

September 2, 2004

Suzanne Q. Bielstein
Director - Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: File Reference No. 1201-100, Proposed Statement of Financial Accounting Standards, *Fair Value Measurements*

Dear Ms. Bielstein:

The Bond Market Association ("TBMA"), the International Swaps and Derivatives Association ("ISDA") and the Securities Industry Association ("SIA") are pleased to offer the following comments in response to the Financial Accounting Standards Board's ("FASB") above referenced Exposure Draft (the "Exposure Draft"), *Fair Value Measurements*.

The comments that follow were developed and are being presented jointly by a working group (the "Joint Industry Working Group") composed of representatives of the respective accounting policy committees of TBMA, ISDA and SIA. Collectively, the membership of these committees have substantial professional expertise and practical experience addressing the accounting policy issues and questions raised by this tentative guidance with respect to financial instruments. A description of our organizations is contained in Attachment I. The Joint Industry Working Group is supportive of the FASB's objective of developing a framework clarifying the fair value measurement objective and its application, and would like to take this opportunity to comment on a few matters in the Exposure Draft, including certain matters for which the Board specifically solicited comments.

The Joint Industry Working Group believes that certain clarifications would enhance the usefulness of a final Statement and improve its application. In addition to those clarifications, we believe that it is critical that the Board field test the provisions of the fair value guidance before the issuance of a final Statement. Our comments cover the following key areas:

- Offsetting positions
- Significant subsequent events
- Most advantageous market/transaction costs
- Block discounts
- Marking to one's own credit spread
- Application of EITF 02-3
- Disclosures
- Fair value option

FAIR VALUE PRINCIPLES

The first three topics – Offsetting positions, Significant subsequent events and Most advantageous market – are principles that appear to only apply to assets and liabilities estimated under Level 1 of the Exposure Draft. We strongly believe that these three concepts should be broadly applied across all levels of the hierarchy as further described below.

OFFSETTING POSITIONS

For estimating fair value, paragraph 17 of the Exposure Draft indicates that for Level 1 estimates of "offsetting positions, mid-market prices shall be used for the matched portion." We support the offsetting concept for estimating fair value as articulated in paragraphs 17 and C53, although we believe a broader application across the hierarchy is appropriate to ensure that all fair value estimates are consistent with trading and risk management practices of dealers. Dealers provide liquidity and make trading in cash

securities and derivative instruments possible. When an entity wants to change its risk profile, it needs to find a willing counterparty with an acceptable credit standing.

Dealers stand ready to act in this capacity and make risk exchange possible by having the expertise to structure a product that meets the client's risk profile, the willingness to accept the offsetting risk position and manage it, and the liquidity to unwind or restructure positions when clients wish to subsequently change their risk profile.

Consistent with this business model, dealers maintain large portfolios of client transactions. As a fundamental principle, dealers manage the underlying risks (such as interest rate risk or credit risk) of transactions. Some of the risks of client transactions naturally offset each other and do not create an "open" risk position for the dealer to manage. Other risks do not naturally offset and may be economically hedged (or "closed out" by entering into an offsetting position) with a combination of cash and derivative instruments. For example, assume that a dealer has executed a one-year, 2 million notional pay 5%, receive-LIBOR interest rate swap with a counterparty and a two-year, 2 million notional receive 5%, pay-LIBOR interest rate swap with a different counterparty. The dealer does not have an open interest rate position in year one but does have an open 2 million notional interest rate position in year two. To offset the interest rate position in year two, the dealer may decide to enter into an offsetting interest rate swap or a series of Eurodollar futures. A dealer's success is dependent upon its ability to close out risk in the most efficient manner through optimal access to markets (cash and derivative). Consistent with this risk management approach, the effect that a potential transaction may have on the aggregate risk position (for example, whether it will create a market risk position or reduce an existing market risk position) is one of many factors considered when determining the pricing offered to a client.

The conceptual basis for applying the offsetting provisions to fair value measurements is to accurately reflect the way that marketplace participants price and manage risk. Therefore, consistent with that approach, the offsetting provisions should not be linked to levels of the hierarchy, but rather should be linked to the way in which marketplace participants price and manage risk. The language in paragraph C53 and International Accounting Standard 39 Financial Instruments: Recognition and Measurement, appears to support a risk management approach as the focus of paragraph C53 is on fair value reflecting the risk retained in the instrument or portfolio of instruments (cash and/or derivative products). We believe using mid-market prices to value offsetting positions is a general principle that should not be restricted solely to Level 1 estimates, as it is appropriate to apply it to each level of the hierarchy as well as across levels of the hierarchy, in order to accurately reflect the risk management position of the company and the economics of its positions. Valuing offsetting positions using mid-market prices provides more relevant information because an offsetting position locks in the net cash flows from the asset and liability positions and potentially could be traded as a matched position without incurring certain transaction costs (i.e., the bid-ask spread).

