Letter of Comment No:



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Ms. Suzanne Q. Bielstein Director—Major Projects and Technical Activities

Mr. Lawrence W. Smith Director—Technical Application and Implementation Activities

Financial Accounting Standards Board (FASB) 401 Merritt 7
P.O. Box 5116
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Re: Proposed FSP FAS 133-a, Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133

Dear Ms. Bielstein and Mr. Smith:

Thank you for the opportunity to comment on the Proposed FSP FAS 133-a, Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133 ("FSP").

In general, we believe that the FSP represents an improvement over the previous guidance in footnote 3 to 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. We also strongly support the Board's rationale for amending DIG Issue B6 so that at initial recognition, dealer profit on a derivative instrument is recognized without regard to whether the derivative is embedded in a nonderivative host or issued as a freestanding instrument. We believe that this returns the accounting literature to one of the core principles of Statement No. 133, which is that a derivative should be accounted for the same whether or not it is freestanding or embedded in another instrument.

There remain, however, certain aspects of the proposal that we find confusing, and we believe that the Board could accomplish its overall objectives with a more simplified approach. Our specific concerns and recommendations follow.

Concept of the Reference Market

It is our view that the basis for revenue recognition should not be the reference market in which the transaction takes place or could take place, but rather, whether the pricing model meets the minimum reliability threshold. We believe this approach is superior because it is more straightforward and is more consistent with the framework of the Fair Value Measurement standard. In addition, we believe that in certain instances the proposed FSP, as drafted, produces what are perhaps unintended results.

In particular, we are concerned that the approach outlined in the FSP may lead to unintended consequences for transactions that a) have Level 5 fair value inputs and b) occur in the reference market — for example, a long-dated, illiquid derivative transaction entered into by two dealers. Following the approach outlined in the FSP, the dealer would first determine that under paragraph 3a the transaction price presumption is not rebuttable. Since the transaction price is not rebuttable, the transaction will not be analyzed under paragraph 4. Therefore, regardless of whether or not the minimum reliability threshold in paragraph 4 is met, a deferred credit or debit will not be established at the inception of the transaction. Since no deferred credit or debit is established at inception, it seems that under paragraph 5 the up-front profit, calculated as the difference between the transaction price and fair value on day two for the instrument, the difference between the transaction price and fair value on day two for the instrument, and the recorded in income on day two, even though the minimum reliability threshold is not met.

Since the proposed approach is both unduly complex and appears to have some unintended consequences, we propose instead that the FSP build on the fair value hierarchy established in the Fair Value Measurement standard, rather than looking to the reference market in which the derivative transaction occurs. Accordingly, we recommend that paragraph 3 be redrafted simply to provide general guidance on the types of situations where the transaction price presumption is rebuttable rather than provide prescriptive and somewhat confusing requirements about the reference market. All prescriptive and somewhat confusing requirements about the minimum reliability transactions should be analyzed under paragraph 4 to ensure that the minimum reliability threshold has been met. This approach will both simplify the analysis and allow for upfront profit to be recognized only in those instances where the minimum reliability threshold for the fair value estimate is met.

Disclosures

In paragraph 6a, the FSP requires disclosure of gross unrealized gains and losses at initial recognition of all derivative instruments recognized in income during the current period. Although we feel that this requirement would be burdensome as there are both definition issues and additional systems requirements needed for implementation, that is not our fundamental objection to the requirement. We simply do not understand the value of this information for Level 1-4 transactions, given that the minimum reliability threshold for recognition has been met. Further, the disclosures would not take into account a number of valuation adjustments, such as those for liquidity or concentrations of credit, that are made at either a portfolio level or customer level. As a result, it would be difficult (if not

impossible) to reconcile the amounts disclosed to the amounts reported in the statement of earnings. Accordingly, we do not believe that the proposed disclosure will provide enhanced transparency in the financial statements or that the benefit of such disclosure will outweigh the costs of obtaining the proposed information on the hundreds of thousands of derivative trades executed each year by our firm.

We further note that the FASB has embarked on a separate project on derivatives disclosures. We recommend that rather than adding on to the fragmented and piecemeal disclosure requirements that exist today, the FASB address the need for disclosures in this area as part of its comprehensive review of derivatives disclosures.

However, if the disclosures in 6a are required, the requirement seems to be too broadly written. Based on the current wording, it is not clear if the gross unrealized gain or loss recognized in income would be adjusted for or would include the following:

- intra-day market movements on the derivative, which may be significant. For example, a transaction may have a zero unrealized gain or loss at the moment the transaction occurs, but if interest rates move during the day (say, due to a major announcement made by the Federal Reserve), the end-of-day unrealized gain or loss for that transaction will not be zero. Tracking the "minute-one" amounts for all transactions is not feasible
- associated hedge costs and intra-day movement on the hedges that help to establish
 the initial value of the derivative transaction
- valuation adjustments such as liquidity and credit exposure adjustments made at the portfolio level.

