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September 7, 2004

Ms. Suzanne Bielstein
Director of Major Projects and Technical Activities
Financial Account Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Proposed Statement of Financial Accounting Standards,

Fair Value Measurements
File Reference 1201-100

Dear Ms. Bielstein:

Merrill Lynch has followed closely the Board's project on fair value, and was pleased to participate in the development of the above-referenced Exposure Draft ("ED") via membership in the Valuation Resource Group. We strongly support the position that fair value is the most appropriate measurement for all financial instruments and encourage the FASB to continue to move forward with guidance that would both clarify and expand its application. In general, we are supportive of the proposed guidance in the ED, and we believe it is consistent with many of the fair value policies that financial institutions such as Merrill Lynch employ today. We also encourage the FASB to adopt a principles-based approach to this project, as it is our view that an accounting standard for measuring financial instruments at fair value should be based on a set of guiding principles that provide for the application of judgment, where appropriate, in developing their fair value estimates.

In that regard, we fully endorse the ED's definition of fair value, as the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties, as well as the ED's objective of a fair value measurement,

which is to estimate an exchange price for the assets or liability being measured in the absence of an actual transaction for that asset or liability. We believe this is a solid foundation for guidance in this area. However, we believe there are some aspects of the ED that could be improved to ensure that they are consistent with a principles-based approach. Accordingly, we offer the following suggestions which we hope the Board will consider as it moves ahead with this project.

Valuation

We agree with the approach that valuation techniques used to estimate fair value should always emphasize market inputs first, especially those derived from active markets, and we believe that the hierarchy that the ED establishes for selecting the inputs that should be used in valuation techniques is a useful starting point for achieving this objective. In addition, and as further discussed below, we believe that the hierarchy is an extremely useful tool for disclosure purposes. However, we believe that, when applied for purposes of valuation, the proposed hierarchy will not always yield a true fair value because it does not acknowledge that the use of judgment and estimates are often required in fair value measurement.

The ED requires an entity to measure fair value based on the following hierarchy:

- Observable market prices for identical instruments when available,
- Prices for similar instruments, with adjustments that objectively reflect the differences between instruments, when available,
- Valuation techniques that maximize market inputs and minimize entity inputs.

We believe that this approach is too prescriptive because it does not acknowledge that the use of judgment and estimates may be required even at the highest level of the hierarchy. For example, even in those cases where observable market prices are available, judgment and adjustments to quoted market prices may still be required on occasion. This is particularly the case for broker-dealers that are in the business of buying and selling securities and may therefore be required to record block discounts in order to arrive at an accurate fair value measurement. While we agree with the Board that this is primarily a "unit of account" issue, and commend the Board for its decision to continue to permit block discounts to be recognized by brokers and dealers that regularly transact in large quantities of securities, we also note that this provides an example of where it is appropriate and necessary to use judgment in order to determine the best estimate of fair value.

As another example, we are not convinced that the Level 2 requirement to price an instrument based on other similar instruments, with an adjustment that objectively reflects the difference between instruments, will be sufficiently workable in practice. This is because we believe that the concept of an "objective adjustment" may be difficult to demonstrate to the degree of verifiability that may be expected in practice, and does not acknowledge the fact that many types of adjustments involve at least some level of subjective judgment and estimation.

The ED also requires the use of bid/offer and mid-market pricing in specific instances. We believe that this level of specificity with regard to pricing is inconsistent with a principles-based approach and recommend that this guidance be deleted. The use of the bid, ask, or mid should be determined solely by applying the general principle of determining the price at which an asset or liability could be expected to be exchanged in a current transaction between knowledgeable, unrelated willing parties.

If this guidance is retained, however, we believe that the guidance regarding using midmarket pricing for the matched portion of offsetting positions should be applied not just to positions in Level 1, as is stated in paragraph 17 of the ED, but to any position, regardless of the level of the hierarchy in which the position has been categorized. (In this regard, it is important to note that the use of the term "offsetting" refers to matching positions from a *risk* and *valuation* perspective. It should not be confused with the concept of netting for balance sheet presentation purposes, where different criteria, such as the legal right of offset and the intent to net settle, are required to be met before a position can be netted.) We believe that mid-market valuation is appropriate whenever offsetting risk positions exist, and that this is a fundamental valuation principle that should be applied consistently across all the levels in the hierarchy.

