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December 15, 1997

Ms. Julie Anne Dilley
Technical Manager
Audit and Attest Standards
File 2605
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

Dear Ms. Dilley:

The Bond Market Association (the "Association")1 appreciates the opportunity to comment on the November 24, 1997 Draft of the Audit Issues Task Force ("AITF") of Proposed AU Section 9336 (the "Proposal") relating to the use of legal interpretations as evidential matter to support management's assertion that a transfer of financial assets qualifies as a sale under Statement of Financial Accounting Standards No. 125 ("SFAS 125") of the Financial Accounting Standards Board ("FASB").

We understand the AITF's desire to issue *auditing* guidance about the kind of evidence required to support determinations made under Paragraph 9(a) of SFAS 125. However, we believe that the Proposal's auditing guidance would actually change the application of the *accounting* standards promulgated in SFAS 125; in particular, the Proposal would effectively void the standard of Paragraph 9(a) that requires that a transfer put assets "presumptively" beyond the reach of creditors. As interpreted in Paragraph 23 of SFAS 125, only "reasonable assurance" is necessary, and **the FASB specifically states in SFAS 125 that certain transfers --which would not seem to meet the standard of the Proposal -- *shall* be accounted for as sales.** Neither the AITF nor the ASB has authority to establish, amend or interpret *accounting* standards; it must provide *auditing* guidance within the constraints established by the *accounting* standard-setter. Simply because the *accounting* standard-setter has, in the view of the *auditing* standard-setter, created a difficult framework within which the *auditor* must perform its function, does not justify a *de facto* change of any *accounting* standard to make it more *auditor*-friendly.

Although the Association appreciates the opportunity to comment on the Proposal in this letter, we note that the comment period was only three weeks and it occurred in the middle of the holiday season. **The Association is concerned with the AITF's apparent rush to finalize guidance, particularly in light of the significance that the Proposal would have for the financial markets.**2 The Association is especially concerned with the AITF's statement in the cover letter to the Proposal that it intends to issue final guidance, **without any opportunity for comment,** regarding Paragraphs 58 and 121 of SFAS 125 (transfers by FDIC-insured institutions).3 The Association believes it is

critical that any guidance that would purport to change the accounting standard be issued in draft form with an opportunity for public and FASB comment.[4]

The Proposal should be held in abeyance until it can be considered by the appropriate accounting standard-setter, the FASB, and if amendment or interpretation of SFAS 125 is appropriate, based on FASB review, then be the subject of the normal due process of the FASB.

I. EXECUTIVE SUMMARY

The Proposal sets a rigid and restrictive standard that is far more stringent than SFAS 125 itself. *By requiring "would" opinions in the case of transfers by entities subject to the Bankruptcy Code,[5] the AITF is arbitrarily going well beyond the "reasonable assurance" standard of SFAS 125 -- both the text of SFAS 125 and the FASB's explicit and implicit treatment of various transactions in SFAS 125 set an accounting standard different from the accounting standard that the Proposal's auditing guidance would purport to set.* The Association is particularly concerned with the adverse market impact of the Proposal on sales of assets coupled with derivatives (such as structured products involving sales with total rate of return swaps), repos that currently qualify for sales treatment under SFAS 125[6] and sales effected through participations.

The Association is convinced that the "would" opinion standard in the Proposal would significantly reduce market activity in transactions such as securitizations and other structured products. These transactions are used extensively by financial institutions to repackage financial assets and instruments to meet the demands of investors and are an important source of funding for many financial institutions. Furthermore, the "would" opinion standard would unnecessarily increase costs to firms that continue to enter into sales transactions that, due to the AITF standard, would be accounted for as secured borrowings -- be they increased regulatory capital requirements or the costs arising from the perception that a firm has greater leverage. Because of these costs, firms may instead restructure certain transactions (including moving them offshore where possible)[7] solely to achieve favorable accounting treatment.

The AITF's "would" opinion standard is inconsistent with the accounting and auditing standards being applied in similar circumstances. In particular, EITF D-43 requires "reasonable assurance" based on "available evidence" that netting "would" be enforceable for a reporting entity to net off-balance sheet and repo exposures. "Would" opinions are not being required to meet those standards.[8]

There is no evidence that the FASB supports the formulaic and restrictive standard proposed by the AITF. Indeed, the Association understands that the FASB has specifically declined to impose a "would" opinion standard, let alone a legal opinion requirement in the first place.

The AITF's stringent "would" opinion standard will result in inconsistency and asymmetry in accounting treatment and will promote opinion-shopping. Different

reporting entities may account for the same transactions differently, and two entities may show the same asset on their balance sheets (and be required to maintain regulatory capital against the same asset); even though the law is the same, the firms' counsel may have different views of the law or a different way of expressing their judgments. Although the Proposal recognizes that bankruptcy opinions are reasoned opinions9, a reasoned "would" opinion standard does not recognize the diversity of opinion practice, particularly in non-U.S. jurisdictions, and will promote opinion-shopping. A less restrictive standard will promote consistency and symmetry in accounting treatment and will reduce time-consuming and costly exercises in opinion-shopping.

