggest that derivatives held by a Financial SPE should be subject only to the limitation that each such derivative:

"Has characteristics that serve to allocate cash flows within the SPE in order to provide for risks and cash flows to the beneficial interest holders that are consistent with the terms of the beneficial interests."

This suggestion is consistent with the comments we made previously on the exposure draft on the amendment of FAS 133.

Other Limitations of a Financial SPE

Unlike QSPEs, Financial SPEs are not permitted to own equity securities. We ask that this provision be clarified to permit Financial SPEs to own non-convertible preferred stock or other "equity" securities that have the characteristics of fixed income securities. A Financial SPE should not be precluded from holding a particular security merely because of the form of the security if the substance of the security is to provide cash flows to the vehicle which can be allocated or passed-through to investors based on their tolerance for risk, which is consistent with the Board's premises surrounding Financial SPEs.

In addition, in using the criteria for QSPEs as defined in FAS 140 as the starting point for identifying Financial SPEs in paragraph 22, we have concerns surrounding the resolution of EITF Issue 02-12 and the potential impact of the consensus reached in that issue particularly as it pertains to certain ABCP structures and master trusts. Depending on the resolution of EITF 02-12, it is possible that some ABCP structures and master trusts used in securitizations would not longer be considered QSPEs and, as such, fall outside the scope of the Financial SPE framework. We do not believe this to be the Board's intention. Further, if the Board has acknowledged that risk-dispersing SPEs should not be subject to the same restrictions on asset sales as a QSPE (as evidenced by the conditions in paragraph 22(b)(3), we fail to see why a Financial SPE should be constrained in its ability to issue beneficial interests. Therefore, we recommend that additional changes be made to paragraph 22(b) so that Financial SPEs should also not be subject to the same restrictions on the tenor or issuance of beneficial interests that may arise in from the pending resolution of EITF 02-12.

Consolidation Based on Voting Interests

We have several concerns with the framework for consolidation based on voting interests contained in paragraphs 9 through 12 and further discussed in paragraphs B7 through B9 of the Exposure Draft.

Legal Form of Equity Securities

The requirement in paragraph 9(c) that the equity investment be subordinate to all other equity investments appears to require that the equity take the legal form of equity. This requirement would appear to apply to the nominal amount of equity that is contained in many transactions for legal, tax, regulatory or other non-economic reasons. In many securitization transactions, a nominal equity holder invests a small amount (frequently \$20,000 or less) and has received fees to fully compensate them for their involvement with no risk. The real "equity" securities in an economic sense frequently take the form of preferred stock (subordinate debt securities in many older transactions). This preferred stock frequently meets all of the other requirements of paragraph 9 and should be the focus of the voting interests model.

This appears to be the only provision in the Exposure Draft in which the analysis is based on the form of the transaction rather than the economic substance. We agree that the economic substance should be the focus of the analysis and do not support the exception made to this provision.

As a result, we suggest that the Board consider an approach in which the nominal equity can be ignored and the voting rights model be applied to the preferred equity, which represents the actual first loss position, or the real

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economic "equity," in the transaction. If the preferred stock meets all of the conditions contained in paragraph 9, the voting interests model would be applied to the preferred stock.

Equity Investment by a Variable Interest Holder

We believe that the requirement in paragraph 9(e) that the equity investment not be provided by a party with any variable interest in the SPE is too restrictive. We understand the Board's concern that an equity investment provided by an investor that owns, for example, a significant interest in the non-investment grade subordinate debt securities issued by the SPE may raise questions as to whether that investor has a controlling financial interest in the SPE and represents a factor that should be considered in assessing potential consolidation. However, such situations should be evaluated based on all of the facts and circumstances of the transaction, as opposed to providing no flexibility in this regard.

Sufficiency of Equity Investment

We agree that the requirement in paragraph 9(b) that the amount of the equity investment must be large enough to permit the SPE to finance its activities without other support is a critical part of the voting interests model.

However, we believe that the analysis regarding the sufficiency of the equity investment is too complicated and relies on information that is not relevant. We believe that the requirement described in paragraph 9(b) that the amount of "the equity investment should be greater than or equal to the expected future losses of the SPE..." represents a reasonable requirement and no additional provisions should be stipulated. If the premise is whether an SPE is able to finance its activities without other support, we would note that this at times principle can be evidenced by virtue of the fact that a rating agency evaluated the capitalization of the SPE and found it to be sufficient in order to provide an investment grade rating for certain of the issued securities.

