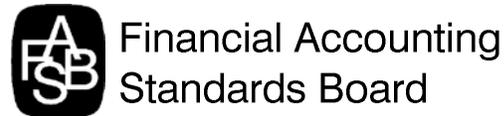


MINUTES



To: Board Members
From: Schonefeld, ext. 442
Subject: Minutes of the June 3, 2009
Board Meeting: Embedded
Credit Derivative Scope Exception
Date: July 28, 2009
cc: FASB: Golden, Bielstein, Lott, Stoklosa, Proestakes, Wilkins,
Laungani, Posta, Chookaszian, Gabriele, Huydic, Derivatives
Implementation Team, Glotzer, C. Smith, Mechanick, Maroney,
Malcolm, Ampofo, Sanguiolo, Finden, McGarity, FASB Intranet
IASB: Leisenring

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement, Interpretation, or FASB Staff Position.

Topic: Statement 133 Implementation Issue No. C22,
"Exception Related to Embedded Credit
Derivatives"

Basis for Discussion: Board Memorandums No. 7 and No.8

Length of Discussion: 9:00 a.m. to 9:50 a.m.

Attendance:

Board members present: Herz, Linsmeier, Seidman, Siegel, and Smith

Board members absent: None

Other participants: Leisenring (IASB)

Staff in charge of topic: Wilkins

Other staff at Board table: Golden, Stoklosa, Maroney, Laungani, and
Schonefeld

Summary of Decisions Reached

The Board approved clarifications to proposed Statement 133 Implementation Issue No. C22, "Exception Related to Embedded Credit Derivatives." That proposed Implementation Issue addresses the scope exception in paragraph 14B of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, which indicates that the concentration of credit risk that is only in the form of subordination of one financial instrument to another should be considered an embedded derivative feature that is not subject to the application of paragraphs 12 and 14A of Statement 133. The Board agreed that the scope exception in paragraph 14B should apply only to the credit derivative features that arise between tranche holders of beneficial interests and that are related to the credit loss allocation among the tranches attributable to the subordination of one tranche to another.

The Board also decided to provide additional guidance about the application of paragraphs 12, 13, and 14A of Statement 133 to the embedded derivative features in the examples in the proposed Implementation Issue C22.

The Board decided to re-expose the revised proposed Implementation Issue C22 for a 45-day comment period. The effective date of the revised proposed Implementation Issue C22 will be the first day of each reporting entity's first fiscal quarter beginning after December 15, 2009.

The Board directed the staff to proceed to a draft of the revised proposed Implementation Issue C22 for vote by written ballot.

Objectives of Meeting

The purpose of this meeting was to discuss the following issues:

1. The application of paragraphs 12, 13, and 14A of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, to the credit derivative features embedded in beneficial interests in securitized financial assets.
2. The breadth of the subordination-related scope exception in paragraph 14B for multi-tranche structures of beneficial interests in securitized financial assets. The discussion of this issue considered the approach for analyzing a beneficial interest (hybrid instrument) in applying paragraph 14A.
3. The need for re-exposure of proposed Statement 133 Implementation Issue No. C22, "Exception Related to Embedded Credit Derivatives."
4. The effective date and transition provisions for Implementation Issue C22.

Matters Discussed and Decisions Reached

Issue 1: Application of Paragraphs 12, 13, and 14A

1. Mr. Wilkins noted that a proposed Implementation Issue C22 was issued in January of 2009 in order to clarify the application of the embedded credit derivative scope exception in paragraph 14B of Statement 133, as amended by FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*. He stated that, in consideration of the comment letters received at the March 2009 Board meeting, the Board decided that further guidance should be added to the January 2009 proposed Implementation Issue to describe the applications of paragraphs 12, 13, and 14A of Statement 133 to determine whether to bifurcate an embedded derivative and account for it separately as a derivative instrument.
2. Mr. Wilkins stated that the Board had an Education Session on April 16, 2009 to discuss the application of paragraphs 12, 13, and 14A of Statement 133. As a result of the Education Session, the staff decided to provide, as

an attachment to the handout for today's Board Meeting (see Appendix A), a series of examples explaining the application of the clearly and closely related notion as discussed by the Board at the Education Session. Mr. Wilkins also stated that the Board has been provided with a draft of the proposed Implementation Issue marked up for modifications to the examples to provide guidance on applying the clearly and closely related notion in Statement 133.