Although legal opinions may be an important source, a firm should be able to provide other available evidence -- such as evidence of regulators' views -- to support its assertion that the isolation criterion has been met. For example, the regulatory policies surrounding the relationship between regulated and unregulated entities may be persuasive evidence of the separateness of those entities in bankruptcy, notwithstanding the inability of counsel to give an opinion (due to the lack of case law) that, standing by itself, does not meet the reasonable assurance standard of SFAS 125.

The treatment of a sale transaction as a financing because of the restrictive standard in the Proposal could impair a purchaser's rights in the event of a bankruptcy of the seller. A court might view a seller's treatment of a sale transaction as a financing for financial reporting purposes as evidence that the transaction should be treated as a financing for bankruptcy purposes. The Association is especially concerned that a court might base its determination on the "seller's" failure to meet the flexible language of SFAS 125, because the secured borrowing treatment was required by the Proposal. Such a result would be contrary to the intention of the parties and the otherwise likely outcome of the litigation.

The Association believes that the appropriate standard is less rigid than that proposed by the AITF, and that the "reasonable assurance" standard of SFAS 125 can be met in a number of ways. Because of the equitable powers of bankruptcy courts and the fact-specific nature of the cases, legal comfort in this area is very subjective. Furthermore, different counsel have different standards in rendering opinions; these differences may be based on, among other things, a firm's policies or the jurisdiction in which counsel practices. Instead of the imposition of an arbitrary and formulaic approach on auditors, a firm and their internal and external counsel10, auditors must have more flexibility in assessing legal comfort and should, where necessary, engage in a dialogue with counsel as to the level of the comfort to determine whether there is "reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee". As stated in the *topic sentence* of Paragraph 23 of SFAS 125, "[t]he nature and extent of supporting evidence . . . depend on the facts and circumstances." The Association believes that the Proposal's "check-the-box" approach is contrary to the case-by-case analysis envisioned by the FASB.

Even though the Association generally disagrees with a formulaic approach to legal comfort, it does believe that certain formulations of a lawyer's conclusion should

presumptively meet the reasonable assurance standard of SFAS 125 (although that presumption could be rebutted by contrary evidence) and some should not (absent countervailing positive evidence). We discuss some specific formulations in the text below.

The Association emphasizes, however, that a list of formulations should not straitjacket auditors and counsel, and that auditors should be entitled to make judgments in particular cases as to whether there is "reasonable assurance." This is particularly important in the context of legal comfort from counsel in non-U.S. jurisdictions who may express conclusions in different language. The phrasing of a foreign lawyer's conclusion might seem weaker than that of a U.S. lawyer, even though it is intended to be stronger (and *vice versa*). The Proposal would not seem to allow this critical flexibility.

Firms should not be required to obtain legal comfort for every non-routine transaction; instead, memoranda of law addressing non-routine transactions meeting certain assumptions should be acceptable so long as the assumptions in the memorandum can be "matched" to the actual transaction. The Association believes that auditors should have flexibility in this regard. In certain circumstances, the auditor may be able to determine that the memorandum encompasses the transaction, while in others the auditor may need assistance either from management or counsel in making that determination. If the auditor cannot determine that the transaction fits within the advice given in the memorandum, it would then seek additional evidence as appropriate. Again, the Association believes this flexibility is entirely consistent with the spirit and letter of SFAS 125.

Finally, the Association agrees that auditors entitled to seek legal comfort as evidence to support a firm's assertions should be entitled to review that comfort and that certain limitations in a legal opinion would be inconsistent with the auditor's use of the legal comfort. The Association does not believe, however, that a limitation on auditors' "reliance" itself unduly restricts the use by the auditor of the legal comfort.

In light of our concern with the impact of the Proposal on the markets and our concern that the Proposal would change generally accepted accounting principles without the normal FASB due process, it is imperative that the next version of the Proposal, if any, should be put out for an extended period of public and FASB comment and that any guidance regarding Paragraphs 58 and 121 of SFAS 125 should also be the subject of public and FASB comment.

II. DISCUSSION

A. The AITF's "Would" Opinion Standard is Far More Restrictive Than SFAS 125; SFAS 125 Requires Only Reasonable Assurance

Although the Proposal does not expressly state that a "would" opinion from counsel is required for a firm to meet the isolation criterion in Paragraph 9(a) of SFAS 125, it is the Association's understanding that Paragraphs 1.13 and 1.17 of the Proposal make this

requirement for "non-routine" transactions clear by negative implication. Under Paragraph 1.13, a "should" opinion would not provide persuasive evidence, and under Paragraph 1.17, an auditor will "usually" not be able to obtain persuasive evidence in a form other than a legal opinion.