The further discussion in paragraphs 11, 12 and B9 introduces requirements that serve merely to complicate the analysis and introduce factors that should not be relevant. Paragraph 11, for example, directs a comparison with the equity investment of a "substantive operating enterprise with similar assets and liabilities, similar activities and similar risks." Paragraph 12 introduces the one-sided presumption that 10% of the SPE's total assets is the minimum equity investment required to support the SPE. This presumption can be overcome only with evidence from comparisons with "businesses that are not SPEs and that engage in similar transactions with similar risks."

Any comparison to a substantive operating enterprise will necessarily introduce risks that are not present in an SPE. As the Board recognized in the summary, SPEs can serve valid business purposes by "isolating assets or activities to protect the interests of creditors." An SPE can provide these benefits to its investors and operate with less equity than an operating enterprise merely because it is bankruptcy-remote and permits only limited activities. The comparison with a substantive operating enterprise ignores these benefits that an SPE can provide. As a result, the comparison between the two capital structures cannot be meaningful.

Consolidation Based on Variable Interests

We have several concerns on the framework for consolidation based on variable interests contained in paragraphs 13 through 21 and discussed further in paragraphs B10 through B17 of the Exposure Draft.

Majority of Variable Interests

We believe that consolidation generally should be based on a majority of the variable interests.

We recognize that majority ownership has never been an absolute requirement for consolidation. Any party that owns less than a majority of the variable interests should be required to determine if there are special circumstances that would indicate that it nevertheless exercises control and, thus, should be required to consolidate the SPE. However, we do not believe that this provision necessarily translates in all cases into consolidation for a party that owns a significant portion, but not the majority, of the variable interests.

Derivative Counterparties

The analysis should be modified for certain derivative counterparties to SPEs that own no other variable interests. Paragraph 18(j) of the Exposure Draft identifies derivatives as one way in which a variable interest can arise. In most cases, we believe that it is inappropriate for a market-based derivative with a senior payment priority to raise the possibility of consolidation of an SPE. FAS 133 already requires the derivative counterparty to account for the derivative at fair market value. A requirement to consolidate the SPE solely as a result of a derivative could in some cases result in a requirement that the derivative counterparty in effect show the notional amount of the derivative on its balance sheet. The Board specifically rejected that approach in FAS 133.

We recognize that certain types of derivatives, such as total rate of return swaps or deep in the money call options, result in the counterparty effectively retaining control of the assets or substantially all of the benefits and risks of the assets of the SPE. We acknowledge that these derivatives should not necessarily be excluded from our suggested modification.

Parties that are active in the derivatives markets may have thousands of open derivative positions. This simplification will ease significantly the burden to monitor the accounting requirements for these derivative positions, which exist solely as part of an entity's derivative trading activities.

Determination of Market-Based Fees

We note several inconsistencies in the discussion of market-based fees in paragraph 19. The first sentence establishes the concept that a market-based fee is one that is "negotiated at arm's length under competitive conditions." The last sentence, on the other hand, indicates that a fee is presumed not to be market-based "unless it [is] comparable to fees in similar... transactions." In other words, the arm's length negotiation of a fee between a service provider and third party investors may not provide enough evidence to establish that the resulting fee is market-based. The first sentence implies the need for a competitive bid. The last sentence mandates a comparison to similar transactions and apparently climinates the negotiation of different structures for fees that investors believe to be more attractive. We believe that this is far too onerous a standard.

We believe that any of the three methods discussed in paragraph 19 should provide sufficient evidence that a fee is market-based: 1) the arm's length negotiation of a fee between unrelated parties with an economic interest (including negotiations directly between the service provider and equity and other investors in a transaction or indirectly between the service provider and an underwriter), 2) a competitive bid and 3) a comparison with the fees in similar transactions.

Tiebreakers are not Necessary

We believe that the "tiebreakers" described in paragraphs 20 and 21 do not appear to be necessary. A primary beneficiary must own variable interests that are either a majority or a significant amount that is significantly more than any other holder. If two enterprises have variable interests "with similar expected losses" or "of similar size," neither enterprise owns variable interests that are significantly more than the other holder. A tiebreaker is not necessary with these requirements. Neither entity will be required to consolidate the SPE.

Implementation Issues

Finally, we believe that there are implementation issues that have not been addressed in the Exposure Draft.

In determining the relative sizes of variable interests, each of the variable interest holders must determine a set of possible outcomes, assess the risk of loss on each of the variable interests under each outcome and estimate the probability of each outcome. This process is highly subjective. Different investors may identify different sets of possible outcomes and may estimate the probabilities of these possible outcomes very differently. As a result, different investors may reach inconsistent conclusions. For example, two different variable interest holders may each reach the conclusion that the other investor is the primary beneficiary (resulting in no party consolidating the SPE) or

they may each reach the conclusion that they are the primary beneficiary (resulting in two parties consolidating the SPE). These inconsistencies should be resolved prior to finalizing the Exposure Draft.

