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Financial Accounting Series

EXPOSURE DRAFT

Proposed Statement of Financial Accounting Standards

Qualifying Special-Purpose Entities and Isolation of Transferred Assets

an amendment of FASB Statement No. 140

This Exposure Draft of a proposed Statement of Financial Accounting Standards is issued by the Board for public comment. Written comments should be addressed to:

Director of Technical Application and Implementation Activities
File Reference No. 1200-001

Comment Deadline: July 31, 2003

Financial Accounting Standards Board
of the Financial Accounting Foundation

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Summary

This proposed Statement would amend and clarify FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, in several ways. This proposed Statement would prohibit an entity from being a qualifying special-purpose entity (SPE) if it enters into an agreement that obligates a transferor, its affiliates, or its agents to deliver additional cash or other assets to fulfill the SPE's obligations to beneficial interest holders (except certain servicing advances and forward contracts to transfer additional financial assets). For example, a qualifying SPE would not be permitted to enter into the following arrangements with a transferor, its affiliates, or its agents:

a. A liquidity commitment, financial guarantee, or other commitment to deliver additional cash or other assets to the SPE or its beneficial interest holders to fulfill the SPE's obligations to its beneficial interest holders
b. A total return swap, other derivative instrument, or other arrangement requiring delivery of assets to a qualifying SPE.

In addition, this proposed Statement would prohibit a qualifying SPE that can reissue beneficial interests from holding liquidity commitments, financial guarantees, or other commitments that entitle it to receive assets in addition to the original transfer if necessary to fulfill obligations to beneficial interest holders unless:

a. No party (including affiliates or agents) provides a commitment with a fair value that is more than half the aggregate fair value of all such commitments.
b. No party (including affiliates or agents) that makes decisions about reissuing beneficial interests provides such a commitment.
c. No party (including affiliates or agents) that holds beneficial interests that are not the most senior in priority provides such a commitment.

Finally, this proposed Statement also would:

a. Require that a two-step transfer used to achieve legal isolation from transferred assets involve a qualifying SPE as the second step if the result of the transfer is issuance of beneficial interests (whether in the form of securities or other undivided interests)
b. Prohibit a qualifying SPE from holding equity instruments
c. Clarify that if a qualifying SPE holds financial assets that will not liquidate under their contractual terms before the termination of the entity, the method and time of disposal or other liquidation must be specified at the date the SPE receives the assets
d. Clarify that assets transferred to any entity, whether or not it is a qualifying SPE, may not be derecognized unless they are isolated from all members of the consolidated group that includes the transferor, except for certain bankruptcy-remote entities.

Reasons for Issuing This Proposed Statement

Statement 140 does not specify the powers of a qualifying SPE to reissue beneficial interests. Although the Emerging Issues Task Force added the issue to its agenda, it did not reach a consensus on those questions. FASB Interpretation No. 46, *Consolidation of Variable Interest Entities,* focused more attention on reissuance of beneficial interests because it included an exception for qualifying SPEs, and that exception created an incentive to convert certain entities to qualifying SPEs to avoid consolidation. Together, those factors caused the Board to undertake a project on the permitted activities of qualifying SPEs. As the project progressed, the Board decided that other aspects of Statement 140 required clarification or amendment.

How This Proposed Statement Would Improve Financial Reporting

The changes and clarifications in this proposed Statement would achieve two objectives. First, they would prevent derecognition by transferors that may continue to retain effective control of transferred assets by providing financial support other than a subordinated retained interest or making decisions about beneficial interests. Second, they would help to ensure that SPEs will not qualify for the exception to Interpretation 46 if any party involved is in a position to enhance or protect the value of its own subordinated interest by providing financial support for or making decisions about reissuing beneficial interests.

Because this proposed Statement does not require entities to gather new information or make additional estimates or assumptions, the incremental costs of implementing the amendments are minimal. However, enterprises may incur costs if they choose to restructure existing entities to avoid recognizing assets or consolidating variable interest entities.

The Effective Date of This Proposed Statement

For public entities, this proposed Statement would apply prospectively to transfers of assets occurring after the beginning of the first interim period after the issuance of the final Statement. For private entities, it would apply prospectively to transfers of assets occurring after the beginning of the first annual period after the issuance of the final Statement.

A formerly qualifying SPE that fails to meet one or more of the conditions for being a qualifying SPE as amended by this proposed Statement would continue to be considered a qualifying SPE if it maintains its qualifying status under previous accounting standards, does not issue new beneficial interests after the effective date of the final Statement, and does not receive assets other than those it was committed to receive (through commitments to beneficial interest holders unrelated to the transferor) under arrangements made before the effective date of the final Statement.

