MorganStanley

Letter of Comment No: 45
File Reference: 1201-100
Date Received: 9-7-14

September 7, 2004

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

Re: File Reference No. 1201-100, Proposed Statement of Financial Accounting Standards – Fair Value Measurements (the "Exposure Draft")

Dear Ms. Bielstein:

Morgan Stanley appreciates the opportunity to provide comments in response to the above referenced Exposure Draft. We support the Board's objective of enhancing guidance about how to measure the fair value of assets and liabilities. However, we have concerns that the fair value measurement provisions as proposed in the Exposure Draft will not promote greater reliability, consistency and comparability in financial reporting, and therefore, do not support issuance of the proposed standard in its current form.

Morgan Stanley actively contributed to the development of comments in the letter dated, September 2, 2004 that has been presented jointly by the Securities Industry Association (SIA), The Bond Market Association (TBMA) and the International Swaps and Derivatives Association (ISDA), also responding to the Exposure Draft. We endorse the tenets in that letter.

In this letter, we would like to emphasize our concerns relating to the fair value hierarchy, offsetting positions, marking for one's own credit spread, the interaction of the Exposure Draft with EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities" ("EITF 02-3"), and the Exposure Draft's disclosure provisions. In general, we believe that the fair value hierarchy contains certain conceptual flaws and, as such, may diverge from the Exposure Draft's fair value objective. With respect to offsetting positions, we firmly support the concept of using mid-market prices for the matched portion; however, we believe this principle should extend beyond Level 1 and apply across all levels of the fair value hierarchy. To the extent that the impact of an

entity's own creditworthiness should be included in the fair value measurement of liabilities, we recommend that the Board consider incorporating principles regarding realizability in the guidance in order to enhance the meaningfulness of the fair value measurements. We also urge the Board to reconcile fully the measurement provisions in this Exposure Draft with those prescribed by EITF 02-3. The concepts in the Exposure Draft refute the notion that historical cost is the best estimate of fair value and therefore EITF 02-3 is as much a fair value measurement issue as it is a revenue recognition issue. Finally, we have certain concerns regarding the disclosure requirements and the extent to which such requirements will enhance a financial statement user's understanding of the fair value measurements being applied and those measurements' impact on an entity's results of operations.

Fair Value Hierarchy

Principles-based Framework

We believe the fair value hierarchy is too prescriptive and will create implementation confusion and thus diversity in practice. Consequently, we recommend that the fair value measurement framework be made more principles based. We agree with the principles laid out in paragraph C43 that (i) there is a need "to consider the assumptions and data that marketplace participants would use in all estimates of fair value," (ii) the "more market inputs, the more reliable the estimate," and (iii) the lowest priority should be given to "entity inputs that reflect an entity's own internal estimates and assumptions." Essentially, an estimate of fair value should rely on the best information available. We believe that a strict hierarchy for measuring fair value is not required. Market inputs should be maximized to the extent they are meaningful, but judgment is required in order to determine which observed information is appropriate for estimating fair value of a particular financial instrument. Rather than a hierarchy that focuses on bucketing by valuation techniques, the measurement framework should base itself on a continuum of inputs, with market inputs rated as the most reliable and entity inputs rated as the least reliable.

If the Board decides ultimately to institute a measurement hierarchy, we have two suggestions. First, the interaction among the levels of the fair value hierarchy and the four markets identified in paragraph 11 should be reconciled as they constitute markets in which assets and liabilities are exchanged and therefore are the source of much of the market information for fair value measurements. Second, we note that the Exposure Draft applies to both financial and non-financial assets and liabilities. While we support the concept of one fair value measurement principle that broadly applies to all assets and liabilities, the guidance necessary to implement that principle may look dramatically different for a financial versus a non-financial asset or liability given their inherent differences and the differences in the markets in which such exchanges occur. Therefore, we suggest that a final standard give greater attribution to the underlying nature of the asset or liability (i.e., financial vs. non-financial) and suggest that separate guidance may be necessary.

The Levels of the Hierarchy

A strict hierarchy suggests that one measurement technique is superior to another in determining fair value. A quoted exchange "price" for estimating fair value may not be available; however, the Board should not discount the fact that valid market inputs and observable market information are available for a reliable estimate of fair value. The fair value hierarchy outlined in the Exposure Draft appears to discount the reliability of fair value measurements based entirely on market information when using an estimation technique.

