LEHMAN BROTHERS

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Financial Accounting Standards Board
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Re: **File Reference No. 1082-200**
Exposure Draft on Consolidation of Certain Special Purpose Entities, a Proposed Interpretation of ARB No. 51

Dear Ms. Bielstein:

Lehman Brothers, a leading global investment bank, appreciates the opportunity to comment on the Financial Accounting Standards Board's Exposure Draft on Consolidation of Special Purpose Entities, A Proposed Interpretation of ARB No. 51 (the "Exposure Draft" or "the Interpretation"). It is with keen interest that Lehman Brothers has been following the FASB's deliberations on accounting for SPE's as we have extensive involvement with SPE's, particularly with respect to securitization transactions (Lehman securitized over $100 billion of financial assets in fiscal 2001). Lehman Brothers fully supports the FASB's goal of improving comparability of accounting for involvement with SPEs and providing appropriate transparency to investors. However, it is our belief that the Exposure Draft does not accomplish these basic objectives and therefore the FASB should not proceed toward a final release unless a number of changes are adopted. These changes should be aimed at reducing the number of inappropriate affirmative consolidation conclusions (i.e., instances in which the model would require consolidation by parties with minimal risks or with purely passive involvement in the SPE), and creating a more practical standard (i.e., one that does not require each investor in an SPE to keep track of the amount of interest held by every investor in the SPE on a continuous basis). Additionally, we do not believe that the FASB's proposed model for risk diversifying financial SPE's (FSPE's) has accomplished its intended purpose of identifying financial SPE's with significant risk diversification such that no party should consolidate. Rather, we believe that that the restrictions on permitted derivatives within FSPE's are overly burdensome and will prohibit the use of the FSPE model for many

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legitimate risk diversifying SPE's (e.g. Collateralized Debt Obligations "CDO's" and Credit Linked Notes "CLNs").

Given the complexity of the Exposure Draft in which consolidation is determined based on three potential consolidation models (the Variable Interest Model, the FSPE Model and the Voting Interest Model) our detailed comments have been segregated below to address specific concerns for each of these models.

The Variable Interest Model

Lehman Brothers supports the FASB's efforts in adopting a principle based approach for its variable interest model, such that a primary beneficiary of an SPE would be required to consolidate. The variable interest model requires consolidation by a primary beneficiary if such party has either (1) a majority of the variable interests or (2) a variable interest that is significant and that is significantly more than the variable interest held by any other individual party. However, for a number of reasons identified below, we believe that the FASB's definition of a primary beneficiary is overly broad and not able to be practically determined.

Majority vs. Significant Variable Interest

Lehman Brothers strongly believes that the FASB should revise its definition of primary beneficiary to be that party which is subject to a majority of the variability of the SPE's returns, rather than the FASB's current definition that defines a primary beneficiary based upon the significance of each party's variability of return relative to others. We believe that this change to majority variable interest will greatly improve the ability to practically implement the Interpretation, while remaining true to the FASB's basic objectives of improving comparability of financial statements and providing increased transparency to investors. If the FASB does not adopt this change we believe there will be less comparability of financial statements. Comparability will be reduced as institutions will differ in their ability to re-evaluate their interest relative to others, given the FASB's requirement to re-assess which party is the primary beneficiary on an on-going basis. Additionally, we believe that the "significant interest" standard is highly subjective and therefore will likely serve to reduce comparability of financial statements rather than improve comparability.

We believe that the concept of requiring consolidation for those entities participating in the majority of risks and rewards is well founded in existing GAAP. ARB No. 51, *Consolidated Financial Statements* requires consolidation for those entities in which an enterprise is able to exercise a controlling financial interest. In practice, a controlling financial interest is rarely deemed to exist for non-SPE's without such party having a majority of the voting interests. As the Exposure Draft is aimed at identifying that party for which control has been disguised through the establishment of the SPE's governing documents (which requires little or no on-going voting control), we believe that it would follow that a party which participates in a majority of the variability of return of the SPE could be presumed to have exercised a controlling financial interest. However, we fail to see how a party with significantly less than a majority of the variable interest, such as a 20% equity holder, should be deemed to be a primary beneficiary assumed to have exercised a controlling financial interest in the establishment of such SPE merely due to the fact that the remaining equity interests are widely dispersed. Similarly, we do not see the improvement in comparability of financial reporting whereby the same 20% equity investor may consolidate in one month when remaining equity interests are widely dispersed but may deconsolidate in the next month if another investor acquires a similar 20% interest.