Staff Recommendation

3. The staff recommended that the Board concur with the staff's modifications to the examples in the proposed Implementation Issue and the staff's analysis and conclusions in the examples included in the attachment to the Board handout (see Appendix A).

Board Comments

4. Ms. Seidman stated that she agreed with the conclusion reached by the staff as to whether there is an embedded derivative that is clearly and closely related to the host contract in almost every example in Appendix A. However, she stated she would use a different approach to evaluate the hybrid instruments and determine the host contract than the approach used by the staff. She stated that she would identify the beneficial interest as the hybrid instrument because it is the instrument that potentially has variable cash flows. Therefore, she stated that in almost every securitization, she would identify a debt host. She stated that she would then evaluate whether the variable cash flows are related to the debt host by looking through the securitization vehicle to see if the risks within the entity are consistent with the risks of the beneficial interest and the cash flows are adequate to satisfy the contractual terms of the beneficial interest.

5. Mr. Smith stated that he does not understand why Ms. Seidman would conclude that there is no embedded derivative in a trust that holds U.S. Treasuries and a credit default swap referenced to XYZ Corporation (similar to example 8A in Appendix A). Mr. Linsmeier stated that he believes Ms. Seidman concludes that there is no embedded derivative in that particular scenario because Ms. Seidman is assuming that U.S. Treasuries do not have credit risk. Mr. Linsmeier disagrees with the notion that U.S. Treasuries have no credit risk.
6. As an example to illustrate her approach to evaluate if there is an embedded derivative requiring bifurcation, Ms. Seidman stated that if a beneficial interest is linked to the credit of XYZ Corporation, but the assets within the entity are ABC debt securities, she would find that the credit risk associated with ABC Corporation is not clearly and closely related to the credit risk associated with XYZ Corporation. Therefore, the beneficial interest has an embedded derivative that requires bifurcation and separate accounting. Ms. Seidman further stated that even if the cash flows match, since the risks are unrelated, an embedded derivative must exist.
7. Mr. Golden stated that he is troubled by Ms. Seidman's approach when he considers a scenario where the trust only holds derivatives and the beneficial interest holder is entitled to net cash flows. Using Ms. Seidman's approach, Mr. Golden believes that no embedded derivatives requiring bifurcation would exist.
8. Ms. Seidman believes there are two ways of approaching the clearly and closely related analysis: (a) starting with the beneficial interest or (b) starting with the instruments held in the trust. Ms. Seidman stated that the staff is starting the analysis by looking at the instruments held in the trust first and that this approach is new and inconsistent with current examples in

Statement 155 and Issue B12. She stated that Issue B12 explained that if the assets in the trust are debt securities, the hybrid is considered to have a debt host. Mr. Wilkins stated that Issue B12 was never finalized. Mr. Linsmeier stated that the thought process in an Issue that was not finalized should not be considered for this proposed Implementation Issue.

9. Mr. Stoklosa clarified that the staff is also starting its analysis with the beneficial interest but that the staff's analysis does not differ based on whether the hybrid instrument is part of a trust or outside a trust (for example, a credit-linked note).
10. Mr. Golden stated using Ms. Seidman's approach would allow entities to circumvent accounting for derivatives by putting them in a trust and issuing beneficial interests. Ms. Seidman stated that she believes that the staff's purpose is to prevent circumvention of derivative accounting by entities putting derivatives in a trust. She believes that there would be no need for embedded derivatives guidance if that was the purpose. The Board could just require all beneficial interest holders to look into the trust and account for all the derivatives held by the trust, whether the derivatives are interest rate, currency, or credit related.
11. Mr. Leisenring stated that the International Accounting Standards Board (IASB) is waiting for the FASB to make a decision on this issue because the IASB expects that U.S. generally accepted accounting principles (GAAP) will move closer to International Financial Reporting Standards (IFRS) as a result of the decisions on this Issue. However, he stated that if the Board agrees with Ms. Seidman's conclusion on Example 8A (no embedded derivative requiring bifurcation), then the IASB will have additional pressure to converge with the FASB as GAAP would require fewer embedded derivatives to be bifurcated than IFRS.

