Via Federal Express

TO: All Board Members, Financial Accounting Standards Board:

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All Participants in the September 30, 2002, Open Roundtable
(names and addresses, as known, shown on attached distribution list; copy also to Other Parties having submitted Letters of Comment as indicated but not participating in the Roundtable, and as and to the extent a mailing address is known)

Re: Observations on Open Roundtable and Status of Process
FASB File Reference No. 1082-200
Exposure Draft Interpretation of ARB 51
"Consolidation of Certain Special-Purpose Entities"

Dear Members of the Board:

Thank you again for the opportunity to be a Participant in the morning session of the above-referenced Roundtable. The discussions there continued in the vein of comment letters submitted in response to the Exposure Draft. Both highlighted the extensive list of issues raised by the approach set forth in the Exposure Draft. They also showed the substantial potential for overlapping conflicts among such issues if addressed within the current framework of the Exposure Draft. Indeed, it is difficult even to contemplate that all of those issues can be appropriately addressed and the potential conflicts resolved within the timeframe repeatedly stated for issuance of a final Interpretation before the end of the year.
Most Participants in the morning session faithfully honored the request of the meeting Chair not to roam into areas of public policy. Nonetheless, it was appropriate that one of the representatives of the SEC emphasized the need to overcome the deleterious effects on market confidence from reported abuses in off-balance sheet finance transactions and the use of SPEs as a vehicle for such transactions. At this point, however, it is likely that the most deleterious impact on the markets is not the lack of confidence resulting from reported abuses. Instead, it is now the uncertainty as to changes which might be imposed in reaction to those abuses, even if such changes would not themselves have prevented them. It was also appropriate for one of the Participants in the morning session to state that it was "more important to get it right than to get it done." Still, if the process is not completed with relative alacrity, there may not be much left for which to get things right.

That requires a delicate balance which, I humbly submit, is much more difficult to achieve with the approach taken in the Exposure Draft than it needs to be. As a result of the current approach and until such time as the process is completed, there will be a risk that ANY transaction utilizing an SPE (or even one utilizing an approach embodying a "virtual" SPE) may ultimately be treated differently than the parties to the transaction expected and on which their negotiations in such transactions would be based. Since early this year, the result has essentially been immobilization of an entire sector of capital formation and/or deployment which historically has been significant, significantly beneficial, and not imbued with the abuses otherwise reported this year.

A. SUMMARY OF PROPOSAL

An alternate approach is needed. Such alternate approach would quickly establish a principles-based standard for identifying entities and transactions which would be excluded from the newly-developed philosophical basis for consolidating "certain" SPEs. The basis for doing so would be satisfaction of criteria demonstrating an actual free-standing status free of "control" by any party or group of related parties. Identifying such category of SPEs could and should be done immediately even before the final Interpretation is ready. That would be coupled with a continuing examination of whether other, less "standard," entities and/or transactions should also ultimately be excluded from the final Interpretation for the same analytical reasons.

Such approach would start with a recognition of two conclusions which have already been reached by the FASB. First, there is nothing inherently improper about SPEs. Many of them can and do serve a legitimate purpose in the manner in which they were formed and utilized. Second, there is nothing inherently improper with free-standing SPEs which are not consolidated in the financial statements of any other entity. The Exposure Draft itself

1 The use of the word "certain" in the title of the Exposure Draft was presumably not accidental or even misleading, although the structure set forth in it could unfortunately leave the impression that one of those explanations (but not both) might be correct. See, Section 1 of Attachment A hereto. In any event, the proposal contained herein is based on an understanding that the world "certain" was both intended and meaningful and a large number of Letters of Comment appear also to have been based on that understanding. The primary purpose of preparing and submitting this proposal is to facilitate a process of identifying those SPEs which would be excluded from coverage of the proposed Interpretation if "certain" is in fact to have meaning.

includes recognition that instances of such non-consolidation will continue to be appropriate even if adopted in its current form as a final Interpretation.\(^3\)

If the categories of appropriate status and treatment could be identified and acknowledged up front, that alone would facilitate recovery of confidence in the markets. It would also provide an environment in which principles could be identified and promulgated in a more deliberate and rigorously analytical environment applicable to all other situations. In that context, I submit for your consideration the approach described herein as an alternative to that reflected in the Exposure Draft.