We strongly believe that the FASB's variable interest model which is predicated upon the relative significance of an entity's variability of return is impractical. Entities involved with an SPE will generally not have information regarding the identity of other variable interest holders in an SPE (or may not be able to achieve such information on a timely basis) and therefore will not be able to perform such periodic re-assessments. We strongly encourage the FASB to modify its definition of primary beneficiary to one based upon majority of variability of return as such evaluation can be accomplished on an on-going basis without reliance on information which may not be possible to obtain, thereby greatly improving the ability to practically implement the Exposure Draft.

10% Legal Equity Requirement

The Exposure Draft states that 10% is not the required minimum legal equity, but rather the equity required must be sufficient to cover expected losses. The FASB would not allow less than 10% legal equity, even if such amount were proven to cover expected losses, unless a comparable operating company with similar risks and rewards is found to have less than 10% legal equity. The practical result of such guidance is to prohibit legal equity below 10%. In practice this guidance would require legal equity equal to be the greater of 10% or the amount necessary to cover expected losses. Rather than adopting an arbitrary minimum 10% standard, we request that the FASB adopt a principle based approach which would require equity to be that amount necessary to cover expected losses, without requiring a company to prove that an operating company with similar risks and rewards also has the same level of equity.

Required Clarifications on How to Apply Primary Beneficiary Model

Lehman Brothers fully supports the FASB's efforts to provide principle-based standards without undue detailed guidance and complexity. We note that the Exposure Draft has omitted many of the specific case examples and preliminary FASB conclusions released in earlier drafts of the FASB's proposed interpretation. We believe that the FASB's omission of guidance previously presented has led to significant debate and confusion on how the Exposure Draft should be applied to these basic examples. Some constituents believe that the FASB removed such guidance based upon changed interpretations of how this guidance should be applied, while others believe that such initial guidance should be authoritative. If the former is true, we respectfully request that the FASB provide clarity in its final release that the FASB no longer deems its preliminary conclusions on sample cases to be authoritative. However, if the FASB believes that prior case examples should be authoritative, we respectfully request that the FASB include these examples as part of its final release with appropriate opportunity for interested parties to further comment on the proposed examples.

We also believe that certain additional guidance is necessary to ensure consistent application of the basic model, specifically with respect to factors to consider when identifying the primary beneficiary if the legal equity requirement is not met. We believe that additional guidance is necessary to highlight the factors to be considered in identifying the primary beneficiary given the complexity involved in evaluating the various forms of involvement of parties to the SPE.

1. *Clarify that Derivative Counterparties Should not be Presumed to be and Should Ordinarily Not be the Primary Beneficiary*

   Financial institutions, as dealers in derivatives, have transacted extensively with SPE's, with much of such interaction in the form of vanilla interest rate and/or currency swaps. We recommend that the FASB clarify that counterparties to arm's length derivatives should not be presumed to be and should ordinarily not be the primary beneficiary of an SPE (e.g., interest rate swap counterparty). Instances in which a derivative counterparty could be deemed to be the primary beneficiary would generally require the derivative counterparty to have an option based contract giving it control over assets in the SPE or instances in which the derivative contract involved a transfer of substantially all of the risks and rewards of the assets in the SPE to the derivative counterparty (e.g. total return swap).

2. *Transferors Should Not Be Presumed to be Primary Beneficiary*

   Prior accounting guidance placed undue emphasis on transferors to consolidate SPE's regardless of the level of their continuing involvement with the SPE. We recommend that the FASB clarify that the transferor should not be presumed to be the primary beneficiary. We believe that such guidance is necessary to ensure that all parties to the SPE are equally at risk for consolidation depending only on variable interest levels. We believe that such guidance is necessary to ensure consistency in the application of the Interpretation, particularly in instances in which the legal equity test has not been met.

