

ASSOCIATION FOR INVESTMENT MANAGEMENT AND RESEARCH®

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July 17, 2002

Letter of Comment No: File Reference: 1100-163 Date Received: 7/17/02

Ms. Suzanne Bielstein
Director of Major Projects & Technical Activities
Financial Accounting Standards Board
401 Merritt 7
Post Office Box 5116
Norwalk, Connecticut 06856-5116

Re: File Reference No. 1100-163 Amendment of Statement 133 on Derivative Instruments and Hedging Activities

Dear Ms. Bielstein:

The Financial Accounting Policy Committee (FAPC) of the Association for Investment Management and Research (AIMR)¹ is pleased to comment on the Financial Accounting Standards Board's (FASB) Exposure Draft, Proposed Statement of Financial Accounting Standards – Amendment of Statement 133 on Derivative Instruments and Hedging Activities. The FAPC is a standing committee of AIMR charged with maintaining liaison with standard setters who develop financial accounting standards and regulate financial statement disclosures and responding to new regulatory initiatives. The FAPC also maintains contact with professional, academic, and other organizations interested in financial reporting.

General Comments

The FAPC supports the standardization of the accounting for derivative instruments, including certain derivative instruments embedded in other contracts, by requiring that an entity recognize those items and measure them at fair value. However, we are concerned that SFAS 133 disclosures remain inadequate. The FAPC supports the re-issuance of comprehensive guidance on derivatives with relevant disclosures that go beyond accumulating existing disparate guidance into one document.

¹ With headquarters in Charlottesville, VA, and regional offices in Hong Kong and London, the Association for Investment Management and Research® is a non-profit professional organization of 57,000 financial analysts, portfolio managers, and other investment professionals in 107 countries of which 44,800 are holders of the Chartered Financial Analyst® (CFA®) designation. AIMR's membership also includes 116 affiliated societies and chapters in 29 countries. AIMR is internationally renowned for its rigorous CFA curriculum and examination program, which has more than 100,000 candidates from 143 nations enrolled for the June 2002 exam.

Specific Comments

Redefinition of a derivative

The FAPC urges the Board to clarify its redefinition of a derivative and explain why it chose 5% as the threshold for determining "little" initial investment for non-option based contracts. We are concerned about these matters because the Board does not provide such quantitative guidance in other cases where judgment is required for establishing materiality. For example, there is no guidance as to what is meant in the test for embedded derivatives under SFAS 133 Par. 13a by an investor not recovering "substantially all" of the initial recorded investment of a hybrid instrument. However, by arbitrarily selecting 5% for determining "little" initial investment for non-option based contracts, it is possible that practitioners will see this as a precedent for defining materiality under SFAS 133.

The redefinition of option-based contracts presents special concerns, as well, because the implications of the proposal are not intuitive and may have unintended consequences. For example, the language in the exposure draft presupposes that option-based contracts will meet the definition of a derivative if a premium equal to the option's fair value is paid or received at the inception of the contract. However, the Committee is concerned that the language used in the proposal could be construed to mean that option-based contracts will meet the definition of a derivative *only* if a premium equal to the fair value of the option is paid or received at the inception of the contract. On the other hand, it leaves open the possibility that non-option based contracts could have a range of possibilities for meeting the definition; i.e. the initial investment of non-option based contracts must be less than the prescribed threshold of 5% of the fully pre-paid amount. It also is unclear if companies can avoid applying SFAS 133 by negotiating deferred payment or receipt of premia at inception of option-based contracts. Ultimately, this redefinition could possibly affect the bifurcation of embedded derivatives and the treatment of loan commitments under SFAS 133.

Beneficial Interests in Securitization

The FAPC supports the proposal to require the bifurcation of derivatives embedded in securitization beneficial interests under certain circumstances. In particular, the Committee supports the expanded scope exception, which acknowledges that many securitizations involve the reallocation of cash flows and risks among beneficial interests, and not simply the segregation of interests and principal payments into two separate instruments. If beneficial interests contain "derivatives" (as defined by SFAS 133 or an amended SFAS 133), then they should be accounted for under SFAS 133. Beneficial interests should not be considered beyond the requirements of SFAS 133 simply because they arise from transactions accounted for under SFAS 140. As such, the proposed amendment should result in greater comparability, as beneficial interests will be reported in a manner comparable to other instruments that have identical characteristics even if they did not arise from a SFAS 140 transaction. Likewise, this change would facilitate consistency across various standards and support the Board's tenet that similar transactions should be accounted for similarly.

