August 30, 2002

Director of Major Projects and Technical Activities
File Reference No. 1082-200
Financial Accounting Standards Board
401 Merritt 7
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Re: Proposed Interpretation on Consolidation of Certain Special Purpose Entities

We are pleased to respond to the Financial Accounting Standards Board’s (FASB’s) proposed Interpretation, Consolidation of Certain Special-Purpose Entities (June 28, 2002).

We strongly support the Board’s stated goal of improving financial reporting by enterprises involved with special-purpose entities (SPEs). In fact, it has been over ten years since we first provided the Board with our views regarding consolidation issues and the consolidation of SPEs, and several more years since we first raised the issue of significant practice problems regarding SPEs. Our comments to the Board over the years have consistently advocated a model based on substance over form — a model that results in assets and liabilities of more SPEs being reported on the balance sheet of the company that has the risks and enjoyed the rewards of those SPEs. Consistent with our historical views expressed in prior correspondence to the Board, we agree with the proposed Interpretation’s increased emphasis on risks and rewards, and a higher capital-at-risk threshold for independent residual equity.

However, although we agree with the Board’s objectives, the proposed Interpretation in its current form falls far short of meeting those objectives, and merely replaces the existing model that needs improvement with another model that needs improvement. We believe that the proposed Interpretation needs significant revision prior to issuance.

While financial statement users clamor for transparent and clear financial accounting standards, the Board has offered a proposed Interpretation that begins with a flawed model, and then makes it worse through a labyrinth of scope exceptions, special models, and ambiguous criteria cobbled together to accommodate certain transactions, without any clear underlying conceptual framework to guide the consolidation decision. Through the deliberation process, the proposed Interpretation has become too complex for preparers to implement, let alone financial statement users to understand.

We have been particularly surprised to read that the Board believes that this proposed Interpretation improves financial reporting by requiring the consolidation of existing SPEs. To the contrary, we believe that the proposed Interpretation will result in the de-consolidation of
many currently consolidated SPEs, leave wide loopholes open for entities to avoid consolidation of SPEs, and lead to inconsistent and non-comparable financial reporting among entities.

We have organized our comments into several major themes, and then address more specific comments on the proposed Interpretation.

We strongly urge the Board to re-think the concepts underlying the proposed Interpretation and replace the proposed Interpretation with a simpler, more consistent consolidation model. We have previously shared with certain Board members our views on what this model should entail.

Given the increasing worldwide usage of SPEs, we also encourage the FASB to consider coordinating with other accounting standard setters around the world on this project.

Scope

One of the fundamental flaws of the proposed Interpretation is that its scope is inadequate to address the problems in current practice, and in fact creates additional problems.

Definition of an SPE

In its description of an SPE, we recommend that the Board be more definitive regarding the “definition of a business” characteristic. We believe that if an entity is a business as described in EITF Issue No. 98-3, “Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business,” then that entity is not an SPE. Conversely, if an entity is not a business, it is an SPE.

Virtual SPEs and SPEs Owned by Substantive Operating Enterprises

We understand that the proposed Interpretation will not address SPEs or groups of assets and liabilities that are included (consolidated) in the financial statements of a Substantive Operating Enterprise, even if these SPEs or groups of assets and liabilities are economically identical to a freestanding SPE that would otherwise be consolidated by the Primary Beneficiary. We believe that this scope exception is a critical and fatal flaw in the proposed Interpretation because it will result in different accounting by Primary Beneficiaries for transactions that are economically the same based solely on the identity of the equity owner.

This scope exception creates a significant loophole that will allow a Primary Beneficiary of an SPE to avoid consolidation simply by finding an Substantive Operating Enterprise that is willing to consolidate the SPE, and is merely acting as an agent for the Primary Beneficiary. As we have discussed in prior correspondence with the Board, it is not clear to us why the Board would choose to create such a significant loophole that will result in fewer entities (or virtual entities) being consolidated by the Primary Beneficiary than occurs under the current framework.
One of these loopholes relates to entities whose business consists of, in part, "renting their balance sheets" for specific transactions. (In fact, deal-makers are already structuring proposed transactions to take advantage of this loophole.) In these transactions, rather than using a separate legal entity, a Substantive Operating Enterprise owns the assets and issues the debt used to acquire the assets; the holder of that debt typically has no recourse to assets other than the assets acquired with the proceeds of the debt and therefore the assets and debt are isolated from the entity's other operations. Those walled-off assets and liabilities form a virtual SPE that is economically identical to a freestanding SPE, but because the assets and liabilities are contained on the balance sheet of a Substantive Operating Enterprise, the Primary Beneficiary is not at risk of consolidating the assets and liabilities under the FASB's proposal.

The proposed Interpretation will also open a loophole that was originally closed by EITF Issue No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions," as it relates to the consolidation of nonsubstantive legal entities that are owned by a Substantive Operating Enterprise to support the activities of the Primary Beneficiary. To illustrate the issue, consider the following example: Developer forms a nonsubstantive, wholly-owned LLC to own and finance the construction of a building that is to be leased upon completion of construction to Corporation, which will use the building as its headquarters. Developer forms LLCs for each of its projects to protect its investments in those projects from an event of default on any of the other projects. The lease to Corporation is a synthetic lease. Based on our reading of the proposed Interpretation, Corporation would clearly be the Primary Beneficiary, but because Developer will consolidate the LLC, Corporation does not have to concern itself with consolidation. We find that to be an illogical result, particularly in light of the fact that under current practice, the lessee would be required to consolidate the LLC. Why should the Primary Beneficiary's accounting be affected by whether the SPE is owned by a Substantive Operating Enterprise or by individuals, when the economics of the transaction are exactly the same?

We strongly believe that the conditions for non-consolidation by the Primary Beneficiary in the proposed Interpretation should be applied to SPEs that exist in "virtual" form, representing a walled-off or non-commingled part of a larger legal entity, and to nonsubstantive entities owned by a Substantive Operating Enterprise. Excluding these SPEs from the requirements of the proposed Interpretation represents a significant step backward from current practice. Today, we apply by analogy the guidance in EITF Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities," Question No. 1, to determine whether virtual SPEs should be consolidated since that consensus represents the closest authoritative literature for those entities. While the legal form of the virtual SPE arrangement is somewhat different from the situation addressed in Question No. 1 in that it does not involve the creation of a legal entity, we do not believe differences in legal form (legal entity that is an SPE as opposed to one that exists in virtual form) should be determinative when the substance of the transactions is the same.
We believe the Board’s rationale for permitting a Primary Beneficiary to avoid consolidating a nonsubstantive SPE merely because it is included in the consolidated financial statements of a Substantive Operating Enterprise lacks concept because it places form squarely above substance.