B. THEORY

The essential theoretical components on which consolidation is based appear to be well-established in ARB 51 and continued in SFAS 94:

- that the operations and financial condition of separate entities are consolidated because they actually evidence a single business enterprise,\(^4\)

- that thus including financial information for otherwise separate and distinct entities more accurately presents the economic reality for both of them than would separate presentation,\(^5\) and

- that presentation in separate financial statements would nonetheless be appropriate where it "would be more informative to shareholders and creditors of the parent company than would ... inclusion ... in the consolidation."\(^6\)

Those principles are then applied to separate entities in the context of one of them having a "controlling financial interest" in the other. While that term has inherent ambiguities which seem to take on a separate life of their own in the Exposure Draft,\(^7\) in the literature existing prior to the Exposure Draft the context served to clarify that the focus was on voting interests which included an element of financial participation in the operations of the entity being examined for possible consolidation by the entity in "control" of it.\(^8\)

In this context, the primary benefit of the Exposure Draft is the effort it represents to modify application of GAAP to recognize the operational and economic reality of SPEs as they are being used. Neither GAAP nor application of it will, however, create reality or even modify it. The Exposure Draft comes perilously close to attempting just that in assuming the

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3 The historical "voting interest" test recognized that as a possible result, as does its proposed continuation in the variation set forth in Paragraph 9 of the Exposure Draft.
4 See, ARB 51, Paragraph 6 and Paragraph 14. Although not stated so directly, this principle is also inherent in ARB 51, Paragraph 1, which was essentially ratified and thereby emphasized in SFAS 94, Paragraph 1.
5 See, ARB 51, Paragraph 1; SFAS 94, Paragraph 1.
6 See, SFAS 94, Paragraph 5.
7 See, Attachment A (text and note at footnote 2 thereof).
8 If the formalities of that were ignored, the end result is a concept of "single business enterprise" which in theory would take on the scope of an entire industry itself.
conclusion that a "variable interest" evidences or even equates to "control." Whatever approach is ultimately taken in the final Interpretation, there must be a clear recognition that changes in GAAP will not change reality if those changes are not fully capable of implementation in the only crucible that ultimately establishes rights and obligations of "control:" judicial determinations of legal principles relating to them.

C. APPLICATION

The alternate approach suggested herein is intended to be embodied in a document which would supersede the Exposure Draft even if not actually as a final Interpretation. It would consist of identification of an "Excluded Category" of SPEs through application of very narrowly-focused criteria. The latter would not be based on operations of the SPE or assets held by it, as appears to be the case of the Exposure Draft. Instead, those criteria would be based on structure of the SPE and the corresponding implications on principles of control. The proposed alternate approach eliminates the incentive of special interests to carve out a niche for certain SPEs utilized by them the latter apparently not always contemplating universal application of the analytical justification offered for doing so.

The proposed alternate approach would also recognize, however, that a "one size fits all" formulation of an Excluded Category would not reflect the reality of the extensive reach of flexibility in structuring SPEs. It does that by adding a "fail safe" examination of instances in which an SPE might not meet the strict criteria of the Excluded Category but nonetheless have inherent and immutable indicia conclusively demonstrating that the SPE is free-standing in fact and not legitimately deemed to be an indistinguishable component of a single business such that consolidation would be merited.

The analytical integrity of the alternate approach is completed with recognition that there cannot be inconsistent applications of separate statements of accounting standards which comprise GAAP without necessarily undermining the credibility of GAAP.

D. COMPONENTS OF A PROPOSED ALTERNATE APPROACH

The following components of the alternate approach are designed with a view toward maintaining a rigorous and constant focus on the principles set forth in Section B and the practical application of them within the standards set forth in Section C.

9 Conceptually, a "variable interest" would arise out of, or in connection with, every commercial contract entered into by any entity. In such instances, there is always a "risk of loss" to a contracting party quite apart from any for which there might be a remedy for breach: a hoped-for strategic benefit not otherwise contained within the negotiated terms of the contract. When that "benefit" is not actually obtained, the contracting party simply negotiated a bad deal. That does not make the "variable interest" nature of such contract in any sense an "investment" but that also is a presumption inherent in the Exposure Draft. See, Paragraph 18 thereof: "Variable interests generally subject the holder to a risk of losing an investment in the SPE or incurring a loss as a result of a contingent obligation ...." [emphasis added].

10 Note that this proposal is based on a presumption that the final Interpretation will include the following characteristics as discussed in the morning session of the Roundtable: (1) it will contain a specific definition of SPE, (2) it will contain a specific definition of "substantive operating entity" ("SOE"), (3) neither such definition will be based on the other but each will be mutually exclusive with the other, and (4) both definitions together will cover all parties which might be subject to consolidation requirements under ARB 51.
1. Create an immediately-recognized Excluded Category\textsuperscript{11} into which SPEs fulfilling such criteria of appropriate structure and independence (and only such SPEs) will fall — and thus will continue to receive the same accounting treatment as previously used.

SPEs meeting the criteria specified in this component 1 of the alternate approach would be excluded from the consolidation requirements set forth in a final form of the Interpretation. The basis of that exclusion would be having demonstrated (by meeting all of the following indicia) actual free-standing status beyond the "control" of any party of group of them acting as a single enterprise:

(a) The SPE has legal existence, recognized as a juridical entity under the laws of the jurisdiction under which it was formed.