It should be noted that we do not object to the disclosure requirements in 6b. We understand the Board's desire for enhanced disclosures regarding financial positions where significant estimation is required in determining fair value and, accordingly, support disclosure of unrealized gains and losses regarding deferral of initial recognition when a minimum reliability threshold is not met for the estimate. However, we do not support the day 2 disclosures required by the Fair Value Measurement Working Draft that relate to all changes in unrealized gains or losses for Level 5 estimates. It is virtually impossible to isolate the day 2 revenue for these instruments since valuation adjustments, which are made at the portfolio level, cannot be allocated to either specific transactions or hierarchy levels in anything but an arbitrary manner.

Amendment to B6

As stated earlier, we support the proposed amendment to DIG Issue B6 if the intent is as we understand it, that derivatives should be valued the same regardless of whether they are freestanding or embedded in another instrument. We believe this principle is clearly espoused in paragraph 18 of the FSP and expressed therein in an exceptionally straightforward, "plain English" manner. Accordingly, we believe that this language should be incorporated in the Response to DIG Issue B6. In addition, similar to our

comments above, we recommend that the concept of "reference market" in the Response be replaced with that of a "minimum reliability" standard for the embedded derivative.

Conversely, we find the language in paragraph 19 and the second paragraph of the Response in paragraph 8 of the FSP to be confusing. We believe that Board is trying to convey to the reader that:

- 1) the unrealized gain or loss to be deferred or recognized in income on day one should be measured as the difference between the fair value and the "transaction price" of the entire hybrid instrument.
- 2) the carrying value of the host should be determined as the difference between the fair value of the hybrid instrument and the fair value of the derivative.

If so, we believe that this guidance is at odds with that in paragraph 18. Simply put, does the FSP require that the unrealized gain or loss be determined based on the fair value of the hybrid instrument (para 19), or only the embedded derivative (para 18)? We believe it should be the latter, and accordingly, we recommend clarifying the language in paragraph 19 and the second paragraph of the Response so that the calculation of the deferred or recognized income and the calculation of the carrying value of the host are straightforward and easy to understand.

Scope

Paragraph 3 of the FSP states that it applies to transactions "involving a derivative instrument." We recommend that the Board clarify that the FSP applies only to standalone or bifurcated derivatives. We do not believe it should be applied to embedded derivatives that are not required to be bifurcated because they are clearly and closely related to the host instrument, or to hybrid instruments that are otherwise recorded at fair value in their entirety with changes in value recorded through earnings pursuant to other applicable GAAP. We believe that applying this guidance to hybrids that are accounted for at fair value in their entirety could be burdensome for investors.

For instance, under one of the proposed amendments to Statement No. 140, investors in asset-backed securities will have the option to either account for a hybrid instrument at fair value or bifurcate the instrument. However, since under Statement No. 115, investors that own asset-backed securities that may have an embedded derivative (e.g., lower-tranched securities) have the option to account for the assets as trading assets, they may decide to elect this option rather than go to the effort of determining whether on not the security is a hybrid. If the scope of the FSP broadly includes derivatives embedded in hybrids, these investors would now be required to analyze these instruments for embedded derivatives, which seems unduly burdensome.

Transition

The proposal requires an entity to disclose, in the year of adoption and in all interim periods in that year, the effect of the change in accounting principle on income and per share amounts. We believe this will be exceptionally challenging for preparers of financial statements because once the new FSP is adopted, they will have to continue to analyze and make decisions regarding up-front recognition or deferral of day one profits under both old and new guidance for all interim periods in the year of adoption. Because these decisions involve a significant amount of judgment and estimation regarding what the reference market of the instrument is, what level of the fair value hierarchy an instrument should be categorized in, and whether a "minimum reliability threshold" is met (versus whether inputs were considered to be sufficiently observable under previous guidance), we think it will be fairly time-consuming (and confusing) for entities to apply both approaches simultaneously. Additionally, for instruments accounted for under DIG Issue B6 such as structured notes, old and new systems will have to be maintained to calculate and amortize the basis of the host instrument. We do not believe that the benefit of such disclosure will outweigh the cost of obtaining the proposed information. Accordingly, we urge the Board to eliminate this aspect of the transition requirement of the FSP.

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Thank you again for your consideration of our views. If you have any questions regarding our comments, please do not hesitate to contact me at (212) 449-2048.

Sincerely,

/s/ Esther Mills

First Vice President