Letter of Comment No: 1 File Reference: 1100-163 Date Received: 5/23/02



May 22, 2002

MP&T Director, File Reference 1100-163 Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Re: FAS 133 Exposure draft comments

To the Director of Technical Projects and Technical Activities:

I am the principal of Kawaller & Company, LLC, which is a private consulting company that specializes in assisting commercial enterprises in their use of derivative instruments. Communicating with clients about FAS 133 issues represents an important part of the firm's activity. Thus, I share the FASB's interest in making FAS 133 as clear and understandable as possible. To that end, I appreciate having an opportunity to comment on some of the amendments being proposed in the recent exposure draft, released earlier this month

My concern has to do with the following text (Paragraph 6.b), "If it is an option-based contract, it has an initial net investment equal to the fair value of the option component."

This proposed text seems to me to reflect a significant change to the definition of a derivative. I read this change to mean that in order for an option (or a contract with option-like characteristics) to be considered to be a derivative under FAS 133, a premium equal to the fair value of the option must be paid or received, at the inception of the trade. Put another way, if no premium is paid or received, or if the premium differs from fair value, the instrument in question would not be a derivative subject to FAS 133.

If my reading is correct, companies would be able to avoid following FAS 133 for a significant number of contracts simply by agreeing to defer payment for options. Alternatively, they might make the argument that they've entered into these arrangements at attractive prices (i.e., purchased at prices below fair value or sold at prices above fair value). Under such conditions, the company could justify the determination that the instrument does not deserve to be considered to be a derivative.

Critically, these arguments apply equally well to embedded derivatives. That is, for many hybrid instruments, an initial premium equal to the fair value of the associated option will not be paid or received at the inception of the trade, such that the embedded option would not satisfy the definition of a derivative on a stand-alone basis; and thus bifurcation would not be required.

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It strikes me that the proposed paragraph is a dramatic departure from the original text and the original intention of the Board, but yet the explanation in Appendix A, justifying the proposed changes, makes no mention of any changes in intent, other than to eliminate some of the ambiguity of the original paragraph 6.b. There is no indication of a basic change in attitude, however, as to what should be covered under this standard and what should be exempt.

As a further indication that the new suggested text may have unintended consequences, I think that the amended language conflicts with the conclusion to DIG Issue C13, which states, "Loan commitments that relate to the origination or acquisition of mortgage loans that will be held for resale, as discussed in paragraphs 21 and 23 of Statement 65 (as amended), must be accounted for as derivative instruments in accordance with Statement 133." As you know, this response was formulated under the earlier definition of a derivative (i.e., the original Paragraph 6.b), which required only that the initial net investment had to be zero or "small" to qualify as a derivative. However, loan commitments are typically issued under a process where no initial net investment is paid or received by the counterparties. Thus, while loan commitments may have satisfied the earlier definition, they do not satisfy the revised definition - irrespective of whether the resulting loans were intended as an investment or for re-sale.

Rather than clarifying the issue of the definitional requirements of a derivative, I believe that the proposed language has muddled the waters. The new language represents a significant philosophical change that would, if adopted, conflict with other guidance certainly DIG Issue C13, but maybe elsewhere, as well. If the philosophical change was not intended, a further revision of Paragraph 6.b is needed. I offer the following suggestion, for your consideration. (Presently proposed footnotes would not be affected.)

If it is an option-based contract,* it has an initial net investment equal to the fair value of the option component. may require an initial net investment that corresponds to an option premium. The size of this initial net investment, however, must be no larger than the value of the corresponding underlying instrument to the option-based contract. If it is not an option-based contract (hereafter referred to as a non-option-based contract), it requires an initial net investment that is less than 5 percent of the fully prepaid amount.†

I believe the above suggestion conforms to the original intent of FAS 133, while the current proposed change does not. That said, if the Board is fully cognizant of the impact of the proposed change, a more expanded justification for this change of attitude would be greatly appreciated.

If you would care to contact me to discuss these comments, I would be most happy to hear from you. Thank you for your consideration.

Sincerely.

Le & Kamelly

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