Proposed Statement of Financial Accounting Standards

Qualifying Special-Purpose Entities and Isolation of Transferred Assets

an amendment of FASB Statement No. 140

June 10, 2003

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INTRODUCTION

1. FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* among other things, establishes the conditions an entity must meet to be a qualifying special-purpose entity (SPE) and establishes isolation of transferred assets as a condition for derecognition of the transferred assets.

2. This Statement amends the conditions for a qualifying SPE in Statement 140 to (a) limit the relationship of a transferor (and its affiliates and agents) with a qualifying SPE, (b) prohibit any party from being in a position to enhance or protect the value of its own interest in a qualifying SPE by providing financial support for or making decisions about reissuing beneficial interests, (c) prohibit a qualifying SPE from holding equity instruments, and (d) clarify the requirements related to instruments with maturities after the termination date of the entity. This Statement also provides that if the result of a transfer is issuance of beneficial interests (whether they are securities, undivided interests, or in some other form), a transferor has not surrendered control of transferred assets in a two-step transfer (used to achieve legal isolation) unless the second step involves a qualifying SPE. Finally, this Statement clarifies that to qualify for derecognition, transferred assets must be isolated from all entities in the consolidated group that includes the transferor, except for certain bankruptcy-remote entities.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendments to Statement 140

3. Paragraph 9(a) is replaced by the following:

> The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any **consolidated affiliate of the transferor** that is not a special-purpose corporation or other entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraphs 27, 28, and 83(c)).

4. Paragraphs 35(c)(1)–35(c)(3) are replaced by the following:

> c. It may hold only:
> (1) Financial assets transferred to it that are not equity instruments and that are passive in nature (paragraph 39)

(2) Passive **derivative financial instruments** entered into with counterparties other than the transferor, its affiliates, and agents that pertain to beneficial interests (other than another derivative financial instrument) issued or sold to parties other than the transferor, its affiliates, or its agents (paragraphs 39 and 40)

(3) Financial assets (for example, guarantees or rights to collateral) that would reimburse it if others were to fail to adequately service financial assets transferred to it or to timely pay obligations due to it, that it entered into when it was established, when assets were transferred to it, or when beneficial interests (other than derivative financial instruments) were issued by the SPE, and that are entered into with certain parties. The limitations on the permissible counterparties to these financial assets are discussed in paragraphs 35(e) and 35(f).

5. The following subparagraphs are added after paragraph 35(d):

e. It may not enter into an agreement (other than a forward contract in a revolving period securitization as discussed in paragraphs 77–79) with a transferor, its affiliates, or its agents that commits any of those parties to deliver additional cash or other assets to the SPE or its BIHs.[*] That prohibition applies to liquidity commitments, financial guarantees, written options, and other arrangements with the SPE as well as commitments to purchase outstanding beneficial interests directly or indirectly from the beneficial interest holders or to otherwise settle beneficial interests with their holders. It also applies to total return swaps and any other derivative instruments that may require delivering additional financial assets. It applies even if the commitment is contingent or conditional, whether the contract is settled net or gross, whether the settlement is current, deferred, or prepaid, and regardless of the relationship of the notional amount of the instrument, if any, with the face amount or value of the transferred assets.

f. If it has the ability to reissue beneficial interests, the following additional limitations apply:

(1) No party (including affiliates or agents) enters into a commitment (or commitments) to deliver additional cash or other assets to fulfill the SPE's obligations to BIHs if that commitment has (or those commitments have) a fair value that is more than half the aggregate fair value of all such commitments to the SPE.

(2) No party (including affiliates or agents) both makes decisions[†] about reissuing beneficial interests and either enters into a commitment (or commitments) to deliver additional cash or other assets to fulfill the SPE's obligations to BIHs or holds beneficial interests other than the most senior in priority.

(3) No party (including affiliates or agents) that holds beneficial interests other than the most senior in priority enters into a commitment (or commitments) to deliver additional cash or other assets to fulfill the SPE's obligations to BIHs.

[*]This prohibition does not include a commitment for servicing advances if the servicer can choose not to make the advance if it believes recovery of the advance from collections on the assets of the SPE is in doubt.

[†]For this purpose, the term *decisions* implies discretion. The ability or responsibility to take action does not imply decision making for purposes of this Statement if the party taking the actions has no discretion.

6. The second sentence of paragraph 39 is deleted.

7. The first sentence of paragraph 45 is replaced by the following:

> A qualifying SPE may have the power to dispose of assets to a party other than the transferor, its affiliate, or its agent on termination of the SPE or maturity of the beneficial interests, but only automatically on fixed or determinable dates that are specified at inception in a manner specified at inception.

8. The following sentence is added at the end of paragraph 45:

> Also, if the SPE can decide whether to sell transferred assets to third parties or distribute them to BIHs, the manner of disposition is not specified at inception.

