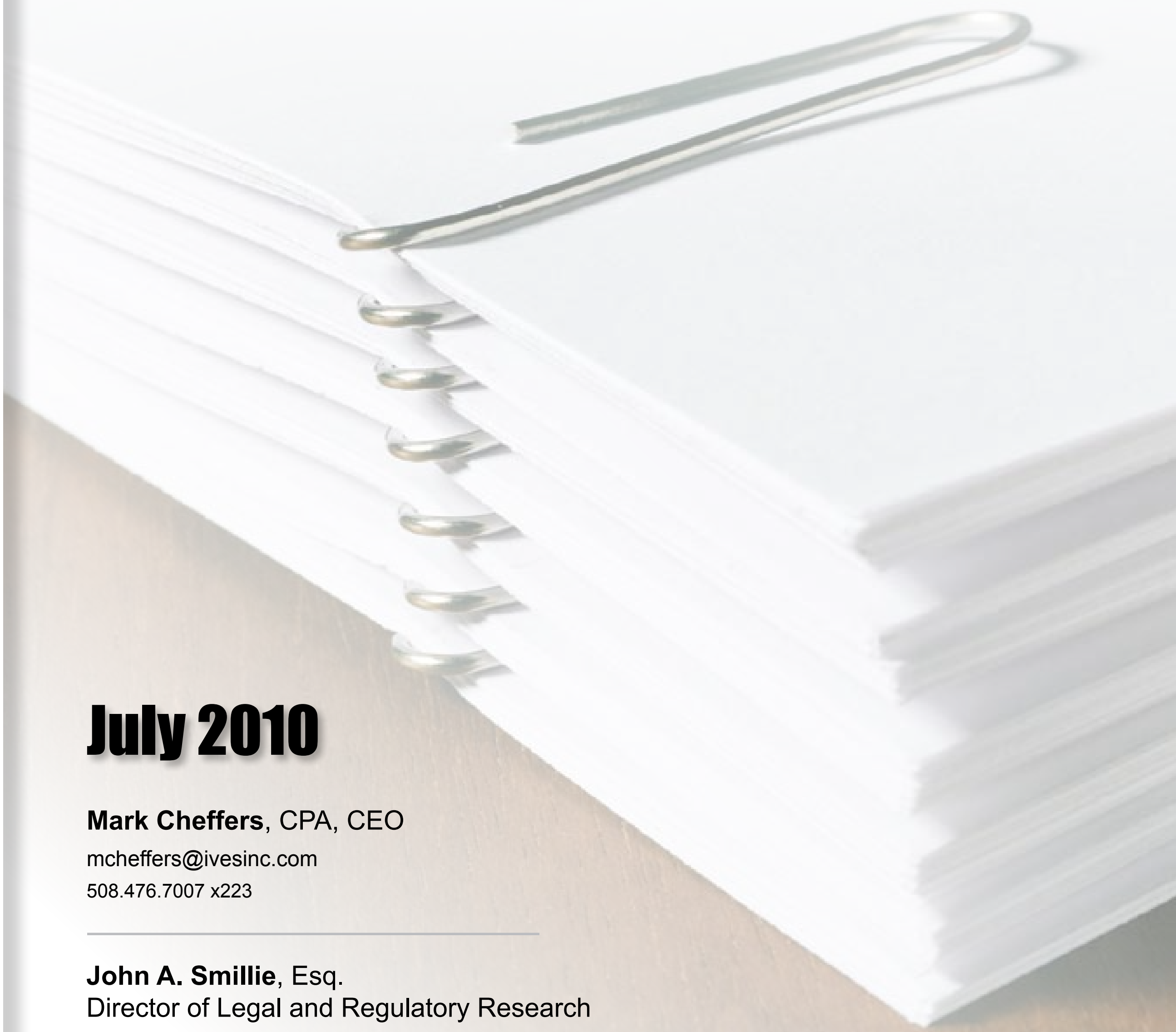
AUDIT ANALYTICS®

SEC Comment Letters:

Inquiries into Transactions Similar to Lehman Repo 105s



July 2010

Mark Cheffers, CPA, CEO
mcheffers@ivesinc.com
508.476.7007 x223

John A. Smillie, Esq.
Director of Legal and Regulatory Research
jsmillie@ivesinc.com
508.476.7007 x245

Table of Contents

I. Executive Summary:

On September 15, 2008, Lehman Brothers filed for bankruptcy protection under Chapter 11 of the Bankruptcy Code. The Bankruptcy Court then appointed an Examiner to review the conduct of Lehman during the years before the insolvency. In March of 2010, the Examiner filed his report, which concluded that a colorable claim existed due to Lehman's failure to disclose certain transactions that Lehman referred to internally as Repo 105 and Repo 108 transactions.

