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Suzanne Q. Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
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Re: File Reference No. 1100-163

Dear Ms. Bielstein:

We appreciate the opportunity to comment on this important guidance:

- Proposed Amendment of Statement 133 on Derivative Instruments and Hedging Activities (the "Exposure Draft" or "ED")
- Derivative Implementation Issues A20, B12, B36, C17 and D2 (the "DIG Issues")
- Questions and Answers Related to Derivative Financial Instruments Held or Entered into by a Qualifying Special-Purpose Entity (the "Q&A")
- Examples Illustrating the Application of the Proposed Amendment of Paragraph 13 of FASB Statement 133 (the "Examples")

For purposes of this letter, the above-noted guidance as it pertains to beneficial interests is referred to collectively as the "D2 model".

As a broker-dealer, Merrill Lynch is involved with many transactions that will be affected by this proposed guidance, including structuring securitization transactions on behalf of clients, underwriting and making a market in beneficial interests, securitizing our own assets, and dealing in derivatives. As such, we are keenly interested in these issues.

Proposed Amendment of the Definition of a Derivative – DIG Issue A20

Statement 133 DIG Issue A20 will dramatically change how derivatives are defined and will result in an increased number of instruments being bifurcated when derivatives contain an off-market element. While we agree that certain derivatives contain financing elements, and bifurcation of this component may make sense for end-users of derivatives, we do not believe that the requirement to bifurcate such derivatives should be applied to dealers in derivatives. We believe that derivative dealers should continue to apply mark-to-market accounting as required by the AICPA Audit Guide, *Brokers and Dealers in Securities,* for their asset and liability derivative positions. Derivative dealers carry their derivatives portfolios at fair value with changes in fair value recorded in earnings, and we do not see how bifurcation enhances the presentation of these transactions.

On the contrary, we believe that this proposal represents a step back from reporting financial instruments at full fair value. Specifically, bifurcation will result in only marking a portion of a financial instrument (the "embedded derivative") to fair value, with changes in fair value recorded in earnings. The remaining "host instrument" may or may not be marked to fair value through earnings on an ongoing basis, depending on how it is classified (as a trading, available for sale, or held to maturity asset), and depending on whether the instrument is an asset or a liability. The latter is a significant factor, because if it is a liability, it would seem that accrual accounting is the only alternative for accounting for the host instrument.

In addition to the fact that bifurcation will potentially result in a single instrument being accounted for using two methods of accounting, there is also the issue of the artificiality and subjectivity of the bifurcation methodology itself. Bifurcation will require a dealer to estimate the fair value of a portion of an instrument, and in many cases this valuation may be subject to more estimation than valuing the instrument as a whole, as the fair value for a unitary instrument which trades in the market is more readily determinable. Thus, bifurcation will introduce more subjectivity into the valuation process, at a time when the SEC is proposing greater disclosure regarding subjectivity of inputs and estimates underlying accounting results. One would think that given the concerns which have given rise to the SEC's proposal, a proposal which would introduce more subjectivity to the financial statements would not be well-received by investors.

Additionally, we believe that the threshold for identifying hybrid instruments, i.e., those with an initial net investment of 5% or more of the fully prepaid amount, is an arbitrary, "bright-line" test that lacks a conceptual basis. Further, in light of the significant daily volumes of transactions entered into by dealers, such a requirement will place an enormous operational burden on dealers to implement new systems in order to identify which transactions will require bifurcation.

Merrill Lynch has consistently supported reporting all financial instruments at fair value, as we believe this is the most transparent and representationally faithful method of accounting for such instruments and most reflective of the economic substance of our

business. A requirement under which a portion of financial instruments would be required to be accounted for on an accrual basis would seem to contradict the goals of the FASB's Fair Value project as well as the recommendations of the international Joint Working Group. In light of this, we strongly recommend that dealers in derivatives be excluded from the scope of the requirement to bifurcate certain derivatives as required in A20.