9. Paragraph 80 and the heading preceding it are replaced by the following:

> **Isolation of Transferred Assets in Securitizations and Other Transactions That Result in Issuance of Beneficial Interests**
>
> A transaction resulting in issuance of beneficial interests (including undivided interests) carried out in one transfer or a series of transfers may or may not isolate the transferred assets beyond the reach of the transferor and its creditors. Whether it does depends on the structure of the transaction taken as a whole, considering such factors as the type and extent of further involvement in arrangements to protect investors from credit and interest rate risks, the availability of other assets, and the powers of bankruptcy courts or other receivers.

10. In paragraphs 81–84, the word *securitization* or *securitizations* is replaced by *transaction* or *transactions* each time that word appears.

11. The following sentence is added at the end of paragraph 83:

> However, isolation is only one of the requirements in paragraph 9, and unless the transfer described in paragraph 83(b) is to a qualifying SPE, the transfer shall be deemed not to meet the requirement in paragraph 9(b) that the transferee has the right to pledge or exchange the transferred assets.

Effective Dates and Transition

12. Public entities shall apply this Statement prospectively to transfers occurring after the beginning of the first interim period after the issuance of the final Statement. Private entities shall apply this Statement prospectively to transfers occurring after the beginning of the first annual period after the issuance of the final Statement.

13. A formerly qualifying SPE that fails to meet one or more of the conditions for being a qualifying SPE as amended by this Statement shall continue to be considered a qualifying SPE if it maintains its qualifying status under previous accounting standards, does not issue new beneficial interests after the effective date, and does not receive assets other than those it was committed to receive (through commitments to beneficial interest holders unrelated to the transferor) under arrangements made before the effective date of this Statement. Otherwise, the formerly qualifying SPE shall be considered disqualified and shall not be eligible for the exceptions in paragraph 46 of Statement 140 and paragraphs 4(c) and 4(d) of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*.

The provisions of this Statement need not be applied to immaterial items.

Appendix A

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

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Appendix A

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction and Background

A1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

A2. Statement 140, which was issued in September 2000 as a replacement of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, establishes the conditions an entity must meet to be a qualifying SPE and establishes isolation of transferred assets as a condition for derecognition of the transferred assets. Statement 140 does not specify the powers of a qualifying SPE to issue beneficial interests, and in 2002, the Emerging Issues Task Force (EITF) undertook a clarification effort.[1] However, the EITF did not reach a consensus. Interpretation 46, which was issued in January 2003, does not apply to qualifying SPEs even though many are variable interest entities, and that exception created an incentive to convert variable interest entities to qualifying SPEs to avoid consolidation. Together, those factors caused the Board to undertake a project on the permitted activities of qualifying SPEs. As the project progressed, the Board decided that other aspects of Statement 140 required clarification.

Benefits and Costs

A3. The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including preparers, auditors, and users of financial information. In fulfilling that mission, the Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. Although the costs to implement a new standard may not be borne evenly, investors and creditors—both present and potential—and other users of financial information benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.

A4. The amendments to Statement 140 add specific guidance related to the powers of qualifying SPEs to issue beneficial interests and to obtain necessary financial support to facilitate issuance and reissuance of beneficial interests. The amendments also clarify other aspects of Statement 140 that have not been applied consistently. The Board believes that the benefits of increased specificity and consistency are significant and that the incremental costs of implementing the amendments are minimal. Enterprises may

[1]That effort was designated as EITF Issue No. 02-12, "Permitted Activities of a Qualifying Special-Purpose Entity in Issuing Beneficial Interests under FASB Statement No. 140."

choose to incur costs to restructure existing entities to avoid recognizing assets or consolidating variable interest entities, but those are not costs of implementing the Statement.

Amendments to Statement 140

A5. The conditions for qualifying SPEs were developed to permit derecognition of assets in certain securitization transactions. Paragraph 9(b) of Statement 140 permits a transferor to derecognize transferred assets only if the transferee can pledge or exchange the transferred assets or the transferee is a qualifying SPE. Initially, the Board believed that the legal structures used in securitizations were passive, pass-through arrangements that received a pool of assets and simultaneously issued beneficial interests. The Board understood that, in some cases, the beneficial interests in a single structure might have different terms, some shorter than the life of the pool of assets in that structure, but it believed that, in the aggregate, the beneficial interests issued at inception were entitled to receive all of the cash inflows from those assets over their lives. If a structure was fixed at inception, it could not pledge or exchange assets it received, and the transferor of those assets could not meet the general condition necessary for derecognition of the transferred assets. However, the Board reasoned that, in effect, the beneficial interests were undivided interests in a pool of assets and noted that holders of the beneficial interests usually had the ability to pledge or exchange their interests. Based on that reasoning, the Board concluded in Statement 125, and affirmed in Statement 140, that a transferor of assets to a passive, pass-through structure that met the criteria for being a qualifying SPE should derecognize the transferred assets if the beneficial interest holders can pledge or exchange their beneficial interests.

