Securities Industry Association

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

Re: Exposure Draft on Accounting for Derivative Financial Instruments

Dear Mr. Butler:

Thank you for your letter of April 28. I am sorry to have missed the April 15th meeting and the opportunity to meet you. I look forward to seeing you at the next FASAC meeting.

With respect to the substance of your letter, I am aware that the Board has made a number of changes to the Exposure Draft[1] over the last few months that have improved some of the significant problems highlighted in the fairly voluminous (and generally quite negative) comment letters received by the Board.[2] However, those changes, welcome as they are individually, really have not met the primary concerns raised in my letter of April 11th.

We understand the goal of the Board for this project is to give users of financial statements a clearer insight into how derivatives can affect a firm's financial condition. No one finds fault with this objective. The problem from our perspective is that in far too many cases the Exposure Draft will have the opposite effect.

This arises because the Exposure Draft singles out "derivatives" from all other financial instruments for fair value accounting. Thus, a firm using derivatives to manage risk may receive very different accounting treatment than a firm using cash instruments for an identical purpose. Even worse, a company that decides to forego using any sort of risk management tools may show, all things being equal, no volatility at all.[3] As a result, the Exposure Draft will create artificial volatility, and have the net effect of encouraging the use of sub-optimal risk management techniques. This creates almost a financial "Heisenberg principle," whereby the measurement technique itself alters the nature of the underlying economics. In this case, prudential risk management would be discouraged, which would be contrary to the lessons that we had hoped all market participants -- whether endusers, dealers or regulators -- would have learned from recent problems in the financial markets. [4]

While my letter referenced a few specific points identified by our firms as presenting difficulties -- such as the limitation on the degree to which portfolio hedging would be recognized (a problem I believe remains unresolved) -- its primary thrust concerned our perception that the Exposure Draft will act as a deterrent for many firms to engage in perfectly prudent and desirable risk management practices. While the Board's changes to the Exposure Draft generally have been positive, such as reducing some of the more glaring earnings mismatches, these changes have by no means relieved our fears about the impact of this proposal on risk management.

In my letter, I also noted the fearsome complexity of implementing the Exposure Draft. In this respect, the Board's amendments have only exacerbated the problem. Indeed, there have been press reports that Board members themselves have begun to complain that they do not understand their own handiwork.[5]

That being the case, it seems to us that the Board should recognize that to proceed with the Exposure Draft would be a grave mistake. I note that in Denny Beresford's recent interview in *The New York Times* he mentioned that adoption of a standard that required fair value reporting of *all* financial instruments would "eliminate a fair number of the problems associated with the derivatives issue." [6] We agree. Our recommendation is that the Board abandon efforts at a piecemeal approach to fair value accounting, and instead direct its limited resources to the development of a consistent and comprehensive approach to fair value accounting for all financial instruments. [7] In our view, any conceivable marginal benefits arising from adoption of the Exposure Draft are very heavily outweighed by the creation of a perverse disincentive to prudent risk management. Surely no public policy is served by such an outcome.

We realize that the Board has expended a great deal of time and effort in this undertaking, but adoption of a standard so flawed and so detrimental to the strong public interest in encouraging better risk management by public companies militates against an imprudent rush to complete the project in the near term. However, should so radical a change in direction prove unacceptable to the Board, we request that at least FASB make further amendments, publish the revised Exposure Draft with a renewed comment period, and engage in a careful field test.

I realize that the Board has received much criticism over this proposal, much of it from the financial services industry. The criticism has arisen from the strong belief that implementation of the Exposure Draft would seriously and adversely impact risk management for U.S. corporations. I hope that our criticisms have been fairly, if candidly, expressed. Given the importance of what is at stake, we could not do otherwise.

I hope that these views help move the Board to a more constructive course with respect to accounting for derivatives. Again, I look forward to meeting you in July.

With best wishes, I am

Sincerely yours,

Marc E. Lackritz
President

cc:
Joe Anania
Dennis Beresford
Anthony Cope
Neel Foster
Gaylen Larson
Jim Leisenring
Tim Lucas
Gary Mueller

Footnotes

1 Although we have used the term "Exposure Draft" both in this letter as well as in our earlier letter, we are not limiting our comments to the document released last June. We are aware that an ever increasing number of changes to that document have been agreed to, at least on an interim basis. Frankly, this highlights one of the difficulties with this project. Since, to the best of our knowledge, no single document incorporating all of the changes has been published, it is becoming increasingly difficult to offer a critique of the Exposure Draft as a whole, since the document seems to be in a continual state of flux.

2 According to one analysis of the comment letters received by the Board, fully 68% of the commentators urged that the Exposure Draft be rejected, while only 13% supported adoption without significant modifications. See, *Managing Financial Risk 1997 Yearbook*, C. Smithson, CIBC Wood Gundy, 1997, p. 177.

3 For example, a firm that has issued debt and simply sits on the resulting interest rate exposure may well appear to be more stable than a similar firm that uses derivatives to manage that risk.

4 We would note that these incidents, whether the Orange County losses or the Barings fiasco, were the result of inadequate (in some cases, nearly non-existent) risk management, and were not in any real sense accounting related.

5 See, *BNA Daily Tax Report* , May 8, 1997.

6 See, *The New York Times*, "Accounting Standards Chief Sums Up His Tenure," June 1, 1997.

7 We understand that the International Accounting Standards Committee ("IASC") has decided to take such an approach.