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Morgan Stanley

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Ms. Suzanne Q. Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
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File Reference: 1100-163

Dear Ms. Bielstein:

Morgan Stanley appreciates the opportunity to comment on the FASB Exposure Draft, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, dated May 1, 2002 (the "ED"). In addition, our comments in this letter encompass related draft Statement 133 Implementation Issues[1] and draft Questions and Answers Related to Derivative Financial Instruments Held or Entered into by a Qualifying Special-Purpose Entity (SPE) (the "FAS 140 Q&As").

We do not support the issuance of the ED as a final standard in its current form. While we agree with the Board's objective to include beneficial interests that arise in a securitization ("beneficial interests") within the scope of Statement 133, we disagree with the approach proposed in the ED. The level of complexity in the ED and draft interpretative guidance is not warranted and application of certain provisions in the proposed guidance to beneficial interests and compound derivatives appears inconsistent with the application of Statement 133 to economically similar financial instruments.

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[1] Specifically, the Statement 133 Implementation Issues referred to in this comment letter include: Statement 133 Implementation Issue No. A20: *Definition of a Derivative: Application of Paragraph 6(b) regarding Initial Net Investment*, Statement 133 Implementation Issue No. B12: *Embedded Derivatives: Beneficial Interests Issued by Qualifying Special-Purpose Entities*, Statement 133 Implementation Issue No. B36: *Embedded Derivatives: Bifurcation of Embedded Credit Derivatives*, Statement 133 Implementation Issue No. C17: *Scope Exceptions: Application of the Exception in Paragraph 14 to Beneficial Interests that Arise in a Securitization*, Statement 133 Implementation Issue No. D2: *Recognition and Measurement of Derivatives: Applying Statement 133 to Beneficial Interests in Securitized Financial Assets (a Resolution of the Issues Raised in Implementation Issue D1)*.

Below we have detailed an alternative proposal for the application of Statement 133 to beneficial interests that we believe to be more operational, relies on already existing Statement 133 guidance, results in consistent accounting treatment for economically similar financial instruments and furthers the Board's objective of fair value accounting for financial instruments. In addition to our proposed alternative, we have included detailed comments and recommendations on the ED and draft interpretative guidance as we believe greater emphasis should be placed on the substance of contracts. Further, we object to the implications of the Board's approach to the qualifying status of SPEs as we fail to see the basis for the proposed accounting results. Morgan Stanley also actively participated in the comment letter on this ED submitted by the Joint Industry Working Group of the Securities Industry Association ("SIA"), The Bond Market Association ("TBMA") and the International Swaps and Derivatives Association ("ISDA"). Certain elements of our comment letter reflect consensuses that were reached by the Joint Industry Working Group.

Proposed Accounting for Beneficial Interests

With respect to the application of Statement 133 to beneficial interests, we recommend alternative modifications to Statement 133, which we believe provide adequate guidance for accounting for beneficial interests and address many of FASB's and its constituents' concerns with the current accounting guidance. Our proposal contains the following two aspects:

1) overall simplification in the Statement 133 model for accounting for beneficial interests, including rescinding paragraph 14 of Statement 133 and evaluating all beneficial interests under paragraphs 12-16 for embedded derivatives if a beneficial interest does not meet the characteristics of a derivative in its entirety under paragraph 6, and
2) to permit the use of fair value accounting for all hybrid instruments that embed a derivative that is not clearly and closely related to the host contract.

Simplified Approach

We do not see any compelling reason to distinguish the application of Statement 133 to beneficial interests from the application of Statement 133 to any contract. To this end, we recommend that all beneficial interests, except those that are deemed to be derivatives in their entirety, be subject to the provisions of paragraphs 12-16 for purposes of identifying embedded derivatives, which then shall be bifurcated and separately accounted for as derivative instruments.