12. Mr. Leisenring suggested solving the convergence issue by requiring all beneficial interests to be recognized at fair value.
13. Mr. Linsmeier stated that the Board needs to decide whether it prefers the staff's approach, which provides symmetry in the analysis of non-structured instruments and structured instruments, or Ms. Seidman's approach, which maintains consistency for all securitization structures whether they have credit risk or other risks.
14. Ms. Seidman agreed with the direction of the staff's analysis of the examples in Appendix A. She stated that she believes the staff's approach is moving towards her expectations of the Board decisions related to embedded derivatives as part of the Financial Instruments: Recognition and Measurement project, which is that instruments with variable cash flows may be required to be carried at fair value.

Board Vote

15. The Board decided to provide additional guidance about the application of paragraphs 12, 13, and 14A of Statement 133 to the embedded derivative features in the examples in the proposed Implementation Issue C22 consistent with the staff's analysis of similar examples in Appendix A.

Issue 2: Breadth of the Subordination-Related Scope Exception

16. Mr. Wilkins stated that the discussion at the April 16, 2009 Education Session revealed a difference in views between the Board and the staff regarding the application of paragraph 14B. Mr. Wilkins stated that the staff believed that the Board's intention was that when the concentration of credit risk that is only in the form of subordination is embodied in the waterfall provisions, which control distributing all aspects of credit risk, the paragraph

14B scope exception applies not only to the embedded credit derivative features related to the credit loss allocation among the tranche holders, but also to all other embedded credit derivative features (such as a written credit default swap) within the structure whose cash flow effects are also controlled by the waterfall provisions. He stated that the Board members pointed out to the staff that they wanted the scope exception to apply only to the embedded credit derivatives between the tranche holders related to subordination. He said that, in other words, the Board members stated that if the entity contains a derivative that, absent the subordination, would be bifurcated, it should still be bifurcated and accounted for separately.

17. Mr. Wilkins stated that the staff agrees with the Board's narrower application of the scope exception. He also stated that the comment letter process highlighted that entities were applying the scope exception even to single-tranche structures, which do not contain subordination.
18. Mr. Wilkins referred the Board to Example 9 in Appendix A to illustrate the difference in views. He asked the Board to assume that the trust in Example 9 issues three tranches (A, B, and Z) of beneficial interests. Mr. Wilkins stated that each of the tranches have three embedded credit derivative features: one embedded credit derivative feature related to the tranche's portion of the credit default swap held by the trust and two implicit purchased or written credit default swaps related to the subordination. He stated that the waterfall provisions effectively allocate all credit losses (for both the ABC debt securities and the written CDS on XYZ securities) first to Tranche Z then to Tranche B and last to Tranche A. Mr. Wilkins stated that under this example, the staff's analysis of the application of paragraph 14B is that none of the three embedded credit derivative features in each of the tranches is subject to potential bifurcation because all three features constitute a concentration of credit risk that is only in the form of subordination due to the

fact that the waterfall provisions control all aspects of distributing the effects of the features' credit risk. In contrast, Mr. Wilkins stated that the Board's view of the application of paragraph 14B is that only the two implicit embedded credit derivative features that were written or purchased by another tranche related to the subordination are not subject to potential bifurcation because those two features qualify for the paragraph 14B scope exception. However, under the Board's view, the credit default swap held by the trust would not qualify for the paragraph 14B scope exception and would warrant bifurcation and separate accounting.

