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September 26, 2003

Director, TA&I-FSP
 Financial Accounting Standards Board
 401 Merritt 7
 P.O. Box 5116
 Norwalk, CT 06856-5116

Re: Proposed FASB Staff Position No. FAS 150-a, Example 4

We appreciate this opportunity to comment on Proposed FASB Staff Position No. FAS 150-a, "Issuer's Accounting for Freestanding Financial Instruments Composed of More Than One Option or Forward Contract Embodying Obligations Under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*" ("FAS 150-a"). We are a global law firm and frequently represent financial institutions and corporations on capital markets transactions.

Example 4 of FAS 150-a describes a form of variable share forward sales contract that is a component of an important equity capital markets product – the "mandatory equity unit" – and suggests that this contract might, under certain circumstances, be a liability within the scope of paragraph 12(a) of Statement 150. We believe that "postpaid" forward contracts providing for payment upon delivery of shares at maturity, rather than in advance, fundamentally lack the characteristics of a liability and thus should be excluded from potential classification as a liability under that paragraph. In addition, we believe that the "predominantly" standard under Statement 150 should be viewed as a high standard, and to the extent it is applied to prepaid variable share forwards should be interpreted as requiring liability treatment only if it is probable (i.e., there is at least an 80-90% chance) that the value of shares delivered under the contract is based on a fixed monetary value known at inception.

Variable Share Forward Contracts and Mandatory Equity Units

Example 4 represents the standard variable share forward component of a mandatory equity unit

Variable share forward contracts are issued as part of a number of equity capital markets products, including mandatory equity units (in this letter, we refer only to forward sale contracts, not forward purchase contracts). Mandatory equity units are a form of convertible security that can provide issuers with an important source of equity capital. These units consist of a fixed income security (typically, either a debt security of the issuer or a U.S. Treasury security) and a forward contract under which investors commit to purchase the issuer's stock for cash on a future specified date (typically 3 years or so after the issue date). The forward contract most often included in a mandatory unit is very similar to that described in Example 4. In that example, the issuer agrees to deliver on the specified date a variable number of shares, based on the stock price on that date, in exchange for \$50. If the issuer's stock price is less than \$50, the issuer delivers 1 share to the investor. If the stock price is between \$50 and \$60, the issuer delivers a fractional number of shares whose value on the specified date equals \$50. If the stock price is greater than \$60, the issuer delivers .833 shares. At inception, the stock price is \$49.¹

Mandatory equity units are an important form of equity capital raising

In difficult markets, issuers may not find adequate investor appetite and attractive pricing in the equity market. These issuers may be able to find needed liquidity and demand in the convertibles market. Due to the influx of capital into convertible funds and convertible arbitrage funds in the past three years, these markets have been and are expected to continue to be an attractive source of equity capital for issuers; in 2002 and the first half of 2003 issuers raised \$17.2 billion in 38 mandatory equity unit offerings. Mandatory equity units are typically purchased by dedicated convertible funds, equity income funds and hedge funds. For a variety of reasons, these investors seek an equity-based exposure but often do not own the issuer's common stock. By issuing mandatory equity units, the issuers can expand and diversify their equity investor base by including purchasers of convertible securities.

Mandatory equity units provide benefits to the issuer

In addition to providing access to the convertibles market, mandatory equity units can provide issuers with rating agency and tax attributes not available from similar transactions, and allow the issuer the ability to retain some participation in the future appreciation of its stock. Rating agencies treat variable share forward contracts as equity instruments. For example, Standard &

¹ The contract described is sometimes called a "participating" contract, because the contract allows the issuer to retain some exposure to potential increases in the value of its stock over \$60. Alternatively, the contract may be "non-participating" or "capped," if the issuer's exposure to equity upside is limited or "capped." Such contracts would provide for delivery of a number of shares equal to 1- (\$10/share price at maturity) when the stock price exceeds \$60, \$10 representing the difference between \$60 and \$50. The discussion in this letter applies equally to both types of contracts.