This alternative results in consistent accounting for similar instruments. In many cases, instruments with economic terms similar to those typically found in beneficial interests are available in the marketplace. For example, a company may directly issue structured notes or may accomplish a similar issuance by issuing beneficial interests through an SPE. The provisions of Statement 133 as proposed in the ED apply different analyses to

structured notes and beneficial interests and therefore render potentially different accounting results depending solely on the issuance vehicle used rather than the economic substance of the transactions. When instruments are economically similar, we believe the accounting provisions should be applied to each instrument in a like manner. In fact, from an investor's perspective, apart from the legal isolation aspects of using an SPE to issue beneficial interests, there is generally no distinction made between instruments issued by a company and investments issued as beneficial interests by an SPE. Each instrument is evaluated in a similar fashion as part of an investor's overall portfolio.

Our proposal would rescind paragraph 14 of Statement 133 and eliminate the need for many Statement 133 Implementation Issues (including B12, B36, C17, D1 and D2) thereby reducing the complexity of the accounting model, creating an accounting model that is more operational for users, eliminating the need for more detailed and confusing guidance and yielding consistency in accounting for similar instruments. Sufficient guidance in accounting for embedded derivatives has previously been rendered, including Statement 133 Implementation Issues B19, *Embedded Derivatives: Identifying the Characteristics of a Debt Host Contract*, and B20, *Embedded Derivatives: Must the Terms of a Separated Non-Option Embedded Derivative Produce a Zero Fair Value at Inception?* Our proposal clarifies that these existing Implementation Issues should be applied to beneficial interests in addition to their current application to other hybrid instruments. Again, we believe that the application of paragraphs 12-16 should be applied consistently to all instruments and no distinction should be drawn in applying Statement 133 to an instrument based solely on the nature of the issuer of an instrument. Statement 133 Implementation Issue B19 requires an analysis based on the stated or implied substantive terms of the hybrid instrument and acknowledges the application of judgment is appropriate. We believe this approach, which is already applicable for existing hybrid instruments, to be consistent with a move to a more principles-based approach in accounting standards and alleviates much of the accounting burden we foresee under the model proposed by the ED and related draft interpretative guidance.

Permit the Use of Fair Value Accounting for All Hybrid Instruments

We recommend that the final standard permit all hybrid instruments, including beneficial interests and structured notes, be afforded fair value accounting treatment in their entirety, with changes in fair value recorded directly in earnings instead of separating only the embedded derivative and therefore instituting mixed attribute accounting for the hybrid instrument. We agree that contracts, which meet the definition of a derivative in their entirety, including beneficial interests, should be recorded at their fair value. However, if a contract, as a result of paragraphs 12-15 and interpretations of such paragraphs through Statement 133 Implementation Issues, is deemed to contain an embedded derivative that is not clearly and closely related to the host contract, the following accounting provisions should apply:

1) the contract may be accounted for as a host contract subject to relevant accounting guidance for such an instrument <u>and</u> an embedded

derivative that is separated and recorded at fair value through earnings, **or**

2) the contract may be accounted for as a hybrid instrument that embodies both the embedded derivative and the host contract remeasured at fair value through earnings regardless of whether the contract is an asset or a liability.

This alternative is consistent with the Board's objective of fair value accounting for all financial instruments, eliminates confusion in financial statement presentation due to mixed-attribute accounting for the host contract and the embedded derivative, provides more relevant financial information to users of financial statements, is consistent with how instruments are priced, traded, and evaluated in the marketplace and is a more cost-beneficial approach. In many cases because of the mutual interdependency of the derivatives that can exist in a hybrid instrument, the value of an embedded derivative is inextricably linked to the host contract. Complexities associated with the valuation of the components of convertible debt have demonstrated these issues in the Board's redeliberation of the FASB project on *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both.* As a result, accounting for an entire instrument at its fair value is more representationally faithful to the financial implications of the instrument taken as a whole.