The hierarchy makes distinctions among (i) identical versus similar assets and liabilities, (ii) quoted prices versus observable market rates, and (iii) valuation techniques based on market inputs versus valuation techniques based on significant entity inputs. The following discussion further elaborates on the inconsistencies we see within the Exposure Draft's fair value hierarchy:

• Level 1 of the fair value hierarchy requires fair value estimates using quoted prices for identical assets and liabilities when active reference markets exist. In our view, only exchange-traded instruments (e.g., equities and listed derivatives) and other liquid assets such as U.S. government bonds are likely to meet these criteria. Level 1 of the fair value hierarchy will generally not apply to over-the-counter (OTC) derivatives such as plain-vanilla swaps (e.g., interest rate, credit default and amortizing swaps) and OTC options where the underlying securities are liquid (i.e., bond options and equity options). In the liquid OTC derivative markets, market convention is to quote market inputs (e.g., bid-ask spreads for a given forward curve) rather than quote the actual price of the instrument. Even plain-vanilla interest rate swaps, for which a price quote theoretically could be obtained from another dealer, are regularly priced using a valuation model (e.g., discounted cash flows or income approach) because it would be impractical and operationally burdensome for dealers to obtain dealer quotes for every single swap, given the size of their portfolios.

While we have classified plain-vanilla derivatives in Level 3 given the stipulations of the hierarchy, we note that often highly reliable, observable market inputs exist for purposes of valuing such financial instruments. Contrary to the statement in C56 that Level 3 estimates "require more estimation and assumption" and are therefore "necessarily more subjective," our view is that there is often little subjectivity involved in valuing these instruments.

• It is unclear what assets or liabilities would be measured under Level 2 of the fair value hierarchy. The Exposure Draft requires that the *price effect* of the differences must be objectively determinable. In order to objectively determine the price effect between the *similar* assets or liabilities, it would seem that a price would need to be available for the exact same asset or liability already being measured and therefore Level 1 of the fair value hierarchy would apply instead.

• By delineating the hierarchy in terms of identical assets or liabilities as opposed to in terms of the maximization of market inputs, we believe the fair value hierarchy as outlined can be misleading. For example, rarely will two identical interest rate swaps exist. On the other hand, completely observable data (i.e., quoted swap rate spreads) may be available to be used in a valuation model for purposes of estimating the fair value of an interest rate swap. Further, we believe that valuation adjustments are entirely appropriate for derivatives in order to arrive at accurate and reliable fair values; and since these adjustments are normally derived from market observable inputs, there should not be a concern regarding excessive entity inputs.

While the Exposure Draft's fair value hierarchy distinctions may have merit from a disclosure perspective, prescribing specific reference points for valuation could decrease the meaningfulness of financial information as better evidence of fair value may be obtained via different means depending upon the circumstances. We note that International Accounting Standards 39 (revised), Financial Instruments: Recognition and Measurement ("IAS 39"), explicitly allows valuation adjustments to financial instruments whose fair value is derived from quoted rates and also that such resulting fair value measurements continue to be designated as the most highly reliable measurements. Given the myriad of transactions that may occur, the types of financial instruments that may exist, and the ongoing development of the capital markets, we have reservations about the extent to which measurement provisions are mandated and caution against an approach that could become overly rules-based.

Multiple Valuation Techniques

Paragraph 21 states for Level 3 assets and liabilities that fair value is applied "using multiple valuation techniques consistent with the market approach, income approach and cost approach whenever the information necessary to apply those techniques is available without undue cost and effort." While multiple valuation techniques may be appropriate for non-financial assets and liabilities, we do not believe the Board should mandate the use of multiple valuation techniques for financial assets and liabilities. Such a requirement would represent a significant and cost prohibitive divergence from practice for valuing financial assets and liabilities. Typically financial assets and liabilities are valued based on one model or a variation of a discounted cash flow approach (i.e., income approach). Requiring additional valuations based on the market and cost approaches will not enhance the reliability of fair value measurement, because invariably the income approach will be superior when measuring Level 3 financial instruments. An acceptable valuation technique incorporates all factors that market participants would consider in setting a price and should be consistent with accepted economic methodologies for pricing financial instruments. Whenever there is a technique commonly used in the market, which has been demonstrated to provide reliable price estimates, that approach should be followed. Thus, we believe the final standard should not require multiple valuations based on the cost and market approaches in all cases, particularly for financial assets and liabilities. This further supports our position that any final standard would be improved through focus on separate guidance for financial instruments versus other assets and liabilities.

Field Testing

Before issuing a final standard, we highly recommend that the Board pursue field testing of the guidance outlined in the Exposure Draft to not only determine the operationality of the proposed guidance but also to determine whether the guidance, as written upon redeliberation, yields the desired outcome of relevant and meaningful financial information for users. At a minimum, the Board should consider a spectrum of assets and liabilities and receive constituent feedback as to how each constituent would apply the provisions of the Exposure Draft to the identified spectrum of assets and liabilities. Differences between constituents' current practices and fair value measurements under existing guidance and resulting practices and fair value measurements under the Exposure Draft guidance can then be identified. These differences could provide useful information about the operationality of the Exposure Draft and whether the objective of improved financial reporting can be achieved through the Exposure Draft's provisions.

