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American
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FORUM

September 14, 2007

Mr. Russell G. Golden
Director of Technical Application & Implementati
Financial Accounting Standards Board
401 Merritt 7
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FSPFAS140D

LETTER OF COMMENT NO. 13

File Reference: Proposed FSP FAS 140-d, *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions* (the "Proposed FSP")

Dear Mr. Golden:

Thank you for the opportunity to provide input related to the above-referenced Proposed FSP. In general we do not support the issuance of the proposed FSP because we believe that (as further described below) the legal analysis which forms a primary basis for its issuance is flawed, and because we believe it addresses a relatively narrow practice issue for which adequate guidance already exists. Further, we believe that the introduction of a new model to analyze these transactions creates significant operational burdens that far outweigh any incremental benefits to be derived from this new guidance.

In addition, we note that the FSP is based upon an entirely new linkage model not contemplated by FAS 140 and that is designed expressly with a particular type of transaction in mind. We note that other linkage models already exist in GAAP and we believe it would be preferable to build on some of these existing models rather than create an entirely new one specific to a single type of transaction.

Moreover, we disagree with the current approach that requires that all of the conditions be met to overcome a presumption of linkage. We believe that determining whether two transactions should be linked is primarily a matter of judgment, and that this type of determination is more appropriately made by considering the factors deemed relevant as indicators, to be considered in the aggregate. Further, we disagree with the condition set forth in the proposed model that requires that the financial asset subject to the transaction must have a quoted price in an active, Level 1 market, as we believe that two transactions can have valid and distinct business or economic purposes without specific regard to the liquidity of the instrument in question.

Finally, we believe that given the operational challenges firms will face in implementing this proposal, we believe that the effective date should be delayed an additional year, to years beginning after November 15, 2008. Alternatively, the guidance should be proposed in conjunction with the other amendments to FAS 140, which we understand are planned to be exposed later this year. We also believe the FSP should be prospective in application. Given the short-term nature of the large majority of repurchase transactions, we believe that a prospective implementation would not materially distort financial results and would greatly alleviate the operational burden in implementing the proposal.

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Basis for Issuance

Based on input from law firm members of the ASF, we question the legal analysis that seems to be part of the motivation for the FSP. As this is a rather complicated point, it may be easiest to discuss in terms of the following example. Assume that a customer buys a security from a dealer. The customer then transfers the security to the dealer under a repurchase agreement. At the same time, the customer transfers another security to the dealer under the same repurchase agreement on the same terms, with the only difference being that the dealer had not previously owned the second security.

The essential legal point is that the dealer's rights with respect to the two securities would be identical, *irrespective of whether the dealer had previously owned the security.* Congress and some courts have historically treated repurchase agreements more favorably (from the perspective of the initial transferee under the repo) in the event of a bankruptcy of the initial transferor under the repo than they have treated economically similar secured lending arrangements. The legal uncertainties at issue in the proposed FSP arise from this special legal treatment of repurchase agreements, and not from a repo transferee's prior ownership of the subject assets. In fact, the simultaneous or subsequent execution of a repurchase agreement with respect to a transferred asset would not ordinarily impair a lawyer's ability to say that the original transfer was a true sale. It only impairs the lawyer's ability to say that the subject asset would not be included in the transferor's bankruptcy estate, because the repurchase agreement creates new rights with respect to the security subject to the repurchase agreement. **This would be just as true for the security that the dealer had never previously owned.**

These legal issues relating to repurchase agreements are the same issues that FASB considered as long ago as the deliberations relating to the adoption of FAS 125. Paragraph A4 of the proposed FSP indicates that recent changes in law might have changed the analysis, but that is not correct. While Congress has modified the treatment of repurchase agreements under federal insolvency laws in the intervening years, none of those changes materially affects the legal issues that appear to be driving the issuance of the Proposed FSP. Therefore, we seriously question the Board's apparent basis for issuing the FSP.

Linkage Model

In addition, as stated above, we note that there are already several models that exist in GAAP to determine when to link two transactions. We do not believe that the specifics of the transactions described in the proposed FSP are so unique as to warrant the issuance of an entirely new linkage model. Instead, we believe that the FASB could easily extend the scope of one of the existing models to the transactions in question. We believe this is preferable as we believe it is too confusing to develop a new model every time a linkage question arises.

In particular, we note that DIG Issue K-1, *Miscellaneous: Determining Whether Separate Transactions Should Be Viewed as a Unit,* provides guidance for when to link two or more separate transactions. It states:

> If two or more separate transactions may have been entered into in an attempt to circumvent the provisions of Statement 133, the following indicators should be considered in the aggregate and, if present, should cause the transactions to be viewed as a unit and not separately:

a. The transactions were entered into contemporaneously and in contemplation of one another.

b. The transactions were executed with the same counterparty (or structured through an intermediary).

c. The transactions relate to the same risk.

d. There is no apparent economic need nor substantive business purpose for structuring the transactions separately that could *not* also have been accomplished in a single transaction.