Investment banks commonly use purchase and resale agreements to obtain short-term financing by transferring assets to the lender. A slightly higher value of assets is transferred to secure the transaction than the amount of money financed. The increase in the asset's value, the overcollateralization, for these types of financing is commonly at or below 2%.

With the backing of a legal opinion from a UK law firm, Linklaters, Lehman concluded that an increase in the overcollateralization would render the return of the asset from the lender less likely and thus convert the transaction from secured financing to a sale. Lehman, therefore, performed transactions on the books of a UK subsidiary with increased overcollateralization of 5% (Repo 105) and, at times, 8% (Repo 108). Lehman characterized these transactions as sales.

Based on the number of letters the SEC sent inquiring about SFAS 140, ¶ 9 compliance, it seems reasonable to assume that the SEC would have made an inquiry regarding Repo 105 and Repo 108 transactions if it was aware of the practice.

Lehman endeavored to achieve a sales status for the transaction because the assets could be removed from the balance sheet (derecognize the asset) and, more importantly, the cash could be used to reduce leverage. Days before the end of a quarterly reporting period, Lehman used Repo 105 and Repo 108 transactions utilizing healthy assets (not toxic assets such as subprime loans) to obtain cash used to pay down liabilities and decrease leverage. A reduction in leverage manifests into better grades from credit rating entities and an increased positive reputation in the market place. After the new quarter began, Lehman's UK subsidiary repurchased the assets with borrowed money and placed the asset back on the balance sheet. This process was repeated every quarter since the early 2000s.

The standard that addresses the proper accounting of a Repo-type transaction is the Statement of Financial Accounting Standards No. 140 (SFAS 140).[1] Paragraph 9 of SFAS 140 itemizes the "conditions for recognition as a sale." If the criteria in paragraph 9 are not met, the transaction cannot properly be treated as a sale, but as short-term financing. A review of SEC Comment Letters since 2004 reveals that the SEC questioned 115 transactions by 102 unique companies to determine if the company's repurchase agreements complied with SFAS 140, ¶ 9. One of the companies that received such an inquiry was Lehman, which responded by advising the SEC that its subprime residential mortgage loans transferred to securitization trusts did not meet the requirements of SFAS 140 and thus the assets were not derecognized from the financial statement.

Since the SEC apparently was not aware of the Repo 105 and Repo 108 transactions on the books of the UK subsidiary, such Comment Letter inquiries for these transactions did not occur. However, based on the number of letters the SEC sent inquiring about SFAS 140, ¶ 9 compliance, it seems reasonable to assume that the SEC would have made an inquiry regarding Repo 105 and Repo 108 transactions if it was aware of the practice.

II. Database Overview

Audit Analytics analysts have read and compiled a database of over 115,000 Comment Letters from 12,949 companies indexed to a taxonomy containing over 1500, predetermined issues, U.S. and IFRS accounting standards, and U.S. Federal securities laws, rules and regulations. SEC Comment Letters are an excellent source of non-binding information about accounting standards and securities law, rules and regulations from a regulator's perspective.

[1] Under FASB's new codification, SFAS 140, ¶ 9 is identified as ASC 860-10-40-5.

III. SEC Staff Reviews of Repurchase Agreements

When a registrant enters into a repurchase agreement, SFAS 140, ¶9 provides the criteria that must be met in order to declare the transaction a sale. Otherwise, the transaction must be characterized as secured financing and accounted as such. The language of SFAS 140, ¶9 is provided below:

> 9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:
>
> > a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 27 and 28).
> >
> > b. Each transferee (or, if the transferee is a qualifying SPE (paragraph 35), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (paragraphs 29−34).
> >
> > c. The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 47−49) or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call (paragraphs 50−54).