Given the complexity and potential implementation hurdles of the proposed amendment, the FAPC would support simpler models for measuring the fair value of embedded derivatives in beneficial interests. But, should the Board choose to employ the simpler models, it should ensure that those models reflect the economics of transactions in the financial statements. Further, the Committee urges the Board to require companies to disclose such information as a way of providing investors with the information they need to make appropriate investment decisions.

Application of the shortcut method and DIG G20

The Committee would like clarification on how the new provision in the shortcut method would work. As proposed, the amendment permits the shortcut method for an interest rate swap with a non-zero initial fair value if the swap mirrors a put or call option embedded in the hedged instrument and the swap's initial fair value equals the time value of the hedged item's embedded option. To prevent a change that might create more problems than it solves, the Committee would like some indication of how the application of the shortcut method would work for such transactions.

The Committee is also concerned that the exposure draft fails to address conceptual issues associated with the treatment of purchased-option premiums in cash flow hedges under DIG G20. Current guidance under G20 indicates that options need not be considered ineffective in a cash flow hedge just because they were purchased at a premium. But this is a pragmatic response that requires different treatment of an option premium depending on whether the option is used in a cash-flow hedge or a fair-value hedge. As such, it is unclear why users are better off with this answer when the intrinsic value and changes in intrinsic value are used to assess effectiveness, the answers should be the same regardless of whether the option is used in a fair-value hedge or a cash-flow hedge.

Normal Purchases and Normal Sales Exception

The proposed amendment addresses the application of the *normal purchases and normal sales exception* to option contracts, forward contracts with optionality and power purchase agreements. However, the addition of power purchase and sales agreements to the exception is not clear. We recognize that there are uncertainties relating to the price of power and that the price may vary depending on deliverability; nevertheless, these uncertainties are no different from other market and environmental factors that are factored into certain option agreements. As a result, we urge the Board to clarify the application of the normal purchases and normal sales on a conceptual basis and not prescribe industry-specific rules.

In addition, the FAPC would like the Board to clarify the application of the normal purchases and normal sales exception to contracts that are expected to result in physical delivery of goods or assets being sold or purchased in the normal course of business and that have price adjustment clauses based on blended indexes. The current guidance lends itself to different possible interpretations, with many affected by industry-specific practice in a geographical location. Industry-specific practice may support price adjustments based on blended indexes whose composition may not include in their entirety ingredients or direct factors in the production of the items being purchased

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or sold under the contract. As a result, the Board should consider establishing a threshold for defining what "clearly and closely related" means for blended indexes. Furthermore, an example of the application of this scope exception would be useful.

Loan Commitments

The FAPC supports the Board's views that loan commitments that relate to the origination or acquisition of mortgage loans held for re-sale be considered derivative instruments by the issuer/lender. As a matter of practicality, the Committee supports the proposed amendment that excludes the holder of a loan commitment (potential borrower under the agreement) from the requirements of this Statement. Furthermore, we support the Board's view that the exclusion should not be extended to the lender because management intent may affect the objectivity of such an exclusion. Finally, the FAPC supports the amendment to SFAS 65 that excludes any loan commitment that is required to be accounted for by the issuer (potential lender) as a derivative under SFAS 133.

Warrants

The proposed amendment permits shares issuable under warrants to be considered restricted (and thus likely not to be a derivative) when "a) the stock purchase warrant is issued by an entity for only its own stock and b) the sale or transfer of the issued shares is restricted for a period of 32 days or more from the date" of exercise. The FAPC supports the restriction on shares to be delivered under warrants issued by an entity. However, the Committee is troubled by the fact that the restrictions apply only to the issuer. Moreover, the Board did not provide justification for its decision to propose a 32-day restricted period.

Disclosures

The FAPC strongly believes that standard setters and preparers have a responsibility to ensure that relevant information is provided to allow investors to make informed investment decisions. Unfortunately, the disclosure requirements of SFAS 133 are weefully inadequate and do not provide relevant information for investors. As such, the FAPC strongly urges the Board to address the issue of disclosures in the final rule, and to consider what investors will need to know from such disclosures. To that end, we would be pleased to work with the FASB to address this issue.

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Concluding Remarks

The Financial Accounting Policy Committee appreciates the opportunity to express its views on the Board's Exposure Draft: Amendment of Statement 133 on Derivative Instruments and hedging Activities. If the Board or your staff have questions or seek amplification of our views, please contact Nazir Rahemtulla at 1-434-951-5337 or at nazir.rahemtulla@aimr.org. We would be pleased to answer any questions or provide additional information you might request.

Respectfully yours,

/s/ Ashwinpaul C. Sondhi

/s/ Joseph A. Boateng

Ashwinpaul C. Sondhi, Ph.D. Chair, Financial Accounting Policy Committee

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