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18 November 2008

Mr. Robert Herz  
Chair, Financial Accounting Standards Board  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06865-5116

**File Reference No.:1610-100**

**Re: Proposed FASB Statement, *Accounting for Transfers of Financial Assets*- an amendment of FASB Statement No. 140**

Dear Mr. Herz,

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),<sup>1</sup> in consultation with its Corporate Disclosure Policy Council (CDPC)<sup>2</sup>, appreciates the opportunity to comment on the Exposure Draft (ED), *Accounting for Transfers of Financial Assets*-an amendment of FASB Statement No. 140 (FAS 140).

CFA Institute represents the views of its investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics* and *Standards of Professional Conduct*.

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<sup>1</sup> The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With offices in Charlottesville, VA, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

<sup>2</sup> The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.



### **Executive Summary of Main Positions**

*International Convergence:* While we agree that any changes to FAS 140 should be ultimately aligned with current efforts of the International Accounting Standards Board (IASB) to amend international accounting for transfers of financial assets, we nonetheless strongly urge the Board to reject pleas to shelve the ED until a converged standard is developed. The Board has expended considerable time and resources to develop a new standard and it is quite evident that immediate improvements are vital to provide investors and the capital markets with information about these significant exposures.

*Removal of the Concept of Qualifying Special-Purpose (QSPE):* We agree that QSPEs should be eliminated and that these entities should be evaluated for consolidation. We agree with the Board's findings that the range of financial assets being securitized and the complexity of securitizations structures have resulted in QSPE criteria being stretched in some cases significantly beyond the intent and requirements of Statement No. 140.

*De-recognition of Financial Assets:* We support de-recognizing assets only when control has been surrendered, and associated financial benefits and risk exposures have ceased, and to de-recognize liabilities only when they have been extinguished. To that end we urge the Board to adopt a no-continuing involvement model for transferred assets to qualify for derecognition accompanied by robust disclosures. This model would be the least complex approach that would also eliminate financial engineering opportunities. In the event that the Board allows some form of continuing involvement, we urge that there be a rebuttable presumption that the transferor maintains effective control. If the transferor rebuts the presumption of effective control but there is still some form of continuing involvement, such transactions shall continue to be reported separately in a statement of financial position in a caption such as "Transferred Assets with Continuing Involvement" and "Transferred Liabilities with Continuing Involvement" (if applicable) accompanied by appropriate disclosures.

*Effective Control:* This proposed guidance is based largely on an isolation analysis conducted from a legal perspective. While this is an essential component, we feel that it is more appropriate that the analysis be performed from a risks and rewards perspective.

*Effective Date:* We agree that the effective date should be as of the beginning of a reporting entity's first fiscal year beginning after November 15, 2009. The Board has rightly concluded that this date is appropriate given the current economic environment and the urgent need to improve transparency related to certain entities that are off-balance-sheet and certain transactions that are currently reported as sales.

### **Continuation of Executive Summary of Main Positions**

*Disclosures:* Recent market events signal the importance of full disclosure of an entity's obligations, none more important than disclosure of off-balance-sheet obligations and continued involvement in transfers of financial assets and liabilities. To that end, enhancements to disclosures will enable investors to identify risks not previously known or understood. We further emphasize that the proposed disclosures should be presented in a manner that (1) strengthens the clarity and understandability of the transactions, (2) clearly reflects management's evaluation of risk and return relationships as they relate to transferred assets, and (3) for those entities using securitizations or transfers of financial assets as a critical funding mechanism integral to their operations, management's assessments of alternative sources of liquidity. We suggest that the ED consider showing example disclosures linking the requirements with the expected outcome, namely--enhanced qualitative and quantitative information.

### **General Comments**

Events of the past several years have clearly exposed why the issues around off-balance-sheet accounting and their impact on the global capital markets are of extreme importance to investors. Accounting for securitizations and special purpose entities (SPEs) lacks the transparency needed for users to make reasoned and informed investment decisions. This lack of transparency has led to substantial losses suffered in this decade, twice: once after Enron and again in the current mortgage crisis. The present problems in the financial markets are linked to insufficient reporting of exposures on the balance sheet and confusion between what is exposure and what is not.

To this point it has been CFA Institute Centre's long-standing position regarding the financial reporting of on or off-balance-sheet assets and liabilities that<sup>3</sup>:

- Assets which a company owns, or in which a company holds or expects to receive a beneficial interest, should be properly recorded in the company's balance sheet with gains and losses recorded as incurred in the income statement; and that
- Liabilities or other obligations for which the company bears exposure to risk should be properly recorded in the company's balance sheet with gains and losses recorded as incurred in the income statement.

