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Financial Accounting Standards Board
401 Merritt 7
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Attention: MP&T Director—File Reference 1082-200

Letter of Comment No: 25
File Reference: 1082-200
Date Received: 08/29/02

Re: Proposed Interpretation of FASB Statement No. 94 and Accounting Research Bulletin No. 51

Dear Sirs:

Thank you for the time and effort spent by all in endeavoring to understand the variety of transactions and structures involving special purpose entities (“SPEs”) currently in use in today’s market. Deriving a set of rules to determine the consolidation question with respect to SPEs in this complex setting is clearly a challenging task, and we appreciate the effort taken in preparing The Proposed Interpretation of FASB Statement No. 94 and ARB No. 51 (the “Proposed Interpretation”). The following are what we hope to be constructive comments on the Proposed Interpretation that will assist in deriving rules that more precisely target situations where consolidation is warranted, while avoiding situations where consolidation would be misleading or unproductive in addressing the issues at hand and the objectives of the consolidation project.

Several Concepts Need More Clarity:

The Proposed Interpretation presents several important concepts and tests that rely on terminology or standards that are somewhat vague and subject to quite varied interpretations. A large degree of uncertainty regarding certain of these tests could have an adverse chilling effect on the use of and investment in SPEs. We have identified below some of the terms and standards below with our suggested clarifications:

1. In paragraphs 6 and 13(c) of the Proposed Interpretation, the tests that “An enterprise that holds either a majority of the variable interest in (or provides a majority of the financial support to) an SPE or holds ‘a **significant**’ variable interest (or provides financial support) that

also is ‘**significantly more than**’ any other enterprise’s variable interest (financial support) is referred to as the primary beneficiary of the SPE.” The terms ‘Significant’ and ‘Significantly More Than’ could be interpreted many ways, including in a way that adversely affects general investment activities by typical investors in securities issued by or other interests in SPEs, such as banks, insurance companies and mutual funds. Does a lead investor now need to be concerned about consolidating the entire SPE and all its assets and liabilities if the investor owns 35% of the most subordinated interest in an SPE and the next largest investor owns 25% of such interest? Does the 25% holder have to monitor purchases and sales by the 35% owner to determine if the 25% holder has become the largest single owner? How will private investors obtain this information? Do these levels of investment and the differential in the levels warrant accounting consolidation of the SPE or indicate a dominant or controlling interest?

We suggest clarifying the term ‘Significant’, as it first appears in both the test under paragraph 6 and the test under paragraph 13(c), to require at least a 25% interest, with the presumption that anything below that level is not ‘Significant’ for the purposes of these tests, provided there are no other voting or variable interests, as applicable, owned by such holder that cause the aggregate of the voting or variable interests of such holder to exceed 25% of all such voting or variable interests. In addition, we also suggest that the term ‘Significantly More Than’ be clarified to mean at least 25% more than the next largest investment. This way, the rules are more clearly targeting interestholders that have a material portion of the voting or variable interest, and which interests exceed the interests of others by a margin that more clearly establishes that holder as the predominant interestholder, as opposed to a situation where there is sharing of risk interests by a few large holders. Situations where institutional investors are taking sizeable positions in SPE subordinated securities should not become the target of the consolidation project, and are not indicative of the activity intended to be regulated or modified by the Proposed Interpretation.

2. In paragraph 9(b) of the Proposed Interpretation, the concept of having an equity investment “sufficient to allow the SPE to finance its activities without relying on financial support from variable interest holders”, is introduced. This is particularly troubling since ‘**variable interest**’ is defined as “the means through which financial support is provided to an SPE and through which the providers gain or lose from activities and events that change the values of the SPE’s assets and liabilities.” Clearly the variable interests are intended to give the SPE financial support. At a very minimum, it should be clarified that:

“the variable interests established at the outset of the transaction need to be sufficient to avoid the need for additional and continued support from the variable interest holders during the life of the transaction. The focus on sufficient investment should be transaction based, rather than based on the life of the SPE, since many SPEs are multi-issuance vehicles and, over time, the amount of their assets and liabilities (and therefore required equity investment) varies with each new transaction.”

3. In paragraph 11 of the Proposed Interpretation, it is stated that in periodically determining whether the equity investment is ‘Sufficient’ (as in paragraph 9(b) of the Proposed

Interpretation) the enterprise must make a judgment about sufficiency by comparing “the amount of the equity investment with the amount of equity invested in substantive operating enterprises with similar assets and liabilities, similar activities, and similar risks if that information is available.” This standard for making a judgment regarding sufficiency of equity is very unclear, as there are many different kinds of substantive operating enterprises that can be compared, each with equity levels and capitalization structures that vary widely. Further, in paragraph 9(b) another guideline is set forth to determine if the equity investment in the SPE is ‘Sufficient’ in that it “should be greater than or equal to the expected future losses of the SPE at all times during the SPE’s existence.” This guideline is probably more meaningful in almost every case. We suggest eliminating the guideline that purports to compare the equity to substantive operative enterprises.