The Association agrees that there is a significant degree of legal content to Paragraph 9(a) of SFAS 125, and that legal comfort from qualified counsel may be an important means for an auditor to obtain evidence of a firm's assertion that the isolation criterion has been met for "non-routine" transactions. However, we strongly believe that SFAS 125 itself does not require, and the FASB has not interpreted SFAS 125 to require, that the legal comfort must come in the form of a legal opinion or that the comfort must meet an inflexible and stringent "would" opinion standard. Instead, SFAS 125 sets forth a "reasonable assurance" standard as to both form and substance that is to be applied in a case-by-case manner on the basis of all available evidence. **The Association therefore believes that the Proposal would actually change generally accepted accounting principles, and we question the AITF's authority to make such a change.**

1. The text of SFAS 125 itself sets forth a standard much less restrictive than the "would" opinion standard in the Proposal

The Association believes that the text of SFAS 125 sets forth a lesser standard than a "would" or "should" opinion standard. The wording of the text of SFAS 125 can support a number of possible interpretations as to the level of comfort that must be obtained to meet the Paragraph 9(a) standard. Based solely on a textual analysis, one can make arguments for a variety of standards, ranging from a "would/should" opinion standard to a "more likely than not" standard11. Given these "mixed signals", it is unclear why the AITF chose the most restrictive interpretation, especially in light of the words of Paragraph 23 that seem to bear most directly on the question of the standard of the legal comfort:

The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated . . . may include making judgments about . . . whether a transfer of financial assets *would likely* be deemed a true sale at law . . . . 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.... (Emphasis added.)

The Association believes that Paragraph 23 itself sets forth the appropriate standard; that standard is a "would likely/reasonable assurance" standard and not a "would" opinion standard.

To the extent that there is textual ambiguity, however, the Association believes that one can go beyond the mere words of SFAS 125 and look to the FASB's explicit and implicit treatment of various transactions in SFAS 125. The lengthy accounting guidance given by the FASB in SFAS 125 in connection with repos, participations and other trading

transactions strongly supports the view that a "reasonable assurance" standard (and certainly not an inflexible "would" standard) is the appropriate standard.

2. A "Would" Opinion Standard is Contrary to the FASB's Treatment of Repos and other Transactions in SFAS 125.

Paragraph 24 of SFAS 125 indicates that "many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control."12 Furthermore, Paragraph 68 states that "... transfers ... that shall be accounted for as sales include transfers with agreements to repurchase at maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets." (Emphasis added.)13

The FASB's statement that repos would qualify for isolation under Paragraph 9(a) is inconsistent with the view that a "would" opinion is required for derecognition. Indeed, the FASB recognizes that repos are "ambiguous" and "difficult to characterize".14 Transactions that are "ambiguous" are hardly susceptible to the receipt of the definitive legal comfort required by "would" opinions. Rather, the FASB's statement that typical repos are "generally" treated as sales in bankruptcy is entirely consistent with a "reasonable assurance" standard.15

Similarly, the FASB seemed clearly to contemplate that participations would qualify for derecognition in many circumstances (see Paragraphs 74-76), yet even well-drafted participations sold without recourse can pose creditors' rights issues.16 **Again, this strongly supports the conclusion that the Proposal's "would" opinion requirements go well beyond SFAS 125.**[17]

3. A "would" opinion standard would be inconsistent with other similar accounting standards

EITF D-43, which interprets FIN 39 (and FIN 41 [18]) states that "[o]ffsetting is appropriate only if the available evidence, both positive and negative, indicates that there is reasonable assurance that the right of setoff would be upheld in bankruptcy." This standard is remarkably similar to that in Paragraph 23 of SFAS 125.19 We do not believe that "would" or "should" opinions are, or have been, required to meet the FIN 39 and FIN 41 standards, but instead that the standard has been applied flexibly and that memoranda or other legal diligence, together with other available evidence20, conveying a "would likely" confidence level have been viewed as sufficient.

EITF D-43 also states that "all of the information that is available, either supporting or questioning enforceability, should be considered." Again, this is remarkably similar to the statement in Paragraph 23 of SFAS 125 that "[a]ll available evidence that either supports or questions an assertion shall be considered." Implicitly in both of these standards, information questioning enforceability is not necessarily inconsistent with reasonable

assurance; on the other hand, it might well be inconsistent with a "would" or "should" opinion.21

Notably, there appear to be substantial similarities between the reasonable assurance required for netting under FIN 39 and FIN 41 and derecognition under SFAS 125 -- in addition to the similarities in language, FIN 39, FIN 41 and SFAS 125 go to the legal underpinnings for accounting treatment and rely in large part on counsel's judgments as to difficult-to-evaluate bankruptcy issues.22 **The Association believes that the flexibility that has been applied in implementing FIN 39 and FIN 41 is appropriate and consistent with the spirit and letter of EITF D-43; the AITF should apply the spirit and letter of SFAS 125 similarly.**

4. The FASB has declined to mandate a "would" standard

SFAS 125 never states that legal opinions should be required or that a "would" or "should" standard is required. Furthermore, we understand that several of the Association's members and counsel have since the publication of SFAS 125 participated in meetings with members and staff of the FASB and that the FASB has declined to indicate that opinions would be required or that they would have to meet a "would" standard.

