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Portfolio Media, Inc. | 860 Broadway, 6<sup>th</sup> Floor | New York, NY 10003 | [www.law360.com](http://www.law360.com)  
Phone: +1 646 783 7100 | [reprints@law360.com](mailto:reprints@law360.com)

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## Heightening Scrutiny Of Repurchase Agreements

*Law360, New York (August 24, 2010)* -- Earlier this year, a bankruptcy examiner concluded that Lehman's financial accounting, in connection with its use of repurchase agreements ("repos"), created a "materially misleading picture of the firm's financial condition."

Generally, repos are loan agreements that allow financial institutions to borrow money for a short term, offering securities held by the firms as collateral while simultaneously agreeing to repay the cash and take back the collateral at a specific point in time. Lehman (according to the examiner) accounted for its repo transactions as sales, thereby reducing the debts on its balance sheet. As a result, Lehman "in effect borrowed tens of billions of dollars in these transactions" without disclosing its borrowing.

Recent developments confirm that, in the wake of the examiner's report, the U.S. Securities and Exchange Commission and other regulators have been closely examining accounting for repos and that they plan to intensify their scrutiny in this area.

Significantly, while many of the press accounts regarding the SEC's focus on repos have centered on banks and other financial institutions, the SEC's most recent public pronouncements make clear it is expanding its efforts to examine all "large and financially significant companies," regardless of their industry.

### The SEC's Recent "Repo" Inquiries

As the Wall Street Journal reported,[1] a recent AuditAnalytics.com study concluded that since 2004, the SEC has questioned 115 transactions conducted by 102 separate companies "to assess if they accounted properly" for repos.[2] Among the 102 companies questioned were Bank of America Corp. and Citigroup Inc., both of which recently disclosed they had "mistakenly booked some repo trades as sales when they should have been borrowings." [3]

These recent disclosures are likely the result of an SEC initiative launched almost immediately after the issuance of the Lehman report. The SEC, concerned that the "findings of the Examiner's Report ... raise questions as to how widespread this practice may be," [4] issued "letters to various public companies requesting detailed information about their use of repurchase agreements or similar transactions ..." [5]

In all, 19 "large public companies" received such a letter, which asked the companies to explain how they used repos and "how they accounted for them in their financial statements." [6] In particular, the SEC asked for "detailed information about the financial statement impact of these transactions throughout each quarter" and a description of "how that impact differed from that presented at each quarter end." [7]

In many instances, the SEC then asked “several companies to enhance their disclosure about their accounting for repurchase and similar transactions and to expand their discussions of off-balance sheet arrangements.”[8]

### **The SEC’s “Repo” Initiatives: Potential New Regulation and a New Specialized Unit**

In recent public statements regarding repos, Chairman Schapiro has stated both that: (1) the SEC is evaluating “whether changes in accounting, disclosure, or to the underlying standards themselves, are needed to ensure that investors have accurate information about a firm’s leverage and risk”; and that (2) public companies can “expect more of these ‘Dear CFO’ letters, as [the SEC] reviews the filings of financially significant companies more deeply and consistently.”[9]

The chairman clearly meant what she said. The SEC recently announced that the Division of Corporation Finance is creating three new specialized offices.[10] One of these new offices[11] is a “disclosure review office that will expand the Division’s enhanced reviews” of “large and financially significant companies.”[12]

Through the new disclosure review office, the division plans to “increase the number of institutions subject to these reviews, concentrate staff expertise, and develop new review techniques to further strengthen its review program.”[13]

### **FASB Considering New Rules**

The SEC is not alone in expanding the examination of repos. During the July 28, 2010, meeting of FASB’s Board of Directors, FASB Chairman Robert Herz announced that, as a result of the Lehman report, the board has launched a project “to improve the accounting for repurchase agreements (repos) or other agreements that both entitle and obligate the transferor to repurchase or redeem financial assets before their maturity.”[14] Once complete, the board will consider how the new proposals compare to any similar standards promulgated by the IFRS.