19. Mr. Wilkins pointed out that each tranche holders' fair value for the bifurcated credit default swap would be affected by the waterfall provisions even though there is no bifurcation and separate accounting for the embedded credit derivative features related to the credit loss allocation among the tranche holders because each tranche's fair value is affected by the expected future cash flows related to that credit default swap that are allocated based on the waterfall provisions.

Staff Recommendation

20. Although the staff had initially recommended the expanded scope exception, the staff supports a narrower scope exception which would apply only to the embedded credit derivative features between the tranche holders related to subordination.

Board Comments

21. Mr. Leisenring stated that the difference between the staff's initial view and the Board's view is important to the IASB because the Board's understanding is consistent with the IASB's. However, he also stated that IFRS and GAAP are still not fully converged because of the FASB's

bifurcation requirement in the event beneficial interest holders need to contribute additional cash to the trust.

Board Vote

22. The Board agreed with the staff recommendation that the scope exception in paragraph 14B should apply only to the credit derivative features that arise between tranche holders of beneficial interests and that are related to the credit loss allocation among the tranches attributable to the subordination of one tranche to another.

Issue 3: The Need for Re-Exposure

Staff Recommendation

23. Mr. Wilkins stated that because significant guidance regarding the application of paragraphs 12, 13, and 14A of Statement 133 is being added to proposed Implementation Issue C22, the staff is recommending that the document be re-exposed.

Board Comments

24. Mr. Smith stated that the new exposure document would need to be issued in the new Codification update format. Mr. Wilkins agreed. Mr. Golden and Mr. Wilkins suggested a 30-day comment period.
25. Mr. Wilkins stated that the new exposure draft would probably be ready for issuance by the middle of July. Mr. Smith stated that considering that the exposure draft will be released in July and Codification will be new to constituents, more than a 30-day comment period may be required. Mr. Smith suggested a 60-day comment period.

Board Vote

26. The Board decided to re-expose Implementation Issue C22 with a 45-day comment period.

Issue 4: Effective Date

Staff Recommendation

27. Mr. Wilkins stated that some respondents to the proposed Implementation Issue suggested delaying the effective date to provide entities with sufficient time to dispose of their investments in actively-managed collateralized debt obligations due to the difficulty in identifying embedded derivatives requiring bifurcation. He stated the entities have a choice of using the fair value option instead of disposing of their investments.
28. The staff recommended that the effective date for the revised proposed Implementation Issue C22 be the first day of each reporting entity's first fiscal quarter beginning after November 15, 2009.

Board Comments

29. Mr. Golden proposed a December 15 effective date. Mr. Herz stated that he was unsure if there were broker dealers affected by this project that have fiscal years ending November 31. He stated that he would prefer that this guidance be effective this year for those broker dealers.

Board Vote

30. The Board decided that the effective date of the revised proposed Implementation Issue C22 should be the first day of each reporting entity's first fiscal quarter beginning after December 15, 2009, subject to research

regarding whether many preparers most affected by the project have fiscal years ending November 31.

Follow-up Items

None.

General Announcements

None.

Attachment to the Board Handout: Chart Illustrating the Application
of Paragraphs 12 and 14A

