

MINUTES



To: Board Members

From: Statement 140 Amendment Team
(Stell, ext. 211)

Subject: Minutes of the September 24, 2003 Board Meeting **Date:** September 30, 2003

cc: Bielstein, Smith, Petrone, Leisenring, Project Team, Mahoney, Thompson, Vincent, Sutay, Gabriele, Swift, Polley, FASB Intranet (e-mail)

Topic: Qualifying Special-Purpose Entities:
Issues Related to Legal Isolation,
Transferor Restrictions, and Equity
Instruments

Basis for Discussion: Board memorandums 5, 6, 7, and 8
dated September 12, 2003

Length of Discussion: 9:20 a.m. to 11:05 a.m.

Attendance:

Board members present:	Herz, Trott, Schipper, Batavick, Crooch, Seidman, and Schieneman
Board members absent:	None
Staff in charge of topic:	Lott and Donoghue
Other staff at Board table:	Smith, Lusniak, and Stell
Outside participants:	None

Summary for ACTION ALERT:

The Board continued its redeliberations of the issues addressed by FASB Exposure Draft, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets*, and reached the following decisions.

1. The legal isolation requirements would be applied only to those affiliates included in the consolidated financial statements in which a transferor is reporting the results of a transfer. In some circumstances, the accounting for a transfer in the financial statements of a parent company would be different from the accounting in the separate financial statements of a subsidiary.
2. *Reissuance of beneficial interests* would be defined as the issuance of beneficial interests to provide cash or assets with which to repay existing beneficial interests held by parties other than the transferor.
3. In the case of a qualifying special-purpose entity (SPE) that reissues beneficial interests, no party should be permitted to hold combinations of rights and obligations that provide it with an opportunity to obtain more than a trivial incremental benefit as compared to similar rights and obligations held by separate parties. (This decision will be discussed further at the October 1, 2003 Board meeting.)
4. A qualifying SPE would be prohibited from holding equity instruments, unless they are received as a result of efforts to collect its financial assets.
5. The definition of *equity instrument* would be the same as the one in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, but the word *security* would be replaced with *instrument*.

The Board also discussed the types of derivatives a transferor could enter into and support commitments that a transferor could provide but reached no decisions. Further discussion on these topics is planned for a subsequent Board meeting.

Matters Discussed and Decisions Reached:

The following paragraphs summarize the discussion at the September 24, 2003 Board meeting. The discussion is grouped by topic.

Legal Isolation

The Board discussed which affiliates of the transferor the requirements for legal isolation should apply to and evaluated the following alternatives:

- All affiliates, including brother-sister entities not included in the consolidated financial statements of the transferor
- Only those affiliates included in the consolidated financial statements in which the transferor is reporting the results of the transfer.

The Board members unanimously agreed that the legal isolation requirements should be applied only to those affiliates included in the consolidated financial statements in which the transferor is reporting the results of the transfer; however, several Board members made additional comments. Mr. Trott stated that the final Statement should clearly state that if a transferor and its parent prepare separate consolidated financial statements, a true sale opinion for the transferor would not necessarily apply to the consolidated financial statements of the parent company. Both Ms. Seidman and Ms. Schipper suggested that the Statement remind transferors to consider whether related party disclosures should be made in connection with a transfer to an affiliate or to a third party with support from an affiliate.

Support Commitments and Derivatives Provided by a Transferor

The Board discussed whether transferors should be permitted to provide certain types of support commitments to qualifying SPEs. The commitments discussed included guarantees of the collectibility of assets, guarantees of the payment of liabilities, and liquidity commitments. The Board also discussed the possibility of not placing any restrictions on the transferor other than the legal isolation requirement if the qualifying SPE does not reissue beneficial interests; however, no decisions were made. The Board also discussed scenarios in which a

transferor provided guarantees to beneficial interest holders to determine whether the legal isolation requirements would serve as an adequate restriction and noted that more research would have to be performed by the staff before a decision could be made. The Board tabled the issue until the next meeting.

Board members also discussed whether transferors should be permitted to enter into derivatives with qualifying SPEs. The staff presented the following alternatives:

A qualifying SPE should be allowed to hold

- Passive derivatives that cannot require the transferor to provide additional assets
- Derivatives with no customized features, such as interest rate swaps based on market indices
- Derivatives with terms and conditions that are the same as those that would have been agreed to with third parties
- Any derivatives that are currently permitted
- No derivatives.