Effective Date and Transition

We believe that the decision by the Board to apply the Interpretation immediately to all SPEs established after the release of the Interpretation and the short transition period for existing SPEs will impose unreasonable hardship on many reporting companies. The transition guidance should reasonably accommodate existing transactions. The FAS 140 requirements that are incorporated within paragraph 22 describe provisions that "were entirely specified in the legal documents that created the SPE." It is impossible to meet this literal requirement for existing SPEs that must be modified to avoid inappropriate consolidation under the proposed interpretation. We urge the Board to clarify that amendments made to program documents for existing SPEs that limit activities in order to comply with the provisions of the new interpretation would be consistent with the requirements.

We anticipate that the provisions of the Exposure Draft would constitute significant changes to long-standing practices in rather common and broad capital market structures. For example, the first ABCP program was established in 1983. Since that time, the ABCP market has more than \$800 billion of asset-backed commercial paper outstanding. Similarly, the first CDO transaction was issued in 1988. Since then, the CDO market has grown to more than \$500 billion. Changes to these markets will have broader implications extending to other financial markets. Multi-seller ABCP conduits and CDOs, for example, have significant holdings of other fixed income securities, including asset-backed securities, CMBS and corporate debt securities.

Many financial institutions, including Morgan Stanley, are involved with hundreds of SPEs. As the Board recognizes, many transactions today use SPEs for "valid business purposes" in order to isolate "assets or activities to protect the interests of creditors or to allocate risks among participants." These SPEs were established with a structure consistent with the accounting guidance in place at that time. A requirement that each of these transactions be re-analyzed in order to address questions that were not present at the time the SPE was established will be onerous and time-consuming.

Consolidation of a QSPE by a Non-Transferor

FAS 140 provides that a transferor of financial assets to a qualifying SPE that meets all of the other requirements of FAS 140 is not required to consolidate the QSPE. FAS 140 addresses only the transfer of financial assets and, thus, does not address the consolidation of a QSPE by other parties to the QSPE.

This matter is particularly important in the CMBS securitization market. Virtually all CMBS transactions are structured to meet all of the 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 third party investors. The third party investor typically serves as the special servicer and is responsible for servicing defaulted loans.

We believe that in most cases, a third party investor that owns the first loss tranche in a QSPE will not be required to consolidate the QSPE. Because a QSPE (and an agent of the QSPE on its behalf) has no discretion regarding the sale of loans, no entity should meet the condition described in paragraph 23(a) of the Exposure Draft. The third party "equity" investor arguably meets the condition described in paragraph 23(b) because it owns the first loss position. Any fees paid to the third party investor, for example, in its role as special servicer in a CMBS transaction, must be justified as market-based; otherwise the investor will meet the condition described in paragraph 23(c) and be required to consolidate the QSPE. We believe that in most cases, the investor should be able to establish that its fee is market-based unless the evidence required to overcome the presumption that the fee is not market-based is unrealistically onerous.

However, this analysis is not sufficiently straightforward. Market participants have questioned whether the highly limited discretion permitted by FAS 140 in, for example, special servicing activities, would cause a special servicer to meet the condition described in paragraph 23(a). In addition, as noted above, it is not clear what evidence will be required to overcome the presumption that a fee is not market-based. However, unlike a guarantee, a back-up

lending arrangement or other types of liquidity support, the equity investor is not required to make any additional investment. Moreover, such investment is fully accounted for on the balance sheet, and there is comprehensive guidance on recognition of income and possible impairment of value of the investment.

We urge the Board to consider a more straightforward test in determining whether a third party investor in a QSPE would be required to consolidate the QSPE. We suggest that the Board consider a simple principle: If the third-party investor had no rights or obligations that would have prevented the transferor of the assets to the QSPE from accounting for the transaction as a sale of assets, 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.

Scope

Paragraph 8(a) provides that a transferor of financial assets shall not consolidate a QSPE as defined by paragraph 35 of FAS 140. This exclusion from the scope of the Exposure Draft should be extended to "grandfathered" QSPEs described in paragraph 25 of FAS 140.

We would be pleased to discuss our comments with the Board or the Staff. Please contact David Moser at (212) 537-2620, Staci Lublin at (212) 537-2456 or Karen Dealey at (212) 537-2452 with questions or comments.

Sincerely,

/s/ Joanne Pace Managing Director, Principal Accounting Officer and Controller