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## **ISDA/TBMA/ASF Meeting with SEC Regarding Swap Counterparty Disclosure October 5, 2006**

Please find below notes of a meeting between SEC Staff (“Staff”) members, and representatives of ISDA, TBMA and the ASF, on October 5, 2006 at the SEC's offices in Washington DC.

This was the first meeting between industry representatives and the SEC to discuss the letter submitted June 9, 2006 by ISDA, TBMA and the ASF, seeking clarification as to financial disclosure about derivatives counterparties that may be required by Item 1115 of Regulation AB.

### **I. Meeting participants:**

#### SEC Staff:

Paula Dubberly

Jeffrey Cohan

Sara Calin

Max Webb

Carol Stacey

Carol McGee

#### Industry representatives:

Donald Bendernagel - Citigroup

Robbin Conner – The Bond Market  
Association

Tom Deutsch – American Securitization  
Forum

Ralph Daloisio – Natexis Banques  
Populaires (by teleconference)

Ken Kopelman – Bear Stearns

Stephen Kudenholdt – Thacher Profitt &  
Wood LLP

Kimberly Summe – ISDA

## **II. Summary of discussion**

The joint proposal to provide some relief from the need for separate financial statements or selected information, where such information is required under Item 1115 as to a derivative that is issued by a subsidiary and is fully and unconditionally guaranteed by a corporate parent and the required information is provided as to the corporate parent, was met favorably.

In lieu of the current Item 1115 requirement requiring fully separated financial statements of a guaranteed subsidiary, the SEC is considering, based on the organization's joint request, only requiring condensed consolidating financial information providing limited financial information as to the subsidiary as contemplated in Rule 3-10 (c) under Regulation S-X, be provided in a footnote to the parent's financial statements. It is not clear whether this would apply to a derivative in the 10% - 20% significance percentage range.

Condensed consolidating financial information is required under Rule 3-10 as to operating subsidiaries. Going forward, the groups will continue to propose that instead a derivative issuer be treated like a finance subsidiary under Rule 3-10, as to which more limited information would be required. However, the Staff is still considering the matter and is expecting additional feedback from the participating organizations on the costs and benefits of this approach.

The Staff is not considering our further proposal to provide similar relief where a derivative is issued by a bank and financial statements or selected information is provided with respect to the holding company, but the holding company does not guarantee the obligations under the derivative.

The Staff is not considering easing in any way the requirements under Regulation AB that any such financial statements or selected information be prepared under GAAP, beyond the limited relief already provided in Instruction 5 to Item 1114.

The Staff is not considering any relief for credit enhancers under Item 1114.

The most likely format for relief would be through a no-action letter. The groups will request that the Staff consider a no-action letter request by one or more of the groups on behalf of the industry, rather than separate requests from each derivatives issuer.

### **III. Meeting notes**

The meeting began with Ms. Summe introducing the topic and thanking the Staff for meeting with us.

Next, Mr. Kudenholdt provided an overview of the key points raised in the letter. The key request is that, where financial statements or selected information is required of a counterparty, and the counterparty is a subsidiary of a parent company that guarantees the obligations of the counterparty under the derivative, then financial statements or selected information of the parent should be sufficient to satisfy the disclosure requirements. Separate financial statements or selected information of the counterparty would not be considered material by investors, and are not provided. We highlighted the analogy made in the letter to Item 3-10 under Regulation S-X, under which separate financial statements are not required of a finance subsidiary where its obligations are guaranteed by the parent.

Ms. Dubberly noted that while we might discuss an analogy to Item 3-10, it was clear that the provision does not actually apply to subsidiaries that issue derivatives and credit enhancements. This is expressly indicated in the adopting release. Ms. Dubberly also noted that the entire discussion was limited to derivatives counterparties under Item 1115, and that the Staff is not considering broadening the discussion to credit enhancers under Item 1114 at this time.

Next, Mr. Daloisio provided an investor's perspective. He indicated his view that separate GAAP financial statements of a derivatives counterparty would be of only "limited utility" and would provide nothing more than an indication of whether the entity was solvent at the date of the report. Because the financial condition of a derivatives counterparty on a going forward basis may be sharply affected by market factors as well as changes in the composition of the outstanding derivatives contracts, separate financial statements would not provide a basis for assessing the ongoing ability of the counterparty to perform its obligations. He noted that GAAP financial statements do not include an analysis of the potential effect of future market conditions on the counterparty's financial condition. For these reasons, as an investor he would instead rely on the consolidated financial statements of the parent, where the parent provides a corporate guaranty of the counterparty's obligations. Parent financial statements, together with other information about the parent that is available in the market, does provide a basis for assessing the ongoing ability of the parent to perform its obligations under the agreement.

Mr. Deutsch then noted that the ASF staff had consulted with its various investor members, and that they uniformly agreed with the view that separate financial information about a derivative counterparty subsidiary would not be material, where the obligations are guaranteed by the parent and the consolidated financial information of the parent is provided.