We also note that by covering in the proposed Interpretation SPEs owned by Substantive Operating Enterprises, a host of Day 2 accounting issues are avoided. Say the Substantive Operating Enterprise sells its investment to an individual investor on Day 2. Or assume an individual investor sells his or her investment to a Substantive Operating Enterprise on Day 2. Changing the consolidation conclusion based on these events seems counterintuitive to us.

Determining When a Substantive Operating Enterprise Should Consolidate

Paragraph 8c of the proposed Interpretation provides a scope exception for "a subsidiary, division, department, branch or other portion of a substantive operating enterprise," but it is not clear how the Board intends that a Substantive Operating Enterprise reach the conclusion that an SPE or legally or economically separate group of assets and liabilities should be consolidated (thereby becoming a "portion" of the Substantive Operating Enterprise). If the Board intends for the Substantive Operating Enterprise to apply the voting interest provisions of ARB No. 51, Consolidated Financial Statements, and FASB Statement No. 94, Consolidation of All Majority-Owned Subsidiaries, then a Substantive Operating Enterprise could make a nominal investment in the voting equity of an SPE, consolidate the SPE, and allow the SPE's Primary Beneficiary to avoid application of the proposed Interpretation altogether, without even considering the requirements of paragraph 9. If the Board intends for the Substantive Operating Enterprise to apply the variable interest model of the proposed Interpretation, then this scope exception appears to begin circular logic: one must apply the proposed Interpretation to determine whether an entity is in the scope of the Interpretation in the first place.

Complexity of Proposed Interpretation

A second critical flaw of the proposed Interpretation is its complexity and ambiguity. We understand the Board’s desire to issue a "principles-based" rather than a "rules-based" Interpretation. A successful principles-based standard must set forth clearly what those principles are and must hold those principles consistently. Instead, the proposed Interpretation creates a tangled web of types of SPEs distinguished by arbitrary decisions, focuses on an ambiguous and judgmental search for "variable interests," and results in an incredibly complex standard that is unlikely to be applied consistently by financial statement preparers. We disagree with the Board’s decision to increase the complexity of this already difficult issue: financial statement preparers will have difficulty applying the proposed Interpretation, and financial statement users will certainly not understand it or its results.

The proposed Interpretation contemplates at least five different types of entities: qualifying SPEs under FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a new category of SPEs that hold financial assets ("financial SPEs"),
normal SPEs (which, evidently, might also be businesses as defined in Issue 98-3), Substantive Operating Enterprises, and non-substantive operating enterprises (e.g. regular businesses as defined in Issue 98-3, but that have insufficient equity to be considered Substantive Operating Enterprises). We think this increased complexity is unnecessary. For example, the Board created financial SPEs to acknowledge that some SPEs "diversify risks and potential benefits related to certain assets or activities." We believe that this characteristic is not necessarily unique to SPEs that hold financial assets, and these types of SPEs do not merit a special accommodation in the proposed Interpretation. If an SPE truly diversifies risk, it should have a broad base of variable interest holders and would not be consolidated by any party under the provisions of paragraph 13; a special accommodation would not be necessary. If the Board believes that its base model leads to an inappropriate result, we encourage the Board to re-evaluate that base model, rather than pursue its current strategy of complex accommodations and work-arounds.

Although the Board created the special class of financial SPEs with certain transactions in mind (collateralized debt obligations and bank-sponsored conduits), creating this class of SPEs creates and intensifies a host of issues. For example, EITF Issue No. 02-12, "Permitted Activities of a Qualifying Special-Purpose Entity in Issuing Beneficial Interests under FASB Statement No. 140," addresses whether a qualifying SPE may manage its beneficial interests, by determining the terms of new beneficial interests, or by prepaying existing beneficial interests. We believe that Statement 140 does not permit a qualifying SPE to engage in such activity, and therefore do not believe that paragraph 22 of the proposed Interpretation can be applied to many of the transactions that the Board had intended to specifically carve out.

The complexity and ambiguity of the proposed Interpretation are even more problematic because of the quick transition period. There will be little time for practice issues to surface and be resolved before preparers need to apply the proposed Interpretation. We believe it is incumbent on the Board to resolve these ambiguities and provide clearer definitions and guidance before issuing the proposed Interpretation.

10% Presumption

We strongly believe that the minimum equity investment by independent, third party owners should be set at a fixed, stated level (a floor amount of at least 10 percent) of the SPE's total assets. We believe it is essential to have a minimum bright-line amount of independent residual equity; otherwise the Board leaves the door open for practice to deteriorate to accept much lower levels of capital under inappropriate circumstances. Our recollection of the primary reason behind the creation of the bright-line 3 percent minimum outside capital requirement in EITF Issue No. 90-15 was to guard against entities inevitably arguing that a smaller amount is sufficient. For example, as discussed at one Board meeting, certain real estate SPEs may in fact require no equity to achieve independent financing. So these SPEs may "legitimately" argue that they need not have 10% equity or even 3% equity, but NO equity in order to not be consolidated by their Primary Beneficiary. We believe leaving this critical aspect open to
judgment is a significant flaw. We are certain that leaving such a key factor open to judgment will create chaos for both preparers and auditors and lead to inevitable criticism and second-guessing that comes with benefits of hindsight. We can already sense deal-makers preparing their analysis on why less and less equity is sufficient. The FASB's willingness to compromise on this issue is at the expense of auditors who will be confronted with every imaginable analysis and argument to reduce the required amount of equity, and at the expense of financial statement users who will face nonconsolidated SPEs in financial statements, without a full explanation or understanding of the creative analysis and arguments used to justify the reduced amount of equity.

Our understanding of the primary reason that the Board decided to make this condition judgmental relates to the belief that the minimum sufficient capital should be less for certain transactions involving SPEs that hold relatively risk-free assets. While such an observation may be valid, we believe that it is not compelling enough to justify the removal of the minimum equity requirement. For example, even if an SPE holds only U.S. Treasury securities, it should not be difficult for the SPE's capital structure to include a tranche of 10 percent independent residual equity. Presumably, it would be much easier to find willing investors for that SPE’s residual equity versus an SPE that holds high-risk assets. Another explanation has been offered: that Substantive Operating Entities in certain industries are not required to have 10% equity (for example, risk-based capital rules for financial institutions require 8%), and it is not fair to require such a high standard in all cases for SPEs. However, this ignores the fact that SPEs have significantly different risk profiles than diversified financial institutions subject to significant oversight and specific capital rules designed to limit risk concentrations that often exist in SPEs. We find both explanations to be less than compelling, and we question why the Board would decide to significantly dilute the most substantive condition required for non-consolidation. We also note that a strict 10% test is consistent with paragraph 36 of Statement 140, which addresses conditions under which an SPE should be granted qualifying status.