A6. Contrary to the Board's initial understanding and belief, it has become apparent that some structures deemed to be qualifying SPEs cannot be said to effectively create undivided interests in the transferred assets. Those structures are not passive, pass-through arrangements. Instead, they finance longer-term transferred assets by issuing shorter-term beneficial interests in the form of commercial paper or other debt instruments that, in the aggregate, do not receive all of the cash inflows from the pool of assets. When the initial beneficial interests mature, they are paid from the proceeds of issuing new beneficial interests instead of from the cash inflows from the pool of assets. The transferee SPE is effectively pledging and repledging the transferred assets, which, as discussed in paragraph 9(b), satisfies one of the three criteria that determine whether the transferor has surrendered control of those assets. The ability to pledge and repledge assets raises questions about consolidation and effective control of transferred assets.

A7. Identification of a controlling financial interest in a passive, pass-through structure that effectively creates undivided interests in assets is unnecessary because control is not pertinent to such a structure. The transferor and its affiliates do not report assets transferred to a qualifying SPE as sold until beneficial interests are issued to unrelated parties, and each unrelated holder controls its beneficial interest and accounts for that interest. However, if a structure is not passive, a transferor or its affiliates may retain effective control of the transferred assets by establishing a controlling financial interest in the structure. Statement 140 prohibits a transferor from derecognizing assets if it retains

effective control over them in ways specified in paragraph 9(c). Decision-making ability over issuance and reissuance of beneficial interests (pledging and repledging the assets) is not one of the specified ways of retaining effective control over assets, but Statement 140 acknowledges the potential importance of control over beneficial interests by identifying the ability to participate in an auction of beneficial interests as a way of maintaining effective control over assets. (Refer to paragraph 53 of Statement 140.)

A8. Liquidity provisions, financial guarantees, written options, and similar arrangements provide financial support for beneficial interests by increasing the probability that the SPE can fulfill its obligations to beneficial interest holders in a timely manner. (For convenience, those and other similar arrangements are referred to herein as liquidity facilities, although they include credit facilities such as credit default swaps and financial guarantees.)[2] Not only does a liquidity facility provided by a creditworthy entity reduce the rate of return demanded by the investors in a qualifying SPE, it may also facilitate the issuance of shorter-term beneficial interests, such as commercial paper, by an SPE holding longer-term assets. Those facilities enhance the return to the transferor or other holder of residual interests affected by the overall performance of the entity.

A9. Liquidity facilities also expose the provider of those facilities to significant market risks. A single enterprise exposed to a majority of the risk of variability in a variable interest entity's assets through a liquidity facility (possibly a guarantee) and a variable fee (which is equivalent to a subordinated beneficial interest whether or not that is its form) or other variable beneficial interest would be considered under Interpretation 46 to be that entity's primary beneficiary and would be required to consolidate it. However, Statement 140 does not include a similar requirement, and qualifying SPEs are exempt from the requirements of Interpretation 46.[3] That exemption could permit an enterprise to have a controlling financial interest in a qualifying SPE (which probably would meet the conditions to be a variable interest entity in Interpretation 46) and not consolidate it.

A10. The Board might have decided to resolve the issues related to beneficial interests by subjecting qualifying SPEs to the requirements of Interpretation 46. The Board did not take that approach because of the different bases of Interpretation 46 and Statement 140. Derecognition of transferred assets under Statement 140 is based primarily on surrender of control and not on the amount of risk a transferor retains. In contrast, Interpretation 46 requires identification of a controlling financial interest based on exposures to losses and rights to residual returns (fees to decision makers are a factor in residual returns). If qualifying SPEs were considered variable interest entities subject to Interpretation 46, a sole transferor to a qualifying SPE would usually be the primary beneficiary because its retained interest is likely to absorb a majority of the entity's expected losses. That would have made the qualifying SPE provisions in Statement 140 ineffective. Transferred assets would have been derecognized and immediately rerecognized through the

[2]Obligations to make servicing advances are not subject to the requirements related to other commitments if the servicer can choose not to make the advance if it believes recovery of the advance from collections on the assets of the SPE is in doubt.

[3]Interpretation 46 might require an enterprise other than the transferor to consolidate a qualifying SPE if it had the unilateral ability to liquidate the SPE or otherwise cause it to cease to be a qualifying SPE.

consolidation of the qualifying SPE. The Board did not want this amendment project to have that effect. Rather, the Board wanted to clarify and amend the Statement, particularly those portions related to permitted activities of qualifying SPEs.

A11. The Board decided that the general themes of risk concentration and risk dispersion inherent in Interpretation 46 and the idea of effective control of assets in Statement 140 provide a reasonable basis for resolving questions related to issuing and reissuing beneficial interests. This Statement addresses risk concentration and risk dispersion primarily by provisions related to liquidity facilities and beneficial interests that are not the most senior. (The Board considered referring to *the most subordinated interests* but decided that term is imprecise. The most subordinated class might be very small, and one or more less subordinated classes might be exposed to expected losses. The Board decided to refer to *most senior* because that term identifies a specific class of instruments without requiring interpretation.) This Statement addresses effective control of assets primarily by provisions related to making decisions about beneficial interests. However, holding subordinated interests and providing liquidity facilities provide an incentive for an enterprise to want effective control.