This is because for valuation purposes, Merrill Lynch does not segregate its derivatives portfolios into categories of transactions, as the fair value hierarchy would suggest. Instead, Merrill Lynch manages its positions on a portfolio basis and marks to the appropriate price based on its net open risk position. We believe that this policy is consistent with best industry practice. A portfolio approach ensures that prices and model inputs are applied consistently throughout the portfolio resulting in consistent fair value. This approach also follows the recommendations of the Group of Thirty Report, Derivatives Principles and Practices, which recommends that mid-market pricing for derivatives portfolios is the appropriate methodology for valuing OTC derivatives.

Thus, application of the fair value hierarchy for valuation purposes in a sense ignores this approach to valuation and imposes an artificial methodology, where greater weight is given to the form of a transaction than to the economic substance or risk of a position. It is for this reason that we strongly believe that the hierarchy is useful only as a disclosure tool. For valuation purposes, we believe that the general principle, that fair value should emphasize market prices and inputs first, accomplishes the Board's objective more effectively than the valuation hierarchy. Accordingly, we recommend that the hierarchy not be applied for valuation purposes.

EITF 02-3

We are also concerned by the Board's decision to exclude a discussion of EITF Issue No. 02-3 ("EITF 02-3") from the ED and to defer its reconsideration to the revenue recognition project. We believe that the two issues, fair value and revenue recognition, are fundamentally intertwined and that to issue a final standard on fair value which does not address EITF 02-3 is conceptually flawed. For example, the guidance in the ED would appear to suggest that the fair value of a highly complex Level 3 derivative instrument should be determined based upon an appropriate model that may require

incorporating significant entity inputs to the model. However, EITF 02-3 would then require the fair value for this instrument to be adjusted so that any upfront profit that was calculated by the model is deferred. Logically speaking, if the amount determined in the first approach is considered to be fair value, then the amount determined after applying the guidance in EITF 02-3 is not. As EITF 02-3 continues to be an issue of paramount importance for many entities in the financial services industry, we believe it is critical that the Board reconcile the inherent conflict in these two pieces of accounting literature as soon as possible. As a result, we encourage the Board to address these concerns in the final fair value standard. Given the importance of this issue, we believe that if it is addressed in this standard, the ED should be re-exposed for public comment on this matter.

Marking to One's Own Credit Spread

The ED requires that for a liability, "the estimate of fair value should consider the effect of the entity's credit standing so that the estimate reflects the amount that would be observed in an exchange between willing parties of the same credit quality." In theory we support this view as we believe it ensures that the valuation approach is evenhanded for both assets and liabilities and that fair value measurements give consideration to all relevant risks, including credit risk; however, we believe that the issue may warrant further consideration by the Board, for the reasons described below.

We believe that changes in creditworthiness should be taken into account when valuing liabilities; however, we would limit the situations to those cases in which the associated gain or loss is *realizable* to the issuer. A simple example to illustrate this point is a situation in which a company has liabilities marked at fair value and subsequently suffers a deterioration in its creditworthiness, and as a result would record a gain in its income statement. Aside from the fact that an issuer could recognize large gains at a time when the issuer may be in financial difficulty, which seems counterintuitive to many, what is most troubling is that it is during these specific times that an issuer is most in need of financing. As a result, the issuer's ultimate realization of this "gain" is unlikely. Accordingly, we question whether a gain that is unlikely to be realized is relevant information to the reader of the financial statements.

Additionally, we believe that a requirement that an entity include the effect of changes in its own credit rating when marking its liabilities would create an artificial distinction between short-term trading liabilities and long-term debt since the ED only encompasses those instruments that are currently required to be accounted for at fair value in accordance with existing literature (i.e., trading liabilities). Since both trading liabilities and long-term debt represent obligations of the issuer, we believe there should be a consistent policy with regards to whether or not changes in credit spreads should be reflected in the valuation of both types of instruments. We would urge the Board to consider how changes in an issuer's credit rating would be incorporated into the valuation of a broader range of issuer liabilities before concluding on this issue.

Most Advantageous Market Price

The ED requires that the fair value of Level 1 instruments be based on the most advantageous market price when multiple markets exist. We agree with this approach as it is common that a broker dealer will transact with a retail client and then, in order to hedge its exposure, will enter into an offsetting trade in the more advantageous wholesale dealer market in order to generate a profit.