We firmly believe that this specific condition for non-consolidation is clearly the most substantive change that is needed in practice today. Articulating this condition as simply a presumption that is open to judgment will significantly reduce the potential improvement that the proposed Interpretation might have made to the current rules.

We are further troubled that the 10% presumption subsequently is rendered toothless by the variable interest model the proposed Interpretation has established to determine the primary beneficiary of an SPEs where the voting interest model does not apply. Consider, for example, a transaction in which Company A sells $100 of assets to an SPE. The SPE issues three classes of interests: $90 of senior debt to third parties, $8 of subordinate debt to Company A, and $2 of common equity to third parties. Although the SPE's legal documents restrict its activities, whatever decisions remain are made by the common equity holders. Assume that the expected losses of the SPE are $3. That is, the equity owners would absorb $2 of the expected losses, and the subordinate debt holders would absorb $1 of expected losses, plus any additional losses that are not reasonably expected to occur. Assume that Company A is not able to demonstrate that
any Substantive Operating Entities engaged in similar activities exist with such a minimal amount of equity.

It is clear to us that under current guidelines, Company A would consolidate the SPE. Under the proposed Interpretation, it is also clear that the SPE does not qualify for the voting interest method, because the equity is not sufficient under the guidelines established. However, under the variable interest model, Company A may very well not consolidate the SPE because a third party absorbs more of the expected losses than Company A.

This example demonstrates that while, on the surface, the 10% presumption in the proposed Interpretation appears stringent and perhaps an improvement from current practice (although, as stated above, we strongly believe the 10% test should be a minimum), in reality the 10% presumption is practically irrelevant. An SPE established by Company A would not be consolidated by Company A simply if a third party absorbs a majority of the expected losses of the SPE (or if Company A simply absorbs no more reasonably expected losses than anyone else), regardless of whether the third party made a 1%, 3%, or 10% equity investment in the SPE. We are deeply troubled by this conclusion.

Operationality Concerns

We are very concerned that the proposed Interpretation is simply not operational and cannot be applied consistently in practice.

The consolidation guidance of the proposed Interpretation is too dependent on the preparer's knowledge of the identity, investments, agreements, and actions of independent, third parties. The voting interest information required to apply ARB 51 and Statement 94 is usually available, while the variable interest information required to apply the proposed Interpretation is very often restricted in transactions involving SPEs. Paragraph 14 requires an enterprise to reconsider its consolidation decision at each reporting date using "all evidence that the enterprise possesses or would reasonably be expected to possess." (We do not believe that footnote 5 is useful, because an "exhaustive search" is no more clear than "reasonably expected to possess.") This will lead to illogical consolidation decisions. Consider the following situations:

• Enterprises A, B, and C each purchase a 1/3 variable interest in an SPE to be evaluated under the variable interest model. Two years after purchase, B and C sell their investment to 20 other parties. Although the trustee of the SPE is aware of this transfer of ownership, the trustee is under no obligation, and is not permitted, to release ownership information to investors. Enterprise A will continue to not consolidate the SPE based on its initial decision because Enterprise A does not have access to any new information.
Enterprises X, Y, and Z enter into a similar arrangement, except that Enterprise X performs servicing for the SPE, and therefore has knowledge of the transfer of ownership by Y and Z. After two years, Enterprise X consolidates the SPE because its variable interest is significant and significantly more than the interests held by other investors.

Thus, Enterprise A and Enterprise X will have the same rights and obligations regarding the SPE. The difference in their consolidation conclusion is based solely on the amount of information to which each enterprise has access.

- Enterprises A, B, and C each purchase a 1/3 variable interest in an SPE to be evaluated under the variable interest model. Immediately after purchase, B and C sell their investment to 20 other parties. Even before the initial investment, B and C had an intention, and in fact had entered into a side agreement, to do so, although Enterprise A was unaware of this arrangement and could not be reasonably expected to have access to Enterprise B and C’s investment strategies.

Under the proposed Interpretation, any enterprise that wishes to avoid consolidation may simply structure the transaction to restrict access to ownership information, and turn a blind eye to transfers of ownership that would result in consolidation, if full access to the information were available.

- Enterprise A and B each purchase a 1/2 variable interest in an SPE. Enterprises A and B are identical investment funds and are Substantive Operating Entities. After applying paragraph 16 of the proposed Interpretation, neither enterprise decides to consolidate because neither enterprises’ activities are more closely associated with the SPE, and they have equal variable interests. After two years, Enterprise B transfers its investment to a wealthy individual’s own investment portfolio.

Enterprise A now consolidates the SPE because the proposed Interpretation draws an arbitrary distinction between a variable interest held by a Substantive Operating Enterprise (Enterprise B) and a variable interest held by an individual (see paragraph 16.a.).

Presumably, it will be essential for the Primary Beneficiary to know or be able to learn whether another entity is already consolidating an SPE, and whether that entity is a Substantive Operating Enterprise. We believe this concept presents operational challenges.

A similar issue exists for qualifying SPEs. If an SPE is qualifying, then the transferor and its affiliates do not consolidate the SPE. Apparently, under the Board’s proposed Interpretation, the information as to whether the SPE is a qualifying SPE is essential for other third party investors (including sponsors, servicers and others) in the SPE because if the transferor does not consolidate the SPE pursuant to paragraph 46 of Statement 140, then an investor might be
required to consolidate the SPE. If an investor in an SPE is not aware that the SPE is qualifying (which is often the case), then that investor may correctly determine that the transferor is the Primary Beneficiary and logically conclude that the transferor should consolidate the SPE. However, unbeknownst to the investor, the transferor does not consolidate the SPE because it is qualifying. A somewhat related issue is introduced at a high level (but not resolved) in the response to Question 37 of the FASB staff Special Report entitled, *A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.*

We are concerned that the proposed Interpretation also puts an auditor in an impossible position regarding the knowledge required to concur in the nonconsolidation decision. If an accounting firm has a business relationship with the trustee of an SPE or other investors of the SPE, that firm will have, or would be expected to have, considerably more information in assessing the consolidation decision than its audit client that is making the consolidation determination. If the auditor makes an assessment solely based on the information that the financial statement preparer has, the auditor may agree with the client’s nonconsolidation conclusion, even though that auditor would be reasonably expected to be aware, through its other information, that the client’s consolidation conclusion is in fact incorrect.

