



**Securities Industry Association**

120 Broadway, New York, NY 10271-0080, (212) 608-1500, Fax (212) 608-1604  
1401 Eye Street, NW, Washington, DC 20005-2225, (202) 296-9410, Fax (202) 296-9775  
info@sia.com, <http://www.sia.com>

February 5, 2002

Mr. Timothy Lucas  
Director of Research and Technical Activities  
Financial Accounting Standards Board  
401 Merritt 7  
P. O. Box 5116  
Norwalk, Connecticut 06856-5116

*Re: Proposed Amendment of Statement 133, "Accounting for Derivative  
Instruments and Hedging Activities"*

Dear Mr. Lucas:

In connection with the current effort to amend Statement 133, the Dealer Accounting Committee ("the Committee") of the Securities Industry Association<sup>1</sup> requests that the Financial Accounting Standards Board ("the Board") consider amending paragraph 16 of Statement 133 to permit the alternative of marking-to-market a hybrid instrument in its entirety, with changes in value recorded in earnings, rather than separating and marking-to-market only the embedded derivative. The Committee members represent many of the largest broker-dealers and have issued many structured notes, such as equity-linked and currency-linked notes. We believe that the requirement to separately identify and mark-to-market the embedded component is unjustified from a cost-benefit analysis and that more relevant financial information is provided to users of our financial statements when the entire contract is reported at fair value with changes in value recognized in the income statement.

---

<sup>1</sup> The Securities Industry Association brings together the shared interests of nearly 700 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of nearly 80 million investors directly and indirectly through corporate, thrift, and pension plans, and generates \$358 billion of revenue. Securities firms employ approximately 760,000 individuals in the United States. (More information about SIA is available on its home page: <http://www.sia.com>.)

## Current Accounting Guidance

The AICPA Broker Dealer Audit Guide prohibits marking-to-market issued debt instruments such as structured notes. Because the instruments are not carried at fair value with changes in value recorded in earnings, broker-dealers are subject to the bifurcation guidelines of Statement 133 and various Derivative Implementation Group Issues. Appendix A provides the Statement 133 guidance that would be affected by an amendment.

The following example illustrates why we believe the current guidance is costly to apply and produces less than relevant financial information.

### The ABC Structured Note

On January 2, 2002, ABC issued a series of equity-linked unsecured senior debt instruments that mature on December 31, 2002. The note terms are as follows:

| <b>ABC Note Terms</b> |                                                                                                                                                                                    |
|-----------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Par value             | \$20 million                                                                                                                                                                       |
| Series par value      | \$10                                                                                                                                                                               |
| Stated interest       | 13 %                                                                                                                                                                               |
| Interest paid         | Quarterly                                                                                                                                                                          |
| Term                  | 1 year                                                                                                                                                                             |
| Purchased put         | If XYZ stock declines by 40% or more from its \$9 closing price on the pricing date, then the principal payment is reduced from par by the amount of XYZ's price decline below \$9 |

### Accounting At January 2 and March 31, 2002

At issuance on January 2, 2002, industry practice for internal tracking purposes is to record the instrument's total fair value using pricing systems used for management reporting purposes. In this case, the instrument's fair value is a \$20 million liability. Thereafter, the pricing system calculates the entire instrument's fair value and change in fair value from the prior period. We think it would be more appropriate to record the instrument's entire fair value change in earnings because this reflects the economics of the transaction. However, Statement 133 requires the purchased put to be separately accounted for as a derivative while other GAAP requires the issuer to record the debt instrument ("host contract") at amortized cost.

In this example, the GAAP presentation at January 2, 2002 is for the issuer to record a debt liability of \$20 million that pays a 3-percent market rate of interest (\$20 million of issuance proceeds are received). The 3-percent rate is derived as a 2-percent one-year LIBOR swap rate plus 100 basis points

attributable to issuer credit spreads. The put is also recorded as an asset of \$1,985,000 and a payable for the same amount because the issuer pays for the put over the instrument's life in the form of an above-market coupon. The put value is derived as the present value of the difference between the debt's contractual 4 quarterly 13-percent coupons and the coupons' 3-percent market rate. This amounts to a put value of \$1,985,000 (the present value of four \$500,000 payments discounted at 2 percent).