Contract Structure	Perceived Host and Embedded Feature	Clearly & Closely Related?
<p><u>Example 1: No Trust Structure — Credit Sensitive Payments</u> ABC issues a fixed-rate debt whose interest rate resets in the event of (1) default (such as violation of a credit-risk-related covenant), (2) a change in the debtor’s published credit rating, or (3) a change in the debtor’s creditworthiness indicated by a change in its spread over Treasury bonds. (Example from FAS 133, ¶61(c))</p>	<p><u>Host:</u> a debt obligation that requires ABC to make fixed periodic interest payments based on the fixed interest rate <u>Embedded Derivative Feature:</u> a derivative that contingently calls for future cash inflows or outflows based on occurrence of any of the three credit risk factors listed.</p>	<p>Yes. Paragraph 61(c) of Statement 133 states that “The creditworthiness of the debtor and the interest rate on a debt instrument are considered to be clearly and closely related.”</p>
<p><u>Example 2: No Trust Structure — Corporate Credit-Linked Note</u> ABC issues a fixed-rate, 10-year, \$10 million credit-linked note with periodic interest payments and repayment of principal at maturity, but upon default of the specified reference security (an XYZ subordinated debt obligation), the redemption value of the note is zero. (Example from Implementation Issue B36)</p>	<p><u>Host:</u> fixed-rate, 10-year, \$10 million credit-linked note <u>Embedded Derivative Feature:</u> purchased derivative that effectively provides cash inflows based on an occurrence of default by XYZ</p>	<p>No. Issue B36 states, “if an instrument incorporates a credit risk exposure that is different from the risk exposure arising from the creditworthiness of the obligor under that instrument, such that the value of the instrument is affected by an event of default or a change in creditworthiness of a third party (that is, an entity that is not the obligor), then the economic characteristics and risks of the embedded credit derivative are not clearly and closely related to the economic characteristics and risks of the host contract, even though the obligor may own securities issued by that third party.”</p>

Attachment to the Board Handout: Chart Illustrating the Application
of Paragraphs 12 and 14A

Trust Components for Beneficial Interest	Perceived Host and Embedded Feature	Clearly & Closely Related?
<p><u>Example 3: Trust with Single Tranche Structure — Holds Fixed-Rate Bonds and a Matching Pay-Fixed, Receive-Variable Interest Rate Swap</u> The Trust issues variable-rate beneficial interests.</p>	<p><u>Host:</u> the investment in fixed-rate bonds <u>Embedded Derivative Feature:</u> the matching pay-fixed, receive-variable interest rate swap</p>	<p>Yes. The economic characteristics and risks of the embedded credit derivative feature are clearly and closely related to the economic characteristics and risks of the host contract, consistent with paragraphs 2 and 3 of Memorandum 7.</p>
<p><u>Example 4: Trust with Single Tranche Structure — Holds Yen-Denominated Floating-Rate Bonds and a Matching Cross-Currency Swap to Pay Yen and Receive Dollars</u> The Trust issues dollar-denominated floating-rate beneficial interests.</p>	<p><u>Host:</u> the investment in yen-denominated floating-rate bonds <u>Embedded Derivative Feature:</u> the matching cross-currency swap to pay yen (based on the yen-related floating rate) and receive dollars (based on the dollar-related floating rate)</p>	<p>Yes. The economic characteristics and risks of the embedded credit derivative feature are clearly and closely related to the economic characteristics and risks of the host contract, consistent with the comments in paragraphs 2 and 3 of Memorandum 7 regarding matching interest rate swaps and matching currency swaps.</p>
<p><u>Example 5: Trust with Single Tranche Structure — Holds Investment in Fixed-Rate ABC Debt Securities and a Purchased Credit Default Swap (CDS) on the Same Securities</u> The Trust issues fixed-rate beneficial interests. The CDS counterparty will make a payment to the Trust to replace any scheduled contractual payment not made to the Trust by ABC.</p>	<p><u>Host:</u> investment in the fixed-rate ABC corporate debt securities <u>Embedded Derivative Feature:</u> the purchased CDS that provides future replacement cash inflows in the event that ABC fails to make any scheduled contractual payments</p>	<p>Yes. The economic characteristics and risks of the embedded credit derivative feature are clearly and closely related to the economic characteristics and risks of the host contract because the purchased credit risk protection in the derivative complements (that is, offsets) the credit risk exposure in the host contract.</p>
<p><u>Example 6: Trust with Single Tranche Structure — Holds Investment in Fixed-Rate ABC Debt Securities and a Written Credit Default Swap on the Same Amount of the Same Debt Securities</u> The Trust issues beneficial interests entitling holders to receive net cash inflows received by the trust. If ABC defaults on its debt, the Trust will need to make payments to its counterparty under the CDS. The investors in those beneficial interests could potentially be required to make additional payments to the Trust to enable it to pay the CDS counterparty.</p>	<p><u>Host:</u> investment in the fixed-rate ABC corporate debt securities <u>Embedded Derivative Feature:</u> the written CDS that may require future cash outflows in the event that ABC fails to make any scheduled contractual payments</p>	<p>No. The economic characteristics and risks of the embedded credit derivative feature are not clearly and closely related to the economic characteristics and risks of the host contract because the written CDS exacerbates (that is, doubles) the ABC credit risk exposure in the host contract.</p>