The proposed Interpretation is also too dependent on an individual preparer’s judgment regarding expected losses of its own investments, and the investments of independent third parties. Paragraph 16 states that an SPE may have only one Primary Beneficiary, but then requires that a tie between variable interest holders is broken by the party with the largest variable interest. The relative size of a variable interest is determined by comparing expected future losses. The proposed Interpretation seems to assume that all parties will reach the same judgments about expected future losses and will identify the same Primary Beneficiary. In reality, different enterprises may reach very different conclusions about expected future losses, and each enterprise may believe that the other enterprise should consolidate, or each enterprise may believe that they should consolidate. The proposed Interpretation may lead to no consolidation or double-consolidation simply due to the judgment involved in the consolidation guidance.

We strongly encourage the Board to revisit the operationality of the proposed Interpretation and reduce an enterprise’s reliance on the identities, investments, and actions of independent third parties when making its own consolidation conclusion.

**Comments on Specific Issues**

**General Approach**

- We understand that the scope of the proposed Interpretation includes investment companies as defined in the AICPA’s Investment Company Audit Guide. Under current practices, entities that appropriately report substantially all their assets at fair value (also including, for example, broker dealers) do not always consolidate entities that they control. We believe that
the Board should fully consider the implications of this decision and communicate its rationale in the basis for conclusions. Including investment companies within the scope of the proposed Interpretation may affect both SEC rules and the Investment Company Audit Guide.

- APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, requires that certain investees that are not consolidated should be accounted for on the equity method due to the significance of the investor's ownership interest. We recommend that the Board consider whether equity-method accounting may be appropriate in situations where the investor is at or near the consolidation margin under the proposed Interpretation.

- EITF Issue No. 97-2, "Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements," provides useful guidance for determining when a manager may control another entity by contract and should consolidate the entity. We recommend that the Board consider the concepts in Issue 97-2 and determine whether the "control by contract" concept may be relevant to servicing relationships involving variable interests.

**Paragraph 7.a.**

- We recommend that the Board consider whether an individual investor should be treated as a Substantive Operating Enterprise for purposes of applying the proposed Interpretation. We believe there are circumstances where the Primary Beneficiary of an SPE is an individual investor, and we do not believe that another variable interests holder should consolidate an SPE simply because the other Primary Beneficiary candidate is an individual rather than a Substantive Operating Enterprise. We believe that there is not a substantive difference between an individual investor and an investor that is a Substantive Operating Enterprise (see paragraph 16.a.).

**Paragraph 9**

- The proposed Interpretation requires that the third party equity investment be "subordinate to all debt and preferred equity interests." The proposed Interpretation should clarify whether the equity investment itself may consist of more than one class of equity, as long as the third party equity investment, taken as a whole, meets the conditions of the proposed Interpretation.

Consider an SPE that issues debt (85 percent), Class A Preferred shares (5 percent), Subordinate Class B Preferred shares (5 percent), and Common shares (5 percent). Assume that Class A Preferred shares are held by the Primary Beneficiary, and Class B Preferred shares and Common shares are held by third parties. The SPE may be structured this way because certain investors have investment guidelines that do not permit common equity investments. Although the third party investment is made in two classes, the entire investment is equity in legal form, is subordinate, and is residual, relative to the beneficial interests retained by the Primary Beneficiary. There appears to be little economic difference
between this capital structure and a capital structure of 85 percent debt, 5 percent Class A Preferred shares, and 10 percent Common shares, held by various parties.

- We agree that an equity investment must be subordinate to all other interests and that if an equity investor funds its investment with fees received from the SPE or the Primary Beneficiary, the equity investment is not at risk. However, the proposed Interpretation should also clarify how subsequent payments to the equity investors should be treated. We believe that the guidance in Question No. 5 in EITF Issue 96-21 is appropriate and should be carried forward in the proposed Interpretation. Payments made to equity investors in excess of previously undistributed GAAP earnings are generally deemed a return of capital. However, we believe that the response to Question No. 5 did not contemplate an equity investor having further ongoing relationships with the SPE, such as acting as servicer or participating as debt holder. Therefore, we believe that there are certain circumstances in which amounts are paid by the SPE or the Primary Beneficiary to an equity owner without indicating that the equity investment is not at risk.

Consider, for example, an SPE that issues beneficial interests in the form of debt and equity to multiple investors. Assume that one investor services the assets held by the SPE, and has invested in both the debt and the residual equity of the SPE. The proposed Interpretation should clarify that if the investor provides substantive services (such as acting as servicer for the assets of the SPE) or is a debt holder, that the payment of servicing fees or interest on the debt are not payments that would indicate that the equity investment is not at risk as long as the payments are determined to be market rates, because they are payments made to the investor not as equity owner but as servicer and debtholder, respectively. Recognizing that it can be difficult to distinguish whether the payment is made as a return of equity investment or as market compensation for other relationships, we believe that preparers should require a high standard of proof that the servicing fee or the interest rate are fair market rates. This standard could be met, for example, if other debt and equity investors with identical rights and no other involvement with the transaction have the same interest rates and dividend yields as the investor who provides other services. We believe the final Interpretation should observe the importance of this issue.

- We disagree that an SPE always does not have sufficient economic substance if the potential returns from equity ownership are directly or indirectly capped. Certainly, a capped equity return may be suspect. But there are many circumstances in which independent equity investors may accept a partially or fully capped return.

Consider, for example, an SPE that owns fixed rate loans and issues debt and equity interests. The potential returns from equity ownership in this SPE are directly capped, not by any structuring technique, but by the very nature of the assets held by the SPE. Under the proposed Interpretation, this SPE could not meet the conditions of paragraph 9c because the equity investor's return is limited by the very nature of the SPE's assets.
A similar situation could occur in an SPE holding a more complex portfolio of financial instruments. Another common situation where the equity owner’s potential returns may be capped involves a non-synthetic lease where the lessee holds an option to purchase the leased asset at a fixed price that is set at a level higher than the expected fair value at the time the option becomes exercisable. An equity investor may be interested in such an arrangement with the expectation that the lessee will purchase the property at the end of the lease so the investor will not need to remarket it.

The proposed Interpretation implies that to have "sufficient economic substance," an SPE must hold some assets with unlimited cash flow potential to allow for an unlimited return. If the Board does intend to require an SPE to have some assets with unlimited cash flow, we disagree. If the Board's intent is not to require an SPE to have some assets with unlimited cash flow, we suggest that the Board clarify its intent.

The proposed Interpretation contemplates contracts to provide services to an SPE that include incentive fees for achieving a certain level of performance. These incentive arrangements may, once the equity investor has achieved a stated rate of return, pay the servicer (a) the right to a certain percentage of the residual cash flows once the equity investor has achieved a stated rate of return, or (b) a stated fee (with a low probability that funds in excess of the stated fee will remain to be paid to the equity investor). Such incentive arrangements either partially limit (through sharing arrangement) or effectively fully limit (through a stated fee) the return to an equity investor. Some equity investors use these variable fees to collateral managers and servicers to incentivize them to maximize the return to the equity investors. We believe that these types of arrangements are not necessarily an indication that the SPE lacks sufficient economic substance.