Statement 133 acknowledges in paragraph 16 the possibility that an entity may not be able to *reliably* identify and measure an embedded derivative. We believe that this situation will be more common than rare particularly in cases where one would be required to apply the proposed accounting model for beneficial interests set forth in the ED and related draft interpretative guidance. Practice, however, has interpreted the Board's comment in paragraph 301 that the circumstance where an entity would not be able to reliably identify and measure an embedded derivative should be unusual to, in essence, be nonexistent. While the Board stated that "[it] expects that an entity that enters into sophisticated investment and funding strategies such as structured notes or other contracts with embedded derivatives will be able to obtain the information necessary to reliably identify and measure the separate components," this expectation reflects a less than full understanding of how the combined instruments are structured and priced. Such instruments are structured in a combined manner and priced as a whole rather than as individual components, which are then aggregated. We observe that the model as proposed in the ED will often create "artificial" derivatives (i.e., derivatives that are not structured and traded on a stand-alone basis in the market) further exacerbating the difficulties with reliable valuation. More reliable information, which is of utmost importance in today's financial reporting regime, is derived from evaluating the fair value of a contract as a whole rather than from the fair values of an instrument's components.

While we are not advocating accounting for a hybrid instrument as a derivative that could be used in a hedging relationship, we do believe that our alternative approach set forth in this letter is consistent with the Board's intent as stated in Statement 133 to establish fair value accounting for all financial instruments. In addition, the Board's objective includes

the promotion of international convergence of accounting standards as part of its mission. The IASB has recently adopted this approach for accounting for hybrid instruments in its Exposure Draft to amend IAS Statement 39 and we believe our proposal to permit the use of fair value accounting for all hybrid instruments is consistent with the ultimate goal of harmonization of global accounting standards.

We believe our alternative approach to accounting for beneficial interests allows for simplification of an already complex accounting standard and is in keeping with the objectives of reliable accounting information, consistency in accounting for similar instruments and an overall principles-based approach for accounting standards. However, if the Board does not accept our alternative approach and believes that specific guidance is necessary for the application of Statement 133 to beneficial interests, revision of and clarification to the ED and related draft interpretative guidance remains essential. We submit further comments on aspects of the ED, draft Statement 133 Implementation Issues and the FAS 140 Q&As as detailed below.

Definition of a Derivative – Amendment to Paragraph 6.b. and Statement 133 Implementation Issue A20

We object to the proposed revised definition of a derivative in paragraph 6.b. in the ED and interpreted by the draft guidance in Statement 133 Implementation Issue A20. At a minimum, this revision has the potential to reduce elements of fair value accounting for instruments, violates the overriding principle established by the Board that prohibits the bifurcation of compound derivatives and introduces further "bright-lines" into the accounting literature.

We recognize the Board's objective in deciding to revise the current definition of a derivative and recognize that current practice has led to a request for clarification of this issue. However, we support a revised definition that affords a more substantive-based approach to accounting for derivatives. In the initial deliberations of the FAS 133 amendment, the FASB staff recommended that the provisions of paragraph 6.b. related to the characteristics of a derivative be clarified so that a derivative required no initial net investment or contained an initial net investment that was considered "small" in comparison to the amount of investment that would result in the contract becoming fully prepaid. We advocate that the Staff's initial recommended change to the derivative definition be retained as a more meaningful framework that will allow for the spectrum of instruments and market situations that can exist. Certain derivatives do contain investing or financing elements, but we do not support introducing a threshold and believe that contracts should be accounted for based on their substance, which requires an element of judgment. Further, no distinction is then necessary for option-based versus non-option-based contracts.

Consider the following example:

> Two parties (Party A and Party B) enter into a forward contract that at its inception has a fair market value of zero and requires no initial net investment. Subsequently, Party A sells its forward contract (an asset) to Party C. As market rates would most likely have moved in the interim period, Party C will be required to make an upfront payment to Party A in order to obtain the contract. It is quite possible that Party C's payment may represent more than 5% of the fully prepaid amount of the forward contract depending solely on movements in market rates and not due to any financing or structuring elements being introduced into the terms of the contract. The substance of the contact has not changed; it remains a derivative contract and any payment made by Party C is not reflective of any substantive financing but merely reflects the fact that the parties have engaged in derivative inventory trading.