To illustrate, a common transaction is one in which a company executes an over-the-counter ("OTC") equity option on a single stock which is hedged by a listed equity option on the same single stock. Although we believe that the listed option is a Level 1 instrument and the OTC option is a Level 3 instrument, the positions offset each other's market risk. Since the company has offset the risk of market exposure associated with the options, using the observed mid-market volatility to price the OTC contract would seem appropriate. The same concept would apply to a portfolio of exchange traded and OTC options.

Furthermore, many marketplace transactions combine instruments and evidence the way that the market prices offsetting risk. Consider a credit default swap ("CDS") bond basis package trade whereby a company purchases a bond from the dealer (a Level 1 instrument) while simultaneously buying credit protection from the dealer through a CDS indexed to the credit of the issuer of the bond (a Level 3 instrument). Although the CDS is referenced to the same entity that issued the bond, a basis position exists due to supply and demand factors; the ability of the company, upon default of the issuer, to deliver other obligations of the issuer in exchange for par under the settlement terms of the CDS; and, differing default scenarios. For such transactions, the bid-offer spread is paid on the basis position (the net open position) and would be less than the bid-offer spread paid if each leg of the transaction were priced separately. We

believe it is appropriate in this case to value the offsetting credit positions at a mid-market price and the remaining net long basis position at bid, consistent with the observed market pricing.

The simplified examples above are designed to illustrate the application of the offsetting concept that is consistent with current trading and risk management practices. Numerous other examples exist, each with its own complexities. However, the general concept is that risks should be valued using mid-market pricing to the extent risks offset each other, regardless of the level of hierarchy used to categorize instruments. If the mid-market valuation concept for offsetting positions is not permitted across all levels of the hierarchy, then positions with similar underlying risk will be valued differently resulting in inconsistent and incorrect fair value measurements.

In addition, it is our understanding that the purpose of footnote 8 is solely to clarify that the offsetting guidance in the Exposure Draft applies to estimating the fair value of offsetting risk positions and is not intended to provide guidance about netting for balance sheet presentation purposes in the financial statements. We do not believe it was the Board's intent to limit the offsetting position provisions in the Exposure Draft to only those transactions that achieve balance sheet setoff under other relevant pronouncements such as FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, and to depart so fundamentally from how the market values risk. We strongly urge the Board to clarify this point.

SIGNIFICANT SUBSEQUENT EVENTS

The Exposure Draft also indicates that entities should establish and consistently apply a policy for determining how significant subsequent events should be considered in determining estimates of fair values under Level 1 of the hierarchy. We believe that adjusting fair value for significant subsequent events is a general principle of fair value measurement and entities should have policies for determining the effect of significant subsequent events on instruments measured under all levels of the hierarchy.

Again consider market-traded debt, valued under Level 1 of the hierarchy, and a CDS (indexed to the credit of the issuer of the debt), valued under Level 3 of the hierarchy. We believe that entities should have policies in place to address an event that affects both instruments, such as events regarding the credit of the issuer. For example, if a subsequent credit event occurs that affects the fair value of both instruments, the provisions of the Exposure Draft would permit the bond's price to be adjusted for the effect of the event. However, as written, the Exposure Draft does not clarify whether it permits the CDS to be adjusted for the same event. If a credit event that affects fair value occurs after the last quoted trade is done but before the end of the reporting period, an entity's policy should address how the event factors into its estimates of fair value under all levels of the hierarchy.

MOST ADVANTAGEOUS MARKET/TRANSACTION COSTS

We support the provision of the Exposure Draft that indicates that when an entity has access to multiple markets, the Level 1 reference market should be the most advantageous market to which an entity has immediate access. We also agree with the Board that in general the goal of most entities is to maximize profit. For example, a dealer may enter into a transaction with a retail client and, in order to maximize profit, enter into an offsetting position by accessing the more advantageous wholesale market thereby recognizing a profit.