Attachment 1 provides a more in-depth analysis of this issue.

- We understand from the Board's deliberations that the Board intended to require the nominal owner of the SPE to be a third party independent from the SPE's Primary Beneficiary (determined under the variable interest model). The proposed Interpretation does not explicitly state this requirement, and we believe it should. The Board may have intended paragraph 9.e. to address this requirement, but we believe that a related party may be able to finance an investment in the SPE without assistance from the variable interest holder, and thus meet the stated requirements of paragraph 9.e.

- We do not understand what the Board intends in paragraph 9.c. by "other parties involved with the SPE." Could that party be an independent derivative dealer that enters into a derivative instrument with the SPE? Certainly, many derivatives would either limit or guarantee the SPE's return, but it is not clear to us whether the Board really intended to effectively prohibit "voting interest" SPEs from entering into derivative instruments.
• We found paragraph 9.d. unclear. Is the intent the same as Question 2 and 3 of Issue 96-21? If so, we believe the guidance could be clarified. We support the guidance in Issue 96-21.

Paragraph 12
• We believe that the proposed Interpretation should provide clear guidance on how to evaluate “sufficient economic substance” with respect to an SPE that holds operating leases or other instruments with off-balance-sheet exposure. The proposed Interpretation uses a measure of the SPE’s total assets to establish a presumption of the minimum amount of equity. The proposed Interpretation acknowledges that this measure is inadequate for SPEs with derivative instruments and that the presence of derivative instruments must be considered in determining the sufficiency of the equity investment. We believe that this logic holds true for other off-balance-sheet arrangements. The proposed Interpretation should make clear that the amount of substantive equity required should not always be measured solely on the SPE’s total assets, but often must additionally consider derivative instruments and the fair value of off-balance-sheet arrangements. Consider the following examples:

- Consider an SPE that holds $20 of fixed-rate financial assets, writes a interest rate call option with a notional of $1,000,000, receives a cash premium of $80, and issues residual equity of $20. Although the $20 of equity is 20 percent of the total assets and capital (the sum of the equity investment and all of the SPE’s debt and preferred equity interests), we believe that this equity investment is inadequate to conclude that the SPE has sufficient economic substance and should not be consolidated by its Primary Beneficiary. We propose that the 10 percent test be based on an amount that includes the notional amount of the derivative since the risks are similar to actually owning the underlying. We believe this would be more operational than a subjective value-at-risk or expected loss test.

- Consider a structured leasing transaction in which Party Z owns an asset that it leases to an SPE under an operating lease with fixed monthly payments. The SPE immediately subleases the asset under an operating lease that has contingent rental payments that are reasonably assured of being made to an Operating Company. A third party has capitalized the SPE with $1, but the SPE records no other assets or liabilities on its balance sheet. The Operating Company is the Primary Beneficiary of the SPE, but would not consolidate the SPE under the proposed Interpretation because a third party has made an equity investment in the SPE that is sufficient, based on the proposed Interpretation’s capital measure. Therefore, the Operating Company discloses only contingent rental payments while Party Z expects to receive its stated rental payments from the SPE. We believe that this measure is not adequate, and believe that the 10 percent test should be applied to the present value of the stated operating lease payments (an off-balance-sheet liability of the SPE) to determine whether the equity investment is sufficient.
• The proposed Interpretation says that the 10 percent minimum capital presumption can be overcome if there is "persuasive evidence." We believe this accommodation is a major flaw in the proposed Interpretation. If the Board proceeds with this guidance and has some specific examples of persuasive evidence in mind, we strongly recommend those items be covered in the proposed Interpretation. For example, the evidence for overcoming the presumption is "the equity of businesses that are not SPEs and that engage in similar transactions with similar risks." In many industries, equity levels vary greatly among companies. Does the Board really believe it is acceptable to look to the two or three most thinly capitalized companies in the SPE's industry as a basis to avoid consolidation?

Paragraph 13.c.
• It is not clear what the Board means by a "significant" and "significantly more." In the weeks since the issuance of the proposed Interpretation, there have already been a number of divergent views offered on this issue. Is 20% significant, by analogy to the threshold for equity-method treatment? Is 10% significant by analogy to the demonstrably distinct test for a qualifying SPE in Statement 140? The answer to this question is best answered by the Board in its own Interpretation, rather than leaving this critical question to varied practice.

Paragraph 14
• Under current practice, the sponsor of an SPE is identified at inception (using, in part, SEC staff guidance in identifying the sponsor), and the consolidation conclusion would not change unless the equity owner or sponsor sells its investment in the SPE. Under the proposed Interpretation, the Primary Beneficiary of the SPE may change simply due to the level of expected losses, which changes the variable interests of the SPE. We believe this leads to an illogical result and in fact reduces transparency.

Consider an SPE that holds $100 of assets (enhanced by the transferor's assumption of the first $5 of losses), and issues $80 of debt, $10 of preferred equity, and $10 of common equity, all to third parties. It expects minimal losses. At inception, the transferor is the Primary Beneficiary and must consolidate the SPE due to the enhancement protecting the equity investor. At a later date (Date 2), the transferred assets become impaired, and use up the enhancement, reducing the remaining amount to zero; the SPE then expects up to an additional $4 of losses, so the common equity is deemed sufficient under paragraph 9. At an even later date (Date 3), the transferred assets become further impaired, and the SPE records a GAAP loss of $10 -- leaving the capital structure of the SPE as $80 of debt and $10 of preferred equity.

At Date 2, does the Primary Beneficiary of the SPE change from the transferor to the common equity holder under the voting interest model, because the transferor's variability in return has been eliminated due to the depletion of the credit enhancement?
If the answer is yes (that is, the common equity holder becomes the Primary Beneficiary, because it now holds the greatest exposure to variability of return), then at Date 3, the Preferred Equity holder presumably becomes the Primary Beneficiary and would have to consolidate the SPE. While these conclusions seem logical from the proposed Interpretation, it results in the consolidation conclusion changing merely because of GAAP losses incurred by the SPE. In addition, this result is illogical because before Date 3, the investor’s recorded investment in the preferred equity is likely declining due to the impairment uncertainty. Then, at Date 3 (after the common equity investment has become impaired, and the fair value of the preferred equity investment has likely been reduced), the preferred equity investor would have to consolidate all of the assets and liabilities of the SPE -- even though the investor has no more rights and responsibilities for these assets and liabilities than at inception of the SPE. Current practice does not change the “parent” of the SPE because of the generation of operating losses, and we believe this result is more logical to financial statement users.