(b) At least ten percent (10\%) of the SPE's reasonably foreseeable total capital requirements would be in the form of invested capital which would be (1) fully subordinate to all indebtedness and to liabilities of the SPE arising out of its operations (collectively, "Debt"), (2) limited with respect to any distributions by the SPE pursuant to the laws of the jurisdiction under which it was formed unless/until standards set forth in such laws regarding financial adequacy in comparison to existing Debt have been met, and (3) the interest representing such investment of capital is specifically recognized as such within the statutory provisions under which the SPE was formed (including, if applicable, in organic documents as specifically authorized in such statutory provisions). The capital investment meeting such standards would be "Equity" for purposes of financial reporting analysis and the holder(s) thereof deemed to be the "Equityholder."\textsuperscript{12}

(c) The Equityholder does not otherwise have any financial interest in the SPE (including, without limitation, separate contractual right of payment for services) in addition to holding such Equity.

(d) Title to the assets held by the SPE is isolated from the risk of bankruptcy of any party other than the SPE and the liabilities of the SPE are isolated from any other party in the event of bankruptcy of the SPE.

Any SPE with the following characteristics will not be eligible for treatment under this Excluded Category: one formed by or at the direction of any party (a "Sponsoring Party") which, in such formation, satisfies the Equity requirement through one or more party who is employed by, controlled by, or under common control or ownership with, such Sponsoring Party.

\textsuperscript{11} It might be more informative to refer to this as a "safe harbor" but that term has taken on its own meaning and even a life of its own in the context of deliberation on the issue of SPE capitalization and solely for that reason is not utilized here.

\textsuperscript{12} In essence, this formulation would replace the "equity interest in legal form" concept currently set forth in response to Question 8 of EITF 96-21. See, separate letter of the undersigned to Ms. Suzanne Bielstein dated September 26, 2002, regarding the inherent dissonance between legal and accounting concepts in use of the "equity interest in legal form" term.
2. Provide limited categories of principles-based exceptions for which otherwise non-conforming SPEs and/or transactions can demonstrate appropriate qualification.

An SPE (and/or transactions involving one, including those involving a "virtual" SPE) not falling into the Excluded Category will nonetheless not be subject to the special SPE consolidation requirements of an Interpretation of ARB 51 if it satisfies any of the following very limited exemptions:

(a) Fails to qualify for the Excluded Category solely for failing to meet the 10% Equity test. The SPE may offer objective and quantifiable evidence that the amount of Equity actually invested is sufficient to fund all reasonably expectable capital requirements of operation, in which case a lower amount may be permitted. If the SPE issues debt which is rated "investment grade" or better by a nationally-recognized credit rating agency and which is not otherwise included in the "Equity" category, there shall be a conclusive presumption that the SPE has met the requirements of this exemption.

(b) Fails to qualify for the Excluded Category solely by virtue of the Equityholder also having another separate financial interest in the SPE. The SPE and the Equityholder must demonstrate that the financial benefit from that separate interest is shared on the same basis by other non-related parties, is less than 20% of the total of such other financial benefit, and is not the largest single portion of such interest. Alternatively, the SPE and/or the Equityholder may demonstrate that such financial interest does not grant to the Equityholder any indicia of "control" of the SPE which is not fully subsumed within, and made redundant by, its holding of the Equity interest.

(c) Fails to qualify for the Excluded Category solely by virtue of the fact that the SPE is not a separately-recognized juridical entity (i.e., a "virtual SPE"). The entity within which such "silo" exists must demonstrate that the provisions establishing and recognizing the "silo" insulation under the laws pursuant to which such provisions were created will also treat the assets contained within such "silo" as having been isolated from the risk of bankruptcy of any party (including the party within which the "silo" resides) and the liabilities allocated into such "silo" are isolated from any other party in the event of any claim against the assets thus held within such "silo."

(d) Other limited situations in which the separate legal "legal entity" requirement is met but not the "Equity" requirement. The SPE will be exempt if it is able to demonstrate that (1) the Equityholder (or, if there is none, the holder of a majority of the "variable interests") is an SOE as that term is to be defined, title to the assets held by the SPE is isolated from the risk of bankruptcy of any

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13 As thus formulated, this would essentially permit an Equityholder to provide debt financing in addition to providing Equity but only in a manner which prevents sweetheart terms for such Debt from essentially offsetting otherwise artificially meaningless financial interests of the Equity itself.

