



David Moser  
Managing Director  
Accounting Policy  
(212) 449-2048  
David\_Moser@ml.com

4 World Financial Center  
New York, New York 10080

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Mr. Larry Smith  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116

Re: File Reference No. 1510-100, Proposed Statement of Financial Accounting Standards, *Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133*

We appreciate the opportunity to comment on the Financial Accounting Standard's Board's ("FASB") proposed Statement of Financial Accounting Standards, *Disclosures about Derivative Instruments and Hedging Activities* (the "ED"). Merrill Lynch has significant experience with derivatives, as both a dealer, providing derivatives to our clients, and as an end-user, entering into derivatives for proprietary trading. Accordingly, we remain very interested in the final outcome of this project.

In summary, we do not support the ED as currently drafted. As a general matter, we believe that rather than issuing limited guidance pertaining solely to derivative financial instruments, the FASB should incorporate an integrated set of disclosures that provides transparency for *all* financial instruments. For financial institutions in particular, requiring different disclosures for derivatives as compared to other financial instruments creates an artificial distinction that bears little relationship to the way these derivatives and other financial instruments are used in practice. In addition, based on our reading of the ED, there seems to be a conflict between the Board's stated objective of increasing transparency of derivatives and the implied objective, which seems more geared towards disclosure of enterprise risk and how it is managed. If the overall goal of the Board is to increase transparency of derivatives rather than to increase risk disclosures, we recommend that the Board undertake this project as part of its broader Conceptual Framework project related to Presentation and Disclosure. Not only would a comprehensive project that addresses all financial statements provide more benefit to users of the financial statements and be more cost beneficial for companies, but we believe it will further the FASB's goal of international convergence since the comparable

guidance issued in International Financial Reporting Standards No. 7, *Financial Instruments: Disclosures*, is aimed at disclosure of all financial instruments.

In the following paragraphs we outline our views on more specific requirements of the ED which we hope the Board will consider.

### **Objective**

We believe that the ED as currently written is internally inconsistent and is unclear as to the overall objective. Although paragraph B13 of the Basis for Conclusion indicates that it was not the Board's objective to require disclosures related to a company's overall risk exposures and the strategy for managing such risk, but rather to increase transparency of derivatives for users of financial statements, statements included in the main body of the ED would seem to indicate otherwise. Paragraph B27 states that "disclosing fair value of derivatives on a gross basis would help in understanding what and how risks are managed". Additionally, paragraph B31 states that "One of the main criticisms of the disclosure requirements in Statement 133 is that they provide little information about the effect that derivatives have on the risk profile of the reporting entity". An indication that the FASB is most interested in risk type disclosures is further implied by the requirement to disclose derivative notionals by underlying type of risk. We strongly encourage the Board to clarify its overall objective prior to finalizing the standard, as we do not believe that the level of information currently required to be disclosed is consistent with the stated goal of increasing the transparency of a company's use of derivatives. If the overall goal is to help readers understand how an entity manages risk and what those risks consist of, we believe that the requirements are best focused on the metrics used to report risk to management and/or regulators (e.g., sensitivity analysis, value-at-risk, etc.). We further believe that a risk-based project would best be handled through an amendment to Regulation S-K Item 305, *Quantitative and Qualitative Disclosures about Market Risk*, rather than through FASB guidance, in part because we have concerns including risk related information in the footnotes to the financial statements, which are required to be audited.

### **Disclosures**

As a general comment, we do not believe that the ED's disclosure requirements are appropriate for financial institutions that hold large portfolios of derivatives as part of their trading books. For an entity such as a manufacturing company that holds a limited number of derivatives, perhaps to hedge its exposure to long-term debt, there may be incremental benefit to users of their financial statements by providing enhanced disclosures related to derivatives. However, for dealers that enter into numerous derivative transactions on a daily basis in their trading books, as well as in qualifying hedging relationships, we believe that requiring voluminous disclosures related only to derivatives will result in numerous pages of information that actually reduces transparency for users of financial statements. For dealers that frequently use cash instruments such as Treasury securities to economically hedge interest rate derivatives,

disclosing information related to derivatives without addressing the hedging instrument provides users with limited information as to how an entity manages its business. As a result, we strongly encourage the Board to reconsider disclosures for derivative dealers, and only require information for those derivatives that are part of qualified hedging relationships as defined under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* ("SFAS No. 133").

If however the Board decides to move forward with a standard that applies the same requirements to both dealer and non-dealer entities, we offer the following comments related to disclosures.