FSPE Model

We fully support the FASB's conclusions in paragraph B19, that no individual party should consolidate a financial SPE that effectively disperses risks. Rather, each party should account for its rights and obligations related to the assets in the SPE. We believe that the FASB introduced its FSPE model to accomplish the objective of identifying those risk diversifying SPE's for which no party would be required to consolidate. Unfortunately, we do not believe that the FSPE Model as currently drafted meets this objective for two primary reasons. First, the criteria utilized to define an FSPE is not based upon the governing principle of requiring significant dispersion of risks, but rather is defined principally upon meeting the criteria of a QSPE which does not necessarily require dispersion of risks. We therefore recommend that the FASB redefine its FSPE Model to require that the SPE result in significant dispersion of risk. Second, the FSPE model places undue restrictions on permitted derivatives, limiting them to only those derivatives permitted in QSPEs. This limitation on permitted derivatives will prevent many legitimate risk dispersing SPE's, such as CDOs and credit linked notes (CLNs), from qualifying as FSPEs.

- *Removal of Restrictions on Permitted Derivatives*

QSPEs and therefore FSPEs, are restricted from transacting in derivatives unless such derivatives are: a) passive, b) do not contain leverage, c) do not relate to other derivatives including bi-furcated derivatives and d) do not introduce new risks into the SPE. We recommend that all restrictions on permitted derivatives be removed from the FSPE model. We believe that the removal of such derivative restrictions is appropriate for the following reasons. First, the types of derivatives that the FASB may want to prevent from use by FSPEs (e.g., total return swaps and deep in the money call options) would already be excluded as a result of the FSPEs governing premise that the SPE result in significant dispersion of risk. Second, one of the primary reasons for limiting the use of derivatives in QSPEs was to prevent circumvention of the FAS 133 requirement to mark-to-market all derivatives. This should no longer be a concern as the proposed FAS 133 amendment and related D-2 guidance will alleviate this issue. QSPEs were also restricted in their use of derivatives, as such entities were not deemed able to engage in transactions involving undue discretion; we believe that this restriction should not be a requirement for an FSPE that is permitted certain discretion in buying and selling assets. Finally, we believe that restrictions on derivatives which introduce new risks and/or which relate to other bi-furcated derivatives are the most troublesome in preventing legitimate risk diversifying SPEs from qualifying for application of the FSPE model. If the FASB does not adopt the suggested changes, CDOs will generally not qualify for FSPE treatment. CDOs will fail to meet the FSPE requirements as they are generally able to invest in certain "synthetic assets" which will require bifurcation of an embedded derivative thereby resulting in a derivative relating to another derivative. Similarly, CLNs will not qualify for the FSPE model as credit derivatives would be deemed to be introducing new risks into the SPE, a prohibited derivative transaction.

For the reasons described above, we do not believe that any restrictions on derivatives are necessary in FSPEs qualifying as risk dispersing entities. However, if the FASB chooses to place restrictions on the use of derivatives within FSPEs we do not believe that such restrictions should be predicated upon the QSPE model. For example, limiting the use of derivatives to passive derivatives rather than permitted derivatives in QSPEs would go a long way in enabling many legitimate risk dispersing entities to qualify for evaluation under the FSPE model.

- *Aligning FSPE model to Variable Interest Model*

As noted above, we believe that the FSPE Model needs to be revised to restrict its application to only those entities that significantly disperse risk. If the conditions for FSPE treatment have been met, we would expect that consolidation would be required less frequently than the general approach, rather than more frequently. We believe the FASB holds this same view, as paragraph B19 acknowledges that in a risk diversifying SPE "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." However, it is our belief that in many cases the FSPE model is more likely to cause consolidation than the general variable interest model.

Unlike the general variable interest model, the FSPE model does not appear to have any relative size requirement for a variable interest that would require consolidation. Rather any party meeting at least two of the three identified conditions would be required to consolidate, irrespective of the level of such variability.[1] Therefore, a party with only a very small subordinate interest (measured in terms of expected future losses), say 1%, would be required to consolidate if such party had any discretionary ability to buy and sell assets. We believe that the FASB should align the FSPE model to be more consistent with the concept of the size of the variable interest required for consolidation under the general approach. We therefore suggest that the FASB redefine the second criteria of its FSPE model to require that such party provide "significant" financial support. Such significant support could be evidenced by a guarantee, a back-up lending arrangement, or other form of liquidity, credit or asset support.

[1] An enterprise meeting two of the following three conditions would be required to consolidate : 1) it has the authority to purchase and sell assets for the SPE and has sufficient discretion to significantly affect the revenues, expenses, gains and losses of the SPE, 2) it provides a guarantee, a back-up lending arrangement, or other form of liquidity, credit, or asset support that is subordinate to the interests of others and 3) it receives a fee that is not market based.