In addition, we believe that all remaining off-balance sheet activities that constitute critical funding or financing mechanisms integral to continued operations be accompanied by clear and

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<sup>3</sup> Letter dated July 31, 2003 Proposed Statement of Financial Accounting Standards : *Qualifying Special Purpose Entities and Isolation of Transferred Assets, an Amendment of FASB No. 140* to the FASB from Financial Accounting Policy Committee (predecessor committee to the CDPC) of the Association for Investment Management and Research.



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transparent disclosures of the impact of those activities and management's assessments of alternative sources of liquidity. The latter assessment may be provided in the form of a sensitivity analysis of critical factors or indicators that would require management to seek those alternative funding sources.

We believe that the scope of the entity should be viewed from the perspective of the shareholder who bears the ultimate risk. Through the process of preparing information that is useful for the most subordinate member of a company's capital structure, the common equity shareholder, we believe sufficient information is ultimately furnished that allows more senior members of the capital structure to effectively assess their relative positions given that common shareholders must value these senior positions in arriving at a valuation for the equity. To this end, the financial statements should fully reflect the fair values of exchanges and transactions, including commitments and other arrangements that have, or possess the potential to have, an economic effect on the risk and rewards of the company as well as continued operations, and, consequently, on the investor's equity position. We are concerned that under current accounting standards, companies have the continued ability to hide assets and obligations as well as critical financing mechanisms and sources of liquidity by removing them from the financial statements. Statements that understate assets or liabilities, financing mechanisms and other risks of a company severely impair the usefulness of the information to investors and other users. The needs of investors for complete, reliable, relevant and timely information should supersede all other interests.

Furthermore, the Securities and Exchange Commission in its June 2005 report, addressed off-balance-sheet implications, special purpose entities and transparency of filings<sup>4</sup>, as follows:

*“Although there is debate about whether the guidance of SFAS No. 140 is effective, much of the controversy is caused not by the standards themselves, but by transactions structuring. Issuers often structure transfers in order to achieve or avoid sale accounting, trigger or avoid the recognition of losses (or gains), or change the measurement attribute applied to the recorded assets and liabilities. The Staff believes, based on its reviews of issuer filings that the most frequent structuring goal is to achieve sale treatment without consolidation of any related SPEs. While economic motivations for most asset transfers exist, some transfers of financial assets appear to be significantly, primarily, or even solely entered into with accounting motivations in mind.”*

Overall we believe that the proposals will improve the relevance, representational faithfulness, and comparability of information provided by an entity about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement in transferred financial assets. However, we offer some modifications to the proposal which we feel will contribute to a more faithful representation of transfers and strengthen the transparency of the risks and rewards associated with the

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<sup>4</sup> *Report and Recommendations Pursuant to Section 401(C) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers*, United States Securities and Exchange Commission.



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transactions. Strengthening the standards regarding asset transfers to reduce accounting motivations and enhance transparency is essential for investors to fully understand the risks associated with their investment in a company.

### **Specific Comments**

#### International Convergence

While we agree that any changes to FAS 140 should be ultimately aligned with current efforts of the International Accounting Standards Board (IASB) to amend international accounting for transfers of financial assets, we strongly urge the Board to reject pleas from some who recommend that the ED be shelved until such time that a converged standard is developed or that any aspects of the ED be eliminated in the interest of convergence rather than in the interest of achieving a high quality standard in the interest of users. The Board has expended considerable time and resources to develop a new standard for transfers of financial assets and it is quite evident that immediate improvements are vital to supply investors and the capital markets with information about these significant exposures. In addition, we believe that SIC Interpretation 12 *Consolidation-Special Purpose Entities* under IFRS results in the current accounting under IFRS being superior to the current accounting under U.S. GAAP. Under SIC 12, SPEs are consolidated when the “substance of the relationship... indicates that the SPE is controlled by that entity.” Therefore, from our perspective, IFRS is currently more successful at ensuring that an entity’s balance sheet includes SPEs when it is exposed to risks and rewards of ownership. To this end, we believe there is more urgency for interim changes to U.S. GAAP prior to the completion and adoption of a converged international standard.

Some have urged that until such time that a converged standard is developed, that expanded disclosures requirements be adopted. Our position has always been that disclosure is not a substitute for recognition and measurement, and recognition and measurement do not eliminate the need for disclosure. Accounts reported on the face of the financial statements are most critical and relevant to investors. The accounts represent the starting point to financial analysis, which must be complemented by high quality note disclosures.