14 See, separate letter of the undersigned to the Members of the Board dated October 9, 2002, with respect to a definition of SPE which does not automatically sweep all nonprofit organizations into it and a definition of SOE which could encompass such organizations within it.
party other than the SPE and the liabilities of the SPE are isolated from any other party in the event of bankruptcy of the SPE, and (3) the assets and liabilities of the SPE are nonetheless reflected on the financial statements of the SOE in a manner which does not impair the "bankruptcy remote" status required in order to satisfy the condition set forth in clause (2) of this Section 2 (d).

3. **Specify scope exceptions based upon compliance with and appropriate satisfaction of other Statements of Financial Accounting Standards which remain unchanged by an Interpretation of ARB 51 and for other limited reasons.**

The scope of the Interpretation would not extend to the following SPEs:

(a) those holding legal title to property and leasing it to another party pursuant to contractual arrangements meeting the requirements of an "operating lease" under SFAS 13 and accounted for accordingly, but solely with respect to such property and lease and to such interests of other parties in and to either;

(b) those satisfying the requirements for being a "Qualifying SPE" under SFAS 140, but solely with respect to activities specifically covered by SFAS 140 and permitted by it to such QSPEs;

(c) those for which an obligation or undertaking subject to the provisions of a final Interpretation on guarantees 15 might otherwise qualify as a "variable interest," but only to the extent that complying with the disclosure requirements of that Interpretation would remove the SPE from the scope of the final Interpretation or ARB 51; and

(d) those for which consolidation by another party would result in such other party being in violation of any applicable law or regulation by so doing, or such other party having received a written legal opinion that such consolidation would present a substantial risk that such other party could ultimately be held to be in such violation and potentially be subject to monetary penalties as a result -- in either of which cases, the SPE then being obligated to reflect such fact in its own financial statements, and such other party then being obligated to disclose in its own financial statements, the apparent conflict between the Interpretation and such law or regulation.

4. **Immediate but potentially interim treatment of all other SPEs (including "virtual" SPEs).**

All SPEs which do not otherwise qualify for exclusion from the consolidation requirements of the final Interpretation pursuant to the tests set forth in components 1, 2 or 3 of this alternate approach would be subject to such consolidation on the following principles:

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15 See, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Guarantees of Indebtedness of Others -- an Interpretation of FASB Statements No. 5, 57, and 107 (Proposed Interpretation)", an Exposure Draft issued by the FASB on May 22, 2002, and for which the comment period expired on June 21, 2002.
The holder of a majority of all voting rights of an SPE will be required to consolidate that SPE unless another entity is shown to have a majority of all "variable interests," and by virtue thereof has actual control of the SPE, in which case such other entity will be required to consolidate that SPE.

If there are no substantively meaningful voting rights with respect to an SPE (or the interests embodying such voting rights not actually held by any party), the holder of a majority of all "variable interests" in that SPE will be required to consolidate that SPE unless another entity is shown to have a "variable interest" of any size which by virtue of such holding grants the latter actual control of the SPE, in which case such latter entity will be required to consolidate that SPE.

A determination with respect to the party required under the Interpretation to consolidate the SPE will be made upon consummation of the transaction utilizing the SPE and creating the "variable interest." Such determination will not be subject to change thereafter unless and until there has been a change of status of such consolidating party and/or its holding of voting or "variable interest" in the SPE, which, by virtue of actions taken by another party, results in such other party acquiring voting control of an SPE in which there are substantively meaningful voting rights or otherwise gaining actual control of the SPE through acquisition of other "variable interests."

All parties having any "variable interest" in an SPE which are otherwise not obligated under the Interpretation to consolidate such SPE will be obligated to disclose such interest in its financial statement in a manner consistent with that to be specified by the Securities and Exchange Commission pursuant to the Sarbanes-Oxley Act of 2002, irrespective of whether any such party is otherwise subject to the reporting requirements of the Securities Exchange Act of 1934, as amended.

5. Future exclusion of additional SPEs and/or transactions covered by item 4.

The Interpretation should explicitly acknowledge that the Board and the FASB staff will continue examining specific forms of SPEs and/or their operations which fall within item 4 but may ultimately be determined not to be suitable candidates for consolidation by any other party. Such acknowledgment should, however, articulate the principles to be applied in making such determination (e.g., those set forth in Section B hereof or similar ones of corresponding nature).

As an initial matter, this would enable the process to go forward in developing a suitable structure for FSPEs without holding up the process while the details of that are being developed and agreed upon. One Board Member in effect invited the Participants in the morning session of the Roundtable to come up with a structure which effectively covers all SPEs which disperse risk without recourse to its owners rather than (as currently provided in the Exposure

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See, letter of the undersigned to Ms. Suzanne Bielstein dated September 26, 2002 (re "Nexus of Accounting and Legal issues") for reasons which it would be appropriate to eliminate the category of "de facto agency relationship" from the list of elements comprising a "variable interest" for purposes of the interpretation of ARB 51. If the alternate approach proposed herein is adopted and the concept of "de facto agency relationship" eliminated, all of the issues of potential conflict set forth in that letter will have been resolved.
Draft) focusing on the nature of assets held by the SPE and the manner in which they are held. It is reasonable for Participants to assume that such offer was not an empty gesture, but it is also reasonable that the process not be held up while the details of that are being addressed.