A hypothetical balance sheet consisting of a limited number of specific assets and liabilities could be designed. Field test participants would then apply the Exposure Draft guidance to such assets and liabilities and provide the Board with the resulting balance sheet. For example, the population could include: a listed equity security, a short position in a credit default swap, an illiquid bond, an interest rate swap, an investment grade bond, a futures contract, a private equity investment, a guarantee obligation under FIN 45, a short sale of a listed equity security, an impaired asset under FAS 144, a physical commodity at a specified location, a forward contract to sell the physical commodity at a different location, a warrant, a foreign currency written option, and a mortgage-backed security. This would enable the Board to identify implementation issues and compare and contrast user's interpretations of the guidance as well as the varying financial statement results among field test participants.

Morgan Stanley is interested in participating in any field test that occurs.

Offsetting Positions

Paragraph 17 of the Exposure Draft requires that, for Level 1 assets and liabilities only, fair value estimates of offsetting positions shall use mid-market prices for the matched portion. We agree with the concept of mid-market valuation for matched positions, but also strongly believe that it should apply to all levels and across levels of the measurement hierarchy, not simply Level 1 estimates.

Dealers engage in an ongoing series of transactions that, at any given point in time, ultimately constitutes their overall aggregate trading assets and liabilities and manage their exposure to the underlying risks (e.g., credit, interest rate, foreign currency, or price) inherent in those transactions on a net risk basis. Dealers do not manage their collective trading risks according to the type of financial instrument held (e.g., Treasuries, listed equity securities, listed options, non-exchange traded options, forward contracts, futures contracts, swap contracts, etc.) or according to one of the prescribed levels in the hierarchy.

We note that in paragraph C53, the Board refers to and quotes the IASB's deliberations about net open positions. We believe that it is telling and altogether appropriate that this paragraph focuses on the "risk retained in the portfolio," rather than the specific instruments that make up that portfolio. It fittingly does not differentiate the offsetting of risks based on how valuations for the financial instruments in the portfolio may be derived.

Based on the levels prescribed by the fair value hierarchy, the situations in which companies will have offsetting risk positions made up of identical financial assets and liabilities that all reside within Level 1 seem to be limited. In fact, it is unclear how applicable the offsetting concept would be within the context of Level 1 estimates – as prescribed, the valuation of *identical* assets and liabilities under Level 1 of the hierarchy that constitute offsetting positions would seem pertinent only in the context of (i) listed equity securities and short sales of the same listed equity securities and (ii) long and short positions of listed futures and options.

However, companies definitely will have offsetting market risk positions that (i) reside solely in Level 3 and/or (ii) straddle Level 1 and Level 3. For example, consider a corporate bond, which contains interest rate risk and credit risk. Assume a company offsets these risks by entering into futures contracts and a credit default swap (with the underlying bond issuer as the reference name) with virtually the same terms as the bond (e.g., notional amounts, maturity, etc.). The futures contracts are Level 1 instruments while the corporate bond and the credit default swap are Level 3 instruments as quoted exchange prices for an identical corporate bond and credit default swap would generally not be readily available. While the positions offset each other's credit and interest rate risks, the Exposure Draft would prohibit mid-market pricing. Yet, the observed midmarket pricing for these instruments would seem appropriate. The same concept would apply to a portfolio of offsetting interest rate swaps. The interest rate swaps would all be valued under Level 3 of the fair value hierarchy. Since they are not categorized in Level 1, as proposed in the Exposure Draft, mid-market inputs appear to be prohibited. Even though there is no net risk, the long positions would be priced at bid and the short positions would be priced at ask resulting in a mismatch for both measurement and earnings purposes.

Because the Exposure Draft relegates mid-market pricing solely to financial instruments valued under Level 1 of the fair value hierarchy, offsetting positions outside of Level 1 that have similar underlying risks will be valued differently, creating mismatches in fair value measurement as well as earnings. We believe this will result in less reliable financial reporting. We believe that mid-market pricing/inputs should be extended to offsetting positions across all levels of the fair value hierarchy.

Marking for One's Own Credit Spread

In estimating the fair value of liabilities the Exposure Draft states that such estimate "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." While we acknowledge that Statement of Financial Accounting Concepts No. 7, Using Cash Flow Information and Present Value in Accounting Measurements, embodies a similar principle, we believe that the application of this particular component of the Exposure Draft could represent a major change in practice for some companies in valuing their trading liabilities and would represent a significant change for all entities if, and when, all liabilities are required to be measured at fair value.