Paragraph 15
- We believe the listing of additional related parties should explicitly include employees of the Primary Beneficiary.

- It is not clear to us how the significance of professional services or business arrangements should be judged. For example, in any transaction, an investment bank may provide professional services that are very significant to that particular transaction. Those services may be very insignificant to the total activities of the Investment bank, or to the Primary Beneficiary. We believe that, under the proposed Interpretation, any party providing significant services to the transaction involving the SPE would be considered a related party and a de facto agent of the enterprise with a variable interest in the SPE. If our understanding is correct, we believe that it would be helpful for the proposed Interpretation to clarify this matter. However, that conclusion may conflict with the guidance that indicates an SPE is not within the scope of the proposed Interpretation if it is consolidated by a Substantive Operating Enterprise. For example, if the investment bank consolidates the SPE, would the fact that the investment bank is considered an agent (that is, a related party) to the Primary Beneficiary trump the scope exclusion? Or does the scope exclusion result in the Primary Beneficiary not needing to assess whether it should consolidate the SPE because the related party is already consolidating it? If the scope exclusion takes precedence, that would appear to permit a brother company to lease, through a synthetic lease, an asset owned by a nominally capitalized SPE owned by its sister company as long as the sister company was a Substantive Operating Entity.

Paragraph 16.a.
- The proposed Interpretation says that only a Substantive Operating Enterprise may be a Primary Beneficiary. We recommend that the Board consider the effect of this guidance on certain common transactions because it may lead to consolidation conclusions the Board did not intend. For example, in a typical sale of trade receivables, an entity transfers receivables
to a wholly owned SPE, and that SPE then transfers receivables to the conduit administered by a financial institution. Thus, the credit enhancement to the conduit is provided by the wholly owned SPE, which is a legally separate bankruptcy-remote entity. If the conduit facility does not meet the conditions of paragraph 22 (a fact that we presume the seller of trade receivables must ascertain through a detailed review of the conduit's organizing documents), the Primary Beneficiary candidates would be the wholly-owned SPE and the financial institution. Without the guidance of paragraph 16, the SPE would be the Primary Beneficiary, because its credit enhancement absorbs the first credit losses. However, paragraph 16 prohibits an SPE from being the Primary Beneficiary, and therefore the financial institution would consolidate, simply because the credit enhancement is provided through a wholly owned SPE of a Substantive Operating Enterprise rather than by the Substantive Operating Enterprise itself.

**Paragraph 17**

- We agree with the proposed Interpretation's requirement to view SPE silos as separate SPEs. However, some will view this guidance as a form of pro rata consolidation. We believe that the basis for conclusions of the proposed Interpretation should reconcile that display guidance with the prohibition against a proportionate gross presentation for equity method investments in EITF Issue 00-1, "Investor Balance Sheet and Income Statement Display under the Equity Method for Investments in Certain Partnerships and Other Ventures."

**Paragraph 18**

- Paragraph 18 says that variable interests generally subject the holder to a risk of losing an investment or incurring a loss. We do not understand how a variable fee addressed in paragraph 19 necessarily meets this description, because we see a difference between (a) incurring a loss on an investment and (b) not realizing all of a servicing contract's upside potential. A service contract may provide for unlimited upside, but that does not mean that the service provider has incurred a loss that is recognizable under current generally accepted accounting principles if the upside is not achieved.

We note that Paragraph 7.b. defines variable interests as "a means through which financial support is provided... and through which the providers gain or lose from activities and events." We recommend that the Board reconcile the concept in paragraph 7.b., which focuses on gains and losses, and the concept in paragraph 18, which focuses solely on the risk of losing an investment.

**Paragraph 19**

- It is not clear what the Board intends by referring to a market-based fee. In the first sentence of paragraph 19, the proposed Interpretation refers to a fee negotiated at arm's length under competitive conditions. However, the last sentence requires that an enterprise assume a fee is not market-based unless it can find comparable fees in observable transactions. These are two very different standards. Certain classes of SPEs may have very unique structures and compensation arrangements, and there may be no similar observable transactions in the
market. Does this mean that those fees are prima facie not market-based, even though they may have been negotiated between unrelated parties and investors or resulted from a competitive bidding process? As an example, hotel management companies frequently compete to operate a hotel owned by an unrelated third party. The owner is free to select the operator based on the terms of the bids and will select the one that results in the greatest return to it, provided the operators are of equal stature. Presumably, the bid process results in a market-based fee for that property, even in the absence of a similar observable price.

Similarly, does the Board intend competitive conditions to mean formal bidding processes? Often, services to SPEs are provided by servicers with whom the investors or other parties are familiar, without any open bidding process, although the fees are negotiated between the servicer, investment bankers, and other parties. Does the lack of open bidding process mean that the negotiated fee is not market-based?

Finally, the FASB's July Technical Plan notes that "if other parties have the ability to replace the service provider without cause, that may also demonstrate that the fee is market-based." However, this concept is not addressed anywhere in the proposed Interpretation. If the Board intends this concept to be used, we recommend that the Board say so, and explain that concept in the final Interpretation.

These issues are very important in deciding whether financial institutions should consolidate their multi-seller conduits under paragraph 23. At present, we cannot tell.

**Paragraph 20**

- If a variable fee arrangement cannot be demonstrated to be a market-based fee, it is not clear how to determine the size of the fee arrangement for purposes of determining the relative amount of variable interests held by the service provider. Specifically, should a service provider consider its gross or net incremental investment in its own business, and from what starting point should expected future losses be deducted?

Consider, for example, a fee arrangement where the provider has made an incremental investment in its own business of $5. The provider receives "senior fees" (paid before payments of principal and returns on investment to debt and equity holders) of $6 and after the debt and equity holders have been paid a stated return, receives a portion of the remaining cash flows, and this portion is estimated to be $10 at inception but with a potential maximum of $25.

Is the service provider's variable interest:
  a) $15 - the amount that the provider is estimated to be at risk of not earning;
  b) $10 - the estimated amount to be received from the incentive fee portion (through which the provider gains or loses from activities of the SPE);
  c) $5 - the incremental investment identified under paragraph 19; or
d) $0 - because the senior fees are more than adequate to cover the provider's incremental investment; or
e) some other amount?

If the Board's intended answer is a), this value might be impossible to determine unless there were some contractually specified maximum amount that the provider could earn.

- The proposed Interpretation compares variable interest first in terms of expected future losses, and only if two variable interests have similar expected future losses is subordination considered. We believe this may lead to an illogical result.