The Proposal's rigid and stringent "would" opinion standard thus goes far beyond SFAS 125 and the intention of the FASB. The Proposal's standard is inconsistent with the explicit and implicit treatment by the FASB of various transactions in SFAS 125, is inconsistent with other similar accounting standards and has never been endorsed by the FASB. The Association does not believe that the AITF has the authority to make this change to generally accepted accounting principles, and believes that any final guidance must be the subject of an opportunity for an extended period of public and FASB comment.

B. A "Would" Standard Would Not Change the Law or Make the Law Clearer and Would Result in Inconsistency and Asymmetry of Accounting Treatment and Will Promote Opinion-shopping

A lawyer's opinion as to whether a sale of financial assets will be respected as such in a bankruptcy will not, of course, necessarily produce that result. Instead, a lawyer's opinion (particularly in the case of bankruptcy opinions) is more in the nature of a prediction, based to the extent possible on prior case law, of how a court is likely to view the particular facts of a transaction. Because of the predictive nature of legal comfort, and because different counsel have different standards in rendering opinions23, a strict "would" opinion standard would promote inconsistency, asymmetry and opinion-shopping. On the same facts, different counsel may well come to different conclusions; some counsel may reach a "would" level of comfort, others may not. *A "reasonable assurance" standard would result in greater consistency and comparability and still provide a strong degree of legal comfort that transferred assets have been placed beyond the reach of creditors; the differing approaches of counsel would be more likely to satisfy*

this flexible standard and different firms would be more likely to account for similar transactions in the same way.

A less restrictive standard will not only promote consistency, it will promote symmetry (one of the principal goals of the financial components approach of SFAS 125); assets will not be shown on two firms' balance sheets at the same time and only one firm will have to maintain regulatory capital against those assets. Furthermore, it will reduce opinion-shopping; the Proposal's "would" standard would cause firms to consider searching for counsel that is willing to render a "would" opinion in lieu of counsel that, in the same transaction, would not.

These issues are likely to be exacerbated in the case of transfers of financial assets by non-U.S. affiliates of U.S. reporting firms. Because the AITF's Proposal does not recognize the diversity of legal opinion practice even in the U.S. context, it will likely have an even more adverse effect in non-U.S. jurisdictions where the distinctions drawn by lawyers in the U.S. between "would" and "should" are likely to be foreign. The Association believes that the AITF must not underestimate the impact of the Proposal on the ever-increasing amount of asset securitization and other sales transactions that are being done by foreign affiliates of U.S. reporting firms. The legal formulas used in the United States should not be imposed on non-U.S. counsel by virtue of auditing practices. A more flexible and less formulaic standard would accommodate the practices of non-U.S. lawyers providing comfort in non-U.S. transactions.

C. Traditional Legal Comfort (Opinions and Memoranda of Law) Should Not Be the Only Form of Persuasive Evidence

Paragraph 1.17 of the Proposal states that "the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion." The Association believes that although traditional legal comfort (whether in the form of an opinion or a memorandum of law 24) may in many circumstances be an important element in the auditor's determination, in many circumstances other evidence may be persuasive. The Proposal does not give adequate recognition to the forms of "available evidence" that Paragraph 23 of SFAS requires a firm to consider in "making judgments" regarding a transfer. The very first sentence of Paragraph 23 states that the "nature and extent of supporting evidence" . . . "depend on the facts and circumstances."

For example, in the case of a sale by a broker-dealer to a third party executed simultaneously with a derivatives contract between the third party and an affiliate of the seller, the issue of substantive consolidation in bankruptcy between the seller and its affiliate could be relevant to the question of isolation; if the seller and the affiliate were consolidated, counsel might not be able to provide reasonable assurance regarding true sale issues. If the affiliate is not a special purpose entity, counsel might find it difficult to render an opinion that the seller and the affiliate should not be consolidated in light of the highly fact-intensive nature of substantive consolidation analysis and the non-special purpose nature of the affiliate in question. Nonetheless, a firm may be able to obtain comfort that does not take the form of traditional legal comfort, because it is not based on

case law, that provides persuasive evidence to the auditors. For example, in the case of a broker-dealer seller, evidence of the regulators' views would be highly probative of the likelihood of consolidation (or the likelihood of litigation), yet would not form the basis of a legal opinion.25

Of course, evidence of the regulators' views should not be viewed in isolation, and should be evaluated along with any legal comfort obtained; together, they might provide reasonable assurance that the assets would be beyond the reach of the transferor or they might not. The fact, however, that the legal comfort alone does not provide such assurance should not preclude the totality of the evidence from providing such assurance.