Given the continuing spectrum of potential contracts, at one point the substance of a contract is clearly a derivative in its entirety with no upfront investment while at the other end of the spectrum a fully prepaid contract more resembles a debt instrument. If an upfront payment for a derivative contract is made solely due to the off-market rate of the contract, the substance of the contract has not changed and a party to that contract should reflect its substance. Under Implementation Issue A1, constituents already are required to assess whether an upfront payment has resulted in a hybrid instrument containing a host contract and embedded derivative. The introduction of a 5% "bright-line" does not appear necessary; however, an emphasis on the need to apply judgment and evaluate the overall substance of a contract may be needed. Again, this position is reflective of our overall comments requesting simplification of already complex accounting guidance and a move toward a more principles-based approach[2].

Bifurcation of Compound Derivatives

Statement 133 prohibits separating a compound derivative into components. In applying the proposed revised definition of a derivative, Example 3 in Statement 133 Implementation Issue A20 appears to contradict this overriding principle for the sake of complying with the form of the proposed amended definition. Compound derivatives, by their construct, rely on interdependent provisions; and adjustments to terms of the individual components of a compound derivative can result in identifying a myriad of different possible combinations of derivatives. Consider the fact that the combination of a purchased call option and a written put option each with the same strike price essentially constitute a forward contract with the same underlying price. Such a

[2] Please note that we agree with the responses to Examples 1 and 2 presented in Statement 133 Implementation Issue A20 that such instruments consist of a debt host and an embedded derivative. The responses indicated are consistent with the substance of the instruments and we submit that the same analysis would also have been reached under our recommended definition if appropriate judgment were applied.

compound derivative could be executed as two options; however, as no initial net investment equal to the fair value of the premiums of the call option and the put option was required in this example compound derivative, under the ED would the holder of this instrument be required to reflect this instrument as four components: an investment asset, a purchased option as an asset, a financing liability, and a written option liability?

In addition, we find Example 3 in Implementation Issue A20 to be counterintuitive as it cites Statement 133 Implementation Issue B22 as the premise for creating a compound derivative comprised of an at-the-money swap component and a written cap component. Statement 133 Implementation issue B22 states that "the terms of the option-based embedded derivative should not be adjusted to result in the derivative being at-the-money at the inception"; however, in fact, Example 3 does exactly that. Example 3 starts with a compound derivative, an interest rate swap (containing off-market terms) with a floating rate cap, with no initial net investment for the compound derivative and essentially forces the recognition of a separate at-the-money interest rate swap and a separate at-the-money interest rate cap. This implementation guidance not only results in the bifurcation of a compound derivative but creates an artificial debt instrument resulting in a component of the compound derivative being reflected by an entity on an accrual basis counter to the Board's goal of fair value accounting for financial instruments.

Further inconsistencies are noted within Statement 133 with respect to this definitional change. The Board continued to hold throughout the existing standard that compound derivatives should not be bifurcated and stated in paragraph 524 that a combined interest rate swap and equity option may not be separated into its component parts. Theoretically, the compound derivative identified in paragraph 524 consists of 1) an off-market interest rate swap with a given fair value and 2) an equity option component with a fair value premium. When combined into a compound derivative, the fair values of the two components netted to zero. Does the Board now believe this compound derivative should be recorded as an equity written option liability, investing asset, and a separate interest rate swap with a fair value of zero at inception?

If the Board does not retain the revision to the definition of a derivative in paragraph 6.b. as initially proposed in the early Board deliberations, we recommend the Board consider that option-based compound derivatives in which a) no initial investment equal to the fair value of the compound derivative is made at inception and b) the fair value of the option component is equal to the fair value of the non-option-based component of the derivative be exempt from the requirements to bifurcate the compound derivative as a hybrid instrument. In Example 3 of Statement 133 Implementation Issue A20, the writer of the cap receives no premium at the inception of the swap; and in essence, the fair value of the option component of $18,838 is equal to the fair value of the off-market interest rate swap. Under our recommendation, this compound derivative should not be bifurcated into a debt host with a value of $18,838 and an "artificial" compound derivative; but rather be accounted for as a compound derivative in its entirety.