Given the wide range of ways in which SPEs are formed and/or operate, the Interpretation should also recognize that similar efforts would be appropriate even in situations where the SPE is not an FSPE. One highly-specialized area which may require such separate attention would be with respect to SPEs used in connection with derivatives and swaps if the provisions of components 1, 2 and/or 3 above do not otherwise adequately provide for them. Participants at the Roundtable particularly interested in such SPEs have demonstrated that they could also fall into a category of legitimacy but at the same time involve highly specialized considerations which have virtually no applicability to the "plain vanilla" form of SPE. The process needs to include an opportunity to demonstrate the former but at the same time the requirements to address the latter should not have the effect of holding other situations for ransom. It does not seem that there is any interest of such Participants to do the latter but a tremendous amount of desire to do the former. That should be a very valuable resource to the Board.

E. RATIONALE AND JUSTIFICATION

The Board has no doubt spent enough time and energy in development of the Exposure Draft as to have some amount of initial commitment to the approach taken by it. That would be fully understandable. Even were that not a basis for discounting consideration of the alternate approach set forth herein, as a matter of intellectual honesty it would still be fully appropriate for Members of the Board to poke and probe the proposed alternative with a goal of testing its viability. For that reason or otherwise, there could be any number of questions the Board might need to raise. Unfortunately, I cannot predict what all of those might be and address them here in advance. Indeed, even addressing a sampling of potential concerns could well dilute attention paid to the proposal for simple length of the letter submitting it. On the other hand, my goal actually is to foster successful completion of the process and for that reason I address a sampling of what I would assume to be the more significant issues in the separate Attachment A hereto.

In light of the significance of the "bankruptcy remote" concept and the role it plays in justifying exclusion from a consolidation system, also set forth in the separate Attachment B hereto is a general description of various structural factors considered by a bankruptcy court in reaching a conclusion on such status.

I hope that the foregoing has not unrealistically imposed on what certainly is limited and valuable time of the Board Members. I am, of course, prepared to be of whatever assistance may be determined by Board Members to be useful in bringing this project both to the correct place analytically and to conclusion. The alternate approach set forth in this letter is intended to provide a mechanism whereby "getting it right" and "getting it done" are not mutually exclusive.

I understand that in the process leading up to issuance of the Exposure Draft one or more interim and preliminary versions of it were circulated to members of the Emerging
Issues Task Force for comment. I further understand that the normal procedure leading up to adoption of a final Interpretation would include circulation to those members of a nearly-final version for purposes of identifying any "fatal flaws" to it. Regardless of whether the proposed alternate approach is ultimately incorporated to any extent in the final Interpretation, I would be pleased to participate in any further comment process (formal or informal) and specifically would appreciate being included in a "fatal flaw" circulation or any other circulation of an interim draft even earlier than that. Indeed, the Board may well wish to consider expanding the "fatal flaw" circulation to at least all of the Participants in the Roundtable and potentially to all parties who submitted Letters of Comment on the Exposure Draft.

Very truly yours,

Steven K. Hazen

See Attachment C hereof which is a Distribution List for other Participants, as known, or in lieu thereof Other Parties having submitted a Letter of Comment on the Exposure Draft.
ATTACHMENT A

Additional Matters of Justification and Rationale

The following correspond to the numbered components of the proposed alternate approach as set forth in Section D of the letter to which this is attached.

1. "Excluded Category"

   The focus of ARB 51 is control. The principle behind consolidation must continue to be based on that concept in order to avoid what was humorously (but usefully) described in the morning session as "willy-nilly consolidation." The approach of the Exposure Draft is based on the assumption that, in the absence of characteristics satisfying "voting interest" analysis, the mere presence of a "variable interest" reflects "control." Given that the "voting interest" analysis excludes only SPEs which have widely-held voting securities (probably an oxymoron), the Exposure Draft is thus effectively based on a non-stated conclusion that all SPEs should be consolidated with someone, even if the fundamental concept of actual control is absent. That is looking through the wrong end of the telescope. The proposed alternate approach starts with a recognition that it applies only to SPEs but does not apply to those SPEs which are structured as actually free-standing entities which are not dependent on, or subject to, unilaterally imposed and exercised control by any other party or group of parties themselves under common control with each other.

