



LETTER OF COMMENT NO. 21

David Moser
Managing Director

Merrill Lynch & Co., Inc.
Accounting Policy

4 World Financial Center FL 15
New York, NY 10080
Tel: (212) 449-2048
Fax: (212) 449-0970
David_moser@ml.com

September 21, 2007

Mr. Russell G. Golden
Director of Technical Application & Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116
director@fasb.org

Re: File Reference: Proposed Issue E23

To Mr. Golden:

Merrill Lynch is pleased at the opportunity to comment on the Financial Accounting Standards Board's ("FASB") proposed Statement 133 Implementation Issue No. E23, Hedging-General: Issues Involving the Application of the *Shortcut Method* under Paragraph 68 ("Proposed Issue E23"). As a market maker in derivatives, we transact with a significant number of clients through interest rate swaps used to hedge their economic exposure to interest rate risk. In providing these instruments for risk management purposes, we are aware that many of these clients apply the shortcut method, which is a prevalent practice.

We support the FASB's decision on many of the issues presented in the Proposed Issue E23 and believe that codifying these issues will bring additional clarity to help alleviate current diversity in practice. However, we strongly disagree with the FASB's majority view that hedging relationships entered into after initial recognition of the hedged item ("late hedges") would preclude the use of the shortcut method. In short, the inability to perform late hedges will have major implications for many of our clients who lack the resources necessary to apply the long haul method and the tolerance to absorb the volatility associated with undesignated hedging derivatives in their earnings. In addition, we believe that this proposed guidance presents an amendment of the current standard.

Please find below our more detailed comments on the issues addressed by the Proposed Issue E23.

Issue 1

We support the FASB's efforts to address the trade date / settlement date issue; however, we believe that either trade date *or* settlement date should be permissible as the hedge designation date -- as written the Proposed Issue E23 suggests that only trade date can be used. We recommend rewording the issue per the following:

Paragraph 68 (Introductory paragraph):

1. The shortcut method may be applied to a qualifying fair value hedge when the relationship is designated on the trade date or settlement date of ~~both the swap and~~ the hedged item (for example, debt) even though the hedged item is not recognized for accounting purposes until the transaction settles (that is, until its settlement date), provided that the period of time between the trade date and the settlement date of the hedged item is within established conventions for that marketplace.

Issue 2

We have no comments on Issue 2 as currently drafted.

Issue 3

We support the FASB's decision to clarify the requirement that the transaction price be zero (from paragraph 68(b)). With the adoption of SFAS 157, *Fair Value Measurement*, there are circumstances where an on-market swap will not have a fair value of zero. Although we agree that a bid-offer spread is a major reason for swaps not having a fair value of zero at inception, additional reasons may arise as more entities apply the guidance in SFAS 157 (e.g., issues associated with considering an entities own creditworthiness). As such, we believe certain other factors should be permissible other than just the bid-ask spread (in the entity's principal market).

Issue 4

Regarding the issue of matching critical terms in paragraph 68(e), we suggest inserting a footnote to clarify that contractual terms which do not affect fair value would not otherwise preclude a hedging relationship from qualifying for the shortcut method. For example, we believe that the contractual ability to cancel debt in different notional increments than the swap contract permits would have no economic value and should not affect the ability to qualify for the shortcut method. We also acknowledge that although a difference in notification period for termination may have some economic value, it is de minimis for the life of the hedge until the termination date occurs and also should not preclude the use of the shortcut method.

Issue 5

We support the FASB's clarification that a discount or premium due to a rounding of the coupon rate should not preclude the use of the shortcut method; however, we would recommend further expanding this exception. As currently drafted, we believe that hedges on many purchased instruments ("asset hedges") would no longer qualify for the shortcut method, as it is near impossible to purchase an instrument at par after its issuance. This would present a major departure from current practice affecting many constituents. We believe this was not the intention of the FASB and that the exception be expanded to allow for asset hedges.

Issue 6

We believe that entering into an interest rate swap as a hedge of an existing issuance does not necessarily invalidate the assumption of no ineffectiveness under the shortcut method. Consider the following example: Company XYZ issues fixed rate debt at par (\$100) on 1/1/2007. Subsequently, market interest rates decline such that on 3/31/2007 the debt has a fair value of \$120 (credit ignored for purposes of this example). We would view the \$120 fair value of the debt as \$100 par value of the liability plus the fair value of the interest rate risk (+\$20). Company XYZ enters into an at-market, receive-fixed, pay-float interest rate swap with a fair value of zero on 3/31/2007 as a hedge of interest rate risk. This interest rate swap meets all the terms in paragraph 68 of SFAS 133 to qualify for the shortcut method.

The table below presents a simple perspective on how to measure the effectiveness of the relationship.