D. The Treatment of a Sales Transaction as a Financing Could Impair a Purchaser's Rights in the Event of a Bankruptcy of the Seller

A court might view a seller's treatment of a transaction structured as a sale as a financing for financial reporting purposes as evidence that the transaction should be treated as a financing for bankruptcy purposes. Because of the "disconnect" between SFAS 125 and the Proposal, the Association is especially concerned that a court might base its determination on the express language of SFAS 125 rather than the proposed "auditing" standard in concluding that the seller could not even provide reasonable assurance that the transfer would be viewed as a sale in bankruptcy. For example, if counsel could render a conclusion that it would be likely that a sale of an asset coupled with a total rate of return swap would be treated as a sale of the asset, yet the transfer was accounted for as a secured borrowing, it is possible that in a bankruptcy of the seller, the seller's accounting treatment of the transaction would be used against the purchaser (who would, of course, take the position that the transaction was a sale). The Association has been involved in several efforts to clarify the treatment in bankruptcy of various financial transactions to comport with the parties' expectations as to the treatment of those transactions (for example, the provisions of the Bankruptcy Code protecting the rights of purchasers of assets under repos26). The Association is very concerned that the AITF's Proposal would undercut these efforts and would produce perverse results.

E. The "Reasonable Assurance" Standard is Not a Formula and Can Be Met in a Number of Ways

Paragraph 23 of SFAS 125 clearly indicates that meeting the isolation standard of Paragraph 9(a) is not a matter of checking a box. Instead, it is a facts-and-circumstances endeavor that is designed to provide reasonable assurance that an asset would be beyond the reach of creditors. The Proposal attempts, on the other hand, to force lawyers' conclusions into a narrow and inflexible formula. Because of the equitable powers of bankruptcy courts and the fact-specific nature of bankruptcy cases, legal comfort in this area is inherently very subjective. Furthermore, different counsel have different standards in rendering opinions27. While the Association understands that the AITF believes that the Proposal would be easy to implement, it simply ignores the reality of the uncertainty in this area. *Instead of the imposition of an arbitrary and formulaic approach on auditors and counsel, auditors should be able to exercise judgment in assessing legal comfort and*

should, if necessary or appropriate, engage in a dialogue with counsel to ascertain the level of counsel's comfort to determine whether the "reasonable assurance" standard of SFAS 125 has been met.

Even though the Association generally disagrees with a formulaic approach to legal comfort, it does believe that certain formulations of a lawyer's conclusion should presumptively meet the reasonable assurance standard of SFAS 125 (although that presumption could be rebutted by contrary evidence). For example, the Association believes that the following formulations (most of which are taken from Paragraph 1.13 of the Proposal) of counsel's conclusions would presumptively provide persuasive evidence that the isolation criterion has been met:

- "In our opinion, the transfer should be considered a sale.28"
- "We are of the view that a court would ..." 29
- "There is a reasonable basis to conclude that ..."
- "We believe a court would likely..."
- "Although the matter is not free from doubt, it is our opinion that a court would ..."

Similarly, the Association believes that certain formulations of a lawyer's conclusion from Paragraph 1.13 of the Proposal should presumptively not provide persuasive evidence that the isolation criterion has been met (unless other available evidence supports isolation):

- "We are unable to express an opinion."
- "It is our opinion, based upon limited facts..."
- "In our opinion, there is a reasonable possibility..."
- "It is our opinion that the company will be able to assert meritorious arguments..."

The Association emphasizes, however, that these formulations should not box auditors and counsel in, and that auditors should be entitled to make judgments in particular cases as to whether there is "reasonable assurance." The auditor's judgment should be made on a case-by-case basis, and the fact that a formulation is not listed above (or in Paragraph 1.12) should not automatically mean that it does not provide reasonable assurance as to isolation.

This is particularly important in the context of legal comfort from counsel in non-U.S. jurisdictions who may express conclusions in different language. The Association believes it is simply inappropriate for the AITF to export U.S. linguistic norms to non-U.S. counsel and that the Proposal must allow for greater flexibility in this regard.

F. Legal Comfort Can Take the Form of a Memorandum of Law and Does not Have to be Obtained for Every Non-Routine Transaction

Paragraph 1.13 of the Proposal states that "conclusions about hypothetical transactions may not be relevant to the transaction that is the subject of management's assertions. . . .

[C]onclusions about hypothetical transactions may not contemplate all of the facts and circumstances or the provisions in the agreements of the transaction that is the subject of management's assertions, and generally would not provide persuasive evidence." The footnote to this statement reads as follows: "a memorandum of law from a legal specialist usually analyzes (and may make conclusions about) a transaction that may be completed subsequently. Such memorandum generally would not provide persuasive evidence, unless the conclusions conform with this interpretation and a legal specialist opines that such conclusions apply to a completed transaction that is the subject of management's assertion." 30

The Association believes that the lack of flexibility reflected in Paragraph 1.13 is inconsistent with SFAS 125 and that it is unnecessary for firms to incur the expense associated with a legal opinion for every transaction in order for auditors to become comfortable with management's assertions regarding Paragraph 9(a) of SFAS 125. While we agree with the concept that some diligence needs to be done to ensure that a particular non-routine transaction fits within the parameters of an opinion or memorandum of law that makes assumptions about a transaction, we do not believe that counsel must in all cases "match" the transaction to the opinion or memorandum. Instead, in many cases, the auditor may be able to determine that the memorandum encompasses the transactions, while in others the auditor may need assistance either from management or a lawyer (including a lawyer that is not an expert in bankruptcy matters) in making that determination. If the auditor, on the basis of this diligence, cannot determine that the transaction fits within the advice given in the memorandum, then in appropriate circumstances, additional evidence would be sought.