Although this guidance was obviously originally intended for a different set of circumstances, we believe it is general enough that it could potentially be applied to the repurchase transactions in question. Accordingly, we recommend that FASB modify the FSP to effectively extend the scope of DIG Issue K-1 to the transactions described in the proposed FSP. We would be happy to work with the Staff to provide assistance to customize the principles in DIG Issue K-1 to the transactions in question.

Linkage Criteria

If the FASB decides to proceed with the issuance of a linkage model that is created for these particular types of transactions, we have serious concerns regarding certain of the criteria as currently proposed. As an overall matter, we strongly believe that the criteria should be set forth as *indicators* which should be considered by the preparer *in the aggregate*, rather than a list of conditions, all of which need to be satisfied. We believe the current approach is overly rules-based and our experience with this type of approach is that it is ill-suited to capturing the many varieties of transactions that arise in practice. We believe that determining whether two contracts should be linked is always a matter of judgment, and that a more nuanced approach that takes into consideration a variety of facts and circumstances is more appropriate to making this type of determination.

In addition, we believe that the requirement in paragraph 7(c), that the financial asset subject to the initial transfer and repurchase financing has a quoted price in an active market, with Level 1 inputs, extends well beyond the overall concept of the FSP, that the transactions have a valid and distinct business or economic purpose for being entered into separately. We believe that two transactions can have valid and distinct business or economic purposes, without specific regard to the liquidity of the instrument in question. For example, with respect to less liquid instruments such as subordinated interests in securitizations, it is typical for a transferor who has structured the securitization to offer financing terms on assets that it has sold to a transferee that reflect the transferor's familiarity with the collateral. The valid and distinct business and economic purpose for such financing transactions is that the initial transferor is seeking to minimize credit risk for risk management purposes. Because the initial transferor has a better understanding of the collateral, it is therefore better able to value the collateral and monitor credit risk. The financing terms of the repo (such as the amount of collateral required) are influenced by the transferor's knowledge of the collateral in question, and not by the transferor's desire to retain or reassume control over the collateral.

Therefore, we recommend that the requirement as articulated in the first sentence of paragraph 7(c) be deleted. If the Board does not concur with our recommendation, we believe that, *at a minimum*, the requirement that the instrument have Level 1 inputs be deleted. We believe that the definition of an "active market" extends beyond Level 1 in the hierarchy. For example, an institution may hold an instrument that has Level 1 inputs but for the sake of operational efficiency, values that instrument using matrix pricing, in which case the instrument is technically reported in Level 2. As a result, such an instrument may be unable to meet the criteria in paragraph 7 even though it is actively traded in the market.

In addition, we note that criterion 7(d), as currently drafted, requires that the borrower be able to substitute the collateral with a different financial asset. Though substitution rights are frequently provided in practice, this is not always the case. As a legal matter, standard industry repurchase agreements do not automatically provide for such rights. Substitution rights are separately negotiated, subject to the acceptance of the counterparty, and any such agreements would be reflected in the individual trade confirmation. To the extent that the collateral is less generic in nature, substitution rights may not be permitted. Importantly, this is true regardless of whether the lender was the initial transferor of the asset. Appendix A to the proposed FSP explains that "the Board believes that when an initial transferee has the ability to use the collateral and has the right to substitute a dissimilar asset in place of the collateral, the initial transferor does not likely control the transferred financial asset." While we agree that substitution rights are an indicator of control being transferred to and obtained by the borrower, we do not believe that they are necessarily a prerequisite for demonstrating control. In instances where substitution rights do not exist, the ability of the borrower to pay off the repurchase facility and control the asset is also an indicator of control being obtained by the borrower.

Accordingly, we recommend that criterion 7(d) be amended to state that "the borrower is able to negotiate to substitute [the collateral] with a different financial asset." Without this change, coupled with the requirement that transactions meet all of the conditions, we are concerned that no repurchase agreement would ever be eligible for separate accounting from the initial transfer, and that linkage would always be required.

Operationality

One of the most challenging aspects of the proposed FSP is the requirement to evaluate not only repurchase transactions entered into on the same date as the initial transfer, but also repurchase financings that "...may occur at a later date". We do not understand the rationale for this requirement as the other linkage models that currently exist in GAAP start with the notion that transactions should only be considered for linkage if "the transactions were entered into **contemporaneously** and in contemplation of one another" (DIG Issue K-1, EITF Issue No. 98-15; emphasis added). While requiring linkage for transactions that were entered into on separate dates in contemplation of one another would be appropriate, it seems counterintuitive that the Board should now seek to link all transactions that are entered into on separate dates. If not initially contemplated as a single linked transaction, it would seem that entering into transactions on separate dates would be a strong indicator that the transactions are, *prima facie*, **not** linked. Further, it seems to us that the "history" of a particular security should be irrelevant to the current accounting treatment.[1]

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[1] We acknowledge the fact that paragraph 55 of FAS 140 requires that transfers of financial assets be assessed for changes that result in the transferor's regaining control of assets sold, such as changes in law or changes in the status of the transferee as a qualifying SPE. However, we believe that given the volume of activity in the repo market, it seems more plausible to assume that the repurchase transaction, when effected at a later date, is occurring in the ordinary course of business and for the purpose of providing secured financing to a counterparty, rather than for the purpose of regaining control over a particular asset.