Application of the Shortcut Method

Due to the proposed change to the definition of a derivative, the ED contains revisions to paragraph 68.b. regarding the application of the shortcut method. If the Board persists and retains this definitional change, we recommend the revisions to paragraph 68.b. be amended as follows:

> "The fair value of the swap at the inception of the hedging relationship is zero except for an interest rate swap containing an embedded mirror-image call or put option as discussed in paragraph 68(d), in which case the fair value of the interest rate swap containing an embedded mirror-image call or put at the inception of the hedging relationship is equal to zero or the time value of the embedded call or put option."

Based on the wording of the amendment to paragraph 68.b. it appears that now an upfront payment equal to the time value of the option premium must be paid at the inception of a cancelable swap in order to qualify for the shortcut method of hedge accounting. Currently in order to qualify for the shortcut method of hedge accounting, constituents must ensure that no upfront payment is made upon executing a cancelable swap (i.e., the fair value of the compound derivative is equal to zero at inception). We believe that either scenario should be acceptable.

Evaluation of Embedded Derivatives in Beneficial Interests

We do not support the model proposed in the ED and related draft interpretative guidance for the accounting for beneficial interests; rather we believe that Statement 133 should be applied on the basis of the explicit terms of the beneficial interest, i.e., the stated and implied substantive terms of the beneficial interest. This approach provides consistency in the accounting for financial instruments as this approach is already applicable for other financial instruments in applying paragraphs 12-15 of Statement 133 as interpreted by Statement 133 Implementation Issues B19 and B20.

The accounting model proposed by Statement 133 Implementation Issues B12, B36, and D2 will result in artificially creating instruments, which are nonexistent as stand-alone contracts in the marketplace. The Board acknowledged this potential risk in its response to Statement 133 Implementation Issue B20 observing that "[s]ince a loan and a derivative can be bundled in a structured note that could have almost an infinite variety of stated terms, it is inappropriate to necessarily attribute significance to every one of the note's stated terms in determining the terms of the non-option embedded derivative." As a result the Board advocated that one look to the substance of an arrangement as a means of validating the explicit terms of a hybrid instrument. The requirement to consider both the terms of the beneficial interest itself and the aggregate sources of cash flows that are available to service the beneficial interest seems unprecedented in the accounting literature. Again, we reiterate that the application of Statement 133 to beneficial interests should be no different than the application of Statement 133 to other financial

instruments. One is not required to look at the sources of cash flows or evaluate the risk management strategies of a corporation when a corporation issues a contract. We fail to understand the rationale for this proposed application of Statement 133 and stress that an evaluation of the substance and overall characteristics of a beneficial interest should be the basis for the application of Statement 133.

In addition, we foresee that the complexities of Statement 133 Implementation Issues B12, B36, and D2 will prove to be nonoperational. For example, in certain collateralized debt obligations ("CDOs"), the underlying collateral is actively managed. The requirement to analyze the detailed holdings of the SPE that issued the CDO will not only be administratively burdensome but may not even be possible as the underlying collateral may change from time to time. It is also unclear how a user would apply the proposed guidance to various classes of beneficial interests given the intricacies of how risks and cash flows from the underlying assets in a securitization may be allocated among the various classes.

Further, the distinctions drawn in the ED between beneficial interests issued by qualifying SPEs and non-qualifying SPEs create additional challenges, particularly for investors in beneficial interests, as we do not believe investors generally will have sufficient information to distinguish investments in qualifying SPEs from investments in non-qualifying SPEs. In fact, investors are provided information based on the substantive economic characteristics of their investment further supporting the position that bifurcation of embedded derivatives be based on the substantive terms of a beneficial interest.