As an alternative, we recommend that entities be given the choice to either bifurcate such derivatives or record them at fair value with changes in value recorded in earnings, as recommended by the Securities Industry Association (letter dated February 5, 2002). Such an approach is also consistent with the IASB approach in its recently issued Exposure Draft to amend IAS 39. The IASB indicated it supported this change by stating that "...to reduce the burden of separating embedded derivatives, an entity should have the option, rather than be required, to measure a hybrid instrument containing an embedded derivative that is not closely related to the host contract at fair value with changes in fair value reported in the net profit or loss." International harmonization would therefore be enhanced if the FASB adopted a similar approach.

Proposed D2 Model

As a general matter, we are concerned that the proposed D2 model significantly increases the complexity of an already highly complex standard. The application of the D2 model to common types of transactions executed in the market (for example, multi-tranched, managed CDOs) is difficult at best, and in many instances neither practical nor operational. Similar to the concerns expressed above regarding A20, we believe that implementing the D2 model as proposed will result in artificially bifurcated "accounting" instruments, the valuation of which will result in the bifurcated parts not reflecting the fair value of the instrument in its entirety.

We note that the DIG has already issued guidance regarding bifurcation of hybrid instruments, namely, paragraphs 12 to 15 of Statement 133 and DIG Issues B19, *Embedded Derivatives: Identifying the Characteristics of a Debt Host Contract* and B20, *Embedded Derivatives: Must the Terms of a Separated Non-Option Embedded Derivative Produce a Zero Fair Value at Inception*? We believe that this guidance should be extended to apply to the beneficial interests in question, as we do not support the creation of another model that is to be applied to instruments that are of a similar nature. Alternatively, we believe that EITF Issue No. 99-20, which addresses recognition of income and impairment of beneficial interests in securitized financial assets, could easily be modified to apply to the instruments in question, resulting in a fairly straightforward accounting model that addresses the key concern regarding accounting for beneficial interests, that of impairment.

Statement 133 Implications for Qualifying SPE Status

We note that the proposed Q&As reiterate the strict limitations on the types of derivatives a Qualifying SPE may enter into, without providing any conceptual basis for such limitation. Our understanding was that these limits were originally proposed because there were no requirements at the time they were introduced to bifurcate derivatives embedded in a beneficial interest issued by a QSPE; thus, the concern seemed to be that derivatives could be hidden by placing them into a QSPE. However, if the D2 model as proposed is finalized, there would no longer seem to be any need for limits on the types of derivatives a QSPE can enter into (as long as the derivatives were passive in nature), because any derivatives held by the QSPE would be required to be bifurcated and accounted for by the holder of the beneficial interests.

Further, even if the FASB opted for an alternative to the D2 model, such as permitting beneficial interests to be marked to market in their entirety, these types of limitations on the types of derivatives a QSPE may enter into would still be unnecessary. The same would also hold true if no bifurcation test were required but beneficial interests were periodically tested for impairment (as presumably there is greater concern regarding the diminution in value of an embedded derivative rather than the increase in value).

Though we have raised this issue before, in a variety of forums, we are disappointed that the Board has not addressed this issue to date. We note that there is a great deal of interplay in the accounting for QSPEs and the accounting for beneficial interests issued by QSPEs and as such, we believe that the requirements for both should be considered and rationalized in a consistent manner. Without reconsidering these limitations on derivatives, we are concerned that there will be many instances in which a QSPE will lose or fail its qualifying status for reasons that are not ultimately theoretically or conceptually supportable.

Changes to Short-Cut Method

We also have some concerns regarding the amendment to paragraph 68(b), which now states that in order to qualify for the "short-cut method," the fair value of a swap containing an embedded mirror-image call or put at the inception of the hedging relationship must be equal to the time value of the embedded call or put option. Though this modification does not address whether this would also require that a *premium be paid upfront* equal to the time value of the call option embedded in the interest rate swap, we understand that some constituents have interpreted the amendment in this manner.

If this were the case, we would be opposed to such a requirement, as this would impose additional credit risk on a derivative dealer. In particular, the derivative dealer typically purchases a call option from an issuer who is seeking to hedge an issuance of callable debt. It would be undesirable from a credit risk perspective for a dealer to have to make an upfront payment on a swap to a counterparty when the dealer is exposed to future credit risk to the counterparty under the terms of the swap.