Attachment to the Board Handout: Chart Illustrating the Application of Paragraphs 12 and 14A

Trust Components for Beneficial Interest	Perceived Host and Embedded Feature	Clearly & Closely Related?
<p><u>Example 7: Trust with Multiple Pari Passu Tranche Structure — Holds Investment in Fixed-Rate ABC Debt Securities and a Written Credit Default Swap on the Same Amount of the Same Debt Securities</u> <i>(Same instruments in the trust as in Example 6)</i></p> <p>The Trust issues multiple tranches of beneficial interests entitling holders to receive net cash inflows received by the trust. Each tranche ranks pari passu with the other tranches. If ABC defaults on its debt, the Trust will need to make payments to its counterparty under the CDS. The investors in those beneficial interests could potentially be required to make additional payments to the Trust to enable it to pay the CDS counterparty.</p>	<p><u>Host:</u> investment in the fixed-rate ABC corporate debt securities</p> <p><u>Embedded Derivative Feature:</u> the written CDS that may require future cash outflows in the event that ABC fails to make any scheduled contractual payments</p>	<p>No. The economic characteristics and risks of the embedded credit derivative feature are not clearly and closely related to the economic characteristics and risks of the host contract because the written CDS exacerbates (that is, doubles) the ABC credit risk exposure in the host contract.</p> <p>Because the Trust issued multiple-tranche pari-passu beneficial interests, the scope exception in paragraph 14B would not apply because the pari passu provisions of the multiple tranches involve no subordination of one tranche to another.</p>
<p><u>Example 8: Trust with Single Tranche Structure — Holds Investment in ABC Debt Securities and a Written Credit Default Swap (CDS) on Debt Securities Issued by XYZ</u></p> <p>The Trust issues beneficial interests entitling holders to receive net cash inflows received by the trust. If XYZ defaults on its debt, the Trust will need to make payments to its counterparty under the CDS.</p>	<p><u>Host:</u> investment in the ABC corporate debt securities</p> <p><u>Embedded Derivative Feature:</u> the written CDS that may require future cash outflows in the event that XYZ fails to make any scheduled contractual payments</p>	<p>No. The economic characteristics and risks of the embedded credit derivative feature (based on XYZ’s credit risk) are not clearly and closely related to the economic characteristics and risks of the host contract (ABC’s securities) because of the difference in risk exposures between the host contract and the embedded derivative feature.</p> <p>The analysis is the same whether or not the investors in those beneficial interests could potentially be required to make additional payments to the Trust to enable it to pay the CDS counterparty.</p>

Attachment to the Board Handout: Chart Illustrating the Application
of Paragraphs 12 and 14A