Identification of the Host Contract in Beneficial Interests

We disagree with the Board's conclusion that beneficial interests issued by qualifying SPEs should be considered to have debt host contracts. We are concerned that all the examples in the draft interpretative guidance utilize qualifying SPEs and that, by analogy, all beneficial interests will be considered to consist of debt host contracts. This conclusion appears inconsistent with Statement 133, paragraph 12.a., which requires an analysis of the host contract based on its economic characteristics and risks.

We maintain that the economic characteristics and risks of a beneficial interest may be more clearly equity-like in nature than akin to debt. This was contemplated by the Board in paragraph 60, which states that "if the host contract encompasses a residual interest in an entity, then its economic characteristics and risks should be considered that of an equity instrument." By definition, residual interest classes are economically equity in securitization vehicles; and further, beneficial interests may also represent legal form equity. Investors in such instruments typically evaluate the residual classes like equity and anticipate an equity-like return for the level of risk associated with the beneficial interest class. While for financial reporting purposes under Statement 140 paragraph 14 or Statement 115 a beneficial interest is accounted for as a debt security, this does not necessarily imply that the economic characteristics and risks of the beneficial interest are

most like debt. The ultimate standard should consider the possibility that qualifying SPEs and other SPEs may issue residual interests that are equity hosts. We believe that this is not only conceptually more principled but will also alleviate many potential operational complexities associated with searching for equity-like embedded derivatives in residual interests.

The Board's conclusion that beneficial interests issued by qualifying SPEs should always be equated to a debt instrument also gives rise to many operational questions. It is not readily apparent that investors will have the ability to distinguish a beneficial interest issued by a qualifying SPE from a beneficial interest issued by a non-qualifying SPE. We noted this concern with respect to the requirement to evaluate the detailed holdings of an SPE and reemphasize our overriding position that basic accounting principles should be applied in like manner to all financial instruments. There is no persuasive reason to differentiate the accounting treatment among types of beneficial interests. We continue to establish that a financial instrument should be accounted for based on its substance and explicit terms whether issued by a qualifying SPE or a non-qualifying SPE.

Implications for Qualifying Special-Purpose Entities

The application of Statement 133, paragraphs 12-16, for accounting for embedded derivatives in beneficial interests should not affect whether or not an SPE meets the required criteria in paragraphs 39 and 40 of Statement 140 to be considered a qualifying SPE. We oppose the intended changes in accounting for securitization transactions that will result from the amended provisions of Statement 133 and the related draft interpretative guidance particularly as noted in the examples of Questions 3 and 4 of the FAS 140 Q&As.

The creation of "accounting derivatives" as a result of the application of Statement 133 to beneficial interests should not subsequently alter the status of a qualifying SPE. In fact, the ED creates further constraints on the ability of an SPE to be considered a qualifying SPE without fully deliberating whether such significant implications to the application of Statement 140 are warranted. We strongly object to the notion that the creation of a "synthetic" or "accounting" derivative through application of the ED should cause an SPE to lose its qualifying status.

Question 3 in the FAS 140 Q&As, as drafted, states, "[a] derivative financial instrument that pertains to a beneficial interest that is also a derivative financial instrument does not meet the limits of paragraph 40 of Statement 140." While the Board has raised concerns regarding derivatives within qualifying SPEs so that opportunities are not created to circumvent the provisions of Statement 133 and so that qualifying SPEs are not engaged in transactions that give it discretion, we fail to see how these concerns remain valid. Since the time period in which the Board initially expressed these concerns, various developments have occurred in the accounting literature to obviate these concerns. We highlight the following points to address these matters:

- Beneficial interests are reflected by investors at their fair value. This fair value either encompasses the value of the entire beneficial interest, which includes the total price risk of any derivatives within the SPE, or reflects the bifurcation of any embedded derivatives in its holdings that also ultimately reflects the fair value of any derivatives within the SPE.
- Counterparties to all derivatives executed by an SPE are required to apply full fair value accounting for derivatives.
- Except for option-based derivatives, derivatives by their construct are passive in nature. In addition, many option-based derivatives can even be considered to be passive in nature. For example, an interest rate cap, while an option contract, generally involves no decision-making activities. The cap merely requires that interest be paid or received upon observing a specified interest rate strike occurring in the market.