When making an inquiry regarding a registrant's repurchase agreement, the SEC would address the criteria presented in SFAS 140, ¶9. The Audit Analytics Comment Letter database identified 203 such letters sent, since 2004, by the SEC to address 115 transactions by 102 unique companies. A review of these letters revealed that 96% of these transactions either derecognized assets using sale accounting or failed to clearly disclose the type of accounting used (secured financing or sales).

The concerns expressed by the SEC during its inquiries typically included a general request that the registrant elaborate on the accounting treatment of the transaction. Of the 115 transactions that received comment letters, 76% contained such a general request, including directives similar to the examples below:

- Explain how your accounting meets all of the requirements of SFAS 140, ¶9.
- Provide a more robust discussion of your activities including your underwriting procedures and criteria as well as your process for determining whether transfers of financial assets qualify for true sale accounting pursuant to paragraph 9 of SFAS 140.
- Describe your accounting policies and procedures in a clear and concise manner, and discuss the accounting treatment for transfers, if any.

If it was clear or likely that the registrant used sales accounting for the transaction, the question typically became more pointed, and the SEC would ask the registrant to justify the selection of sales accounting. This type of direct request was sent to about 24% of the companies. In some inquiries, the SEC would follow the general inquiry with more specific questions regarding the particular criteria expressed in one of the three subparagraphs of SFAS 140, ¶9. As shown in the table below, the SEC sent questions regarding the ¶9(a) requirement, that the asset be isolated from the registrant and its creditors, to about 6% of the companies. Questions regarding the ¶9(b) requirement, that the recipient have the ability to freely transfer the assets after the transaction, were sent to 6% of the companies. Of the three subparagraphs, the SEC cited subparagraph (c) most frequently when questions became more specific. Subparagraph (c), cited in letters sent to about 18% of the companies, requires the registrant to eliminate effective control over the assets, control that may be achieved through repurchase agreements or a right to demand return. A registrant cannot not take advantage of sale accounting if the registrant has agreement to repurchase the asset or has the right to demand return of the asset.

SEC Comment Letters with FASB 140, ¶9 Compliance Inquiry (Number of Transaction Inquires = 115)		
Subject of Inquiry	**Conversations/ Inquiries**	**%**
¶9: General Inquiry to Determine if Accounting Complied with Standard	87	76.0%
¶9: More Specific Inquiry about Criteria Listed in Subparagraphs	27	24.0%
(a): Asset's Isolation from Transferor and its Creditors (subset of 27 letters above)	7	6.0%
(b): No Restriction on Recipient to Pledge or Sell Transferred Assets (subset)	7	6.0%
(c): No Effective Control of Assets (i.e. repurchase or demand return) (subset)	21	18.0%

These inquiries on the part of the SEC resulted in four registrants restating their financial statements because they had inappropriately accounted for the transaction as sales[2]:

1. Oriental Financial Group Inc (CIK 1030469) restated 13 quarters (7/1/2002 to 9/30/2005) on 3/15/2006 resulting in a negative cumulative change in net income of $21,915,000;
2. W Holding Co Inc (CIK 1084887) restated 11 quarters (01/01/2003 to 09/30/2005) on 1/31/06 resulting in a negative cumulative change in net income of $5,584,000;
3. Soyo Group Inc (CIK 1108955) restated 5 quarters (1/1/2006 to 3/31/2007).
4. Navistar Financial Corp (CIK 51303) restated 15 quarters (1/1/2002 to 9/30/2005).

A fifth registrant, Popular Inc (CIK 763901), received a SFAS 140 inquiry after the company disclosed in its 2007 10-K that it had "completed a recharacterization of certain on balance sheet securitizations recorded as secured borrowings to permit their recognition as sales under SFAS 140." After Popular made three attempts to explain the justification for the recharacterization, the SEC stated that "the Company should restate its financial statement . . . to remove the effects of the recharacterization. Alternatively, if the Company believes that the correction of the error is not material, the Company may provide a materiality analysis supporting their conclusion." The Company disagreed with the Staff's belief that it should restate, citing numerous reasons why that would be severe step but provided a SAB 99 materiality assessment (redacted in the company's response letter) which ended the inquiry.