We object to the disclosures required in paragraph 44C of the ED as we believe that level of detail required is likely to impair rather than improve transparency for users of financial statements. Specifically, we are most troubled by the requirement to disclose the following information:

- Fair value and notional amounts held at the end of the reporting period for those derivatives in an asset position versus those in a liability position
- Location and amount of gains and losses reported in the income statement, disclosed separately for those derivatives that exist at the end of the reporting period and those derivatives that existed during the period but are no longer held at the end of the period
- Derivative notionals, and
- Contingent events

#### *Asset/Liability Breakout*

We do not see the benefit to users of financial statements of reporting the fair value and notional amounts and related gains and losses of derivatives separately for those derivatives in an asset position versus those in a liability position at period end, particularly because derivative fair values may fluctuate between an asset and liability position from one period to the next. Additionally, this is not information that we currently have available; significant system changes would be needed in order to comply with this disclosure requirement. Disclosure of similar type information (i.e. the reconciliation of recurring fair value measurements using inputs within Level 3 of the fair value hierarchy) was initially proposed in the exposure draft for SFAS No. 157, *Fair Value Measurements* ("SFAS No. 157"), but ultimately excluded from the final requirements. As a result, we do not understand the Board's reasoning for requiring such detailed information in this project and would suggest that to the extent that fair values, notionals and gains/losses are required to be reported in the final standard, that it be done on an aggregate basis.

#### *Disclosure of Gains/Losses*

We are strongly opposed to the guidance that requires gains and losses related to derivatives to be broken out separately between those derivatives that existed during the period, but no longer exist at period end versus those derivatives that remain outstanding at period end. We can infer from this requirement that the Board is looking to distinguish

those derivative gains/losses that have actually already been realized from those gains/losses that are unrealized. We are troubled by this requirement as users may interpret this to mean that unrealized gains/losses are of lower quality than realized gains/losses. Consistent with our earlier comment that disclosures should be for all financial instruments and not just derivatives, we think providing this information for derivatives only would not enhance overall financial transparency. We are also concerned by the requirement to disclose this information as we believe that it undermines the concept of fair value and because this is not how we evaluate our business or manage risk. We also note that paragraphs 32c and 32d of SFAS No. 157 already require disclosure of unrealized gains/losses for Level 3 positions held at period end. Finally, we question how the benefits of such disclosure outweigh the costs of obtaining such information. The effort and costs to produce this information can be significant, particularly for an entity that has thousands of derivative transactions (that are not Level 3 in the fair value hierarchy) which have components of realized and unrealized gains/losses, such as swap transactions which have periodic realization events over an extended period of time. As a result, we encourage the Board to exclude this requirement from the final standard.

#### *Notional Disclosures*

The ED states that the disclosure of notional amounts related to all derivative instruments will provide users of financial statements better information related to an entity's overall volume of derivatives and the magnitude of risks being managed. We believe that the Board has adequately addressed the issue of notional disclosures in previous projects, particularly in SFAS No. 133. We note that SFAS No. 133 does not require disclosure of notional amounts and therefore we do not provide this information in our quarterly or annual reports, which is consistent with industry practice. To require the reporting of notional amounts of contracts again would represent a step backwards, as the notional value of a contract is not an indicator of the risks of the contract and can be misleading to users of the financial statements. As a result, we see little benefit from reintroducing the disclosures that were required under the superseded guidance in SFAS No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*.

#### *Disclosure of Contingent Features*

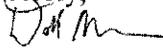
Under paragraph 44D of the ED, an entity is required to disclose the fair value amount of both derivative and non-derivative instruments that contain contingent features, and the amount of collateral that would be required to be posted at period end if the contingent features were to be triggered. The ED does not clearly define "contingent features" but does provide an example in paragraph A16, which refers to a downgrade in an entity's credit rating as the contingent feature. If this is the only contingent feature the Board is contemplating, which we believe is appropriate, the ED should be clear on this matter. However, if the Board's definition of "contingent feature" is meant to encompass other features such as early termination events, price triggers, etc., the ED should indicate that position. We recommend that the disclosure in paragraph 44D focus specifically on downgrades in an entity's credit rating.

## Effective Date

We encourage the Board to reconsider the proposed effective date when finalizing the ED. The ED currently requires derivative disclosures for interim and annual periods ending after December 15, 2007. Considering that we do not currently have systems in place to compile the information required to be disclosed under the ED, we do not believe that it will be operationally feasible to comply with the effective date. Furthermore, it is our understanding that many entities will also be focused on complying with the new guidance required under SFAS No. 157 and SFAS No. 159, *The Fair Value Option for Financial Assets and Liabilities*, which both have an effective date of January 2008. As a result, we believe that in order to adequately meet the final standard's objectives, an effective date of periods ending after November 15, 2008 would be most appropriate. This effective date would also improve comparability in financial reporting between entities that have fiscal years ending in November, as is typical in the broker-dealer industry, and those that have calendar year-ends.

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Thank you again for the opportunity to comment on the ED. We hope the Board will give consideration to our comments as they continue to deliberate this project. We are available to answer any questions should you require clarification on any of the points above. Please feel free to call me at (212) 449-2048.

Sincerely,  
  
/s/ David Moser