With regard to the guideline for sufficiency of equity set forth in paragraph 9(b) related to expected losses, in many transaction involving SPEs, the liabilities of the SPEs are rated by one or more nationally recognized statistical rating agencies. In that instance, we propose that a guideline be incorporated in the Proposed Interpretation that essentially says:

“If the liabilities of the SPE that are senior to the equity investment are rated by at least one nationally recognized statistical rating agency as having a rating that is investment grade, then the equity investment is sufficient for purposes of the voting interest test.”

A rating of investment grade purports to assess the likelihood of repayment of the indebtedness so rated as being likely and without significant risk of nonpayment as of final maturity. This concept meshes quite well with the guideline set forth in paragraph 9(b) focusing on expected losses and the two standards are internally consistent.

4. In paragraph 14 of the Proposed Interpretation, there is a requirement that “**all factors**’ influencing consolidation decisions shall be reconsidered at each reporting date using all evidence that the enterprise possesses or would reasonably be expected to possess.” This is clarified by a footnote stating that “an entity is not required to conduct an **‘exhaustive search’** for information...” There still remains a large gap between the requirement to consider ‘all factors’ and the caveat that ‘exhaustive searches’ are not required. If ‘all factors’ are to be considered, the factors listed in the Proposed Interpretation include, among other things, the ability to make decisions on the SPE’s activities (how will this affect the servicing and back-up servicing industries), the relative size and amount of all equity investments, ongoing levels of expected losses in SPE assets and operations, the relative size and amount of subordinated investments in SPEs and knowing about and understanding investments by one SPE in the securities of another SPE. The factors must also be monitored by entities that may not currently be the primary beneficiary or entity consolidating the SPE. This seems extremely onerous to any party having involvement with an SPE. Is it intended that any party investing in subordinated tranches of SPE securities, providing liquidity or credit enhancement to an SPE or performing servicing or back-up servicing functions to an SPE continuously monitor each of these factors to determine if it has moved into a position of needing to consolidate an SPE with whom it has done business? Will this requirement cause entities in the business of acting as

servicers/managers, investors, credit enhancers or liquidity providers to avoid SPE transactions altogether due to the uncertainty of their ongoing information obligation and the uncertainty that they might be the entity required to consolidate an SPE with whom they do business? This result is in no party's best interest.

Our initial suggestion is that in order to provide more certainty for entities involved with SPEs and to more accurately target appropriate consolidation situations, the primary beneficiary and entity required to consolidate the SPE be determined upon establishing the SPE and its engaging in the initial transaction. That entity should expect to continue to consolidate for the life of the SPE and other entities contracting with the SPE should not be at risk of having to consolidate at some later time in the life of the SPE. Only in situations where there is no primary beneficiary and no entity consolidating the SPE at the outset should the ongoing monitoring and re-evaluation requirement apply.

In any event, we suggest the following standard apply in determining what information a party should consider in the evaluation and re-evaluation process:

“Information that an enterprise would reasonably be expected to possess means information that may be obtained from publicly available sources, from servicer, manager or trustee reports on the SPE, its assets and its liabilities, from the seller or other parties typically obtained in the ordinary course of purchasing or selling assets of the SPE, from the non-confidential information and records of the trustee or other entity keeping track of the securityholders of an SPE (but the requirement to obtain such information from the trustee or other recordholder shall be limited to such times as a securityholder makes an initial investment and each additional investment in such SPE's securities). Information that is not publicly available and cannot be obtained through a request for such information made to the trustee or the servicer/manager of the SPE, does not constitute information that an enterprise would reasonable be expected to possess.”

Minimum Equity Investment Requirement Too Rigid:

The Proposed Interpretation sets forth a requirement in the voting interest approach to consolidation that the equity investment in an SPE be “sufficient to allow the SPE to finance its activities without relying on financial support from variable interest holders” (Proposed Interpretation, paragraph 9(b)). Paragraph 12 states that “an equity investment shall be presumed to be insufficient to allow the SPE to finance its activities without relying on financial support from variable interest holders unless the investment is equal to at least 10 percent of the SPE's total assets.” This seems almost completely arbitrary. Has it been established that 10 percent is the level of equity sufficient to support a business activity? SPE's engage in a wide variety of activities involving an even wider variety of assets, so how can it be laid out as a rule that at least 10 percent equity is required in all cases unless persuasive evidence otherwise is presented when these activities vary so widely? Why presume at all? Why not let the standard articulated in

Section 9(b) of having sufficient equity to support the expected losses from the business of the SPE over its life be the governing standard without presumption?

We propose eliminating the 10% requirement in paragraph 12 and instead relying on the standard for determining sufficient equity set forth in paragraph 9(b) and related footnote 3. We also recommend the following additional clarification:

“If the liabilities of the SPE that are senior to the equity investment are rated by at least one nationally recognized statistical rating agency as having a rating that is investment grade, then the equity investment is sufficient for purposes of the voting interest test. In the absence of a rating or a rating of investment grade on the senior liabilities, a party determining consolidation on the basis of voting interests may establish the sufficiency of the equity investment in an SPE by obtaining a cashflow and expected loss analysis, based upon reasonable assumptions, from an established, independent financial analyst (which shall include, by way of example, investment banks, commercial banks, securities analysts, investment managers or investment or financial advisers) expert in the business of preparing such analyses, which analysis establishes that under loss or default scenarios consistent with historical loss and default information over a comparable period of time, expected future losses would not exceed the equity investment in the SPE.”