- *Market Based Fees*

In paragraph 19 of the Exposure Draft, the FASB requires that all fees from an SPE be presumed not to be market based, unless it can be demonstrated to be comparable to fees in similar observable arm's length transactions. We object to this presumption and the required evidence necessary to overcome it. We request that the FASB remove its presumption that fees are not market based and instead provide indicators which provide evidence that a fee may not be market based. At a minimum, we believe that the FASB should more broadly define evidence necessary to overcome the presumption that fees are not market based (e.g., evidence that a service provider could be terminated without cause).

Other Comments

1. *Matched Presentation*

   If consolidation is required under the Interpretation for an SPE holding financial assets, we recommend that the FASB require display of such interests on the face of the balance sheet on a matched basis.[2] Similarly, a separate section on the income statement would be devoted to income and expenses of the SPE allocable to third parties with the remainder representing the entity's allocated return. We believe that the matched presentation provides the most relevant information to investors as they would be able to clearly ascertain the level of an entity's involvement with such SPEs while at the same time not artificially increasing the balance sheet for liabilities for which the entity has no obligation to pay other than from the SPE's assets.

   One of the difficulties of the SPE consolidation issue is that it ends up with an all or nothing solution. One could argue that it is just as misleading to consolidate as it is not to consolidate when the transferor retains rights only to limited portions of the cash flows of a financial asset. We believe that the matched presentation effectively addresses these concerns.

[2] The matched presentation is similar to the linked presentation in the UK, such that a separate section of the asset side of the balance sheet would be devoted to display of certain bankruptcy remote SPEs. An SPE's gross assets would be shown on a separate line, immediately followed by a deduction for the non-recourse debt and third party equity interests issued by the SPE, arriving at a net interest in the SPE.

2. Income Statement Impact

We believe that the income statement impact of consolidating an entity should not distort the non-recourse nature of the SPE's assets and liabilities. We therefore believe that consolidation of a bankruptcy remote SPE for which the entity does not exercise control over the SPE's financial assets, should result in an income statement impact consistent with the income statement effect of recording only the retained interest in such SPE. As currently drafted, it is not clear whether a primary beneficiary would be able to reduce the carrying value of consolidated SPE liabilities for losses incurred on assets it consolidates that will ultimately be passed on to the liability holders (due to non-recourse financing) at settlement. We therefore recommend that the FASB clarify such guidance to allow for the adjustment of the carrying basis of a consolidated SPE's liabilities, to the extent that losses on assets are not to be borne by the consolidating entity.

3. Disclosure

We support disclosure requirements aimed at improving transparency to investors; however we do not believe that the FASB's recommended disclosures with respect to administrators of financial assets and/or placement agents will provide such increased transparency. The FASB has recommended that administrators and placement agents of SPEs shall disclose the assets and liabilities of the SPEs that it serves and shall describe the purpose of those SPEs. As administrators and placement agents may have no further involvement with an SPE other than to collect market based fees for services provided, we fail to see how the increased disclosures will provide relevant and meaningful disclosure to investors. Rather, we support the FASB's recommended disclosures for primary beneficiaries of SPEs. We believe that these disclosures along with existing and proposed disclosure requirements for commitments and guarantees will provide the necessary information to ensure appropriate transparency for investors.

Conclusion

Lehman Brothers requests that the FASB carefully consider the above comments in re-deliberating its consolidation guidance, as SPEs play a vital role in the global capital markets. We believe that the Interpretation is overly broad and will likely result in a significant number of inappropriate affirmative consolidation conclusions. We urge the FASB to consider the potential consequences of an overly broad standard and the impacts this could have on the markets as it finalizes the Interpretation.

We strongly recommend that the FASB adopt our recommendation of a majority variable interest approach, as we believe that such change will go a long way in improving the ability to practically implement the Interpretation. We also believe that removal of restrictions on permitted derivatives for FSPEs along with other suggested changes should significantly reduce the number of inappropriate affirmative consolidation conclusions, enabling legitimate risk dispersing SPEs to qualify for application of the FSPE model.

We appreciate the opportunity to provide these comments for your consideration in finalizing this accounting guidance. If you have any questions please do not hesitate to call me at (212) 526-9295 or Kristine Smith, V.P. Accounting Policy, at (212) 526-0664.

Sincerely,

Christopher M. O'Meara
Managing Director
Controller