The most advantageous market is defined as the market that maximizes the net amount received taking into account the cost to transact in the respective markets. However, the Exposure Draft also states that the price used to estimate fair value should not be adjusted for the costs to access the reference market. As highlighted in the example below, we believe that the prohibition against adjusting for such transaction costs will produce anomalous results.

Consider a common marketplace example, in which a company purchases a barrel of oil. The spot price of a barrel of oil at Location A where the company intends to execute any future sale is \$35 and the company would incur no transaction costs to execute at Location A. The company determines that the spot price of a barrel of oil at Location B is \$40 and the related transportation costs are \$4. If the company were to actually transact at Location B, the company would have to arrange for transportation of the oil. Assuming the

company has made these arrangements and, therefore, has immediate access to the reference market at Location B, the company would mark the barrel of oil to \$40, the spot price of oil at Location B. Under the provisions of the Exposure Draft the company would recognize an immediate gain of \$5, of which \$4 represents transaction costs. This provision will have the effect of causing an entity to record unrealized gains in one period and related expenses or realized losses in another period.

The example above illustrates the anomalous results associated with requiring a company to recognize again that primarily represents the transaction costs of executing in a particular market. We recognize the Board's concerns regarding consistency in fair value measurement; however, relevance of the fair value measurements is of equal importance. We believe that the most advantageous market provision as currently contemplated in the Exposure Draft may force companies to recognize gains that will merely be expensed in a later period. Therefore, while we support the concept of the most advantageous market, we have concerns regarding the prohibition against adjusting the estimated fair value for transaction costs that would be incurred.

In addition, the Exposure Draft appears to be internally inconsistent with regard to treatment of transaction costs for a Level 1 instrument versus treatment of such costs for a Level 3 instrument. Paragraph B9 of the Exposure Draft emphasizes that fair value shall not be adjusted to take into account Level 1 transaction costs whereas paragraph 23(f) states that "a price might need to be adjusted for difference in the unit of account, condition, or location, or to reflect the appropriate valuation premise." We are unclear as to whether it was the Board's intent to differentiate the treatment of transaction costs depending on where within the hierarchy a position is categorized. However, we believe that, in order to ensure the relevance of a fair value measurement and to achieve consistency across levels of the hierarchy, the Board should include a provision similar to that of paragraph 23(f) in **all** levels of the hierarchy. In addition, given paragraph 23(f), it is unclear what costs may be deemed transaction costs for purposes of applying the most advantageous market provisions of the Exposure Draft.

Clarifying the applicability of offsetting, significant subsequent events and most advantageous market concepts to all levels of the hierarchy as indicated above would ensure that meaningful, relevant information is provided in the financial statements and improve the operability of a final Statement.

* * *

Our comments related to the remaining topics – Block discounts, Marking to one's own credit spread, Application of EITF 02-3, Disclosures, and Fair value option – relate to specific provisions of the Exposure Draft or to issues that we believe should be addressed in the Exposure Draft.

BLOCK DISCOUNTS

We support the decision of the Board as articulated in the Exposure Draft that for large positions of securities held by broker-dealers and certain investment companies a fair value estimate would include a block discount. Including such a discount enhances the relevance of financial statements and provides representationally faithful information. Since block traders transact in the block market, the application of such a discount produces a value that accurately reflects the business activities of the entity. The block discount provisions of the Exposure Draft will prevent the income statement distortion that could occur if entities that purchased a large position at a discount were required to recognize a gain that may never be realized due to the size of the block.

MARKING TO ONE'S OWN CREDIT SPREAD

Footnote 4 of paragraph 5 and paragraphs A23 to A27 indicate that, in determining the fair value of liabilities, the effect of the entity's credit standing should be considered. We understand the reasons for considering the effect of an entity's credit standing in estimating the fair value of liabilities. However, practice is currently mixed with regard to whether the effect of an entity's own credit standing is included in fair value estimates of trading liabilities.

FASB Statement of Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, states that including changes in an entity's own creditworthiness in fair value measurements provides the most relevant information; however, existing higher level GAAP has not clearly addressed this issue in a consistent manner. In FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, the Board acknowledged its pronouncements to date have not broadly addressed whether it is appropriate to reflect changes in creditworthiness in fair value measurements, but decided not to provide additional guidance.