Time	Bond		Swap		Effectiveness
	Fair Value	ΔFV	Fair Value	ΔFV	
1/1	100		-		
3/31	120	+20	0		
6/30	118	-2	-3	-3	150%
9/30	106	-12	4	+7	58%
12/31	102	-4	3	-1	25%
3/31 Maturity	100	-2	0	-3	138%

If we look at the total changes in fair value of the bond as compared to the total changes in fair value of the swap, it is clear that this relationship is not highly effective and should not qualify for hedge accounting. However, this view does not accurately reflect the hedging relationship as it includes the previous, unhedged \$20 of interest rate risk (and its decay over time) in the hedged change in fair value of the bond – the swap is not designated as hedging the risk from the prior period. The debt can thereafter be broken down into three parts: the par value, the decay of the previous \$20, and subsequent changes in fair value of the interest rate risk. In order to meet hedge accounting, the decay must be excluded from the measurement of effectiveness, as it is not relevant to the analysis of what is actually being hedged. We believe this concept applies equally to support the use of the shortcut method on asset hedging as affected by Issue 3.

The table below demonstrates that when the prior interest rate risk is eliminated from the measurement of effectiveness, the intended hedging relationship is accurately reflected as being effective. As expressed by the minority Board members with an alternative view to Proposed Issue E23, “the changes in the fair value of a debt instrument prior to the hedge transaction do not distort the effectiveness of the hedging relationship going forward, provided that the terms of the swap match the remaining term of the debt. In that case, it is still reasonable to assume that changes in fair value of the swap will be highly effective in offsetting subsequent changes in the fair value of the debt attributable solely to subsequent changes in the benchmark interest rate.”

Time	Bond					Swap		Effectiveness
	Fair Value	Fair Value Components			ΔHedged FV	Fair Value	ΔFV	
		Par	Pre-hedge FV	Hedged FV				
1/1	100					-	-	
3/31	120	100	20	0		0		
6/30	118	100	15	3	3	-3	-3	100%
9/30	106	100	10	-4	-7	4	+7	100%
12/31	102	100	5	-3	1	3	-1	100%
3/31, Maturity	100	100	0	0	3	0	-3	100%

We believe this example illustrates the distinction between the total changes in fair value including the *unhedged* amortization of the prior fair value of the interest rate risk at the time the hedge was put into place versus the *hedged* change in fair value due to subsequent changes in interest rates. Despite the fact that the hedging relationship is entered into after the hedged debt was issued, the swap perfectly offsets the intended hedged changes in fair value of the debt.

As a practical matter, it is important to note that, based upon our interaction with our clients, the vast majority of liability hedges entered into by them (as much as 90%) are done after issuance of the liability for a variety of reasons. One key reason is that many of our clients simply do not have the staffing resources available to simultaneously complete the debt issuance and enter into a swap. Such resource constraints also prevent these companies from the ability to implement the documentation and testing requirements to achieve long haul hedge accounting. Based upon feedback from our clients, we believe that the inability to apply the shortcut method will result in many constituents abandoning their prudent risk management due to the inability to 1) manage the long haul hedge accounting process and 2) absorb the income statement volatility associated with not applying hedge accounting. We believe this is a step in the wrong direction – accounting should accurately reflect the economics of a transaction, not drive it.

Another reason for late hedging is that it is not unusual for clients to manage interest rate risk on a holistic basis, with consideration for all of their assets and liabilities that have interest rate risk. As the balance of assets and liabilities and fixed versus floating risk changes, the risk decision on an individual instrument may change. Clients utilize the shortcut method to “swap the coupon” to achieve the desired balance of overall risk. By using the shortcut method, a client can more effectively convert an instrument to float from fixed (or vice versa) by using an interest rate

swap, rather than retiring the fixed rate instrument and issuing a new floating rate instrument. The impact is the same, but with a greater cost benefit.

Another concern we have with the proposed literature is that we are unaware of the issue of late hedging ever being a disputed practice. We believe the FASB contemplated the practice of late hedging when the shortcut model was created - examples 2 and 5 from SFAS 133 indicate explicitly (in the footnotes to paragraphs 115 and 134) that the trade date of the swap and borrowing date of the debt "...need not match for the assumption of no ineffectiveness to be appropriate."

Finally, we feel that it is particularly inappropriate to question a prevalently applied accounting practice when a revision of hedge accounting as a whole is on the FASB's short term agenda. We would propose the removal of the late hedging issue from the Proposed Issue E23 or at a minimum allow for grandfathering of existing hedges which would provide continuity for risk management activities until the application of the long haul method can be finalized.

Issue 7

Regarding the final issue, we agree with the FASB that hedges of zero-coupon bonds do not qualify for the shortcut method. In contrast to the issue of late term hedging, we agree that the interpretations to date have lead many to agree that hedging of zero-coupon debt is not feasible under the shortcut method.

* * * * *

Thank you again for the opportunity to comment on the Proposed Issue E23. We hope the FASB will give consideration to our comments as they continue to deliberate this project. We are available to answer any questions should any clarification on the points above be necessary or helpful. Please feel free to contact me at (212) 449-2048.

Sincerely,

/s/ David Moser
Managing Director, Accounting Policy