   Although there may be instances in which control might be assumed, the entity structure set forth in component I of the proposed alternate approach is clearly not one of them. In all scenarios involving the elements set forth therein, the ultimate negotiation of transaction terms will be conducted at arms'-length by parties having dissonant interests. If the result of that is a capital structure which does not seem to grant "a controlling financial interest," the Equityholder has made a free determination that the anticipated return on the Equity invested is suitable for its purposes -- essentially the definition of a free and transparent market transaction. If the free market recognizes such party as the Equityholder, what benefit is served by having utilizing a different approach for accounting purposes. Doing so would risk presentation which would be informative to the market and investors, not more.

   Note that the only real "abuse" identified in the press or public hearings regarding use of SPEs was the almost "alter ego" way in which the Sponsoring Party treated the SPE but did so to the separate benefit of persons other than the shareholders of the Sponsoring Party, persons who themselves nonetheless had some variant of a fiduciary obligations to those shareholders. The exclusionary paragraph at the end of the litany of required features is designed to keep this Excluded Category from such use and abuse.

1 Be that actual or virtual, but not to SOEs -- and only as the two terms are defined.
2 Note that this term has two insurmountable defects. First, it is ambiguous in not being clear as to whether the "control" component of it relates to "interest" or the "financial" nature of that interest. Second, if (as it appears to be used in the Exposure Draft) it is the latter, it also essentially begs the question of control by asserting that a "financial interest" by its nature constitutes "control" but otherwise neither makes a showing of that or articulates a standard why which such "control" is determined and subsequently measured. Both problems would be eliminated if the concept of "controlling financial interest" either were defined to mean an interest which evidences control and has a financial component, or were simply restated that way.
3 And, not coincidentally, the law.
4 See, Letter of Comment No. 36 from Senator Carl Levin.
The structure of analysis set forth in the alternate approach also makes it completely unnecessary to create the new concept contained in the Exposure Draft of "first dollar loss." While interesting, that phrase has the built-in ambiguity as to "first among whom" and then essentially begs the question by making it "first, period" quite apart from whether the compared parties are in any sense part of the legally-recognized capital structure of an entity. Virtually all business enterprises routinely enter into contracts which seek to allocate such losses as between the parties based not on the capital structure of either party much less any sense of "control" by one party over the other. The examination can only have relevance to consolidation if made explicitly and solely with respect to funds actually brought into the entity as a formal part of such capital structure. Among other things, it is only the latter which the state laws governing operations of commercial enterprises require be examined in determining whether a distribution can be made to Equityholders -- and that will not change even if the Exposure Draft were adopted in its current form.

This component of the proposed alternate approach is based on the assumption that the Exposure Draft legitimately contemplates that it would apply only to "certain" SPEs and not to all of them. The justification for such assumption (apart from the words themselves and even the apparent framework of the Exposure Draft) relies heavily on the underlying principle of consolidation: existence of an actual "single business enterprise" in which the consolidating party exerts actual "control" over the consolidated party. It is not at all clear, however, from the Exposure Draft whether there would ever be a non-consolidated SPE as both the "voting interest" the "variable interest" tests as currently written could have the result of driving the SPE into the financial statements of some party unless the Equity of the SPE were held so broadly as eliminate any "control." If so, the result would be to exempt only those SPEs which could do the greatest amount of damage to the greatest number of investors. That is presumably not what was intended by the FASB in developing the Exposure Draft.

2. **Specific Criteria for Exclusion of Otherwise Non-Conforming SPEs**

In all cases, the focus must continue to be on actual control. Each of the special cases set forth in this component of the proposed alternate approach examines the absence of a particular element otherwise defining the Excluded Category and identifies ways in which its absence would not defeat a conclusion that the SPE is nonetheless free-standing and removed from either dependency on or actual control by another party. By way of example, item (b) in this component would permit an Equityholder also to loan funds to the SPE on terms demonstrating arms'-length negotiation.

There may be other ways to accomplish the same standard of analysis pursuant which "control" is not assumed when the absence of its actual existence can otherwise be shown. In any event, there must always be a means built into any final Interpretation for defeating any presumption of consolidation if the "control" element on which it is based can be demonstrated not to exist in fact. The limited additional "exemptions" set forth in this component are designed to recognize that and specify a method for testing it.

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5 The Exposure Draft fails to make legitimate distinction between strategic purposes for negotiation contractual relationships and "investments." See, text and note of footnote 9 of the letter to which this is attached.

6 See, Section B of the letter to which this is attached.
3. Scope Exceptions for Compliance with Other GAAP Provisions / Avoiding Conflicts within GAAP.

There is no way to get around the fact that the Exposure Draft in its current form purports only to be an "interpretation" of ARB but as a practical matter either modifies or otherwise vitiates the relevance of test specified in other GAAP provisions. By way of example, a lease which would be deemed under the Exposure Draft to be a "variable interest" rendering the lessee as the "primary beneficiary" of the SPE could not simultaneously be an "operating lease" for purposes of SFAS 13 instead of a "capital lease" even though the lease might clearly satisfy the conditions of SFAS 13 for treatment as the former.