In the absence of clear guidance for derivatives, practice has developed two views. Certain constituents agree with the view in the Exposure Draft. They believe that including the effect of a change in an entity's own creditworthiness in fair value measurements for liabilities is consistent with the widely accepted view that the asset side of the balance sheet must be adjusted for credit risk in determining fair value. This approach ensures that the credit risk component of a valuation methodology is consistent for both assets and liabilities and that fair value measurements include all risks related to the contractual agreement. These constituents believe that the market considers the effect of an entity's creditworthiness in the fair value measurement of derivative liabilities and, therefore, the entity has the ability to realize the effect.

However, the majority of constituents believe that there is little market transparency or conclusive research indicating that derivative transactions in the marketplace consistently reflect the creditworthiness of the "issuer." These constituents believe that including an entity's own creditworthiness in the determination of fair value may not be appropriate as the entity does not typically have the ability to realize gains or losses arising from the changes in its own creditworthiness. It is also worth noting that the Basel Committee on Banking Supervision (the "Committee") decided that the potential inclusion of gains and losses arising from the changes in an entity's own creditworthiness in Tier 1 or Tier 2 capital raises significant supervisory concerns, and therefore, the Committee is of the view that such gains and losses should be excluded from regulatory capital. These constituents believe that this is a factor that the FASB may want to consider when concluding on the issue of marking for one's own credit spread.

Both groups of constituents believe it is appropriate for an entity to include the effect of changes in an entity's own creditworthiness in fair value estimates where the effect is contemplated in the marketplace and when the entity has the ability to realize the effect. This approach is consistent with the concept of fair value being the amount at which an asset or liability could be exchanged between unrelated willing parties as defined in the Exposure Draft.

Including the effect of changes in an entity's credit standing in fair value measurements of liabilities when the entity does not have the ability to realize the effect results in fair value information that is less relevant to financial statement users. For example, there may exist a case in which an entity's credit rating has deteriorated significantly. However, in this situation, it is unlikely that the entity would be able to extinguish its liabilities and thus realize the gain, as it is probable that (in the case of a significant credit deterioration) the entity needs the funding. In that case, even if the liability can be extinguished, the entity would have to replace it by refinancing at a higher effective interest rate. We offer this example to illustrate that there may be cases where an issuer is unable to realize gains resulting from changes in its credit. Without the ability to realize the value, the effect of an entity's credit standing on the value of its liabilities would be inappropriately included in the fair value measurement of the liabilities. Furthermore, this could result in fair value information related to the liability that is less relevant to the readers of financial statements.

Regardless of how the Board ultimately concludes on this matter, the Board should consider a requirement that an entity disclose its accounting policy regarding whether or not fair value measurements of liabilities contemplate changes in the entity's own credit spread. Such a disclosure would clarify an entity's approach to fair value measurements and would provide users of financial statements with the information needed to understand the nature of those fair value measurements.

EITF 02-3

We support the Board's objective of a single fair value hierarchy as provided in the Exposure Draft. However, we believe further clarification is needed in regard to the potential interaction between the Exposure Draft and EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities" ("EITF 02-3"). The fair value hierarchy in the Exposure Draft requires that preparers "estimate an exchange price for the asset or liability being measured in the absence of an actual transaction for that asset or liability" and provides guidance on how valuation inputs should be derived in arriving at that fair value estimate. However, it appears that EITF 02-3 may preclude a preparer from applying certain provisions of the Exposure Draft as it relates to Level 3 estimates.

For example, consider a 10-year written OTC equity option on a single name stock where only two years of observable data is available. Under the Exposure Draft, the entity would supplement the two years of market data with entity-derived data to arrive at a fair value estimate under Level 3 of the hierarchy. However, under EITF 02-3 this value would be adjusted to transaction price regardless of the value estimated under the provisions of the Exposure Draft. Thus, the fair value estimated under the Exposure Draft and the fair value resulting from the application of EITF 02-3 would not be compatible.

For financial institutions that are in the business of buying and selling financial instruments, EITF 02-3 has been an issue of critical importance. We do not believe that delaying discussion of EITF 02-3's relevance to the issue of fair value will improve financial reporting. As a result, we would strongly encourage the Board to consider adding this issue to the scope of the final standard. Due to the significance of this topic, we believe that any decisions reached with regard to this topic should be exposed for comment.