A12. In summary, this Statement prohibits certain specified combinations of rights and obligations that facilitate concentrations of risks or concentrations of risks combined with decision making. The three factors indicative of concentrations are (a) beneficial interests other than the most senior, (b) liquidity facilities, as described in paragraph A8, and (c) discretion in reissuing beneficial interests. A combination of any two of the three in a single party is sufficient to prohibit an SPE from being a qualifying SPE. (Refer to paragraphs 35(f)(2) and 35(f)(3) of Statement 140, as amended by this Statement.) Because liquidity facilities are essential to reissuance of beneficial interests and the concentration of risk caused by provisions of such facilities by a single party may give that party the incentive and the ability to direct an SPE's activities, paragraph 35(f)(1) of Statement 140, as amended by this Statement, prohibits a single party from providing more than half of the liquidity facility to an SPE that reissues beneficial interests. A qualifying SPE also is subject to additional restrictions related to its relationship with the transferor (including its affiliates and agents). The transferor may not provide any liquidity facility even if the SPE does not reissue beneficial interests, and risk transfers from a qualifying SPE to a transferor through derivative instruments are prohibited. (Refer to paragraph 35(e) of Statement 140, as amended.) Those additional requirements result from concerns about the potential for enterprises to execute transfers that do not change their economic position in any essential way but that significantly change their financial statements.

A13. The Board's intention is to prohibit any party from being in a position to enhance or protect the value of its own interest in a qualifying SPE by providing financial support for or making decisions about reissuing beneficial interests. One effect of this prohibition is to reduce (but not eliminate) the difference between the effects of applying Statement 140 to a particular SPE and the effects that application of Interpretation 46 would have on the same SPE.

A14. The Board decided to prohibit a qualifying SPE from holding equity instruments because a transfer to a qualifying SPE may permit an entity to effectively convert equity instruments such as limited partnership interests, on which gains and losses would be reported in earnings under the equity method, to securities that can be designated as available-for-sale under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, on which gains and losses are reported in other comprehensive income.

A15. The Board also decided to require that the second step in a two-step transfer must be a qualifying SPE if the transaction results in issuance of beneficial interests whether those interests are in the form of securities or in some other form. Some enterprises concluded that a transferee has the ability to pledge and repledge assets in which the ultimate transferees hold undivided interests and that, therefore, it was possible to obtain sale treatment under Statement 140 without using a qualifying SPE in some two-step transfers. Other enterprises assumed that a qualifying SPE would be necessary. When the Board decided to prohibit affiliates and agents of transferors from entering into liquidity commitments, financial guarantees, and similar arrangements with qualifying SPEs, it intended the requirement to apply if the ultimate transferees receive beneficial interests in the transferred assets instead of receiving the whole assets. If sale accounting could be achieved in a two-step transfer without using a qualifying SPE, that requirement could be avoided. Therefore, the Board decided to require that to achieve sale treatment, a two-step transfer must include a qualifying SPE as the second step.

A16. Finally, the Board decided to amend paragraph 9(a) to clarify that the transferred assets must be isolated from all entities in the consolidated group that includes the transferor, except for certain bankruptcy-remote entities. Paragraph 27 already includes such a requirement, but questions arising in practice suggested to the Board that emphasis and additional clarity are required.

Effective Dates and Transition

A17. The Board decided that the accounting provisions of this Statement that are changed from or are in addition to those in Statement 140 should be applied prospectively to transfers of financial assets occurring after the beginning of a public entity's next interim period and after the end of a private entity's next annual period. That transaction-based prospective approach is the same as that used in Statement 140 and was adopted in this Statement for the same reason: to achieve consistency in accounting for transfers of financial assets and to ensure that all entities entering into a given transaction report that transaction under the same guidance. Retroactive implementation for all entities was not feasible, and allowing voluntary retroactive implementation would impair comparability of financial statements by permitting disparate accounting treatment for similar transactions reported in previous periods.

Appendix B

AMENDED PARAGRAPHS OF STATEMENT 140 MARKED TO SHOW CHANGES MADE BY THIS STATEMENT

B1. This appendix contains paragraphs of Statement 140 marked to integrate changes from this amendment.

Paragraph 9

9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than **beneficial interests** in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if *all of the following conditions* are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any **consolidated affiliate of the transferor** that is not a special-purpose corporation or other entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraphs 27, 28, and 83(c)).
b. Each transferee (or, if the transferee is a qualifying SPE (paragraph 35), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (paragraphs 29–34).
c. The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 47–49) or (2) the ability to unilaterally cause the holder to return specific assets, other than through a **cleanup call** (paragraphs 50–54).