G. Auditors Should be Entitled to Review, but not Rely on, a Lawyer's Conclusions

Paragraph 1.15 of the Proposal states that "an auditor should not use as evidence a legal opinion that . . . *restricts use* of the findings expressed therein . . . ." (Emphasis added.) The Association agrees that language in the legal conclusion flatly prohibiting the use of the conclusion by the auditor may not be acceptable. In this regard, we believe that it should be sufficient for counsel to acknowledge that its client may show a copy of the legal conclusion to its auditors for the purpose of the auditors' evaluation of the firm's assertions in its financial statements. Counsel should not, however, be required to allow the auditors to "rely" on the conclusion. 31

For the foregoing reasons, the Association strongly urges the AITF to hold the Proposal in abeyance until it can be considered by the FASB and be the subject of the normal due process of the FASB, including an opportunity for public comment.

III. CONCLUSION

We would be happy to discuss our views at your convenience. Please contact either of the undersigned at (212) 440-9400 or our special counsel in this matter, Seth Grosshandler of Cleary, Gottlieb, Steen & Hamilton, at (212) 225-2542 with any questions or comments.

Sincerely,

Paul Saltzman
Senior Vice President and General
Counsel

Patricia E. Brigantic
Vice President and Assistant General
Counsel

cc: Michael Sutton, Chief Accountant,
Securities and Exchange Commission
Richard R. Lindsey, Director, Division of Market Regulation
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Office of Thrift Supervision
Shiela Albin, Associate General Counsel for Operations
National Credit Union Administration
Members of the Board of Directors, The Bond Market Association
Members of the Accounting Policy Committee, The Bond Market Association
Selected Staff of The Bond Market Association

Footnotes:

1. The Bond Market Association (formerly PSA The Bond Market Trade Association) represents approximately 200 securities firms and banks that underwrite, trade and sell a wide range of fixed income securities, both domestically and internationally. Among other market activities, our members are active participants in transactions involving the securitization of financial assets, both domestically and internationally, as well as a variety of other transactions involving the transfer of financial assets (e.g., repos, securities lending, participations, structured products).

In its preparation of this letter, the Association has had extensive discussions with its primary members -- securities firms and banks -- as well as its associate members -- accounting and law firms.

More information about the Association can be obtained from our website at www.bondmarkets.com.*back*

2. The impact of the Proposal would go beyond banks and broker-dealers; many affected parties -- accountants, auditors, lawyers, federal and state regulators and other preparers and users of financial statements -- may not even be aware of the existence of the Proposal. The normal due process of the FASB would allow a studied and fair approach to the issues raised in the Proposal. *back*
3. The AITF states in the cover letter accompanying the Proposal that it has initiated discussions with the FASB regarding Paragraphs 58 and 121 of SFAS 125, and that it plans to include guidance based on the discussions in the final interpretation. We also understand that the AITF has requested that the FDIC confirm certain policies regarding how it might exercise its powers in case it became the receiver or conservator of an FDIC-insured institution. *back*
4. FDIC-insured banks may be directly and adversely affected by such guidance, and the AITF should not underestimate the potential negative consequences both to the institutions affected and the markets. Second, that guidance may be relevant to issues going beyond sales of assets by FDIC-insured institutions. For example, there are many parallels between the treatment of various transactions in proceedings in respect of a U.S. broker-dealer under the Securities Investor Protection Act and the treatment of those transactions in FDIC conservatorship or receivership proceedings. A full exposure of the Proposal would allow interested parties to address all of the issues raised by the Proposal. *back*
5. The Association does not address herein any issues regarding the specific nature of legal comfort that should be obtained in the context of transfers by FDIC-insured institutions, in light of the particular provisions of the Federal Deposit Insurance Act. As stated above, the Association believes that it is critical that any guidance regarding Paragraphs 58 and 121 of SFAS 125, particularly any guidance that would purport to change the accounting standard, be issued in draft form with an opportunity for public and FASB comment. Furthermore, although the Proposal seems to address specific legal formulations in the context of transfers by FDIC-insured institutions (see footnote 5 in the Proposal), the Proposal is ambiguous in this regard (see footnote 4 in the Proposal). The Association believes that, if the AITF disregards our comment that further public and FASB comment is necessary on the existing Proposal, it should at the very least make clear that the Proposal does not apply to transfers by FDIC-insured institutions, and then put any guidance on transfers by FDIC-insured institutions out for public and FASB comment. *back*
6. We do not address Paragraphs 9(b) or (c) of SFAS 125 herein. It is our understanding that a repo, if it met the requirements of Paragraph 9(c) (i.e., "control" is not maintained), could qualify as a sale of the underlying asset if the requirements of Paragraphs 9(a) and (b) were met. We also do not address the

question of when a transaction is a "routine" transaction as discussed in Paragraph 1.04 of the Proposal, in which case legal opinions need not be obtained.*back*