Similarly, there is no way to get around the fact that the Exposure Draft in its current form would have the effect of depriving certain SPEs the status provided under SFAS 140 as a Qualifying SPE. A similar situation could easily arise in the future if the final Interpretation of treatment of "guarantees" specifies accounting treatment which would otherwise be followed with respect to non-consolidated SPEs but the final Interpretation of ARB 51 utilized exactly the same characteristics of the SPEs obligations to reach a conflicting result.

An argument could be made for exempting the foregoing categories of SPEs from the coverage of a final interpretation of ARB 51. Unfortunately, doing so would then focus on the operations and assets of the applicable SPE instead of its structure and the implications thereof on whether the SPE is truly independent. For that reason, the proposed alternate approach would simply exclude from the scope of a final Interpretation of ARB 51 those SPEs for which fundamental principles contained in such final Interpretation would be in inherent conflict with other provisions of GAAP.


The idea behind the proposed alternate approach is to utilize the structure of the Exposure Draft but only in those situations which do not fall into components 1, 2, or 3 of the alternate approach. I have not attempted to re-write the Exposure Draft with that in mind and recognize that doing so would have its own challenges. I would, of course, be happy to submit for consideration a draft Interpretation as it would look utilizing the alternate approach and coordinating into it the "primary beneficiary" components of the Exposure Draft as thus applicable. I will not, however, undertake that effort unless and until I receive confirmation that such effort could be productive in facilitating the Board's efforts in a manner which would be desirable to it.

The justification for "immediacy" as set forth in this component 4 of the proposed alternate approach must be self-evident. If not, I will note here that the purpose is to create sufficient certainty in this area as to permit a long-immobilized capital formation process to be put back to work. That cannot, however, occur at the expense of unnecessarily and even improperly denying such market access to legitimate and defensible transactions structures.

The "snapshot" approach to applying the standard recognizes that the goal should be to achieve not only comparability as between separate entities in the same business but also within an entity on a period-to-period basis.

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7 As noted earlier, one change which would be required to avoid conflict between the accounting and legal disciplines would be to eliminate the "de facto agency relationship" concept from the elements comprising "variable interest." See, footnote 16 of the letter to which this is attached.
5. **An Ongoing Process.**

There almost certainly will be transactions and SPE structures which require much greater detail in examination and analysis than could effectively be done without impeding clarifications of a more generic nature on a timely basis. The question for the Board would be whether to defer applicability to such structures/transactions or to sweep them into the general rule on a temporary basis unless covered by the provisions of components 1, 2, or 3 of the proposed alternate approach. The proposed approach has the latter mechanism built into it for the policy reason referenced above as to period-to-period basis, but I acknowledge that an argument could be made that the reverse approach would also have that effect.
SPEs which issue debt instruments either rated by a national credit rating agency or serving as the underlying security for other debt thus rated must often demonstrate to the satisfaction of such rating agency that the SPE is a "bankruptcy-remote entity." Even when such rating is not obtained, that also may be required by parties investing Equity in the SPE or extending credit to it. In either case, that condition is frequently satisfied by the SPE delivering a legal opinion to the requesting party on that issue.  

Such status is impacted by two separate analyses:

1. the risk of bankruptcy of the SPE in conducting the business specified for it in the transaction involving such debt or investment, and

2. the risk that the assets of the SPE would be subjected to "substantive consolidation" with those of another entity which might become bankrupt.

As a practical matter, the rating agencies, creditors and investors are able to assess that risk as it applies to the SPE and its intended operations. They recognize that no legal opinion could be rendered that the SPE would, in fact, never become insolvent by virtue of its own operations. Instead, those parties look exclusively to the question of the potential for "substantive consolidation" of the SPE for purposes of insolvency proceedings involving another entity.

Substantive consolidation is a judicially-created doctrine arising from the general equity powers granted to federal bankruptcy courts. Under the doctrine of "substantive consolidation," a bankruptcy court may, if appropriate circumstances are determined to exist, consolidate the assets and liabilities of different entities by merging the assets and liabilities of the entities and treating the related entities as a consolidated entity for purposes of the bankruptcy proceeding. Substantive consolidation can be used with similar effect to extend the debtor's bankruptcy proceeding to include within the debtor's estate the assets of a related entity which is not a debtor in a case under the Bankruptcy Code.