Poor's has attributed 80% equity credit to "deferred equity,"² which means that the positive credit rating effect of the security is 80% of that achieved by issuing common stock. Similarly, Moody's Investors Service has placed mandatory equity units within basket D of their debt-equity continuum, where basket A represents the most debt-like instruments and basket E represents the most equity-like instruments.³ Likewise, lenders tend to view such contracts as equity when reviewing an issuer's credit position. This equity treatment serves to maintain or improve an issuer's credit ratings and, consequently, its cost of both debt and equity capital.

A portion of the periodic payments on mandatory equity units is also tax-deductible for issuers.⁴ As a result, these securities often provide a lower after-tax cost of equity capital than alternative equity securities. We understand that most issuers of these securities are U.S. taxpayers that utilize the tax deductions to offset taxable income from operations.

"Postpaid" variable share forward contracts should not be treated as liabilities

As the discussion above shows, mandatory equity units represent a vital source of equity funding for a broad array of issuers. To provide greater certainty to issuers, we urge the FASB to provide further clarity on the application of paragraph 12(a). In particular, for reasons described below, we believe that postpaid forward contracts, including those described in Example 4, should not be tested under paragraph 12(a).

Paragraph 12 of the Statement provides that,

[a] financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares shall be classified as a liability ... if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following: a. [a] fixed monetary amount known at inception (for example, a payable settleable with a variable number of the issuer's equity shares)....

As an example of this, paragraph A18 presents a transaction where an issuer receives \$100,000 in exchange for a promise to deliver \$110,000 worth of its own shares at a future date. This transaction appears similar to the incurrence of debt, where the issuer receives funds in exchange for the promise to pay, at a later date, a fixed amount of value (predetermined at inception). The

² Standard & Poor's, Corporate Ratings Criteria, pp. 96-97 (2002).

³ Moody's Investors Service, Rating Methodology – Moody's Tool Kit: A Framework for Assessing Hybrid Securities, p. 18 (1999). It is important to the Moody's analysis that the issuer issues new equity and receives additional cash at maturity in all stock-price scenarios due to the share delivery formula in the variable share forward contract. Ibid.

⁴ This treatment was reaffirmed in IRS Revenue Ruling 2003-97.

shares are effectively being used as currency to repay the loan. Statement 150 concludes that this contract is a liability.

However, postpaid forward contracts, including Example 4 and the variable share forwards included in mandatory equity units, do not entail the receipt of funds at inception to be repaid through delivery of a fixed value in the future. When value is delivered and equal value in a different form is contemporaneously received, the concern that paragraph 12(a) is meant to address is no longer present.

The economic sub-components of the variable share forward are all instruments that lack the characteristics of a liability

To further illustrate this point, the economic return profile of the contract as described in Example 4 can be broken down into three components: (1) the issuer purchases from the investor a put option on one share with an exercise price of \$50, (2) the issuer sells to the investor a call option on .833 shares with an exercise price of \$60 per share, and (3) the issuer agrees to sell to the investor in the future a number of shares whose then current value is \$50, for \$50 of cash, if the stock price is between \$50 and \$60. For share prices below the put exercise price of \$50, as the share price fluctuates, the investor's intrinsic value changes dollar for dollar with (and in the same direction as) a single share of stock. For share prices above the call exercise price of \$60 per share, as the share price fluctuates, the investor's intrinsic value changes dollar for dollar with (and in the same direction as) the value of a fraction of one share of stock. Statement 150 clearly excludes those two components – the purchased put option and the written call option – from its scope.

While the final part of the contract – an agreement to sell a fixed number of shares for their value at maturity – might be considered in some respects to be an obligation, it does not appear that the FASB intended for it to be deemed a liability under Statement 150. At no point, including at settlement, does the issuer owe the investor any net value when the stock price is in the \$50 to \$60 range; otherwise stated, the net monetary value of the obligation in this range is zero. Thus, even if the agreement were viewed as a form of liability, this liability would have a mark-to-market value of zero at all times, since the amount received for the shares will always equal their value. Such an arrangement is qualitatively different from the transaction described in paragraph A18, in which the investor is receiving at settlement a net fixed value of \$110,000, effectively to repay the pre-agreed fixed future value of \$100,000. The FASB seems to have viewed the paragraph A18 transaction as a liability because of this loan-and-repayment element, as evidenced by paragraph 12(a) of Statement 150, which itself references a “payable settleable with a variable number of the issuer’s equity shares” (emphasis added). The obligation to issue a variable number of shares worth \$50 in contemporaneous exchange for \$50 would not appear to be such a “payable.”