Consider an SPE that issues $10 of subordinated debt to one investor and $90 of senior debt to ten investors, and expected losses are $25. Under the proposed Interpretation, the loss expected to be incurred by senior debt is $15. Therefore, the senior debt is determined to be the variable interest, and the senior debt holders must compare their interests to one another to determine who the Primary Beneficiary is. We do not agree with this result, because it appears that the subordinate debt holder has a significant amount at risk and has provided more financial support to the SPE than any other party.

We recommend that the most subordinate interest be considered the variable interest in all cases, and if expected losses exceed the amount of that subordinate interest, then more senior interests may also be variable interests. The aggregate group of variable interest holders should then be evaluated as a whole to determine the Primary Beneficiary.

**Paragraph 22**

- What does the Board mean by an "equity security?" FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, defines an equity security as

  any security representing an ownership interest in an enterprise (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants, rights, and call options) or dispose of (for example, put options) an ownership interest in an enterprise at fixed or determinable prices. However, the term does not include convertible debt or preferred stock that by its terms either must be redeemed by the issuing enterprise or is redeemable at the option of the investor.

Is convertible debt equity under the proposed Interpretation? What about S&P indexed notes? We do not understand the concept behind the specific prohibition against "equity securities" as holding by the special class of SPEs defined in paragraph 22.

We understand that other restrictions on qualifying SPEs may effectively preclude these instruments from being held by a qualifying SPE because the equity derivative components relate solely to beneficial interests that must be bifurcated under the guidance in DIG Issue D2, *Applying Statement 133 to Beneficial Interests in Securitized Financial Assets* and the
Board's proposed Statement, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. We encourage the Board to consider the effect of these restrictions to avoid a situation where one document (the proposed Interpretation) would seem to allow these equity-like holdings, where another document (the proposed amendment to Statement 133) would preclude them.

Paragraph 26
- If the final Interpretation excludes virtual SPEs from its requirements, we expect that many entities will seek early adoption to be able to deconsolidate those virtual SPEs that were previously consolidated due to an insufficient equity investment by the owner(s) of the SPE. If the Board concludes that deconsolidation of virtual SPEs (and SPEs consolidated by a Substantive Operating Enterprise) is somehow an improvement in practice, then the proposed Interpretation should address whether FASB Statement No. 98, Accounting for Leases, applies to SPEs being deconsolidated if they own and lease real estate, including real estate with equipment, under synthetic leases. We believe Statement 98 should be applied, noting that the continuing involvement by the lessee (Primary Beneficiary) would often result in accounting for the transaction as a financing, leaving the lessee's balance sheet unchanged. Application of Statement 98 would reduce the number of nonsubstantive entities that are deconsolidated, at least at transition. Similar issues arise for asset derecognition addressed in Statement 140.

- The proposed Interpretation is to be applied as of the beginning of the "first fiscal period" beginning after March 15, 2003. Companies with calendar-year fiscal years that report their results on a quarterly basis would then apply the proposed Interpretation on April 1, 2003. However, calendar year-end companies that report their results only annually (i.e. privately held companies) may have no similar "interim period" in their financial reporting calendar, and would apply the proposed Interpretation on January 1, 2004. This would result in noncomparable year-end financial statements for many companies, and we do not believe that this is the Board's intent. We recommend that the Board require the proposed Interpretation be applied at the beginning of the first "fiscal quarter" beginning after March 15, 2003.

- For many SPEs, we do not believe that initially recognizing at their fair value on the date of application individual assets, liabilities and noncontrolling equity interests of an SPE that is consolidated as a result of applying the proposed Interpretation provides useful information to financial statement users. For synthetic leases involving large fixed assets, determining the current fair value may be impractical. We support an approach to use adjusted historical amounts, unless determining those amounts is also impracticable, in which case fair values should be used.

- In its basis for conclusions, the Board should explain why it rejected retroactive restatement, the normal transition under APB Opinion 20 for changes in entities comprising the reporting
enterprise. The transition guidance in the proposed Interpretation results in noncomparable historical financial statements, and the Board should consider permitting retroactive restatement for entities that have the necessary information and wish to provide comparable historical financial statements.

**Paragraph A2**

- The proposed Interpretation says that the Primary Beneficiary cannot directly or indirectly guarantee the SPE's debt and avoid consolidation of the SPE, but notes that guarantees that protect the SPE's lenders after the equity owner's investment has suffered a total loss would be acceptable (see footnote 7). Because the equity investment is required to be subordinate to all debt interests, it is not clear what arrangement paragraph A.2.c. of the proposed Interpretation would preclude. It seems that the equity investment must always be subordinate to the debt interest, so the Primary Beneficiary would never be precluded from guaranteeing the SPE's debt, because such a guarantee would never protect the equity investment. The proposed Interpretation should reconcile this inconsistency.

- We understand that the proposed Interpretation would not preclude the third-party investor from making arrangements to mitigate its risk, through guarantee reimbursement agreements, standby letters of credit, or residual value guarantees or incurring nonrecourse debt to finance the investment. The proposed Interpretation simply precludes the Primary Beneficiary from providing the protection, or making arrangements for another party to provide the protection. We disagree with both the concept and the operationality of this approach. We support current practice in this area.

Conceptually, we believe that a structure in which a third party makes an equity investment and then mitigates its economic exposure is substantively the same as a structure in which one third party makes a nominal equity investment and another third party invests in subordinated debt. In both cases, the voting rights of the equity have been separated from the economic risk of the transaction, and the owner, by voting rights, has no economic incentive to act independently. We believe that these two structures should receive the same accounting treatment, and that the proposed Interpretation should require, to avoid consolidation by the Primary Beneficiary, that the third party investor be prohibited from mitigating (through hedging with derivatives or otherwise) the risks associated with its equity investment. (This prohibition can be achieved in practice through contractual requirements and can be verified through periodic confirmation procedures with the equity investor, who is normally known to the SPE sponsor through the original solicitation process.)

We also believe that it may be impractical to determine whether the Primary Beneficiary has made "arrangements for another party" to provide protection. The structuring process is often complex, and arrangements are signed simultaneously, and it may be impossible for a preparer or auditor to determine whether the Primary Beneficiary or its agents had made
arrangements on behalf of the equity investor to mitigate its risk outside of the SPE, or whether the equity investor did so independently. We believe that this is a distinction without a difference (since under both scenarios, the equity is protected from loss by a third party), and will result in serious practical issues -- the resolution of which would dramatically affect the accounting for the transaction.

