

Morgan Stanley

March 2, 2007

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



LETTER OF COMMENT NO. 31

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

Dear Mr. Smith:

Morgan Stanley appreciates the opportunity to provide comments in response to the proposed Statement of Financial Accounting Standards, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133* (referred to as the "Exposure Draft" herein). We have also contributed to the March 2, 2007 letter submitted by the International Swaps and Derivatives Association ("ISDA").

We understand the Board undertook this project to address concerns raised by constituents regarding the adequacy of current disclosures in providing useful and relevant information regarding an entity's derivative activities and believe that information to be especially relevant to derivatives in designated hedging relationships. However, we are concerned that the nature and presentation of the proposed disclosures as they relate to derivatives entered into as part of an entity's trading activities would be misleading to financial statement users in that they portray only a component of the overall risk inherent in a firm's trading portfolio. We believe the purpose and risk related to this category of derivative usage would be better portrayed through disclosures of the overall trading position, such as through a value-at-risk ("VAR") or similar sensitivity analysis. Given the cost associated with the significant level of operational and system changes that would be required to derive the proposed disclosures for this group of derivatives, we believe it to be of utmost importance that the disclosures being made are the most relevant to financial statement users.

We would also note that the proposed disclosures for derivative instruments coupled with the numerous disclosures requested under Statement of Financial Accounting Standards No. 157 ("SFAS 157"), *Fair Value Measurements*, and Statement of Financial Accounting Standards No. 159 ("SFAS 159"), *The Fair Value Option for Financial Assets and Financial Liabilities*, would result in information related to financial instruments being presented in multiple locations and will create a fragmented depiction of an entity's overall

risk management profile. Rather than take a patchwork approach to these disclosures, we urge the Board to consider limiting this project to derivatives used for hedging purposes, as this would provide the most relevance to the proposed disclosures, and then work toward a focused, comprehensive set of disclosures that would encompass all financial instruments.

In addition to these overarching comments, we also offer the comments in Attachment I for your consideration. We would be pleased to discuss our concerns with the Board or the Staff. Please contact Esther Mills at (212) 276-4364, Donna Grabarek at (212) 276-2459 or myself at (212) 276-7716 with questions or comments.

Sincerely,

/s/ Greg Sigrist  
Managing Director

## **Attachment I**

### **Scope**

We believe that limiting scope of the Exposure Draft to derivative instruments in *designated and qualifying hedging relationships* would better meet the concerns expressed by constituents of obtaining a better understanding of how and why derivative instruments are being utilized to manage risk exposures. We do note that derivatives are only one tool employed by entities for risk management and *focusing on these instruments in isolation* will not present an overall picture of an entity's financial results and risk management techniques. For example, most large financial institutions additionally employ non-derivative fair value financial instruments, such as equity and debt positions, to mitigate risks.

We appreciate the Board's concern that expanding the scope of this project to encompass all financial instruments would result in a longer-term project that would significantly delay guidance on the enhanced disclosures requested by the user community. However, given that derivatives are only one component of a much larger risk management strategy, we encourage the Board to continue to develop more comprehensive guidance that will ultimately encompass all financial instruments in subsequent phases to this project.

### **Disclosures Related to Derivative Instruments Designated and Qualifying as Hedging Instruments**

#### *Notional Amounts*

Paragraph 44C (a) of the Exposure Draft requires disclosure of the notional amount of derivative instruments held at the end of the reporting period. We understand that the Board included this requirement as they believed notional values would provide insight into the overall volume of derivative transactions as well as the magnitude of the risks being managed. However, in the context of the trading activities conducted by large financial services firms, notional information is largely extraneous and offers little in terms of understanding derivative instruments and their usage. Additionally, notional amounts alone can distort the risk exposure of an entity. For example, a company may enter into a series of five forward contracts at \$100 million notional per contract. Per paragraph 44C (a) of the Exposure Draft, the total \$500 million notional amount would be disclosed. If the risk inherent in the hedged item is only \$100 million, then reporting a \$500 million notional amount may overstate the entity's exposure. If this disclosure is required, we believe a more meaningful alternative is to limit the disclosure to the notional amount of hedged items as this information will provide a better indication of the magnitude of the risk being managed.

### *Leverage Factors*

To the extent leverage factors exist in derivative instruments, paragraph 44C (e) of the Exposure Draft requires disclosure of the estimated magnitude of such factors on the derivative's notional amount and underlying risk. We are uncertain of how relevant this information is for hedging relationships and are concerned that the disclosure of leverage factors could imply that exposures exist in derivative instruments that are not incorporated in or offset by the hedged item. For a hedge to be deemed highly effective, changes in the derivative would need to offset between 80% and 125% of the changes in the fair value or cash flows of the hedged item. As a result, a corresponding amount of leverage would invariably need to exist within the hedged item in order to qualify for hedge accounting under SFAS 133. We, therefore, ask the Board to reconsider this disclosure requirement.

### **Disclosures Related to Derivatives Not Designated as Hedging Instruments under SFAS 133**

The Exposure Draft requires disclosure by underlying risk of the notional, fair value, and gains or losses recognized for derivative instruments that have not been designated as hedging instruments. Disclosure is further required by each type of exposure being offset by the derivative instruments.

Derivative instruments that are entered into as part of an entity's trading activities would fall within this category. Since most large financial institutions do not manage derivatives on a contract-by-contract basis rather than as part of an overall risk management strategy, we are concerned that the presentation of this information in isolation by underlying risk and type of exposure will be misleading to financial statement users and extremely difficult to display. To consider an example, many large broker-dealer entities engage in a matched book business whereby long and short derivative positions having similar notional amounts and tenors are economically offset in the statement of financial position. Disclosing the asset and liability fair value amounts of such instruments could indicate that an entity's exposure is significantly greater than it really is since the exposure related to the long position is effectively offset via entering into the offsetting short position [and vice versa]. It is a common practice in the financial services industry to enter into offsetting positions to close out instruments, such as swaps, as this tends to be operationally easier than terminating the entire instrument. Presenting information for a matched book strategy in the format proposed would, therefore, be misleading to financial statement users.

Additionally, the majority of derivative instruments contain more than one underlying (for example, a credit default swap will encompass both interest rate and credit risk) and are usually a part of multiple hedging strategies. As a result, we believe it would not be practical or meaningful to provide the level of granularity requested.

As noted above, we believe a better alternative would be to permit SEC registrants the option of presenting this information in through VAR or a similar sensitivity analysis.

## **Effective Date and Transition**

The effective date for the proposed statement is for fiscal years and interim periods ending after December 15, 2007. We are concerned that this will not allow sufficient time for *large financial institutions to implement the proposed disclosure requirements.*

Information is currently not maintained in the manner and the level requested and as a result, significant systems and operational process updates would need to be made in order to track and aggregate such information. We believe it will be extremely difficult to accomplish this in such a short time frame and urge the Board to consider extending the effective date to allow financial statement preparers additional time to develop the necessary systems and to work through implementation issues.