LEHMAN BROTHERS

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Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
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By email to: director@fasb.org

Re: **File Reference No. 1200-001** ***Qualifying Special-Purpose Entities and Isolation of Transferred Assets, an amendment of FASB Statement No. 140***

Ladies and Gentlemen:

Lehman Brothers, a leading global investment bank, appreciates the opportunity to comment on the Financial Accounting Standards Board's ("FASB" or "Board") Exposure Draft, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets, an amendment of FASB Statement No. 140* ("Exposure Draft" or "ED"). We have followed the Board's deliberations on this project with keen interest because we are extensively involved with SPEs, particularly those related to securitization transactions that are typically transacted with qualifying special-purpose entities ("QSPEs"). In addition, we have participated in the comment letter dated July 28, 2003, submitted jointly by the Bond Market Association and the American Securitization Forum. We are in support of the commentary provided and recommendations presented therein.

We support certain of the FASB's stated objectives in issuing the ED. However, we cannot support the issuance of the ED as we believe the ED will have over-reaching impacts beyond these objectives. In addition, we believe the ED strays significantly from the FAS 140 control-based financial-components model (FAS 140 model). That model is effective for the vast number of securitization transactions in which transferors of financial assets disperse risk through QSPEs and all parties to such QSPEs recognize only the risks/rewards they assume. Further, the ED lacks a fundamental governing principle because it attempts to combine the FAS 140 model with a risks and rewards model. As a result, we believe the ED will not be operational. Our suggested changes are intended to keep the ED consistent with the FAS 140 model while restricting the use of QSPEs in transactions that do not disperse risks.

Over-Reaching Impacts

Following are the key areas of the ED we believe will introduce change with over-reaching impacts and unintended consequences.

- *Prohibition on Transferor's Ability to Transact Derivatives with QSPEs*

The ED would prohibit a transferor from transacting in any derivative with a QSPE, including vanilla interest rate and currency swaps. We understand the FASB restricted the use of derivatives because of its initial focus on total return swaps. However, we do not support the ED's prohibition of transferors' ability to transact in any derivatives with QSPEs. The purpose of many securitization transactions is to transform the risk of financial assets into new risks matching those desired by investors. It is common for financial intermediaries, which may also be transferors in securitizations, to transact in derivatives with such QSPEs. Because FAS 140 already limits the use of derivatives in QSPEs to only those passive derivatives meeting certain criteria consistent with the control framework, we do not consider it necessary to further restrict transferors' ability to transact derivatives with QSPEs. If the FASB retains the rule prohibiting derivatives between transferors and QSPEs, we suggest the rule be limited to total return swaps and their substantive equivalent. However, we believe such explicit prohibition is unnecessary because the ED's clarification of the conditions necessary to achieve sale accounting by transferors will preclude derecognition by transferors entering into total return swaps and their substantive equivalent with QSPEs.

- *Limits on Other Support Commitments Provided by Transferors*

The ED would prevent an entity from being a QSPE if it enters into any agreement that obligates a transferor to deliver additional cash or other assets to fulfill the SPE's obligations to beneficial interest holders. Such agreements include liquidity commitments, financial guarantees and other commitments to deliver cash or other assets to the SPE. We disagree with the proposed complete prohibition of future cash commitments by transferors and believe such prohibition will have significant unintended consequences. We believe the types of support commitments the FASB intends to preclude (e.g., total return swaps and credit guarantees) will be prohibited by the ED's clarifications of the legal isolation requirements.

Specifically, we believe the new paragraph 35(c) prohibiting any and all support commitments to be overly broad. In addition, this new restriction will introduce significant conceptual inconsistencies with the FAS 140 model and likely will raise a number of practice issues. If the FASB retains the proposed language, a number of exceptions or clarifications will be needed to avoid significant unintended consequences.

1. Pure Liquidity Commitments

   The FASB specifically cites liquidity commitments as being newly-prohibited support transactions between transferors and QSPEs. We believe "pure" liquidity commitments should not be prohibited support transactions. Pure liquidity commitments are arrangements that terminate and cannot be exercised against the liquidity writer when the credit of the supporting assets deteriorates and/or the borrower defaults. Rather than prohibiting all liquidity commitments as support transactions, we believe the FASB should rely on the legal isolation criteria to prohibit support transactions that provide substantive recourse. We believe support commitments by transferors that combine both liquidity and credit will generally fail the legal isolation conditions and derecognition will not be permitted. In contrast, a pure liquidity commitment generally will meet the legal isolation requirements for derecognition.