7. In certain jurisdictions, the law may be clearer on true sale issues than in the United States. For example, English bankruptcy law (which would require an English transferor) is attractive, because it is our understanding that English law generally treats transactions documented as sales as sales. *back*
8. In this regard, any final guidance should make clear that it is limited to the issue of Paragraph 9(a) of SFAS 125. *back*
9. A reasoned opinion generally means a qualified opinion in which counsel sets forth the analysis that forms the basis of its conclusion in the opinion itself. Opinions in the bankruptcy area tend to be reasoned opinions, because of the equitable powers of bankruptcy courts and the subjective and often difficult nature of the issues being addressed. *back*
10. The use of the phrase "legal specialist" in the Proposal could be taken to mean that counsel must in all circumstances be an "expert" in bankruptcy matters. We believe that, where it is appropriate to consult counsel, in many circumstances that counsel does not have to be a bankruptcy expert. For example, an internal counsel may be familiar with a transaction and, although not an expert, would feel comfortable in providing his or her legal judgment as to the treatment of the transaction in bankruptcy. *back*
11. "Presumptively" (which in layman's terms seems to be a relatively flexible standard) appears, of course, in Paragraph 9(a) itself and would seem to suggest a very low standard. The reference in Paragraph 57(a) to sales to SPE's being "likely" to be judged beyond the reach of the transferor implies a "more likely than not" standard. On the other hand, the reference in Paragraph 118 to assurances acceptable to rating agencies implies a "would/should" standard (***as discussed below, the rating agencies will often accept "should" opinions***). Notably, Paragraph 118 does not form an integral part of SFAS 125, as it is contained in Appendix B (unlike Paragraphs 22 through 84, which are contained in Appendix A). *back*
12. The minutes of the March 27, 1996 meeting of the FASB indicate that :

    "Mr. Bullen recommended that the final Statement note in Appendix A that certain transactions meet criterion 9a, even though they may not meet the other control criteria, for example, repurchase agreements, securities lending transactions, and loan participations. He stated that would help accountants and preparers understand the criterion. No Board members disagreed with the staff recommendation." (Emphasis added.)

    See also Paragraph 138 of SFAS 125: "if judged by the criteria in paragraphs 9(a) and 9(b) . . ., financial assets transferred under typical repurchase . . . agreements would qualify for derecognition as having been sold for proceeds consisting of cash and a forward purchase contract." *back*
13. We understand that the AITF believes that the "would" opinion standard is required by Paragraph 23 of SFAS 125 (even though that Paragraph, as discussed above, speaks of "reasonable assurance" that a transfer "would" be considered a

sale). Notably, Paragraphs 24 and 68 are of the same importance in interpreting SFAS 125 as Paragraph 23; each is in Appendix A ("Implementation Guidance") and each is an "integral part of the standards provided in" SFAS 125 (Paragraph 22). We assume that no legal opinion or other comfort would be required if transactions described in Paragraph 68 are treated as sales in accordance with the prescriptions established by the FASB in that Paragraph. *back*

14. Paragraphs 135 and 142 of SFAS 125. *back*
15. The Federal Reserve Bank of New York, in an amicus brief filed with the U.S. Supreme Court in Nebraska Dept. of Rev. v. Lowenstein, 115 S.Ct. 557 (1994), a recent tax case involving repos, cautioned the Court that "characterization of repos is a dangerous process." Repos are hybrid transactions that are often characterized differently for different purposes (i.e., commercial law, tax and bankruptcy). Because of the difficulty in characterizing repos as either purchases and sales or secured borrowings for bankruptcy purposes, special bankruptcy protections have been enacted in order to protect the functioning of a vitally important financial market. In light of this difficulty, it is very unlikely that any legal specialist would be able to provide a "would" opinion that a repo constitutes a true sale. The fact that the FASB, obviously keenly aware of the "difficult to characterize" nature of repos, would state that they meet the isolation criterion of Paragraph 9(a) is strong evidence that a "would" level of legal assurance was not intended by the FASB to be the standard for isolation. *back*
16. Participations have been the subject of a great deal of insolvency case law, principally involving banks. Although most of that case law indicates that, where a lead lender sells a participation without recourse, the underlying asset (or portion thereof subject to the participation) is not property of the lead's estate, the case law is not entirely uniform. In addition, if the underlying borrower has a deposit with the lead, it can set off its obligations under the loan against the deposit obligations of the lead, notwithstanding the participation of the loan (and to the detriment of the participant). This legal landscape seems inconsistent with a "would" opinion standard, yet the FASB seemed clearly to contemplate that participations would qualify under Paragraph 9(a) of SFAS 125. *back*
17. Outside of the context of repos and participations, the majority of examples in SFAS 125 suggest that many transactions that would not meet a "would" opinion requirement should nonetheless meet the isolation standard of Paragraph 9(a). See Paragraphs 6, 32, 41 and 46, which imply that a put should be treated the same whether written by the seller of the subject asset or a third party and that sales of loans with recourse should be treated as sales. When a put is issued by a seller of an asset or when loans are sold with recourse, there may well be true sale issues inconsistent with "would"-level comfort. *back*
18. The FIN 39 standard is incorporated into FIN 41 (netting of repos). *back*
19. Of course, the AITF Proposal would only apply to determinations under Paragraph 9(a) of SFAS 125. In light of the similarity of wording between Paragraphs 23 of SFAS 125 and EITF D-43, however, the Association believes that the AITF should make the limited application of the Proposal clear in any final guidance. *back*