In addition, we point out that derivatives are often included within SPEs to serve as risk-transformation vehicles in order to provide investors with a desired risk profile. For example, in Example 1 of both Questions 3 and 4 of the FAS 140 Q&As, an entity transfers treasury securities into an SPE and the SPE executes a long forward contract indexed to the S&P 500. The structure was executed in this manner as investors desired to obtain exposure to the S&P 500 and entering into a forward contract indexed to the S&P 500 was more efficient than actually holding all of the equity securities that comprise the S&P 500 index in their relative market-value weightings. Investors will reflect the beneficial interest at fair value on their balance sheet, in essence reflecting the fair value of the long forward contract. The counterparty that executed the long S&P 500 forward contract with the SPE would reflect the forward derivative contract on its balance sheet at fair value. Also, note that the long forward derivative contract is passive in nature. Again, we fail to see how the Board's concerns with respect to derivative contracts in SPE vehicles remain valid.

Accordingly, we recommend that Statement 140, paragraph 35.c.(2) be revised to permit qualifying SPEs to hold "passive derivative financial instruments that pertain to beneficial interests (other than ~~another~~ *a freestanding* derivative financial instrument)..." We supported a similar position that was presented by TBMA and ISDA in the November 16, 2001 response letter regarding the October 2001 Tentative DIG Guidance, which we believe remains a valid point for the Board's consideration. We believe that this revision will address many of the potential instances in which SPEs that today currently meet the criteria for qualifying status under Statement 140 will fail to retain their qualifying status under the ED. We are aware that the Board was reluctant to consider amending Statement 140 because of the resulting potential application of the revised guidance to enable further off-balance sheet structures and the circumvention of Statement 133. While this concern was expressed, we do not believe this concern to be founded in any analysis of the potential implications of adopting the above recommendation; and we respectfully submit that the consequence of the recommendation would be merely to continue to afford the current accounting treatment to structures for which derecognition has already been deemed appropriate under Statement 140.

In addition, we propose that Statement 140, paragraph 40.c. be amended to read as follows:

> "Has characteristics that relate to, and partly or fully but not excessively counteract, some risk associated with those beneficial interests or the related transferred assets, *or serve to allocate cash flows within the qualifying SPE in order to provide for risks and cash flows to the beneficial interest holders that are consistent with the substantive terms of the beneficial interests.*"

Given the significant interaction in the accounting for beneficial interests between Statement 133 and Statement 140 and the impact of the provisions within these standards on securitization transactions, we strongly urge the Board to reevaluate Statement 140, paragraphs 35.c.(2), 40.b., and 40.c. (as previously recommended) as part of the process of rendering a final standard. A more comprehensive analysis and approach that fully considers the implications of the proposed Statement 133 guidance for accounting for beneficial interests is necessary.

FAS 140 Q&As

We believe that the interpretative guidance set forth in the draft FAS 140 Q&As is unnecessary. We have stated above that we disagree with the conclusions reached in Questions 3 and 4. Again, we reiterate that the accounting application of Statement 133 to beneficial interests should not impact the qualifying status of an SPE. Additionally, we see no benefit from the FAS 140 Q&As as written and do not see the need for clarifying guidance with respect to any of the questions.