IV. SEC Staff Reviews of Lehman Brothers Holdings, Inc.

As shown on the summary table on the right, since 2004 the SEC Comment Letter correspondence to Lehman involved 3 conversations resulting in 5 letters from the SEC and 8 letters from Lehman Brothers. These letters referenced two annual reports (10-Ks), five quarterly reports (10-Qs) and one registration statement (S-4) filed by Lehman Brothers. Lehman sent five of the filings (an annual report, three quarterlies, and a registration) to the SEC in 2005 and three of the filings (an annual report and two quarterlies) in 2007. As listed in the table below, during these conversations, the SEC raised 40 issues, including two subcategories, contained in the Audit Analytics comment letter taxonomy.

Conversations	Letters from SEC	Letters From Lehman
3	5	8

Filing Type Referenced	File Date	Number of Letters Referencing
10-Q	7/10/2007	3
10-Q	4/9/2007	3
10-K	2/13/2007	3
S-4	10/21/2005	4
10-Q	10/11/2005	6
10-Q	7/11/2005	6
10-Q	4/11/2005	6
10-K	2/14/2005	6

[2] The fact that a company restated their financials is not an indication that the company was in any way attempting to manipulate the status of their asset holdings. Some of the restatements listed may be the result form more than one issue. The dollar value presented represents an adjustment for all the issues and could not be segregated. For example the 10-KT from Oriental Financial disclosed other errors unrelated to SFAS 140 and informed Audit Analytics that the SFAS 140 portion of the restatement was very minor. The Navistar restatement was positive.

Issues Addressed in SEC Comment Letters to Lehman Brothers Holdings Inc.			
Issue	Conversations	From SEC	From Lehman
Contingencies & Commit, legal, (FAS 5 or IAS 37) accounting issues	2	3	4
Fair value measurement, estimates, use (incl. VSOE)	2	2	4
Deferred, stock-based SFAS 123 only (subcategory)	1	1	3
EPS, ratio and classification of income statement issues	1	2	3
Future Comment	1	0	3
Legal matters/issues (identify, disclose, explain)	1	2	3
SFAS 123 issues	1	1	3
Deferred, stock-based and/or executive comp issues	1	2	2
Proforma financial information reporting issues	1	0	2
SFAS 5, paragraph(s) 9-12	1	1	2
Valuation of assets, liabilities or equity issues	2	1	2
Acquisitions, mergers, and business combinations	1	1	1
APB Opinion No. 25 issues	1	0	1
Consolidation (Fin 46, variable interest, SIV, SPE & off-B/S)	1	1	1
Financial derivatives/hedging (FAS 133) acct issues	1	0	1
Gain or loss recognition issues	1	1	1
Investment in subs./affiliate issues	1	1	1
Letter memorializing and/or responding to a telephone or person	1	0	1
Loans receivable, valuation and allowances issues	1	1	1
PPE issues - Intangible assets and goodwill	1	1	1
Request to accelerate or expedite registration	1	0	1
SFAS 107 issues	1	1	1
SFAS 133, paragraph(s) 6-10	1	0	1
SFAS 140 issues	1	0	1
SFAS 142 issues	1	0	1
SFAS 142, paragraph(s) 11	1	1	1
SFAS 148 issues	1	0	1
SFAS 157 issues	1	0	1
SFAS 5 issues	1	1	1
1940 Act, § 3 issues (inadvertent investment company)	1	1	0
Closing SEC letter associated with SEC commentary	2	2	0
Contingencies and Commitments (MD&A) disclosure issues	1	1	0
Cost-benefit/undue burden issue in disclosure	1	1	0
Debt, quasi-debt, warrants & equity (BCF) security issues	1	1	0
FIN 14 issues	1	1	0
FIN 46 (R) issues	1	1	0
Regulation S-X, Rule 3-10 issues	1	2	0
SFAS 133 issues	1	1	0
Subsidiary issues-- US or foreign (subcategory)	1	2	0
Third party expert input/consulting/advice issues	1	1	0

As highlighted in the table above, one letter from Lehman Brothers discussed SFAS 140 issues. An excerpt from page 4 of an August 13, 2007 letter to the SEC (see Figure 1 below) shows that the transferred assets under issue were subprime residential mortgage loans. For these assets Lehman stated that "the transactions [transferring subprime residential mortgage loans to securitization trusts] did not meet the requirements of SFAS No. 140, *Accounting for Transfers and Services of Financial Assets and Extinguishments of Liabilities* ("SFAS No. 140") and therefore were not derecognized from our Consolidated Statement of Financial Condition." The type of asset under review in the letter below was not the type of assets Lehman used in its Repo 105 and Repo 108 transactions in the UK.