2. Standard Representations and Warranties

   We believe a literal interpretation of the ED, with its blanket prohibition of support commitments by transferors, will prohibit entities from being QSPEs when the transferor makes certain representations about the assets to the buyer and provides some remedy if those representations are later determined to be false. Because representations and warranties are normal course of business in many securitization transactions, we are concerned with the far-reaching implications of the proposed prohibition.

   Again, we believe the enhanced legal isolation conditions necessary for transferors to derecognize assets sold will address the FASB's concerns in this area without the need for further restrictions on support agreements. We believe the level of recourse provided by the seller is of critical importance in determining whether assets have been legally isolated. Evidence to support whether representations and warranties are recourse can be found in the Federal bank regulators' risk-based capital rules. These rules exclude from the definition of recourse those representations and warranties that are not meant to serve as credit enhancements, including representations and warranties that permit the return of assets in instances of misrepresentation, obligor fraud or incomplete documentation.

3. Compensating Interest

In many mortgage-backed securitization transactions, servicers agree to remit a full month of interest on each underlying loan, even if the loan prepaid during the month. However, the required additional payment of such interest (in excess of collections received) is generally treated as a reduction from the servicing fee and is generally capped at the amount of the servicing fee. This is a long-standing practice to which investors are accustomed and this servicing obligation is accounted for in calculating any servicing asset or liability. The ED is unclear about whether this compensating interest payment would be deemed a support arrangement by a transferor that is also a servicer, thereby prohibiting the entity from qualifying as a QSPE. If the FASB retains the prohibition on support arrangements rather than relying upon the legal isolation requirements, we suggest it clarify that such compensating interest arrangements will not be deemed to be support arrangements because servicers can never be required to make a net payment. Rather, they can only receive reduced servicing fees.

4. Other Non-Substantive Support Obligations

Transferors provide many forms of non-substantive support arrangements to QSPEs. FAS 140 contemplated that transfers of financial assets with some recourse to the transferor could qualify for sale treatment, provided the legal isolation requirements are met. We believe the ED's prohibition on transferors participating in any support arrangements with QSPEs lacks a supporting principle. We suggest these additional restrictions on support arrangements be eliminated. We believe the ED's revised legal isolation criteria will effectively prohibit transferors from derecognizing transactions that do not disperse risks (i.e. total return swaps or their substantive equivalents).

Legal Isolation Conditions

We fully support the proposed changes to paragraph 9(a), which clarify the legal isolation conditions necessary to achieve sale accounting. The proposed changes make clear the conditions for legal isolation that must be met for the transferor and any consolidated affiliate of the transferor. However, we do not support the new language added to paragraphs 81 through 84, which we believe will prevent sale treatment in two-step securitization transactions unless the second transfer is to a QSPE. It is unclear why the FASB proposed this language and what perceived problem the FASB is trying to address. We believe this new language is inconsistent with the basic sale paradigm of FAS 140 paragraph 9 which treats transfers as sales provided 1) assets are legally isolated 2) the transferee has the right to exchange or pledge the assets received (or beneficial interests, if QSPE) and 3) the transferor does not maintain effective control over the transferred assets. This new language would appear to preclude derecognition in any two-step transactions in which the transferor meets the current paragraph 9 conditions for sale treatment and concludes consolidation would not be required of the second SPE (which is not a QSPE) because the transferor is not the primary beneficiary. This does not appear

to be the FASB's intended result and we suggest this language be removed from the final document.

Ability to Re-issue Beneficial Interests

The proposed changes to paragraphs 35(c) (3) and new paragraph 35(f), create additional restrictions on entities that have the ability to re-issue beneficial interests from meeting the QSPE criteria. We have a number of concerns with the proposed changes.