The staff recommended that the Board not prohibit any derivatives that are currently permitted. Board members expressed their concern with total return swaps (or a combination of interests that effectively function as a total return swap) and noted that such derivatives could effectively function as a guarantee of the payment of the liabilities of a qualifying SPE. The staff noted that it would be fairly easy to prohibit total return swaps, but nearly impossible to prohibit combinations of interests that function as total return swaps, and recommended that no such prohibition be made. One Board member noted that a comment letter was received outlining suggested amendments for addressing total return swaps and that the Board needed time to consider those suggestions more fully. The staff added that total return swaps became an issue because of transfers of equity securities, which would be prohibited in the Exposure Draft.

The Board also discussed whether any restriction on total return swaps should apply to all SPEs or just to qualifying SPEs. Ms. Seidman asserted that if the requirement was applied broadly, then the notion of effective control would need to be reconsidered. The Board did not reach a decision and directed the staff to be prepared to discuss the issue at the next meeting.

Qualifying SPEs That Reissue Beneficial Interests

The Board discussed how reissuance of beneficial interests should be defined. Board members agreed with the staff's recommendation that *reissuance* be defined as the issuance of beneficial interests to provide cash or assets with which to repay existing beneficial interests held by parties other than the transferor. The Board also agreed that issuances from master trusts (revolving structures) would not be considered reissuances as long as the newly-issued beneficial interests represented a reduction in the transferor's retained interest.

Ms. Seidman stated that the Board's intentions related to master trusts should be discussed in the basis for conclusions. All Board members agreed.

The Board also discussed whether qualifying SPEs that reissue beneficial interests should be subject to the following special limitations:

- Reissuance should be prohibited
- The requirement in paragraph 35(b) is sufficient (the activities of a qualifying SPE should be significantly limited and entirely specified)
- Reissuance should be limited to beneficial interests with specified ranges of terms to maturity
- Reissuance of beneficial interests should be subject to limits similar to the limits on sale of assets in paragraph 35(d)
- No party should be permitted to hold combinations of rights and obligations that provide more than a trivial incremental benefit as compared to similar rights and obligations held by separate parties.

The staff recommended that no party be permitted to hold combinations of rights and obligations that provide more than a trivial incremental benefit as compared

to similar rights and obligations held by separate parties. Board members agreed with that principle but raised additional concerns.

Mr. Trott recommended that a qualifying SPE always be disqualified if a party that provides liquidity also makes decisions or provides credit support. Ms. Seidman disagreed and recommended that existing guidance be reinforced rather than placing more restrictions on qualifying SPEs. Mr. Crooch stated that it would be difficult for a party to compare its rights and obligations to those held by separate parties, and he suggested that the principle be reworded to prohibit a single party from holding a combination of rights and obligations that would provide it with an *opportunity* to obtain more than a trivial incremental benefit. The Board members unanimously agreed with that suggestion.

Equity Instruments

The Board reaffirmed the proposal in the Exposure Draft to prohibit qualifying SPEs from holding equity securities and discussed the following potential exceptions:

- Temporary investments in money-market fund shares of cash collected pending distribution to beneficial interest holders
- Temporarily, equity instruments obtained as a result of efforts to collect other financial assets
- Temporarily, equity investments in entities that isolate from the qualifying SPE assets obtained as a result of efforts to collect financial assets
- Equity instruments that have redemption or maturity dates, for example, mandatorily redeemable preferred stock and other financial assets with embedded equity features, for example, convertible bonds
- Equity-form beneficial interests issued by other SPEs that hold only assets that are permitted assets of qualifying SPEs.

Board members unanimously agreed to make exceptions to the prohibition for the first two types of temporary equity investments (as listed above). The third type was considered to be only a subset of the second type and need not be

mentioned separately. The remaining two types of investments would not be exceptions.

The Board also discussed how the phrase *equity instrument* should be defined. They considered the following alternatives:

- Equity instruments should not be defined; instead, the Statement should refer to the definition of equity securities in Statement 115.
- Equity instrument should be defined using a definition similar to that in Statement 115, but the word *security* should be replaced with *instrument*.
- The definition of equity instrument or equity security should include convertible debt and preferred stock that by its terms either must be redeemed by the issuing enterprise or is redeemable at the option of the investor, both of which are specifically excluded from the definition of equity securities in Statement 115.

The Board agreed with the staff's recommendation that *equity instrument* should be defined using the definition in Statement 115, except that the word *security* would be replaced with *instrument*.

Follow-up Items:

None.

General Announcements:

None.