Apart from our theoretical concerns regarding this requirement, we believe that from a practical perspective, such a requirement renders the FSP virtually inoperative. The markets for many of the securities in question are so active that an instrument may have been bought and sold many times over by an institution, and yet still be eligible for linkage. The FSP would therefore require a reporting entity to design systems to identify all securities upon transfer, and maintain this history for an indefinite period, so that a security would be "flagged" any time a repurchase financing was entered into with the same counterparty where the referenced security is provided as collateral. Financial institutions currently do not have these types of system capabilities, and would not be able to design the required systems by the anticipated effective date of the proposed FSP. In addition, we question the financial reporting benefit of designing such systems in relation to the tremendous cost that would be required in order to do so. The only operational way to implement the FSP as drafted would be to make certain broad assumptions regarding various financial instruments, which would be by definition of limited use. Accordingly, we recommend that this requirement be eliminated.

Scope

If the Board decides to proceed with the issuance of the FSP as drafted, we also have questions regarding the scope of its application. As currently written, the scope of the proposed FSP is unclear. Although we believe the FASB intended this FSP to apply only to repurchase and reverse repurchase agreements, footnote 2 suggests that it could apply to a wider range of financing transactions than contemplated by the FASB. Conversely, paragraph B1 states that "The purpose of this example is to...prevent an inappropriate analogy to other financing transactions that are outside the scope of this FSP" - suggesting that the scope of application should not extend beyond what is traditionally viewed in practice as a repurchase agreement. Depending on how these paragraphs are interpreted, and which paragraph is viewed as taking precedence over the other, the FSP could be viewed as encompassing any collateralized financing arrangement, such as securities purchased by a retail customer and financed with a margin loan from a dealer. We do not believe that the FSP should apply to margin loan transactions, as they are demonstrably distinct from the transactions in question: for example, among other features, the financial institution provides a significantly lower amount of financing to the customer (maximum of 50%).

Moreover, to the extent that the scope of the proposed FSP extends beyond traditional repurchase agreements, this would magnify operationality issues, and more importantly, we do not believe that this is what the Board had intended. Therefore, for clarity's sake, if the Board decides to proceed with the issuance of the FSP as drafted, we recommend that the scope be clarified to apply to repurchase and reverse repurchase agreements as defined in footnote 1 of FIN 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*: "For purposes of this Interpretation, a repurchase agreement (repo) refers to a transaction that is accounted for as a collateralized borrowing in which a seller-borrower of securities sells those securities to a buyer-lender with an agreement to repurchase them at a stated price plus interest at a specified date or in specified circumstances. The 'payable' under a repurchase agreement refers to the amount of the seller-borrower's obligation recognized for the future repurchase of the securities from the buyer-lender. In certain industries, the terminology is reversed; that is, entities in those industries refer to this type of agreement as a 'reverse repo.'"

Effective Date and Transition

Should the staff and Board decide to proceed with the proposed FSP as currently written, we would suggest that the guidance be applied prospectively to new transactions, and that the guidance should not be required to be applied to existing repurchase agreements given cost-benefit considerations. Given the short-term nature of the large majority of repurchase transactions, we believe that a prospective implementation would not materially distort financial results and would greatly alleviate the operational burden in implementing the proposal.

In addition, we do not believe that the proposed effective date would provide sufficient time to implement this guidance. Reporting entities would need significantly more time to make necessary system changes. Therefore, we believe that the effective date should be delayed an additional year, to years beginning after November 15, 2008.

Examples

Paragraph 9 discusses the accounting for a situation in which a transaction does not meet all the criteria in paragraph 7 and fails to meet the sale criteria of FAS 140. As discussed in paragraph 9, in such a situation "...the transaction shall be accounted for based on the economics of the combined transactions, which generally represent a forward contract." We believe it would be very helpful if the proposed FSP were to provide an example detailing the accounting for such a transaction.

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Again, we thank you for the opportunity to provide input related to the proposed FSP. Please contact any of the undersigned, or George Miller, Executive Director of the American Securitization Forum at 646.637.9216, with any questions or comments.

Sincerely,

Esther Mills, Chair,
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Lisa-Filomia Aktas, Deputy Chair,
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