Consistent with the Exposure Draft's objective that emphasizes the exchange price notion and the general concept that "[A]n observed market price encompasses the consensus view of all marketplace participants about [a]...liability's utility," we believe it is appropriate for an entity to include the effect of changes in its own creditworthiness in fair value estimates where the effect is contemplated in the marketplace and when the entity has the ability to realize the effect. We recommend that the Board incorporate these concepts into its approach for fair value measurement of liabilities.

Interaction with EITF 02-3

We believe that the Board must address EITF 02-3 and completely reconcile its fair value measurement provisions for derivatives with those prescribed in this Exposure Draft. In EITF 02-3, the FASB staff asserts that if the fair value estimate is, in effect, a Level 3 estimate using significant entity inputs, then transaction price (i.e., historical cost) is the means by which to estimate fair value of a derivative instrument at inception. We disagree with the FASB staff and believe that traditional valuation methodology is the best path to reliable fair value. Naturally, valuations have to be applied soundly and consistently, with high quality controls, and in accordance with best practices.

The Exposure Draft contradicts the claim in EITF 02-3 that historical transaction cost is superior to a Level 3 estimate of fair value. Paragraph 5 of the Exposure Draft states: "the objective of a fair value measurement is to estimate an exchange price for the asset or liability being measured in the absence of an actual transaction for that asset or liability." The Exposure Draft then goes to great lengths to provide guidance on how to use valuation inputs in arriving at that fair value estimate.

The first sentence in the Summary to the Exposure Draft states, "this proposed Statement would provide guidance for how to measure fair value." We believe that the EITF 02-3 issue is exactly that -- a matter of how to measure fair value. Meanwhile, paragraph C61 of the Exposure Draft subtly implies that EITF 02-3 precludes the use of Level 3 valuation techniques for estimates of the fair value of certain derivatives. We do not understand this as the Exposure Draft, if finalized, would rank at a higher level of GAAP than EITF 02-3. In addition, the distinctions between EITF 02-3 and the Exposure Draft will result in different practices for initial fair value estimates of financial instruments and subsequent fair value estimates. Therefore, the issue of day-one measurement of derivatives is every bit as much a fair value issue as it is a revenue or earnings recognition issue. A final standard will be incomplete if the Board further delays addressing this matter.

Disclosures

We understand the objective of providing financial statement users with information regarding the extent of fair value measurements, the transparency of such measurements and the extent to which subjectivity surrounding fair value measurements has impacted financial statement results. In fact, Morgan Stanley has continued to significantly enhance its disclosures regarding the use of fair value, including information about the transparency of market information and valuation methodologies. This is reflected particularly in disclosure of our Critical Accounting Policies within Management's Discussion and Analysis as well as in the financial statement footnotes.

While we support the general concept underlying the Exposure Draft's required disclosures, we believe the requirement to disclose the amount of unrealized gains or losses associated with all fair value measurements will not provide useful information to financial statement users. To the extent subjectivity is involved in the measurement or fair value is estimated using significant entity inputs, we believe that this information will be of the most interest to financial statement users. Thus, we recommend that disclosures be focused in this area and propose disclosure of total gains and losses resulting from fair value measurements using significant entity inputs.

Most broker-dealer systems would not currently be able to produce the required disclosures. Substantial operational efforts would be required to isolate, and therefore report, the unrealized gains and losses for trading assets and liabilities for a given period. This is reflective of the fact that management does not evaluate its risks and trading operations in this manner. Given the costs involved, disclosure of unrealized gains and losses for fair value measurements involving little subjectivity and that are based entirely on observable market data does not appear warranted. However, if the final standard continues to include the proposed disclosure requirements, we recommend that the Board consider a delayed effective date with respect to the quantitative aspects of the requirements to allow constituents sufficient implementation time.

It is important to note that disclosures required as part of this project would be supplemented by the qualitative disclosures that are already presented regarding fair value measurements and we are supportive of the Board's objective of providing financial statement users with information about how fair value measurements are determined.

Again, we support the Board's objective of enhancing guidance about how to measure the fair value of assets and liabilities in order to achieve consistency of application and improve the representational faithfulness of fair value measurements to the extent possible. We, however, convey our concerns that certain concepts in the prescribed fair value hierarchy will not yield more meaningful fair value measurements and would be pleased to

discuss our comments with the Board or the Staff. Please contact Karen Dealey at (212) 537-2452, Staci Lublin at (212) 537-2456, David Shelton (212) 537-3323 or myself at (212) 537-2620 with questions or comments.

Sincerely,

/s/ David S. Moser Managing Director Principal Accounting Officer