Paragraph 35

35. A qualifying SPE[16] is a trust or other legal vehicle that meets *all* of the following conditions:

a. It is demonstrably distinct from the transferor (paragraph 36).
b. Its permitted activities (1) are significantly limited, (2) were entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds, and (3) may be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by

[16]The description of a qualifying SPE is restrictive. The accounting for qualifying SPEs and transfers of financial assets to them should not be extended to any entity that does not currently satisfy all of the conditions articulated in this paragraph.

entities other than any transferor, its affiliates, and its agents (paragraphs 37 and 38).

c. It may hold only:
   (1) Financial assets transferred to it that are not equity instruments and that are passive in nature (paragraph 39).
   (2) Passive **derivative financial instruments** entered into with counterparties other than the transferor, its affiliates, and agents that pertain to beneficial interests (other than another derivative financial instrument) issued or sold to parties other than the transferor, its affiliates, or its agents (paragraphs 39 and 40).
   (3) Financial assets (for example, guarantees or rights to collateral) that would reimburse it if others were to fail to adequately service financial assets transferred to it or to timely pay obligations due to it, that it entered into when it was established, when assets were transferred to it, or when beneficial interests (other than derivative financial instruments) were issued by the SPE, and that are not entered into with certain counterparties. The limitations on the permissible counterparties to these financial assets are discussed in paragraphs 35(e) and 35(f).
   (4) Servicing rights related to financial assets that it holds.
   (5) Temporarily, nonfinancial assets obtained in connection with the collection of financial assets that it holds (paragraph 41).
   (6) Cash collected from assets that it holds and investments purchased with that cash pending distribution to holders of beneficial interests that are appropriate for that purpose (that is, money-market or other relatively risk-free instruments without options and with maturities no later than the expected distribution date).

d. If it can sell or otherwise dispose of noncash financial assets, it can do so only in automatic response to one of the following conditions:
   (1) Occurrence of an event or circumstance that (a) is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; (b) is outside the control of the transferor, its affiliates, or its agents; and (c) causes, or is expected at the date of transfer to cause, the fair value of those financial assets to decline by a specified degree below the fair value of those assets when the SPE obtained them (paragraphs 42 and 43)
   (2) Exercise by a BIH (other than the transferor, its affiliates, or its agents) of a right to put that holder's beneficial interest back to the SPE (paragraph 44)
   (3) Exercise by the transferor of a call or ROAP specified in the legal documents that established the SPE, transferred assets to the SPE, or created the beneficial interests in the transferred assets that it holds (paragraphs 51–54 and 85–88)
   (4) Termination of the SPE or maturity of the beneficial interests in those financial assets on a fixed or determinable date that is specified at inception (paragraph 45).

e. It may not enter into an agreement (other than a forward contract in a revolving period securitization as discussed in paragraphs 77–79) with the transferor, its affiliates, or its agents that commits any of those parties to deliver additional cash or

other assets to the SPE or its BIHs.[*] That prohibition applies to liquidity commitments, financial guarantees, written options, and other arrangements with the SPE as well as commitments to purchase outstanding beneficial interests directly or indirectly from the BIHs or to otherwise settle beneficial interests with their holders. It also applies to total return swaps and any other derivative instruments that may require delivering additional financial assets. It applies even if the commitment is contingent or conditional, whether the contract is settled net or gross, whether the settlement is current, deferred, or prepaid, and regardless of the relationship of the notional amount of the instrument, if any, with the face amount or value of the transferred assets.

f. If it has the ability to reissue beneficial interests, the following additional limitations apply:
   (1) No party (including affiliates or agents) enters into a commitment (or commitments) to deliver additional cash or other assets to fulfill the SPE's obligations to BIHs if that commitment has (or those commitments have) a fair value that is more than half the aggregate fair value of all such commitments to the SPE.
   (2) No party (including affiliates or agents) both makes decisions[†] about reissuing beneficial interests and either enters into a commitment (or commitments) to deliver additional cash or other assets to fulfill the SPE's obligations to BIHs or holds beneficial interests other than the most senior in priority.
   (3) No party (including affiliates or agents) that holds beneficial interests other than the most senior in priority enters into a commitment (or commitments) to deliver additional cash or other assets to fulfill the SPE's obligations to BIHs.

Paragraph 39

39. A financial asset or derivative financial instrument is passive only if holding the asset or instrument does not involve its holder in making decisions other than the decisions inherent in servicing (paragraph 61). Investments are not passive if through them, either in themselves or in combination with other investments or rights, the SPE or any related entity, such as the transferor, its affiliates, or its agents, is able to exercise control or significant influence (as defined in generally accepted accounting principles for consolidation policy and for the equity method, respectively) over the investee. A derivative financial instrument is not passive if, for example, it includes an option allowing the SPE to choose to call or put other financial instruments; but other derivative financial instruments can be passive, for example, interest rate caps and swaps and forward contracts. Derivative financial instruments that result in liabilities, like other liabilities of a qualifying SPE, are a kind of beneficial interest in the qualifying SPE's assets.

