

**Securities Industry Association**

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Mr. Robert C. Butler
Chairman
Financial Accounting Standards Advisory Council
401 Merritt 7 PO Box 5116
Norwalk, CT 06856-5116

Re: Exposure Draft on Accounting for Derivative Financial Instruments

Dear Mr. Butler:

Congratulations on your recent appointment as Chairman of FASAC. I look forward to meeting you and working with you in the coming months and years. I had hoped to meet you at next week's FASAC meeting, but since I will be in Asia for most of the next two weeks, I will be unable to attend. However, I did want to leave you and the Board with a few thoughts on the Exposure Draft on Accounting for Derivative Financial Instruments and Hedging Activities (the "Exposure Draft").

As I suspect you know, the Exposure Draft is widely regarded by the securities industry as misguided and deeply flawed, and as likely to have a very deleterious impact upon prudent risk management. We believe that the current treatment of gains and losses from hedging transactions is essentially sound, and better accords with the underlying economic reality. We believe it should be built upon. In sharp contrast, the Exposure Draft departs radically from current practice and would impose arbitrary rules governing the use of derivatives and hedging transactions.

The rapid pace of innovation in the financial services industry in recent years has provided a much better insight into the various risks to which firms are subject and permitted much greater management of such risks than was previously the case. Increasingly, risk management is a key business component for all U.S. corporations. However, we believe that the shortcomings of the Exposure Draft -- such as the limitation of hedge accounting for partial hedging strategies, and the artificial nature of transactions required to qualify for hedging on a portfolio basis -- will act as a deterrent for many firms to engage in perfectly prudent risk management practices.

The sheer complexity of implementing the Exposure Draft also presents a considerable challenge, both to reporting entities and users of financial statements. This concern is heightened by reports that FASB's staff has been asked to develop detailed guidelines to govern how a firm should go about bifurcating risks in implementing the Exposure Draft. We

believe that this presents a very real possibility of leading to unintended results, and that this level of detail is best left to firms and their outside auditors to work out for themselves. A single, uniform approach to this issue is most unlikely to be appropriate for all reporting companies.

We are also concerned that adoption of the Exposure Draft in its current form would seriously distort the underlying economic reality of many risk management practices. We fear that adoption of the Exposure Draft may have the result of creating a "Heisenberg" effect; i.e., its attempt to quantify exposures will create such distortions so as to have the effect of changing the economic reality it purports merely to measure.

Below are a few brief points highlighting what we see as major flaws in the Exposure Draft.

- Adoption of the Exposure Draft will produce additional volatility in earnings, whose net effect may be to make "risk acceptance" more palatable than risk management;
- The Exposure Draft would distort economically similar transactions. For example, in a given instance, liquidity and credit concerns might suggest the use of exchange traded derivatives by a firm, rather than use of some other hedging mechanism. However, the treatment mandated by the Exposure Draft might effectively preclude a firm from choosing that course;
- The Exposure Draft is very complex and rather than setting forth general principles, it offers a very detailed road map; we believe that continued product innovation will require that it be continuously amended as new products are developed, necessitating
- The requirement to "pair off" or allocate derivative instruments to specific transactions will prove complex and quite burdensome to firms whose inventory turns over rapidly, and will prove counter-productive for entities that hedge on a portfolio basis;
- The economic costs that would be imposed by the Exposure Draft are much too great. These costs arise not merely from the expense of directly implementing it, but even more importantly from the costs to firms of utilizing less than optimal hedging strategies in an effort to obtain more favorable accounting treatment.

The incremental but very tangible improvements in accounting for derivatives that have resulted heretofore from the efforts of the Board, the SEC, and the demands of the marketplace have evolved into a standard that we believe provides a fair insight into the great majority of transactions. Even so, if a new methodology provided a clearly superior alternative, I believe that the securities industry would be prepared to pay the price. However, in our view, the Exposure Draft falls woefully short. We urge FASB to adopt amendments to the Exposure Draft rectifying these and similar problems, and then re-expose it for public comment.

Sincerely,

Marc E. Lackritz
President

cc: Joseph V. Anania; Dennis Beresford; Carol M. Clarke; Anthony T. Cope; John M. Foster; Gerhard G. Mueller; James J. Leisenring; Timothy S. Lucas