Paragraph A3

- In a long-term operating lease without a residual value guarantee, we do not understand why the lender to the SPE would be the probable Primary Beneficiary in a non-synthetic lease transaction. Consider the following example:

Assume the equity participant contributes an amount equal to 8 percent of the SPE's total capitalization and the lender makes a fixed-rate loan for the balance. The amounts are used to purchase an office building that will be leased under a long-term lease to a single, creditworthy tenant. The present value of the minimum lease payments is 89 percent of the fair value of the asset at inception, and the term of the lease is less than 75 percent of the estimated economic useful life. Because of the location of the asset, it is not expected that the fair value of the building will decline significantly during the term of the lease. Any decline in the fair value of the property will result in the equity participant losing all or a portion of its investment before any other party would incur a loss. Any gain resulting from a sale of the property, either at the end of the lease or during its term, will be realized by the equity participant.

As long as the reasonably possible losses do not significantly exceed the amount invested by the equity participant, and in the absence of the lender's sharing in any increase in the fair value of the property, it seems to us that the equity participant (not the lender) should be the party that consolidates the nonsubstantive SPE. If the lender participated in a majority of the increase in the fair value of the asset, and were exposed to losses resulting from reasonably possible declines in the fair value of the asset, then we agree with the conclusion in paragraph A3 because, in that circumstance, it appears that the lender would have an investment in real estate based on the guidance of AICPA Practice Bulletin No. 1, Exhibit I, on acquisition, development, or construction arrangements.

- We are disappointed in the Board's decision to remove the Appendix of example transactions from the proposed Interpretation. We found the examples to be helpful illustrations of the Board's thinking and believe that examples are needed to help preparers comprehend the proposed Interpretation.

- For transactions involving "originating loans or buying, holding and selling financial instruments (for example, collateralized debt obligations and loan conduits)," the proposed Interpretation notes that "the Primary Beneficiary may be the administrator, the entity that
provides credit protection, or a holder of subordinated debt or nonvoting equity interests.” It is not clear to us why the holder of voting equity interests that failed paragraph 9 would not be a candidate for Primary Beneficiary.

* * * * *

Finis.

Very truly yours,

Arthur Andersen LLP
Attachment 1 - Capped Return to Equity Investor

Question: One of the conditions for non-consolidation of an SPE under EITF Issue No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions," is that a third party investor make a substantive residual equity investment that is at risk during the entire term of the SPE. Does the requirement that the third party equity investment be at risk, with unlimited downside potential, also require that the equity investor have unlimited upside potential, or can the residual equity investor's return be capped at a certain rate?

Background: Consider the following capital structure of an SPE holding a portfolio of financial assets (including loans, high yield debt securities, equity securities, etc.) with a fair value of $100:

| Class A Notes, stated interest of 8%, held by third parties | $91 |
| Preferred Equity, stated dividend rate of 12%, held by transferor | $6 |
| Residual Common Equity, held by third parties | $3 |

Transferor would like to participate in the economics of the portfolio of securities, and as servicer, has the responsibility to manage the portfolio to maximize the return. Residual equity holder may wish to provide the servicer with an incentive to manage the portfolio profitably by providing a variable servicing fee above a stated flat fee.

This may take various forms:

1) Equity investor gets residual return until it has received a positive return of 25%, and then the remaining upside is given to the transferor/servicer. The equity investor deems 25% to be an outstanding rate of return, and in order to provide the servicer with maximum incentive to perform well, is willing to give away all upside beyond this rate.

2) Equity investor gets residual return until it has received a positive return of 25%, and then the remaining upside is split 50/50 between the preferred equity investor (transferor) and the residual equity investor.

3) The preferred equity holder has an option to convert its preferred equity into a stated number of shares of common equity (or holds an option to purchase common equity with a strike price of $0) after the common equity holder has received a return of 25%. Once the option is exercised, the transferor and third parties would share in the residual upside proportional to their common equity ownership (which may range from 1%/99% to 99%/1%, based on the stated conversion rate)

4) Equity investor gets a residual return until it has received a return of 25%, and then the transferor/servicer gets a supplemental servicing fee of 4%, and then upside beyond that level accrues to the equity investor.
Response: It depends on the facts and circumstances of the individual transaction. Each situation addressed above achieves the same objective in a different way, and none are, *prima facie*, prohibited limitations on the return of the equity investor. There are some transactions in which the residual equity investor's return may be capped at a certain rate, and all of the excess return may go to another beneficial interest holder, which may be the transferor, or may be some other preferred equity or debt investor. Although Issue 90-15 requires that the third party equity investor must be at risk of losing its entire investment, Issue 90-15 does not contain a requirement that the investor have unlimited potential for returns, so the residual equity investor's return may be limited.

We note that in certain transactions, for example, involving the transfer of loans or other financial instruments with contractual cash flows without unlimited upsides, the return to the equity holder is naturally capped by the nature of the financial instruments held by the SPE. We believe that *unlimited* upside, therefore, is not always a required characteristic of an equity instrument.

Transaction characteristics that would support the acceptability of a capped return to an equity investor include:

- the transferor performs some function that would make it logical for the residual equity owner to provide upside as an incentive to the transferor
- the fair value of the assets is somewhat subjective and the upside arrangement is a way of compensating the transferor if its more optimistic view of the value of the assets is confirmed in the market.

In contrast, transactions without these types of characteristics raise questions regarding whether the equity investment is really equity, in substance. For example, if the transaction involved the SPE holding only equity securities, it may not be clear why the residual equity owner would be willing to cap the return because equity securities require little servicing. In contrast, if the transaction involved receivables, loans, or property plant and equipment, the capped return may be more understandable.

In any case, it is important that the equity investment be equity in form and in substance. We believe that the cap placed on the return must be at a high enough level that it 1) is differentiated from the returns on the debt instruments issued and 2) has the substance of an equity-type rate of return. The exact level of an acceptable cap is transaction-specific and largely dependent on the structure of the transaction and nature of the assets involved.

In a December 2000 speech, the SEC staff addressed several factors that indicate that an "equity" investment is in substance a debt investment:

- The securities are issued in the form of notes;
- The securities have a principal amount and fixed final maturity date with periodic cash payments. (However, the payments on the securities are contingent upon the occurrence and magnitude of an insured event.);
- The securities have no potential for capital appreciation or growth in the principal amount of the investor's investment;
- The sponsor was unable to obtain a legal opinion concluding that the securities would be deemed to be equity under the law; and
- The securities are marketed as debt securities. Additionally, investors view the securities in a manner similar to high-yield bonds, emerging market debt, and other high risk fixed income instruments that offer a higher coupon payment to offset the investor's exposure to event risk.

It is not always clear why an equity investor would accept a limited upside return while accepting the first risk of 100% loss, and additional scrutiny of the terms of the equity investment may be warranted in such a circumstance, because it may suggest that the equity investor's downside risk is somehow limited. At a minimum, a limited upside return should increase the engagement team's awareness of the potential for a limited downside risk, perhaps not transparent in the transaction.