With respect to matters of scope, we suggest the FASB clarify that a remarketing is not a re-issuance. For example, in municipal bond securitization, certificates representing beneficial interests in underlying municipal bonds are periodically remarketed by a designated remarketing agent. The remarketing agent resets the interest rate on the certificates at a market-clearing rate at the time of each remarketing. Because the same securities remain outstanding (with the same CUSIP and same stated maturity) we do not believe that such remarketing results in a re-issuance. Additionally, it is important to note that these securities are not deemed a new issuance for tax or securities law purposes.

Furthermore, in issuing paragraph 35(f) there appears to be a presumption that any re-issuance involves discretion, which is inconsistent with the passive nature of a QSPE, and therefore separate rules are warranted for such entities. We disagree, and suggest the provisions relating to SPEs that re-issue beneficial interests apply only when the range of permitted maturities creates the possibility of materially influencing the residual cash flows in a transaction--for example, maturities in excess of 397 days. We believe that a limited ability to set interest rate modalities for periods under 397 days is fully consistent with the FAS 140 framework as it does not involve discretion that can be expected to influence the residual returns to the transferor in any material way. As evidence of this view, we look to analogize to FAS 140 paragraph 35(c)(6), which allows for the limited discretionary ability to invest excess cash held by a QSPE, provided such investments are generally in money market or equivalent securities. The definition of money market instruments under Rule 2a-7 of the Investment Company Act specifies that such instruments must have maturities of 397 days or less.

We also are concerned that the conditions which nullify QSPE-status under paragraph 35(f) are arbitrary and without a governing principle. Those conditions include both the two-out-of-three test and the prohibition on any single party entering into more than 50% of any support commitments and/or derivative transactions entered into by the SPE. In addition, we believe the proposed changes will result in a large number of false positive results in which transferors are precluded from derecognizing transferred assets even though this inability to derecognize assets results from actions that 1) are not within the transferor's control, 2) may not affect the economic position of the transferor and 3) do not result in the third party obtaining substantial control or variability in the economics of the entity. We believe significant changes are required to the proposed rules because they are largely non-operational. We understand the FASB drafted the two-out-of-three test with the expectation that if one party failed two out of the three conditions then such party's combined set of risks/decision making abilities would result in such party being

required to consolidate under FIN 46. However, this expectation may not be true, as we believe that many financial institutions will "touch" a single SPE in multiple ways, often causing such institution to fail the two out of three test but without being the primary beneficiary. For example, a financial institution, as a market maker, may hold small amounts of financial instruments issued by a QSPE in which such financial institution also is a derivative counterparty and/or liquidity support provider. In these instances the ED would force transferors to re-recognize transferred financial assets because they would likely fail the 9b criterion for sale accounting. It is also likely the financial institution would not be deemed the primary beneficiary of the entity. We do not believe this is a rational result.

Finally, the ED appears to require syndication of guarantees, liquidity facilities and derivatives because it requires that no single party enter into more than 50% of any support commitments and/or derivative transaction entered into by such entity. We fail to see why syndication should be required when such agreements do not result in concentration of the expected losses with any single entity. The ED would result in increased costs associated with securitization transactions.

For these reasons, we suggest the FASB limit the arbitrary nature of the paragraph 35(f) conditions. For example, the final standard might nullify QSPE-status only when a party fails the two-out-of-three test and/or has more than 50% of any support commitments or derivative transactions AND, as a result of those relationships, bears a majority of the expected losses. We believe such an approach would be more consistent with the FASB's intent in this area.

Conclusion

Securitzation SPEs (QSPEs) play a vital role in the global capital markets. We believe the ED over-reaches the FASB's intended goals and will have significant unintended consequences. In addition, we believe the ED is not principles-based because it combines elements of both control and risks-and-rewards models. We believe the proposed model to be non-operational. We urge the FASB to consider the potential consequences of an over-reaching standard and the effect this could have on the securitzation markets.

Our suggestions are primarily focused on eliminating the blanket prohibitions of transferors participating in derivatives or other support commitments with QSPEs. We believe our suggested changes remain consistent with the FASB's intent of restricting the use of QSPEs in transactions that do not disperse risks, while also rendering much of the ED's rules-based guidance unnecessary.

We appreciate the opportunity to provide you with our comments. If you have any questions please do not hesitate to call me at (212) 526-0664.

Sincerely,

/s/ Kristine Smith

Kristine M. Smith
Senior Vice President
Accounting Policy