#### Removing the Concept of Qualifying Special Purpose Entity (QSPE)

We agree that QSPEs should be eliminated from paragraph 9 of Statement No. 140 and that these entities should be evaluated for consolidation. Clearly the range of financial assets being securitized and the complexity of securitization structures today have resulted in the current QSPE criteria being stretched in many cases well beyond the intent and requirements of Statement No. 140. The original model of the QSPE was built on the premise that many securitized entities operated with no decision-making authority which has simply not been the case in many structures.

Furthermore, this is supported by the conclusions reached by the SEC in its report cited above:

*“Some of this structuring has been undertaken by using QSPEs in situations that appear to the Staff to be beyond those originally contemplated by the FASB.*”

*...Although the limitations on the activities of QSPEs do not permit the QSPE to manage the assets on its balance sheet, there are few explicit limitations on managing the balance sheet liabilities. That is, in structures where the QSPE holds longer term assets and funds the purchase of such assets through the issuance of shorter term interests to investors, decisions have to be made regarding the nature of the new interests to be issued when the original short term interests mature. In practice, these decisions are made by the issuer transferring the financial assets. Accountants and auditors have concluded that the SPE – despite such management of liabilities – is a QSPE under SFAS No. 140, and is therefore exempt from consolidation. These and other interpretations of the QSPE guidance have expanded the activities of QSPEs beyond the simple pass-through entities originally envisioned by the FASB.”*

Eliminating the concept of the QSPE should result in a substantial amount of structures being consolidated onto the balance sheets thereby greatly improving transparency and usefulness to investors.

#### De-recognition of Financial Assets

We strongly believe that in order for a transfer of financial assets to be accounted for as a sale that an entity should have no continuing involvement in the transferred assets. Adopting a no-continuing involvement model significantly reduces the opportunity to develop structures whereby, transferors may continue to exert influence over the transferred assets and yet record the transaction as a sale.

However, should the Board reject the no-continuing involvement model then we believe that evidence of continuing involvement should raise a rebuttable presumption that the activity is a financing, not a “sale”. In general, we believe the definition of continuing involvement should include any transfer of assets or liabilities (to a related or unrelated entity) that:

- Constrains the resources of the transferor,
- Limits the benefits the transferor would normally receive from a sale or transfer,
- Adds to or does not reduce risks related to or stemming from operating, investing, or financing activities of the transferor,
- Exposes the transferor to incremental risks in the event the transferee is unable to provide services or discharge its contractual obligations, or
- Implies continuing involvement affecting risk or return (i.e., requires or may require additional collateral, cash or equity investment, repurchases of transferred assets or liabilities).

If there is continuing involvement, the transferor must rebut the presumption that 1) it has not relinquished effective control, and 2) it must affirm it has no intent to support the transferee, the transferred assets, or any class of the beneficial interest holders in the event of financial distress.





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If the entity satisfactorily rebuts the presumption of effective control, but there is still some form of continuing involvement, such transactions shall continue to be reported separately in a statement of financial position in a caption such as “Transferred Assets with Continuing Involvement” and “Transferred Liabilities with Continuing Involvement” (if applicable) accompanied by appropriate disclosures. Both assets and liabilities should be reported at fair value. Displaying these transactions on the face of the statement of financial position elevates the transparency of these transactions to the users. These balances should not be shown as a net number on the face of the balance sheet, rather they should be shown gross and may be aggregated. The notes should sufficiently disaggregate the amounts based on transfer class for investors to fully understand and interpret information about the assets.

Determining an entity’s continuing involvement in a transfer requires judgment especially as it relates to remaining de minimis risks and benefits. While it may seem that insignificant involvement would not warrant disclosure, it may be important for investors to understand (1) the reason for continuing involvement, and (2) the likelihood of the need to use alternative funding methods. In those situations, entities should follow a principles-based approach for disclosing information deemed useful to investors. For example, an entity should disclose the business purpose, risks, guarantees, liquidity needs, and other information (as it relates to the different classes of continuing involvement) considered beneficial to investors.

#### Effective Control

Paragraph 9 establishes the criteria for determining whether a transfer qualifies for sale accounting as follows:

- 1) *Legal Isolation*: The transferred financial assets have been isolated from the transferor and its consolidated affiliates even in bankruptcy, and
- 2) *Effective Control*: The transferor and its consolidated affiliates do not maintain effective control over the transferred financial assets. The transferor has effective control over the transferred financial assets (1) if there is a restriction on the transferee’s right to pledge or exchange the transferred financial assets, and (2) that constraint does not provide the transferee with a benefit.