Given that the power to order substantive consolidation derives from the equity jurisdiction of the bankruptcy courts, the issue is determined on a case-by-case basis and the decisions reflect the courts' analysis of the particular factual circumstances presented. A court's inquiry requires an examination, inter alia, of the corporate structures of the entities proposed to be consolidated, their inter-corporate relationships, and their relationships with their respective creditors and other third parties. Since the doctrine of substantive consolidation is an equitable one, the courts will also examine, inter alia, the impact upon the creditors of each entity if consolidation were to be ordered, and whether such parties would be unfairly prejudiced or be treated more equitably by substantive consolidation. The case law indicates a general recognition that substantive consolidation is an extraordinary remedy vitally affecting substantive rights which, due to the potential inequities caused because consolidation almost

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1 As that term is defined in the letter to which this is attached.

2 The description contained in this Attachment is provided solely for convenience of the Members of the Board in illustrating the extremely focused nature of criteria set forth in components 1 and 2 of the proposed alternate approach. Neither this Attachment nor the letter to which it is attached constitutes a legal opinion on federal laws (including insolvency law) or on the laws of any state governing the formation and operation of SPEs and may not be relied upon as such by any recipient hereof, intended or otherwise.
invariably redistributes wealth among the creditors of consolidated entities, should only rarely be
granted.

Substantive consolidation was accomplished in early cases by "piercing the
corporate veil" of the debtor, i.e., by finding that the entity with which consolidation was sought
was the "alter-ego" or an "instrumentality" of the debtor which was used by the debtor to hinder,
delay or otherwise defraud creditors. Although later cases relaxed the requirement of fraud, in
certain circumstances courts will still pierce the corporate veil to effect a substantive
consolidation if fraud or similar activity is present. In cases involving the consolidation of
corporate entities, however, courts generally have recognized that the comparison of substantive
consolidation and corporate veil piercing is not particularly suitable. Consequently, modern
federal courts have increasingly looked to federal bankruptcy law precedent rather than state
corporate law doctrine when ruling on substantive consolidation motions.

Circumstances where substantive consolidation has been ordered include cases
where it can be shown that one or more entities are "mere instrumentalities" or "alter egos" of
another entity. This has occurred under a variety of factual patterns. In 1940, the United States
Circuit Court of Appeals for the Tenth Circuit\(^3\) set forth the following list of factors\(^4\) to be
considered in determining whether one entity is a "mere instrumentality" of another:

1. The parent corporation owns all or a majority of the capital stock of the subsidiary.
2. The parent and subsidiary corporations have common directors or officers.
3. The parent corporation finances the subsidiary.
4. The parent corporation subscribes to all the capital stock of the subsidiary or otherwise
   causes its incorporation.
5. The subsidiary has grossly inadequate capital.
6. The parent corporation pays the salaries or expenses or losses of the subsidiary.
7. The subsidiary has substantially no business except with the parent corporation or no
   assets except those conveyed to it by the parent corporation.
8. In the papers of the parent corporation, and in the statements of its officers, "the
   subsidiary" is referred to as such or as a department or division.
9. The directors or executives of the subsidiary do not act independently in the interest of
   the subsidiary, but take direction from the parent corporation.
10. The formal legal requirements of the subsidiary as a separate and independent
    corporation are not observed.

In addition, courts have ordered substantive consolidation where
interrelationships among entities have become hopelessly obscured and there would be great
difficulty and expense in separating the assets, liabilities and businesses of the entities so that
separate administration would not be practicable. A decision of the United States Court of

\(^3\) Fish v. East, 114 F.2d 177, at 191.
\(^4\) Frequently cited subsequently by other courts, to the point of being something of a "lode stone" component
    of analysis.
Appeals for the Second Circuit\(^5\) summarizes the key factors as (i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit,\(^6\) or (ii) whether the affairs of debtors are so entangled that consolidation will benefit all creditors.

The "mere instrumentality" and "hopelessly obscured" cases comprise the bulk of the reported decisions considering substantive consolidation. Nonetheless, some courts have also ordered substantive consolidation where consolidation would enhance the debtors' chances of successful reorganization. The courts in those cases have, however, emphasized the absence of any harm or prejudice to any particular group, or have concluded, after considering the equities, that any harm or prejudice is outweighed by the benefits of substantive consolidation.

In the context of the foregoing, it must be readily apparent that the process of achieving "bankruptcy-remote" status and satisfying the conditions imposed in demonstrating it are quite rigorous. Equally relevant to the proposed alternate approach set forth in the letter to which this is attached, the steps required to do so demonstrate that the SPE actually is free-standing and not "dependent" on or actually "controlled by" any other entity, as consolidation for financial reporting purposes would otherwise indicate. Consolidation in such circumstances would at best be inappropriate under existing standards of ARB 51 and SFAS 94 and at worst be both misleading and false.

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\(^6\) This concept would be particularly problematic if triggered solely by virtue of consolidation for financial reporting purposes. See, letter to Ms. Suzanne Bielstein dated September 26, 2002, re "Nexus of Accounting and Legal Issues."
ATTACHMENT C

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