As a result, we believe it best not to treat variable share forwards as liabilities when each of their components are accounted for either as equity or as an obligation resulting in no future “net outflow” of value from the issuer.

The variable share forward can be recast as a set of transactions that are clearly equity contracts under Statement 150

As a further indication that such a result is justified for variable share forwards similar to that in Example 4, we note that such contracts can be replicated with two transactions that should be clearly outside the scope of Statement 150. This contract may be replicated with the pairing of (a) a fixed share forward sale contract, where the issuer sells to the investor 1 share of stock for \$50 at maturity, and (b) a call spread where the issuer receives from the investor a variable number of shares (between 0 and .167 shares) based on the stock price at settlement. We understand that these two components fall outside the scope of Statement 150. First, the fixed share forward sale contract is not a liability. Second, the call spread entitles the issuer to receive a number of shares equal to 1 minus \$50 divided by the stock price, if the stock price is between \$50 and \$60, and .167 shares, if the stock price exceeds \$60. (This is equivalent to the issuer having bought a call option on 1 share of stock struck at \$50 and having sold a call option on .833 shares of stock struck at \$60 per share.) Such a call spread purchased by the issuer would not be within the scope of Statement 150, since it does not require a transfer of assets to repurchase shares or involve an issuance of shares. We believe that it would be counterproductive if issuers were compelled to restructure a common, well developed product into a more complicated instrument, especially where there does not appear to be a policy justification for treating the variable share forward as a liability.

In any case, the threshold for “predominantly” should be a high one, akin to a “probable” standard

As set forth above, we believe that the FASB did not intend for postpaid forwards, including the variable share forward described in Example 4, to fall under Statement 150 by reason of paragraph 12(a). We likewise believe that the standard for classifying prepaid variable share forward contracts, under which the payment for the stock is made at inception, as liabilities should be clarified. Under Example 4 and paragraph 12(a), an instrument is within the scope of the Statement if on the issue date “the monetary value of the obligation to issue a variable number of shares is predominantly based on a fixed monetary amount known at inception (as it is in the \$50 to \$60 range).” As indicated in paragraphs B46-47 of Statement 150, the word “predominantly” was added to paragraph 12 in order to prevent issuers from avoiding the scope of Statement 150 “by embedding a small amount of monetary value variation in response to changes in the fair value of the issuer’s equity shares.”

We believe that the standard “predominantly” was deliberately meant to be a high standard, but because of the absence of guidance on its meaning, we believe that further clarification would be beneficial. In particular, in the context of variable share forwards we ask that the FASB confirm that paragraph 12(a) and thus Statement 150 does not apply unless it is probable (i.e., there is at least an 80-90% probability) at inception, that the number of shares to be issued is based on a fixed monetary amount known at inception (i.e., in the example, the stock price at settlement is within the \$50-\$60 range).

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Conclusion

To summarize, we believe that postpaid forward contracts, including the variable share forward described by Example 4 of FAS 150-a, should not be analyzed under paragraph 12(a) of Statement 150, and that potential classification of such contracts as liabilities may compel issuers to adopt complex, inefficient transactions meant to simulate the results of variable share forwards while avoiding liability treatment. Additionally, we request further clarification of the "predominantly" standard for application of paragraph 12(a) to prepaid variable share forward contracts. We believe it should be viewed as a high standard that should be interpreted as requiring liability treatment only if it is probable (i.e., there is at least an 80-90% chance) that the value of the obligation to deliver shares is based on a fixed monetary amount known at inception. The FASB's adoption of these conclusions would provide helpful certainty regarding the accounting treatment of important financial products that lack the hallmarks of a liability.

If you have any questions regarding our comments or wish to further discuss any of the matters addressed herein, please feel free to contact the undersigned at (212) 848-8830.

Sincerely yours,

Robert Evans III