This proposed guidance is based largely on an isolation analysis conducted from a legal perspective. While this is an essential criterion, the FASB has acknowledged that attorneys do not always agree on whether a particular transaction meets the requirements for a true sale opinion. Therefore, it is more appropriate that the analysis be performed from a risks and rewards perspective to augment the legal assessment. The potential risks and rewards could be implicit or overt in that there is a continued willingness on the part of the transferor to support liquidity, credit or other economic requirements of the transferred assets. For example, there are many entities with strong brand identification and due to their reputational risk, there is the assumption in the market that they will step in to support the transferred asset in the event of failure. This implicit assumption is well known in the markets and therefore has implied economic value. If in fact the transferor retains risks and rewards, then the transaction should be



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accounted for as a financing. While the FIN 46 (R) proposal would require consideration of reputational risk in the qualitative assessment, a no-continuing involvement approach in FAS 140 would incorporate such risk as a rebuttable presumption.

Finally, paragraph 87 shows examples of removal-of-accounts provisions (ROAP) that do not preclude transfers from being accounted for as sales. We disagree. These examples appear to be actions which should indeed preclude such transfers from being accounted for as sales. Whether or not the action is caused by a third-party rather than the transferor should be irrelevant; the nature of the agreement for these provisions is a form of continuing involvement and/or effective control.

#### Effective Date

We agree that the effective date should be as of the beginning of a reporting entity's first fiscal year that begins after November 15, 2009. The Board has rightly concluded that this date is appropriate given the current economic environment and the urgent need to improve transparency related to certain entities that are off-balance-sheet and certain transactions that are currently reported as sales.

#### Disclosures

In our comment letter regarding FSP No. 140-e and FIN 46 (R)-e, *Disclosures about Transfers of Financial Assets and Interests in Variable Interest Entities* we stressed that recent market events signal the importance of full disclosure of an entity's obligations, none more important than disclosure of off-balance-sheet obligations and continued involvement in transfers of financial assets and liabilities. Enhancements to the disclosure will enable investors to identify risks not previously known or understood. We support the enhanced disclosure and further emphasize that the proposed disclosures should be presented in a manner that strengthens the clarity and understandability of the transactions. To that end, we suggest that the ED consider showing example disclosures linking the requirements with the expected outcome, namely-enhanced qualitative and quantitative information. In this regard, we found that many of the disclosures in the report of the Senior Supervisors Group, "Leading Practice Disclosures for Selected Exposures," (April 2008) are useful for investors in assessing the nature, purpose, size, activities and risks.

We feel that while the level of disclosure proposed by the ED may appear excessive, and will certainly draw cries of information overload as well as adverse cost-benefit arguments, it is essential to understanding the nature of the transaction and the associated risks because of the general lack of transparency in the disclosures existing today. Preparers may object to providing the expanded disclosure, but given the actual losses incurred from off-balance-sheet transactions to date and the potential for more, we feel that the added transparency is essential to fully understanding the economic effects and risk exposure. Additionally, preparers of financial statements argue frequently that additional disclosures cannot be assimilated or are not used. We believe that more accurate and useful information does not result in overload. Moreover, key attributes of any disclosures should be parsimony and transparency. Entities with sound risk





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management and financial reporting practices should have much of the required information readily available as a part of their routine risk assessment for these investments. The failure to analyze risks regularly could prove more costly in the long run as unforeseen developments adversely impact the financial fundamentals for these investments. We refer the Board to our comment letter dated October 20, 2008 addressing the FSP mentioned above for more information regarding enhanced disclosures about transfers of financial assets.

### **Closing Remarks**

In closing we would like to thank the Board for the opportunity to comment on the Exposure Draft and reiterate that we are generally supportive of the direction being taken in accounting for transfers of financial assets. We once again urge the Board to expeditiously issue an improved standard so that these significant off-balance-sheet transactions are finally made more transparent to investors and other users of financial statements.

If you, other Board members or your staff have questions or seek further elaboration of our views, please contact either Matthew Waldron, CPA , by phone at +1.434-951-5321, or by e-mail at [matthew.waldron@cfainstitute.org](mailto:matthew.waldron@cfainstitute.org), or Patrick Finnegan, CFA, by phone at +1.212.754.8350, or by e-mail at [patrick.finnegan@cfainstitute.org](mailto:patrick.finnegan@cfainstitute.org).

Sincerely,

*/s/Kurt N. Schacht*

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Managing Director

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cc: Corporate Disclosure Policy Council