Setting aside the issue of credit risk, we note that the "short-cut method" is broadly premised on achieving symmetry between the debt being hedged and the hedging instrument (the swap). Typically, when an issuer issues callable debt in the marketplace, the issuer does not pay an upfront premium to its investors for the call option purchased; rather, the premium is paid to the investors via an adjustment to the yield on the debt. That is, the premium is effectively paid to the investors over time. Therefore, we believe that the swap used to hedge the debt should also be permitted to embed the value of the option premium in the swap payments to the issuer.

Accordingly, we believe that the Board should either clarify that its amendment to paragraph 68(b) has no implications on the manner in which the option premium is paid, or acknowledge that the time value of the option premium may be embedded into the coupon payments on the swap. Further, the Board should acknowledge that embedding an option premium into the coupon payments on the swap would not be a violation of A20 (and hence would not be required to be bifurcated), given that the intent is merely to mirror the cash flows of the debt instrument being hedged.

Other Matters – Third Party Matched Offset Requirement

We would also like to take this opportunity to reiterate to the Board our position regarding the matched offset requirement imposed by Statement 133 as it applies to dealers in derivatives. We continue to strongly disagree with this requirement because it does not take into account the fundamental nature of our industry and state-of-the-art risk management techniques.

Statement 133, as interpreted by the DIG, requires inter-company interest rate derivatives to be designated as hedging instruments only if a member of the consolidated group entered into a third party *matched offset* derivative. This requirement resulted in a major change to our risk management strategies.

Prior to the implementation of Statement 133, Merrill Lynch's risk management strategies were executed using a derivative dealer subsidiary responsible for managing risks on an entity-wide basis. A centralized risk management function was responsible for evaluating the aggregate risk position of the company and entering into the appropriate transactions to manage interest rate, credit, and foreign exchange risks to the desired level. The centralized function, by virtue of its sophistication and market access, can enter into transactions that transfer risk to third parties in a manner that is significantly more cost effective and operationally efficient than if each affiliate were to lay off its risk directly with third parties. Furthermore, managing risk in the aggregate reduces counterparty credit risk.

The requirement to offset certain intercompany derivatives with third party transactions required us to disaggregate risks arising from inter-company derivatives from risks

arising from derivatives with unrelated third parties, and manage such risks separately. Thus, the effect of adoption of this requirement of SFAS 133 has been to reduce the efficiency of current risk management practice and increase operational and credit risks due to the increase in the number of required transactions. Furthermore, we do not believe that our investors or readers of our financial statements have derived any benefit from this requirement.

We believe that this requirement is unwarranted for dealers in derivatives, in that derivative dealers account for their activities on a mark-to-market basis, such that any retained risk not laid off to a third party is recognized in earnings. In addition, we note that the Board made an exception to the requirement for a matched offset derivative for foreign currency cash flow hedges where a central treasury function is employed. We believe there are parallels between the way a central treasury function and a derivative dealer manage risk, and there is no conceptual distinction between the nature of currency risk and interest rate risk which would warrant a different accounting approach for these transactions.

Accordingly, we strongly recommend the Board take this opportunity to amend Statement 133 to exempt dealers in derivatives from the matched offset requirement, provided that (1) the dealer is able to quantitatively demonstrate that risk has been laid off via risk measurement tools and (2) any retained risks are recognized in earnings.

Implementation Date
Finally, we believe that if the ED is finalized, especially as it relates to the D2 model and the A20 bifurcation requirements, the implementation date should be extended to the third quarter of 2003. Given the number of other proposals which will be likely implemented either this year (SEC disclosure requirements regarding critical accounting estimates), or early next year (SPE consolidation guidance), and which will require an extensive amount of implementation effort, we urge the Board to consider this delay in the effective date of this ED.

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We thank you for the opportunity to comment on this proposal. Please do not hesitate to contact me at 212-449-2048 with any questions on our comments.

Sincerely,

/s/ Esther Mills

Esther Mills
First Vice President
Accounting Policy