At March 31, 2002, industry practice for internal tracking purposes is to record in earnings the instrument's total change in fair value by using pricing systems used for management reporting purposes. The instrument's total fair value is also recorded on the balance sheet for internal reporting purposes. However, for GAAP purposes we are required to separately calculate the debt instrument's change in fair value and eliminate this change in value from GAAP earnings because the host is required to be recorded at its book value.

### **Why The Complexity?**

Some of our members have over a thousand structured notes and the process of separating a "make-believe" debt instrument's change in fair value and eliminating this amount from earnings is time consuming and administratively cumbersome. The costs to separate the debt component increases as the complexity of the transaction increases to include currency puts and knock-out/knock-in options. Bifurcating such embedded derivatives is complex due to the mutual interdependency of the derivatives; in many cases their value is inextricably linked to the value of both the debt host and embedded equity derivative. Bifurcation implicitly assumes that the remaining debt host has a constant, accreting value. However, because of the interdependency of the derivatives and "host" instrument, this is not always the case. Thus, the Committee believes that bifurcating the derivatives and valuing them separately will at times provide misleading results.

Therefore, we believe that permitting entities the alternative to record the entire hybrid instrument's fair value change in earnings provides more meaningful financial information to users of broker-dealer financial statements, and is more cost effective. This should not have a significant impact on the balance sheet, as many broker-dealers report the embedded derivative in the same balance sheet caption as the debt host. Such an approach is also consistent with the intended amendments to IAS 39, where the IASB has agreed to provide an alternative to report the entire changes in a hybrid instrument's fair value in net earnings. Furthermore, providing this alternative will not provide the opportunity to create an accounting abuse. (To alleviate any such concern, issuers could be required to disclose their policy on accounting for these instruments in the footnotes to their financial statements.) Additionally, this does not impact investor accounting, because investors have the ability under

Statement 115 to classify the security as a trading and mark-to-market the instrument and record any changes in value to the income statement.

The Committee therefore requests that the Board include this alternative as part of the current FAS 133 amendment process. We look forward to discussing this proposal with the Board, and appreciate your continuing efforts to both provide more relevant financial information for users of financial statements and to simplify accounting guidelines.

Sincerely,

Joanne Pace  
Chair,  
Dealer Accounting Committee

## **Appendix A**

### **GAAP Guidance For Structured Notes**

#### **Embedded Derivative Instruments**

12. Contracts that do not in their entirety meet the definition of a derivative instrument (refer to paragraphs 6–9), such as bonds, insurance policies, and leases, may contain “embedded” derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract (“the host contract”) is that some or all of the cash flows or other exchanges that otherwise would be required by the host contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more underlyings. An embedded derivative instrument shall be separated from the host contract and accounted for as a derivative instrument pursuant to this Statement if and only if all of the following criteria are met:

- a. The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract. Additional guidance on applying this criterion to various contracts containing embedded derivative instruments is included in Appendix A of this Statement.
- b. The contract (“the hybrid instrument”) that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.
- c. A separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6–11, be a derivative instrument subject to the requirements of this Statement. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

[A1, B1, B6–B8, B10–B20, B22–B24, C6, C8, C9, D1, K2, K3]

16. In subsequent provisions of this Statement, both (a) a derivative instrument included within the scope of this Statement by paragraphs 6–11 and (b) an embedded derivative instrument that has been separated from a host contract as required by paragraph 12 are collectively referred to as derivative instruments. If an embedded derivative instrument is separated from its host contract, the host contract shall be accounted for based on generally accepted accounting principles applicable to instruments of that type that do not contain embedded derivative instruments. If an entity cannot reliably identify and measure the embedded derivative instrument that paragraph 12 requires be separated from the host contract, the entire contract shall be measured at fair value with gain or loss recognized in earnings, but it may not be designated as a hedging instrument pursuant to this Statement. [B6, B8, B11]