Certain Misleading Consolidation Results:

The Proposed Interpretation leads to certain misleading consolidation results. The following are some instances where consolidation in accordance with the current Proposed Interpretation does not lead to clearer disclosure or financial statements.

1. Entities regularly involved in the management of leveraged investment funds, including CDO managers, regularly contract with the SPEs that are the funds to provide investment and asset management advice to such SPEs for a fee, a portion of which is commonly in the form of an incentive fee based upon asset performance. In addition, the investor market frequently requires these managers to ‘have some skin in the game’ in the form of an investment by the manager or its affiliates in the equity of the fund/SPE. There would be no beneficial purpose served by requiring investment managers of leveraged funds to consolidate the assets and liabilities of these funds on their balance sheet. Such consolidation would be more misleading and confusing than requiring such entities to include on their balance sheet only the investment they are actually making in the fund/SPE.¹ We suggest that an exemption from the

¹ In this regard, we refer with concurrence to the letter dated April 1, 2002 from the Bond Market Association, International Swaps and Derivatives Association and Securities Industry Association addressed to Mr. Edmund Jenkins of the Financial Accounting Standards Board.

SPE consolidation rules be crafted to entities purely engaged in the investment and asset management business. We propose the following:

“Any entity primarily engaged in the business of providing asset or investment management or investment advisory services to its clients for a fee that is comparable to the fees charged by other asset or investment managers managing similar assets and with no interest in the SPE or its assets that could be considered a variable interest, except an investment in the equity of the SPE intended to and not exceeding the level that is sufficient to satisfy investor requirements for the manager or advisor, shall not be required to consolidate the SPE.”²

This would avoid having entities that are in the business of investment management getting caught up, unintentionally, in the SPE consolidation rules set forth in the Proposed Interpretation.

2. The Proposed Interpretation includes in paragraphs 22 and 23 rules for SPE's that hold certain financial assets. These rules appear to be applicable to bank sponsored multi-seller conduits. Essentially, if an entity involved with an SPE holding financial assets meets at least two of three conditions, then it is considered to provide significant financial support through a variable interest. Those conditions are, briefly, having the authority to purchase and sell assets or significantly affect revenues, expenses gains or losses, providing a guarantee, back-up lending arrangement, or credit support that is subordinate to the interest of other parties, and receiving a fee that is not market based. In most bank sponsored multi-seller conduits, the bank acts a referral agent, determining the asset pools in which the conduit will invest, and also acts as a provider of liquidity to the commercial paper that is issued.³ As such, a bank sponsoring a conduit would be considered to provide significant financial support to the SPE through a variable interest and, in the absence of another suspect, be required to consolidate the multi-seller vehicle. We believe this is the wrong result in certain cases.

First, banks sponsoring conduits do not bear the full risk of loss or realize the full benefit of gain on the assets of the conduit, so to consolidate the conduit vehicle would be misleading and not supported by the objectives of the consolidation project. Second, multi-seller conduits serve as a means of diversifying risk and providing more efficient funding to borrowers and

² In determining whether an entity is primarily engaged in the business of investment management, we propose that any SEC registered investment advisor or any entity that derives at least 50% of its annual income from its investment management business shall be considered “primarily engaged” in the investment management business.

³ We believe in most cases, the bank's fees as referral agent, usage fees for the conduit and fees for providing liquidity are established to be competitive with other similar conduits and, as such, should meet the definition of ‘market based’. Confirmation of this point would be appreciated.

sellers of assets. Penalizing banks for making such conduits available by requiring consolidation could result in limiting a legitimate capital markets financing mechanism.

Further, banks providing liquidity do so not as a means of providing financial support in the nature of loss coverage, subordinated equity or credit enhancement, but to provide liquidity as a means to smooth out timing differences between cash flows from the assets and maturity payments on the commercial paper when commercial paper cannot be resold. Liquidity is a very different type of financial accommodation from the other items listed in paragraph 23(b), such as guarantees, credit support and subordinated interests. As such we believe that providing liquidity to a multi-seller SPE should not be listed among the items in paragraph 23(b) at all, but instead specifically excluded. Further, it should be made clear that entities meeting the requirements of paragraphs 22 and 23 as providing significant financial support are then measured by the 'variable interest' consolidation test to determine the consolidation question. In this context, we repeat our suggested clarifications to the concepts of "Significant" and "Significantly More Than" set forth in our paragraph 1 above under the heading "Several Concepts Need More Clarity". These several changes will be helpful in targeting consolidation of multi-seller conduits only where the sponsor provides true financial support that exceeds the support provided by other entities by a material amount and will avoid consolidation where there is true diversification of risk shared among a number of parties.

We appreciate the opportunity to present our comments. If you have any questions regarding this letter, please contact the undersigned at the telephone number above or any of the Latham & Watkins representatives listed below.

Sincerely,

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