

**Securities Industry Association**

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Julie Anne Dilley
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Audit and Attest Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: November 24, 1997 Draft of Proposed AU Section 9336; File No. 2605

Dear Ms. Dilley:

Thank you for giving the Capital Committee of the Securities Industry Association ("SIA") the opportunity to respond to the above-referenced working draft of a proposed audit interpretation of Statement on Auditing Standards No. 73, Using the Work of a Specialist ("Draft Interpretation"). We understand that the Draft Interpretation is being considered by the FASB 125 Audit Issues Task Force ("Task Force") of the Audit Standards Board ("ASB"). The intended purpose of the draft is to provide guidance regarding the use of a legal specialist's finding as audit evidence to support Management's assertion that a transfer of financial assets meets the legal isolation criterion of paragraph 9(a) of Statement of Financial Accounting Standards ("SFAS") No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." The Committee takes great interest in SFAS 125 and other accounting pronouncements inasmuch as the basis for most regulatory computations is data prepared under generally accepted accounting principles.

We believe that, in its current form, the Draft Interpretation requires a level of legal assurance that is likely to be, as a practical matter, unattainable or extremely difficult to obtain in many instances. This strictness, in turn, will deter many commonplace securities transactions that have long been treated as sales. In addition, we believe that, as currently written, the Draft Interpretation is inconsistent with certain of the key provisions of SFAS 125.

The Draft Interpretation Sets an Impracticably High Standard for Legal Comfort and Would Significantly Hinder Well-Established Types of Securities Transactions . The Draft Interpretation effectively requires that in order to book any "non-routine" transaction as a sale under paragraph 9(a) of SFAS 125, management must obtain an opinion letter of counsel stating the lawyer's belief that the transfer "would be considered to be a sale" under the U.S. Bankruptcy Code. Counsel advises us that there is little case law with respect to the bankruptcy status of transactions covered by SFAS 125 upon which a lawyer could base a "would" opinion. Moreover, for many types of transactions, different lawyers may come to different legal conclusions as to whether a "would" standard is satisfied. A less severe standard, more in line with current practice (whether a "more likely than not" standard or some similar articulation), would increase the likelihood that firms will account for similar transactions in a consistent manner.

The draft states that "the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion" and that "conclusions about hypothetical transactions may not be relevant to the transaction that is the subject of management's assertions. . . ." We question this view in two respects. First, we believe that there may be occasions when other facts, such as regulatory approval or guidance, can be sufficient to demonstrate that the isolation criteria have been met.

Second, the practical effect of this view would be to require an opinion letter for a vast number of transactions, such as securitizations, for which they have not been required until now. We believe that auditors should not be required to obtain a legal opinion for every transaction. Rather, in many instances, it should be sufficient for auditors to require that a determination has been made that a particular transaction fits within the assumptions made in a prior opinion or legal memorandum.⁴ Auditors should have the same latitude under SFAS 125 that they have in applying other accounting standards, such as FIN 39, to make judgments as to what evidence is required to support an audit determination.

The Committee believes that the effect of requiring "would" opinions would be to discourage or curtail many structured transactions. The reason for this is two-fold. First, because of the impracticality of obtaining such a high level of legal comfort, broker-dealers would be forced to carry transactions on their books that otherwise would be on their books only under very remote circumstances (*i.e.*, a bankruptcy of the broker-dealer coupled with the failure of a legal comfort letter). The "would" approach poses even greater concerns for non-U.S. affiliates of U.S. financial institutions. We understand that there is currently varying practice with respect to providing "would" opinions in many foreign jurisdictions. The failure of non-U.S. lawyers to accommodate the terms of the interpretation draft would be yet another impediment that the Draft interpretation would pose to many transactions.

Second, in many instances in which transactions are still undertaken, there will be undue legal and regulatory consequences. For example, in some situations there could be a significant possibility that a broker dealer would be compelled to record a sale on its balance sheet, while a counter-party broker-dealer would also record the same assets on its balance sheet.⁵ As a result of this double-counting, both sides of transactions may be required to take capital charges on the same assets, potentially diminishing broker-dealers' ability or desire to provide market liquidity. Consequently, as currently drafted, the Draft Interpretation would create

unnecessary and undesirable obstacles to transactions that are integral to the modern securities markets.⁶

The Draft Interpretation Is Inconsistent With Standards Set Out in SFAS 125. While the exact nature of evidentiary matter that can satisfy Paragraph 9(a) is not entirely clear, the Committee believes that SFAS 125 does not require that legal comfort must come in the form of a legal opinion, and, to our knowledge, the FASB has not put forward such a restrictive requirement. The relevant provisions of SFAS 125 suggest that no particular form of legal comfort is required in all situations. Paragraph 9(a) requires that "the transferred assets have been isolated from the transferor – put *presumptively* beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership" (emphasis added). Paragraph 23 states that the evidence needed to support a determination that financial assets have been isolated in this manner depends on the facts and circumstances. Paragraph 23 concludes with the statement that "derecognition of transferred assets is appropriate only if the available evidence provides *reasonable assurance* that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates" (emphasis added).⁷

In contrast, paragraphs .12 and .13 of the Draft Interpretation suggest that the form of legal assurance must be the highest possible assurance – that the transfer of financial assets "would be" considered a sale, and therefore not deemed to be property of the seller's estate in bankruptcy, or "would not" result in a court order consolidating the assets and liabilities of the purchaser with those of the seller. Paragraph .13 specifically rejects less strict formulations of opinion language, such as "reasonable possibility," "reasonable basis to conclude." "should," "more likely than not," "would presumptively be," and "it is probable that." ⁸

The Committee believes that the emphasis in these provisions of the Draft Interpretation on the need for a "would" opinion is much more inflexible than is suggested by the italicized words from SFAS 125 set out above. We believe SFAS 125 contemplates a number of levels of possible formulations of the strength of the legal opinion that must be obtained to satisfy paragraph 9(a). Paragraph 9(a) uses the word "presumptively". Similarly, paragraph 23 uses the terms "would likely" and "reasonable assurances that assets would," and Paragraph 118 refers to assurances acceptable to rating agencies, which do not typically require "would" opinions.