Trust Components for Beneficial Interest	Perceived Host and Embedded Feature	Clearly & Closely Related?
<p><u>Example 8A: Trust with Single Tranche Structure — Holds Investment in U.S. Treasury Securities and a Written Credit Default Swap (CDS) on Debt Securities Issued by XYZ</u> The Trust issues beneficial interests entitling holders to receive net cash inflows received by the trust. If XYZ defaults on its debt, the Trust will need to make payments to its counterparty under the CDS.</p>	<p><u>Host:</u> investment in the U.S. Treasury securities <u>Embedded Derivative Feature:</u> the written CDS that may require future cash outflows in the event that XYZ fails to make any scheduled contractual payments</p>	<p>No. The economic characteristics and risks of the embedded credit derivative feature (based on XYZ's credit risk) are not clearly and closely related to the economic characteristics and risks of the host contract (U.S. Treasury securities) because of the difference in risk exposures between the host contract and the embedded derivative feature. The analysis is the same whether or not the investors in those beneficial interests could potentially be required to make additional payments to the Trust to enable it to pay the CDS counterparty.</p>
<p><u>Example 9: Trust with Multiple-Tranche Structure and Subordination — Holds Investment in ABC Debt Securities and a Written Credit Default Swap (CDS) on Debt Securities Issued by XYZ</u> The Trust issues two tranches (a senior and a junior) of beneficial interests entitling holders to receive net cash inflows received by the trust. If XYZ defaults on its debt, the Trust will need to make payments to its counterparty under the CDS. Credit losses are allocated to the junior tranche, which must be exhausted before credit losses are allocated to the senior tranche. However, none of the investors in the beneficial interests for any tranche could potentially be required to make additional payments to the Trust to enable it to pay the CDS counterparty.</p>	<p><u>Host:</u> investment in the ABC corporate debt securities <u>Embedded Derivative Features:</u> (1) the written CDS that may require future cash outflows in the event that XYZ fails to make any scheduled contractual payments (2) the credit derivative related to the credit loss allocation between the tranches</p>	<p>Not applicable. The scope exception in paragraph 14B would apply because the multiple-tranche structure with subordination involves the concentration of credit risk that is only in the form of subordination of one financial instrument to another. Therefore, the embedded derivative features (for both credit aspects) are not subject to the application of paragraphs 12 and 14A of Statement 133. (The above guidance reflects the staff's understanding. Under the attending Board members' view in ¶5 of Memorandum 8, the scope exception in paragraph 14B would not apply to the written CDS.)</p>

Attachment to the Board Handout: Chart Illustrating the Application
of Paragraphs 12 and 14A

Trust Components for Beneficial Interest	Perceived Host and Embedded Feature	Clearly & Closely Related?
<p><u>Example 10: Trust with Multiple-Tranche Structure and Subordination — Holds Investment in ABC Debt Securities and a Written Credit Default Swap (CDS) on Debt Securities Issued by XYZ</u></p> <p>The Trust issues two tranches (a senior and a junior) of beneficial interests entitling holders to receive net cash inflows received by the trust. If XYZ defaults on its debt, the Trust will need to make payments to its counterparty under the CDS. Credit losses are allocated to the junior tranche, which must be exhausted before credit losses are allocated to the senior tranche. However, the investors in the beneficial interests for each of the two tranches could potentially be required to make additional payments to the Trust to enable it to pay the CDS counterparty.</p>	<p><u>Host:</u> investment in the ABC corporate debt securities</p> <p><u>Embedded Derivative Features:</u></p> <p>(1) the written CDS that may require future cash outflows in the event that XYZ fails to make any scheduled contractual payments</p> <p>(2) the credit derivative related to the credit loss allocation between the tranches</p>	<p>No. The economic characteristics and risks of the embedded CDS derivative feature (based on XYZ's credit risk) are not clearly and closely related to the economic characteristics and risks of the host contract (ABC's securities) because of the difference in risk exposures between the host contract and the embedded derivative feature.</p> <p>Similarly, economic characteristics and risks of the embedded credit-loss-allocation derivative feature (with losses from the senior tranche's portion of trust instruments allocated first to the junior tranche) are not clearly and closely related to the economic characteristics and risks of the host contract (with respect to each tranche) because of the difference in risk exposures between the host contract and the embedded derivative feature.</p> <p>The scope exception in paragraph 14B would not apply to the two embedded credit derivative features because the multiple-tranche structure with subordination involves the concentration of credit risk that is not only in the form of subordination of one financial instrument to another due to the potential for investors to be required to make future payments.</p>