While we are supportive of this general concept to determining fair value, we believe the guidance should be revised slightly in two respects. First, we suggest that the guidance be revised slightly to incorporate the concept of a "sustainable" market – that is, the most advantageous price should be used if the market is sufficiently deep and liquid to absorb the investor's position at that price. Second, we are concerned by the proposed requirement to consider transaction costs when determining the most advantageous market price since the ED does not allow adjustments to fair value to be taken to reflect those costs. We believe that recording an upfront gain based on a price that necessitates incurring significant transaction costs, which are then not taken into account in valuation, may result in an earnings overstatement. As a result, we would encourage the Board to reconsider the requirement to include transaction costs in the determination of the most advantageous market price.

Disclosure

As noted above, we believe that the fair value hierarchy is an excellent means of conveying to the readers of financial statements the degree of estimation and judgment employed in valuing financial instruments. In fact, the three-level hierarchy is quite similar to the approach Merrill Lynch has used in its discussion of critical accounting estimates in the Management's Discussion and Analysis section of our financial statements.

The Merrill Lynch approach was developed to reflect the level of judgement required for valuing various types of financial instruments and can be summarized as follows:

- Category 1 includes highly liquid cash and derivative instruments for which quoted market prices are readily available. This category includes most "cash" equities, exchange traded options and U.S. Government bonds, where the level of estimation and judgment in valuation is extremely limited.
- Category 2 includes instruments where judgment is applied to valuation, but is fairly limited in nature. It predominantly includes derivative instruments that are valued using models where the inputs are directly observable in the markets, such as US dollar interest rate swaps; and cash instruments for which cash prices are available but may trade less frequently such that there is not complete price transparency for those instruments across all market cycles (e.g., many corporate and municipal bonds).
- Category 3 includes less liquid instruments that are valued using a model, where either the inputs to the models and/or the models themselves require significant

judgment by management. This category includes instruments such as private equity investments and certain long-dated or complex derivatives.

The main difference between our approach and the approach in the ED appears to be with respect to Merrill Lynch's Category 2. Broadly speaking, this category captures many instruments that we believe would be included in Level 3a in the ED approach, such as US Dollar interest rate swaps. Given that the market for these instruments is one of the deepest and most liquid in the world, it would seem inappropriate to categorize them in Level 3, thereby possibly giving a misleading impression to financial statement readers that there is a greater deal of subjectivity in the fair value of these instruments than is actually the case. In addition, Merrill Lynch's Category 2 includes certain instruments that under the ED would be included in Level 1, such as certain fixed income instruments, where prices can be obtained but are not always sustainable across all market cycles.

Although we understand that there are different approaches to conveying the relevant information to financial statement users, and we believe that in general the form of disclosure should be left to the discretion of the preparer, if an approach is mandated, we recommend that the FASB consider the Merrill Lynch approach. We are available to share with the Board the benefit of our observations and experience related to the categorization of financial instruments at your convenience.

Additionally, while we understand the Board's desire for enhanced disclosure regarding fair value measurement, we are concerned by the requirement to disclose the amount of unrealized gains or losses recorded in the income statement because this is not consistent with the way in which management evaluates its business or manages its risk. We also believe that such a requirement is inconsistent with the concept of fair value as the amount that could be exchanged between unrelated willing parties. Nowhere in accounting literature does the concept of fair value distinguish between unrealized and realized gains and losses. By creating this distinction, we believe that the Board is undermining the concept of fair value and is casting doubt on the validity of unrealized amounts as "good earnings." We do not believe that the proposed disclosures will provide enhanced transparency in the financial statements and do not believe that the benefits of such disclosure will outweigh the costs of obtaining the proposed information. Such costs can be significant in the case of instruments which have components of both realized and unrealized gains/losses, as in the case of swap transactions and other instruments which have periodic realization events over an extended period of time.

As an alternative solution, and to provide readers with additional information regarding fair value sensitivity in the financial statements, we would suggest that the Board consider a requirement to disclose total gains and losses recorded in the income statement for those positions where significant estimation is required in determining fair value. Under Merrill Lynch's proposed categorization approach outlined above, this would involve disclosure of the total earnings in the income statement related to "Category 3" positions. We believe that this form of disclosure would balance the need for enhanced fair value reporting with the cost of obtaining such information.

Once again, we appreciate the opportunity to provide our comments to you. We look forward to participating in the fair value roundtable discussions later this month. Please do not hesitate to call either of us if you have any questions before then.

Sincerely,

/s/ Esther Mills

Esther Mills
First Vice President

/s/ Keith Bailey

Keith Bailey Managing Director