Figure 1: Excerpt Page 4 of Lehman's August 13, 2007 Letter to the SEC

Mr. Jeffrey Gordon
United States Securities and Exchange Commission — Division of Corporate Finance
August 16, 2007
Page 4 of 9

Quantify your portfolio of subprime residential mortgages. If practicable, please breakout the portfolio to show the underlying reason for subprime definition (e.g., subject to payment increase, high LTV ratio, interest only, negative amortizing).

Based upon our subprime definition above, our inventory positions are as follows:

Dollars in millions	**At 5/31/07**	**At 11/30/06**
Fair value of subprime residential mortgage whole loans (originated or purchased)	$****	$****
Fair value of interests in subprime residential mortgage securitizations	$****	$****
Fair value of subprime residential mortgage servicing rights	$****	$****

The above fair value of subprime whole loans includes approximately $**** and $**** at May 31, 2007 and November 30, 2006, respectively, of subprime residential mortgage loans transferred to securitization trusts; however, the transactions did not meet the requirements of SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* ("SFAS No. 140") and therefore were not derecognized from our Consolidated Statement of Financial Condition. The trusts to which the loans were transferred are bankruptcy remote special purpose entities ("SPEs") and accordingly the investors in the trusts have no recourse to our other assets in the event the borrowers to the underlying loans fail to fulfill the terms of the lending contracts. For further discussion, see the Filings, Notes to the Consolidated Financial Statements, "Summary of Significant Accounting Policies — Securitization Activities."

V. Bankruptcy Examiner's Determination that the Evidence Supports a Colorable Claim

After Lehman Brothers filed Chapter 11 bankruptcy on September 15, 2008, the bankruptcy court appointed an examiner to review the conduct of Lehman during the years prior to the insolvency. The examiner, Attorney Anton R. Valukas, filed a report with the court dated March 11, 2010 (Examiner's Report or ER). Attorney Valukas found that Lehman Brothers entered into transactions Lehman called Repo 105 and Repo 108 transactions. These transactions were nearly identical to repurchase and resale agreements (a type of short-term secured lending), but Lehman took the position that these transactions could be accounted for as a sale because Lehman gave the recipient higher overcollateralization than normal. Normally, the recipient of the asset receives a value no more the 2% of the money transferred. Lehman, however, overcollateralized the transaction by 5% (Repo 105) and, at times, 8% (Repo 108). Lehman maintained that this increase in asset value surrendered would make it much less likely that the transferee would return the asset and thus the transaction could be accounted for as a sale instead of secured lending. The Examiner noted specifically that Lehman used a large overcollateralization (a haircut) in order to satisfy the requirements of ¶9(c) and avail itself of sale accounting. ER at 977.[2] In support of its position Lehman referenced ¶¶ 47-49, 217-218 as justification for the premise that posting more collateral in a Repo 105 transaction for the same loan would allow the transaction to achieve the off-balance sheet treatment of the collateral. ER at 977. The Examiner also noted that these transactions were made by a UK affiliate because Lehman could not find a U.S. law firm that would provide an opinion letter concluding that such a transaction was a true sale. In his report the examiner noted the following:

> Unable to find a United States law firm that would provide it with an opinion letter permitting the true sale accounting treatment under United States law, Lehman conducted its Repo 105 program under the aegis of an opinion letter the Linklaters law firm in London wrote for LBIE, Lehman's European broker-dealer in London, under English law.

Examiner's Report at 740.

[2] A copy of the ***Report of Anton R. Valukas, Examiner*** may be obtained at http://lehmanreport.jenner.com/ .

Lehman wished to account for this transaction as a sale because the cash could then be used to decrease leverage, which resulted in higher scores from credit rating agencies. The Examiner found that days before the end of a quarterly reporting period, Lehman used Repo 105 and Repo 108 transactions utilizing healthy assets (not toxic assets such as subprime loans) to obtain cash used to pay down liabilities and decrease leverage. After the new quarter began, Lehman repurchased the assets with borrowed money and placed the asset back on the balance sheet. The Examiner found that this process was repeated every quarter since the early 2000s with the final three quarter-ends temporarily reducing liabilities by approximately the following amounts: $38.6 billion in Q4 of 2007, $49.1 billion in Q1 of 2008, and $50.4 billion in Q2 of 2008.