The SEC’s demonstrated past interest in repos, coupled with its and the FASB’s current efforts to intensify their examination of this area, augurs not just potential regulation, but also enforcement actions. As Chairman Schapiro told Congress earlier this year: “Where we find that companies are engaging in financial transactions that are inconsistent with their publicly reported financial condition, we will take appropriate action.”[15]

In light of the certain further scrutiny of repos, any public company that has recently employed them or similar financing arrangements should review, with qualified counsel, its disclosures to determine whether they provide a fair presentation of the company’s finances.

--By Perrie M. Weiner (pictured) and Patrick O. Hunnius, DLA Piper

*Perrie Weiner is managing partner of DLA Piper’s Century City, Calif., office and international co-chair of the firm’s securities litigation group. Edward Totino is a partner with the firm in the Century City office. Ana Tagvoryan and Joshua Briones are both associates in the firm’s Century City office.*

*The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or Portfolio Media, publisher of Law360.*

[1] “SEC Had ‘Window Dressing’ on Radar for Years,” Wall Street Journal, July 21, 2010 (available at [online.wsj.com/article/SB10001424052748704723604575379633816181998.html?](http://online.wsj.com/article/SB10001424052748704723604575379633816181998.html?))

[2] Id.

[3] Id. See also “Citi Explains How It Hid Risk From the Public,” Wall Street Journal, July 14, 2010 (available at [online.wsj.com/article/SB10001424052748703722804575369480020362058.html?](http://online.wsj.com/article/SB10001424052748703722804575369480020362058.html?)); “BoFA Admits Hiding Debt,” Wall Street Journal, July 10, 2010 (available at [online.wsj.com/article/SB10001424052748704799604575357421366347624.html?](http://online.wsj.com/article/SB10001424052748704799604575357421366347624.html?)).

[4] Testimony Concerning the Lehman Brothers Examiner’s Report, Before the House Financial Services Committee (Chairman Mary Schapiro, Apr. 20, 2010) (available at [sec.gov/news/testimony/2010/ts042010mls.htm](http://sec.gov/news/testimony/2010/ts042010mls.htm)) [“Schapiro Testimony”].

[5] Id.

[6] Testimony Concerning Accounting and Auditing Standards: Pending Proposals and Emerging Issues (James L. Kroeker, May 21, 2010) (available at [sec.gov/news/testimony/2010/ts052110jlk.htm](http://sec.gov/news/testimony/2010/ts052110jlk.htm)) [“Kroeker Testimony”].

[7] Schapiro Testimony.

[8] Kroeker Testimony.

[9] SEC Speech: Remarks at CFA Institute 2010 Annual Conference (SEC Chairman Mary L. Schapiro) (available at: [sec.gov/news/speech/2010/spch051810mls.htm](http://sec.gov/news/speech/2010/spch051810mls.htm)).

[10] “SEC Adds Units to Oversee Financial Institutions, Asset-Backed Securities, New Financial Products and Trends,” SEC Press Release, July 16, 2010 (available at [www.sec.gov/news/press/2010/2010-124.htm](http://www.sec.gov/news/press/2010/2010-124.htm)).

[11] The other offices are: (1) the “ABS and Other Structured Finance Products” office, which will “review disclosures in asset-backed securities and other structured finance products and monitor their impact on the markets” and “lead rulemaking and interpretive activities related to structured products;” and (2) the “Capital Market Trends” office, which will “evaluate trends in securities offerings and capital markets to determine whether rules and regulations are keeping pace and working effectively.” Id.

[12] Id. In the same press release announcing this new office, the SEC disclosed that “[s]ince late 2008, the Division has been conducting continuous real-time reviews of the periodic reports filed by some of the largest bank holding companies and other large financial institutions.” Id.

[13] Id.

[14] Financial Accounting Standards Board, Summary of Board Decisions, July 28, 2010 Board Meeting (available at: [www.fasb.org/cs/ContentServer?c=FASBContent\\_C&pagename=FASB%2FFASBContent\\_C%2FActionAlertPage&cid=1176157148781](http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FActionAlertPage&cid=1176157148781)); an archived audio file of the meeting is available at [craig.teamline.cc/fasb\\_archive11](http://craig.teamline.cc/fasb_archive11).

[15] Schapiro Testimony.