DISCLOSURES

We support the general concept behind the Exposure Draft's required disclosures. However, we believe the requirement to disclose the amount of unrealized gains or losses associated with fair value measurements does not provide useful information and may provide misleading information to financial statement users. This is because this is not a means by which management evaluates its business. Consider an at-the-money written option with a premium received of \$100. Subsequent changes in the fair value of the option may include both realized and unrealized gains. The periodic time value decay (of the original \$100 premium received) will, over time, result in realized gains; other changes in value are considered unrealized gains or losses. Segregating the accounting for the instrument in this manner for disclosure purposes does not add transparency to the valuation process. Furthermore, the effort to produce this type of disclosure for a given reporting period is significant and should not be underestimated, as it will require modifications to companies' systems and reporting processes.

We do however understand that users of financial statements may desire additional information regarding fair value measurements estimated using significant entity inputs. Therefore, for estimates that use significant entity inputs we propose requiring entities to disclose total gains and losses (realized and unrealized). The total gain or loss could be presented as a percentage of total earnings for the period.

It is important to note that disclosures required as part of this project would be supplemented by the qualitative disclosures that are already made regarding fair value measurements. Currently, qualitative information regarding valuation methodology and techniques is disclosed within many banks' and brokerdealers' critical accounting estimate disclosures in the Management's Discussion & Analysis section of their public filings.

FAIR VALUE OPTION

The Joint Industry Working Group notes that the Board has recently undertaken a separate project to determine the scope and application of a "fair value option" for financial instruments. We would like to take this opportunity to reiterate our support for a fair value option which would be applied broadly, to any financial instrument, and to suggest that the Board's separate project be incorporated into this one. While we understand that the purpose of the Exposure Draft is to address how to measure fair value and not when to measure at fair value, we believe that a discussion of the fair value option is particularly relevant to this project. However, should the Board decide to handle the fair value option as part of a

separate project, we believe that the fair value option should be subject to the same fair value hierarchy that is ultimately developed via this Exposure Draft. That is, we do not support the proposed approach that the IASB has put forward in its recent exposure draft of amendments to The Fair Value Option, which introduces a verifiability requirement for applying the fair value option. We believe that it is critical that all financial instruments that are measured at fair value be subject to a single standardized fair value hierarchy.

CONCLUSION

In addition to the technical comments above, we believe it is critical that the Board field test the fair value guidance before the issuance of a final statement. The field test should apply the proposed fair value measurement guidance to marketplace transactions estimated using each level of the hierarchy (e.g., listed equity securities, plain-vanilla interest rate swaps, high yield bonds, exotic derivatives). An analysis of the field test should focus on both the valuation results and the operationality of the guidance. The Joint Industry Working Group is available to assist with this field test.

Again, the Joint Industry Working Group appreciates the opportunity to provide the foregoing comments in response to the Exposure Draft. In addition, the Joint Industry Working Group would like to express its desire to participate in the scheduled fair value measurement roundtable. Should you have any questions or desire any clarification concerning the matters addressed in this letter or if you would like to discuss our participation in the scheduled roundtable, please do not hesitate to contact any of the undersigned at the telephone numbers provided, or George Miller, Senior Vice President and Deputy General Counsel of TBMA at 212.440.9403, Robert Pickel, Director and CEO of ISDA at 212.901.6020 or Jerry Quinn, Vice President and Associate General Counsel of SIA at 212.618.0507.

Sincerely,

Shannon Warren
J.P. Morgan Chase & Co.
212.648.0906
Chair, North America Accounting Policy Committee
International Swaps and Derivatives Association

Esther Mills
Merrill Lynch & Co.
212.449.2048
Chair, Accounting Policy Committee
The Bond Market Association

Sarah G. Smith
The Goldman Sachs Group Inc.
212.902.5675
Chair of the Dealer Accounting Committee
Securities Industry Association

cc: George Miller—*The Bond Market Association*
Robert Pickel—*International Swaps and Derivatives Association*
Jerry Quinn—*Securities Industry Association*
Hee Lee—*Ernst & Young LLP* (Outside Accounting Advisors to *The International Swaps and Derivatives Association*)

Attachment I

The Bond Market Association represents securities firms and banks that underwrite, distribute and trade debt securities, both in the United States and abroad. The Association's members are active participants in the securitization market, collectively accounting for the vast majority of primary issuance and secondary market trading in U.S. mortgage-backed and other asset-backed securities. More information about The Bond Market Association may be obtained from its Internet website, located at www.bondmarkets.com.

ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry. ISDA was chartered in 1985, and today has more than 600 member institutions from 46 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 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. According to the Bureau of Labor Statistics, the U.S. securities industry employs 790,600 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated \$213 billion in domestic revenue and an estimated \$283 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)