The Draft Interpretation is Inconsistent With Audit Practice Regarding Similar Accounting Standards. In other circumstances involving the accounting treatment for significant financial transactions, FASB pronouncements have not been understood to require a "would" opinion from counsel. In particular, SFAS 5, SFAS 109, FIN 39 and FIN 41 are, like SFAS 125, FASB pronouncements (some of them quite recent) that address the legal comfort that is appropriate for accounting treatment. However, we understand that none of these pronouncements require a "would" opinion.⁹ It is difficult to see why a higher standard of reasonable assurance should be taken in connection with isolation of assets under SFAS 125 than, for example, under FIN 39.¹⁰

II. Suggested Changes to Draft Interpretation.

Consistent with our comments above, we believe that the following changes would address

some of our concerns:

- .05, second sentence. Change to "use of a legal specialist often [strike usually] is necessary."
- .12, first sentence. Strike "persuasive evidence" and replace with "reasonable assurance."
- .12, first and second indented paragraph. Strike italicized "would" and replace with "should."
- .13. Strike "persuasive evidence" in first and second sentences and replace with "reasonable assurance."
- .13. In the list of sample phrases that would not provide reasonable assurance, strike the third, fourth, sixth, eighth, ninth and tenth bulleted phrases.
- .13. Strike footnote 6.
- .16. Strike "persuasive evidence" and replace with "reasonable assurance."
- .17. In the second sentence, strike " the auditor usually will not be able to obtain persuasive evidence" and replace with "often will not be able to obtain reasonable assurance." In the third sentence strike "persuasive evidence" and replace with "reasonable assurance."

Conclusion.

Again, the Committee very much appreciates the opportunity to comment on the Draft Interpretation. If you have questions about this letter or we can be of further assistance, please contact the undersigned at 212-902-1360 (or via e-mail at mark.holloway@gs.com), or contact the Committee's staff adviser, George Kramer, at 202-296-9410 or at gkramer@sia.com.

Sincerely,

Mark W. Holloway
Chairman
SIA Capital Committee

cc:

Michael H. Sutton, SEC Chief Accountant
Richard Lindsey, Director, SEC Division of Market Regulation
Michael Macchiaroli, Associate Director, SEC Division of Market Regulation
Michael Helmick, President, SIA Financial Management Division
Capital Committee members.

Footnotes:

¹ The Securities Industry Association brings together the shared interests of more than 770 securities firms throughout North America to accomplish common goals. SIA members -- including investment banks, broker-dealers, and mutual fund companies -- are active in all markets and in all phases of corporate and public finance. In the U.S. SIA members collectively account for approximately 90 percent, or \$100 billion, of securities firms' revenues and employ about 350,000 individuals. They manage the accounts of more than 50-million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans. More information about SIA is available at our Internet web site, <http://www.sia.com>.

² SIA's concern about the serious adverse effect that the Draft Interpretation could have on the securities markets is widely held. In spite of the fact that the Draft Interpretation was only circulated just prior to Thanksgiving, allowing only 12 business days for the industry to respond, SIA has been advised that a number of securities firms and at least one other trade association plan to respond. This high response rate to an interpretation that the ASB itself acknowledges has relatively remote authority is highly indicative of widely held concerns about the business implications of the interpretation.

³ We understand that the Bond Market Association plans to discuss extensively the current trends in the case law in this area. To avoid redundancy, we refer you to that letter for more information on this point.

⁴ Such a determination would not necessarily have to be made by a lawyer, so long as the person making the determination is able to give the auditors comfort that the transaction is encompassed within the assumptions made in a prior opinion letter or legal memorandum.

⁵ For example, for certain types of sales, (e.g., structured transactions) bankruptcy case law is scarce or non-existent. Since a "would" opinion in such areas is likely to be unobtainable, the selling broker-dealer and the receiving broker-dealer might both have to carry assets on their books.

⁶ For example, a "would" opinion might be impossible to obtain for an asset sale coupled with a total return swap, because there currently is no bankruptcy case law on this type of transaction. However, if this compels sellers to carry such assets on their balance sheets, it becomes more probable that if a bankruptcy involving such assets ever does occur, a court might conclude from the fact that the asset remained on the seller's balance sheet that there was not an intent to sell.

⁷ Paragraph 118 is the only provision of SFAS 125 that suggests that any particular form of legal assurance is required. That paragraph only states that the FASB developed its criteria for Paragraph 9(a) "in large part" with reference to rated securitization practices, and that "credit rating agencies and investors . . . *sometimes* seek assurances from attorneys" (emphasis added) about the bankruptcy status of special purpose vehicles and securitized assets.

⁸ Paragraph .12 of the Draft Interpretation assumes that "persuasive evidence" is the standard that supporting evidence of isolation must satisfy. We respectfully suggest that Paragraph 23 of SFAS 125 strongly suggests that the appropriate standard is "reasonable assurance."

⁹ Our understanding is that under these pronouncements, legal comfort (whether an opinion letter or other legal memoranda) providing a "more likely than not" assurance has been widely accepted as sufficient.

¹⁰ FIN 39 states that "[o]ffsetting is appropriate only if the available evidence, both positive and negative, indicates that there is a reasonable assurance that the right of setoff would be upheld in bankruptcy." It would be difficult to construe this language as generally mandating a "would" opinion of counsel.