Grandfathering Qualifying Special-Purpose Entities

Given the implications of the proposed guidance to qualifying SPE structures, if the Board does not adopt our above recommendations, we urge that provisions be included in the final standard to grandfather all qualifying SPE structures in existence at the effective date of the standard. While limited provisions were granted in the ED as stated in paragraph 42, we do not find these exemptions sufficient to address the resulting significant implications for current qualifying SPE structures. Our position is driven partly by the significant operational burden that will be imposed by requiring a reevaluation of all existing qualifying SPE structures. Further, the proposed disclosure of the assets and liabilities of grandfathered qualifying SPEs should not be required. Not only would a cost-benefit analysis defeat this requirement, we do not deem this disclosure to yield meaningful information as the transferor has no control over such assets nor are the liabilities obligations of the transferor. The transferor is also not exposed to the risks of the gross assets and liabilities of the SPE.

Additionally, a qualifying SPE by its construct is a passive vehicle – once a qualifying SPE is established, it is intended to run its course in accordance with its underlying

governing documents. There is no basis for disrupting essentially completed and past transactions that were established in good faith. Paragraph 55 of Statement 140 discusses the changes that may result in a transferor's regaining control of assets previously derecognized. Clearly no change in law or other circumstance has occurred except for a change in an accounting convention if the ED as drafted results in a final standard. We do not believe the provisions of paragraph 55 of Statement 140 should be applicable for existing qualifying SPE structures when no true economic events have occurred and the SPE remains in place in accordance with its original governing documents. There has been no occurrence of a compelling event that indicates that a transferor has now actually obtained control of the transferred assets, which is ultimately the construed inference for SPEs which would lose their qualifying status under the ED if grandfathering of existing structures is not permitted.

Effective Date and Transition

The Board is aware of the discussions surrounding the initial implementation of Statement 140 and the need for sufficient transition periods to address matters that impact existing structures. The Board has required that the provisions of the ED be effective immediately upon issuance of a final standard for holders of beneficial interests and for transferors for which qualifying SPEs will no longer retain their qualifying status due to the application of the ED and the related draft interpretative guidance to the beneficial interests issued by such SPEs. It is unacceptable to provide no transition period for this proposed amendment and interpretative guidance.

It is clear that the proposed accounting model for beneficial interests is unduly complex. Given the intended time frame for issuance of a final standard and the period in which companies will then shortly be required to render financial statements[3], it is quite possible that a company with significant securitization volume would not be able to completely and reliably apply the proposed standard in the allotted period before an earnings release or regulatory filing deadline. Further, since a final standard would not be available until issuance, which also then coincides with the proposed standard's effective date, an entity can not even reliably begin preparatory work to adopt the final standard prior to the effective date.

We respectfully request that a reasonable transition period be provided. We recommend that the provisions of the final standard be applicable for transactions occurring, including newly created SPEs and beneficial interests issued, after September 30, 2003. Therefore, all the currently proposed guidance should be applied for financial statement periods

[3] The Board intends to issue a final standard in the third quarter of 2002. Under the ED, provisions related to the amended definition of a derivative, the amended scope exception in paragraph 14 of Statement 133 and the separate reporting of embedded derivatives (relating to beneficial interests issued by SPEs that would no longer meet qualifying status under the revised guidance) would be effective for Morgan Stanley's fiscal year ended November 30, 2002. Given the far reaching implications of the proposed guidance and the complexity of the proposed model, such a truncated implementation period is not sufficient for an accounting standard of this magnitude.

ending on or after September 30, 2003. If the Board does not accept our recommendations regarding grandfathering existing qualifying SPEs upon adoption and rescind the FAS 140 Q&As, we recommend that the provisions that impact the determination of an SPE's qualifying status be applicable for financial statement periods ending on or after December 15, 2003. This will allow for adequate time to operationally evaluate the impact of the standard on existing structures, appropriately value and recognize any embedded derivatives in beneficial interests if necessary and take measures to address the financial implications (e.g., debt covenants, financial ratios and rating agency considerations) of any SPEs that would no longer meet the criteria for qualifying status.

We appreciate the opportunity to comment on this proposal. We would be pleased to discuss our comments with the Board or the staff. Please contact either 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
Principal Accounting Officer and Controller