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[*]Obligations to make servicing advances are not subject to the requirements related to other commitments if the servicer can choose not to make the advance if it believes recovery of the advance from collections on the assets of the SPE is in doubt.

[†]For this purpose, the term *decisions* implies discretion. The ability or responsibility to take action is not decision making for purposes of this Statement if the party taking action has no discretion.

Paragraph 45

45. A qualifying SPE may have the power to dispose of assets to a party other than the transferor, its affiliate, or its agent on termination of the SPE or maturity of the beneficial interests, but only automatically on fixed or determinable dates that are specified at inception in a manner specified at inception. For example, if an SPE is required to dispose of long-term mortgage loans and terminate itself at the earlier of (a) the specified maturity of beneficial interests in those mortgage loans or (b) the date of prepayment of a specified amount of the transferred mortgage loans, the termination date is a fixed or determinable date that was specified at inception. In contrast, if that SPE has the power to dispose of transferred assets on two specified dates and the SPE can decide which transferred assets to sell on each date, the termination date is *not* a fixed or determinable date that was specified at inception. Also, if the SPE can decide whether to sell transferred assets to third parties or distribute them to BIHs, the manner of disposition is not specified at inception.

Paragraphs 80–84

Isolation of Transferred Assets in Securitizations and Other Transactions That Result in Issuance of Beneficial Interests

80. A transaction resulting in issuance of beneficial interests (including undivided interests) carried out in one transfer or a series of transfers may or may not isolate the transferred assets beyond the reach of the transferor and its creditors. Whether it does depends on the structure of the transaction taken as a whole, considering such factors as the type and extent of further involvement in arrangements to protect investors from credit and interest rate risks, the availability of other assets, and the powers of bankruptcy courts or other receivers.

81. In certain transactions, a corporation that, if it failed, would be subject to the U.S. Bankruptcy Code transfers financial assets to a special-purpose trust in exchange for cash. The trust raises that cash by issuing to investors beneficial interests that pass through all cash received from the financial assets, and the transferor has no further involvement with the trust or the transferred assets. The Board understands that those transactions generally would be judged as having isolated the assets, because in the absence of any continuing involvement there would be reasonable assurance that the transfer would be found to be a true sale at law that places the assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

82. In other transactions, a similar corporation transfers financial assets to an SPE in exchange for cash and beneficial interests in the transferred assets. That entity raises the cash by issuing to investors commercial paper that gives them a senior interest in cash received from the financial assets. The beneficial interests retained by the transferring corporation represent a junior interest to be reduced by any credit losses on the financial assets in trust. The commercial paper interests are highly rated by credit rating agencies only if both (a) the credit enhancement from the junior interest is sufficient and (b) the transferor is highly rated. Depending on facts and circumstances, the Board understands

that those “single-step” transactions often would be judged in the United States as not having isolated the assets, because the nature of the continuing involvement may make it difficult to obtain reasonable assurance that the transfer would be found to be a true sale at law that places the assets beyond the reach of the transferor and its creditors in U.S. bankruptcy (paragraph 113). If the transferor fell into bankruptcy and the transfer was found not to be a true sale at law, investors in the transferred assets might be subjected to an automatic stay that would delay payments due them, and they might have to share in bankruptcy expenses and suffer further losses if the transfer was recharacterized as a secured loan.

83. Still other transactions use two transfers intended to isolate transferred assets beyond the reach of the transferor and its creditors, even in bankruptcy. In those “two-step” structures:

a. First, the corporation transfers financial assets to a special-purpose corporation that, although wholly owned, is so designed that the possibility that the transferor or its creditors could reclaim the assets is remote. This first transfer is designed to be judged to be a true sale at law, in part because the transferor does not provide “excessive” credit or yield protection to the special-purpose corporation, and the Board understands that transferred assets are likely to be judged beyond the reach of the transferor or the transferor's creditors even in bankruptcy.
b. Second, the special-purpose corporation transfers the assets to a trust or other legal vehicle with a sufficient increase in the credit or yield protection on the second transfer (provided by a junior retained beneficial interest or other means) to merit the high credit rating sought by third-party investors who buy senior beneficial interests in the trust. Because of that aspect of its design, that second transfer might not be judged to be a true sale at law and, thus, the transferred assets could at least in theory be reached by a bankruptcy trustee for the special-purpose corporation.
c. However, the special-purpose corporation is designed to make remote the possibility that it would enter bankruptcy, either by itself or by substantive consolidation into a bankruptcy of its parent should that occur. For example, its charter forbids it from undertaking any other business or incurring any liabilities, so that there can be no creditors to petition to place it in bankruptcy. Furthermore, its dedication to a single purpose is intended to make it extremely unlikely, even if it somehow entered bankruptcy, that a receiver under the U.S. Bankruptcy Code could reclaim the transferred assets because it has no other assets to substitute for the transferred assets.