The Examiner reported that "[a] review of Lehman's public filings confirms that Lehman did not disclose its use of Repo 105 transactions, either by name or characterization, in its Forms 10-K or 10-Q." ER at 967. Further he stated that "[n]one [of the SEC employees who had some responsibility to monitor Lehman's business operations] had been informed of Lehman's use of Repo 105 transactions." ER at 967. In addition, the Examiner concluded that, after having reviewed the periodic reports filed in 2007 (Form 10-K) and first and second quarter 2008 (Forms 10-Q), an investor reviewing these forms would not have been able to discern that Lehman was engaged in Repo 105 transactions. ER at 973.

By the end of the investigation, the Examiner concluded that Lehman's failure to disclose the Repo 105 and Repo 108 transactions in the SEC filings rendered the filings materially misleading and therefore a colorable claim existed against the officers and auditor of Lehman Brothers. Based on the number of letters the SEC sent inquiring about SFAS 140, ¶ 9 compliance, it seems reasonable to assume that the SEC would have made an inquiry regarding Repo 105 and Repo 108 transactions if it was aware of the practice.

As previously noted, Lehman referenced ¶¶ 47-49 as justification that a larger overcollateralization would convert the secured loan transaction into a sale. It is interesting to note that AIG presented this same justification in response to a direct query by the SEC in support of its sale accounting in connection with securities lending transactions disclosed in its 2008 10-K. Excerpts of the Comment and Response are provided below:

Comment

[Y]ou disclose that in connection with certain securities lending transactions, you met the requirements of sale accounting under SFAS 140 because collateral received was insufficient to fund substantially all of the cost of purchasing replacement assets for the securities lent to various counterparties. Please explain why this would result in a deemed sale under SFAS 140 as indicated by your disclosure. (UPLOAD, 4/2/2009)

<u>Response</u>

[T]he securities lending transactions . . . were accounted for as sales because they met all of the criteria set forth in paragraph 9 of FAS 140, as follows: . . .

Paragraph 9(c), because AIG no longer maintained effective control over the transferred assets. While AIG is both entitled and obligated to reacquire the securities before maturity pursuant to the terms of these securities lending agreements, AIG will not be able to reacquire the securities on substantially the agreed terms in the event of default by the transferee because collateral obtained during the contract term was not sufficient to fund substantially all of the cost of purchasing replacement securities lent to the various counterparties. Paragraphs 47-49 of SFAS 140 provide specific guidance with respect to the sufficiency of collateral in securities lending arrangements. Specifically, paragraph 47b and 49 describe the requirement more definitively that "a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of replacement assets from others." (CORRESP 4/30/2009).

AUDIT ANALYTICS® - PUBLIC COMPANY MARKET INTELLIGENCE

Audit Analytics® is the premier public company market intelligence service providing independent research to the investment, accounting, insurance, legal, regulatory and academic communities.

Audit Analytics® provides detailed intelligence research on over 20,000 public companies and 1,500 accounting firms. Our data includes detailed categorizations of issues and is considered by many professionals to be the best primary data source for tracking and analysis of the following public company disclosures:

- **Sarbanes-Oxley Disclosures**
  - Track Section 404 internal control disclosures and Section 302 disclosure controls.
- **Auditor Information**
  - Know who is auditing whom, their fees, auditor changes, auditor opinions and more.
- **Restatements**
  - Identify company restatements by type, auditor and peer group. Analyze by date, period and specific issue.
- **Litigation & Legal Disclosures**
  - Search all federal litigation by auditor, company and litigation type. Know who is representing whom.
- **Corporate Governance**
  - Track director & officer changes, audit committee members, C-level executives and their biographies.

Detailed reports are easily created by issue, company, industry, auditor, fees and more and are downloadable into Excel. Daily notifications via email are available for auditor changes, restatements and director & officer changes.

Access to Audit Analytics® is available via on-line subscription, enterprise data-feeds, daily email notifications and custom research reports.

CONTACT

For more information on subscriptions, data feeds, XML APIs or to schedule an on-line demonstration, please contact:

Audit Analytics® Sales
(508) 476-7007
Info@AuditAnalytics.com