One of the Staff members then asked what the investor's view would be where the parent entity is a non-US bank that does not have GAAP financial statements and does not

reconcile to GAAP. In response, Mr. Daloisio stated that non-GAAP financial statements made under IFRS standards would provide an adequate basis for assessing the parent company's ability to perform its obligations, even if not reconciled to GAAP, and that this information would be better than GAAP financials on a derivatives subsidiary which would not be useful for the reasons already discussed.

Mr. Berdernagel then proceeded to provide the large bank perspective on this issue. (The June 8 letter advocated an additional position to the effect that where the derivative is issued by a bank, the financial information of the holding company should always be adequate.) In his experience, the consolidated GAAP financial statements of the bank holding company are in practice used for all purposes. No one has ever asked for separate financial statements for the bank. In addition, with respect to any obligation of the bank, no one has ever asked for a guaranty from the bank holding company.

However, the Staff did not appear willing to consider a general rule that where a derivative is issued by a bank, the financial information of the holding company would be acceptable in all cases without regard to whether there was a guaranty. That portion of the joint proposal appears effectively off the table at this point.

The Staff then introduced the question of why this matter is presenting an issue now, and why the issue was not covered during the Regulation AB comment process.

Our group responded that the concern results from negotiating agreements with swap counterparties, under which the significance percentage is recalculated on an ongoing basis while the ABS transaction continues to file 34 Act reports. Under these agreements, if the applicable Item 1115 disclosure threshold is crossed, then either the required disclosure must be provided or the counterparty must be replaced. While it was agreed that the actual risk of crossing a disclosure threshold is remote, nevertheless reasonable steps must be taken to prepare for this eventuality. This requires an assessment of the practicalities and costs of compliance with the disclosure requirements, which in turn has raised significant concerns.

Mr. Kopelman then proceeded to outline cost estimates that he had received from internal estimates at Bear. For a single derivatives subsidiary, the cost of producing full separate GAAP financial statements would be \$650,000 for the first year, and would be \$400,000 per year thereafter. The cost for producing just selected financial information would be \$150,000 per year. These estimates include both internal resources as well as the external accountants.

Further to the question of why this issue was arising now, Mr. Kudenholdt noted that persons studying and commenting on the proposed Regulation AB focused on the language within Item 1115 regarding derivatives being provided by an entity "or group of affiliated entities." This language was widely viewed as permitting information to be provided with respect to the consolidated group, particularly where the derivative was provided by a subsidiary and guaranteed by a parent.

Ms. Dubberly responded that the referenced language was to address the possibility of separate derivatives from affiliated entities, which should be counted together to the disclosure threshold.

Mr. Bendernagel noted that the burden being contractually imposed on derivatives counterparties, to indemnify the ABS issuer for liabilities resulting from the counterparty's failure to provide financial information as required, was disproportionate to the value of the transactions. Mr. Kopelman noted that regardless of whether the need for separate financial information as to a derivatives subsidiary should have been foreseen by the industry, it is important now to not repeat the same mistake and to provide some relief to make the requirements more workable.

In response to specific questions from the Staff, the representatives indicated that any derivatives subsidiary would be 100% owned, and that any parent guaranty would be full and unconditional and a guaranty of payment (not of collection). While all derivatives issued to non-affiliates would be guaranteed by the parent, in some cases a derivatives subsidiary might issue a non-guaranteed derivative to another affiliate.

At this point, the Staff suggested that the relief granted might be that, in addition to financial statements or selected information as to the corporate parent on a consolidated basis, condensed consolidating financial information providing limited financial information as to the subsidiary, as contemplated in Rule 3-10 (c) under Regulation S-X, would be provided in a footnote to the parent's financial statements. This would only be available where the corporate parent provides a full and unconditional guaranty of the derivative, and the subsidiary is 100% owned. There would be no easing of the rules regarding a non-US entity. This would only apply to interest rate and currency swaps, or other swaps that may be allowed under Regulation AB (if any). It is not clear how this would apply to a derivative in the 10% - 20% significance percentage range.

In response, the groups proposed that instead a derivative issuer be treated like a finance subsidiary under Rule 3-10, as to which more limited footnote information would be required. Furthermore, there should be no restrictions on other types of derivatives that the subsidiary might issue to persons other than ABS issuers.

In response to Staff inquiry, the representatives estimated there to be 20 - 50 derivatives counterparties that would be in need of this relief. It was noted that it would be unwieldy to have each such entity request its own no-action letter. However, the Staff also indicated that this relief was too complex to be included in a telephone interpretation, and that a formal regulation change was also not desirable.

At the conclusion of the meeting, it was agreed that the industry representatives would consider further the workability of providing condensed consolidating financial information, and that there would be further discussion about whether a no-action letter request on behalf of the industry could be submitted by one or more of the groups.