20. For example, we believe that firms have supported offsetting with certain counterparties on the basis of regulatory pronouncements or realities, even if there is no traditional legal comfort that offsetting would be enforceable. *back*
21. The "all available evidence" standard of diligence that balances positive and negative evidence is echoed in SFAS 109 (Accounting for Income Taxes). Paragraph 20 of SFAS 109 states that "[a]ll available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, a valuation allowance is needed." The Summary further states that "[j]udgment must be used in considering the relative impact of negative and positive evidence.... The more negative evidence that exists (a) the more positive evidence is necessary and (b) the more difficult it is to support a conclusion that a valuation allowance is not needed." Again, the balancing of positive and negative evidence, when applied to a lawyer's judgment, may well be inconsistent with a "would" or "should" opinion. *back*
22. The other area in which counsel's judgments are often used as evidence to support accounting conclusions is under SFAS 5 (Accounting for Contingencies). Paragraph 36 of SFAS 5 indicates that, *among other factors*, the "opinions *or* views" of legal counsel should be considered. The Association believes that, although the language of Paragraph 36 of SFAS 5 is not so nearly identical to Paragraph 23 of SFAS 125 as are EITF D-43 and Paragraph 20 of SFAS 109, it conveys the same message: auditors must be flexible in evaluating legal evidence in evaluating a firm's assertions. *back*
23. There is a wide range of opinion practices in the United States. For example, some counsel do not even believe there is a difference between a "would" and a "should" opinion while others do. The AITF's Proposal fails to recognize this diversity. *back*
24. We discuss our views on opinions versus memoranda of law below. *back*
25. Footnote 2 of the Proposal is thus unsatisfactory, in that implies that the legal specialist should consider applicable regulatory policies in arriving at a legal conclusion. Indeed, a legal specialist may find it inappropriate to base any legal conclusion on the policies of a regulator. Our point is that regulatory policy, which may have a significant bearing on the probable outcome of any litigation or whether litigation is even brought, is not susceptible to traditional legal comfort yet is very relevant to, if not determinative of, the issue of isolation. *back*
26. More recently, the Association has been working with the President's Working Group to make several changes to U.S. bankruptcy and insolvency laws. See in this regard "Financial Transactions in Insolvency: Reducing Legal Risk Through Legislative Reform", a position paper prepared jointly by the Association and the International Swaps and Derivatives Association, Inc. (April 2, 1996). *back*
27. For instance, some counsel may be comfortable giving a legal conclusion in a highly subjective area if they believe that they will not be liable for negligence in rendering that conclusion. Other counsel may instead require affirmative case law support for a conclusion. Some counsel may be more concerned with reputational issues than other counsel. These are just some examples of the different considerations that different legal specialists consider in approaching opinion practice. *back*

28. Some rating agencies will accept "should" opinions in certain circumstances (e.g., in opinions regarding substantive consolidation); thus, even under the most restrictive view of SFAS 125, "should" level comfort should constitute persuasive evidence. This conclusion is supported by the view of some, but not all, U.S. counsel that there is no difference between a "would" and "should" opinion.

    As noted above, we do not address in this letter the level of comfort that should be acceptable in the case of transfers by FDIC-insured banks (such as the "either there is a sale or there is a perfected security interest" opinions routinely rendered to the rating agencies in securitizations by FDIC-insured institutions). Again, we believe it is critical that the public and the FASB be given an opportunity to comment on any guidance in this regard. back *back*
29. The AITF's proposed acceptance of counsel's "belief" (see Paragraph 1.12) but not its "view" (see Paragraph 1.13) seems counterintuitive. *back*
30. We agree with the statement in the footnote, to the extent it implies that a memorandum of law *can* provide persuasive evidence. *back*
31. Language such as that found in Paragraph 7 of the American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975) is an example of an approach that the Association believes should be acceptable. That Paragraph, which is often incorporated by reference in counsel's responses to auditors' requests for information pursuant to SFAS 5, provides as follows:

    "Limitation on Use of Response. Unless otherwise stated in the lawyer's response, it shall be solely for the auditor's information in connection with his audit of the financial condition of the client and is not to be quoted in whole or in part or otherwise referred to in any financial statements of the client or related documents, nor is it to be filed with any governmental agency or other person, without the lawyer's prior written consent. Notwithstanding such limitation, the response can properly be furnished to others in compliance with court process or when necessary in order to defend the auditor against a challenge of the audit by the client or a regulatory agency, provided that the lawyer is given written notice of the circumstances at least twenty days before the response is so to be furnished to others, or as long in advance as possible if the situation does not permit such period of notice. *back*