The Board understands that the "two-step" transactions described above, taken as a whole, generally would be judged under present U.S. law as having isolated the assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. However, isolation is only one of the requirements in paragraph 9, and unless the transfer described in paragraph 83(b) is to a qualifying SPE, the transfer shall be deemed not to meet the requirement in paragraph 9(b) that the transferee has the right to pledge or exchange the transferred assets.

84. The powers of receivers for entities not subject to the U.S. Bankruptcy Code (for example, banks subject to receivership by the FDIC) vary considerably, and therefore some receivers may be able to reach financial assets transferred under a particular arrangement and others may not. A transaction may isolate transferred assets from a transferor subject to such a receiver and its creditors even though it is accomplished by only one transfer directly to an SPE that issues beneficial interests to investors and the transferor provides credit or yield protection. For entities that are subject to other possible bankruptcy, conservatorship, or other receivership procedures in the United States or other jurisdictions, judgments about whether transferred assets have been isolated need to be made in relation to the powers of bankruptcy courts or trustees, conservators, or receivers in those jurisdictions.

Appendix C

EFFECT OF THIS STATEMENT ON EITF ISSUES

C1. The following table lists Issues discussed by the EITF and EITF Topics that affect qualifying SPEs and isolation of transferred assets and indicates (a) the status of the EITF consensus or topic after issuance of this Statement and (b) the effect of this Statement on that consensus or topic (if any).

Status Legend	
Resolved	Issue is resolved by this Statement.
Other	This Statement affects the applicability of the consensus to qualifying SPEs but does not resolve or nullify it.

Issue or Topic Number	**Title**	**Status**	**Analysis**
84-5	Sale of Marketable Securities with a Put Option	Other	This Statement prohibits an entity from being a qualifying SPE if it enters into an agreement with the transferor that transfers some or all of the risks inherent in the transferred assets back to the transferor. Consequently, a qualifying SPE cannot hold a put option written by the transferor on the transferred assets, and the consensuses in Issue 84-5 do not apply to transfers to qualifying SPEs.
85-25	Sale of Preferred Stocks with a Put Option	Other	This Statement prohibits an entity from being a qualifying SPE if it enters into an agreement with the transferor that transfers some or all of the risks inherent in the transferred assets back to the transferor. Consequently, a qualifying SPE cannot hold a put option written by the transferor on the transferred assets, and the consensus in Issue 85-25 does not apply to transfers to qualifying SPEs.
85-40	Comprehensive Review of Sales of Marketable Securities with Put Arrangements	Other	This Statement prohibits an entity from being a qualifying SPE if it enters into an agreement with the transferor that transfers some or all of the risks inherent in the transferred assets back to the transferor. Consequently, a qualifying SPE cannot hold a put option written by the transferor on the transferred assets, and the consensuses in Issue 85-40 do not apply to transfers to qualifying SPEs.

Issue or Topic Number	Title	Status	Analysis
89-2	Maximum Maturity Guarantees on Transfers of Receivables with Recourse	Other	This Statement prohibits an entity from being a qualifying SPE if it enters into an agreement with the transferor that transfers some or all of the risks inherent in the transferred assets back to the transferor. Consequently, a qualifying SPE cannot hold a put option written by the transferor on the transferred assets, and the consensus in Issue 89-2 does not apply to transfers to qualifying SPEs.
02-12	Permitted Activities of a Qualifying Special-Purpose Entity in Issuing Beneficial Interests under FASB Statement No. 140	Resolved	This Statement establishes requirements that a qualifying SPE must meet if it can reissue beneficial interests and thereby resolves the issue.
D-63	Call Options "Embedded" in Beneficial Interests Issued by a Qualifying Special-Purpose Entity	Other	This Statement limits the ability of certain parties to make decisions about reissuing beneficial interests of a qualifying SPE. Thus, an SPE would not be a qualifying SPE if certain parties have the ability to exercise the call options embedded in beneficial interests.
D-66	Effect of a Special-Purpose Entity's Powers to Sell, Exchange, Repledge, or Distribute Transferred Financial Assets under FASB Statement No. 125	Other	This Statement prohibits an entity from being a qualifying SPE if it enters into an agreement with the transferor that transfers some or all of the risks inherent in the transferred assets back to the transferor. Consequently, a qualifying SPE cannot hold a put option written by the transferor on the transferred assets, which means that the applications described in Examples 1 and 3 change. The SPEs in those examples are not qualifying SPEs because they hold options to put assets to the transferor.