

Financial Accounting Standards Board Russel G. Golden, Technical Director

Regarding: Par. 14B of Statement 133 Due 2-13-09

File Reference: C22

From: Dr. Joseph S. Maresca CPA, CISA

Colleagues,

Thank you for the opportunity to critique Par 14B of Statement 133 together with the illustrative examples.

GENERALLY, the Statement describes certain exceptions related to embedded derivatives. Guidance is provided on how to determine which embedded derivative features are considered not to be embedded derivatives to be analyzed under Par 12,13 and 14A for bifurcation and separate accounting treatment. (AMENDS 14B of Statement 133)

Embedded derivative features related only to the concentration of credit risk in the form of subordination of one financial instrument to another shall not be considered an embedded derivative subject to Par 12, 13 and 14A. Those embedded derivative features don't have to be considered for bifurcation and separate accounting. P. 3 of 6

Other embedded credit derivative features on some CDO and synthetic CDO instruments are embedded derivatives subject to a Par 12, 13 and 14A analysis of whether or not the economic characteristics and risks of embedded derivative features are related to the economic characteristics and risks of the host contract provided that contract is not a derivative in its entirety under Par. 6 Apparently, the embedded derivative provisos of Par 12,13 abd 14A do not apply to a contract meeting the definition of a derivative in its entirety. More specificity could be provided here.

Example 35 describes dollar denominated float rate interest issued by the SPE holding Yen Float Rate Bonds and matching cross-currency swaps to pay Yen and get dollars because the economic characteristics and risks of the embedded derivative feature(s) are closely related to the host. The example describes a concentration of risk in the form of subordinating one form of financial instrument to another; thereby making the transaction not subject to bifurcation and separate accounting under Par 12, 13 and 14A.

Although the transaction may not be subject to the bifurcation and separate accounting under Par. 12, 13 and 14A, the current environment is favorable to currencies like the Yen and unfavorable to the British Pound. In addition, there are major market gyrations which follow the trend of the Yen as a lead indicator for purposes of intermarket analyses. Ultimately, the accountant is most interested in which party bears the risk of loss and whether or not the initial assessment of risk of loss may be reversible by a Court of law.

The Sixth Circuit Court of Appeals interpreted the duties imposed on banks that market derivative products and rejected a universal duty of appropriateness. Instead, the Court reasoned; thusly, "Let the buyer beware." The Sixth Circuit determined that there is no specific duty of appropriateness deriving from any longstanding legal authority or stare' decisis. Therefore, swaps are "principal to principal"

transactions and end users must obtain their own independent advisors to assist in the evaluation of the proposed transactions.

Ultimately, the best recourse for the accountant and client organization is to draw "air tight" agreements spelling out the rights, duties, obligations, remedies and legal Court jurisdictional venues for derivative-type transactions. The accountant must consider the VIX index of market variability, currency moving averages on the major markets and an intermarket analyses in some specific instances. Accountants are not investment advisors per se. Having said that, the accountant must be mindful of extreme gyrations in key markets at the interim period or at year end prior to the issuance of the client financial statements.

Power and Telephone Supply Co. v. SunTrust Banks, Inc. 2006 U.S. App. LEXIS 12087, 2006 FED App. 166P (6th Circuit TENN. 2006)

Power and Telephone entered into interest rate swap agreements in 1999 and 2000 with SunTrust. fixing a part of its variable rate indebtedness. The swaps were favorable to Power and Telephone until interest rates experienced a dramatic drop from 2000-2002.

Power and Telephone's borrowing needs decreased, and the company unwound the swaps in 2003. Subsequently, Power and Trust filed a complaint against SunTrust seeking millions in damages and claims on theories of breach of fiduciary duties, misrepresentation of material facts and negligence. Ultimately, the Sixth Circuit affirmed the District Court's summary judgment dismissing all claims against the Sun Trust Bank.

There are some important exceptions to the general rule.

Example 36 describes variable rate interest in SPEs holding fixed rate bonds and matching pay fixed Receivable Variable Interest Rate swaps not having embedded derivatives requiring a bifurcation under Par 12, 13 and 14A because the economic characteristics and risks of an embedded derivative feature is similar to the economic characteristic and risks of the host contract.

If the notional amounts of fixed rate bonds and variable interest rate swaps are unmatched thereby creating the possibility that the financial instrument held by the SPE might not provide the necessary cash flows to the swap counterparty, the variable rate interest provision must be evaluated for an embedded derivative under Par 13 because the underlying transaction contains an interest rate or interest rate index. I concur.

P. 38 describes securitization which introduces new credit risk since the cash flows are related to changes in credit risk and aren't present in the financial instrument held by the SPE. Beneficial interests are a hybrid with an embedded derivative which is subject to Par 12, 13 and 14A. I concur.

Partially funded CDO instruments have tranches which expose investors to potential payments related to default on written credit default swaps containing embedded derivatives subject to the application of Par. 12, 13 and 14A provided that the investor's overall contract is not a derivative in its entirety. Par 6 of Statement 133. I concur.