



KPMG LLP
757 Third Avenue
New York, NY 10017

Telephone 212-909-5600
Fax 212-909-5699
Internet www.us.kpmg.com

May 23, 2007



LETTER OF COMMENT NO. 3

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

Proposed DIG Issue C21, “Scope Exceptions: Whether Options (Including Embedded Conversion Options) Are Indexed Both to an Entity’s Own Stock and Currency Exchange Rates”

Dear Mr. Smith:

We appreciate the opportunity to comment on proposed DIG Issue C21, “Scope Exceptions: Whether Options (Including Embedded Conversion Options) Are Indexed Both to an Entity’s Own Stock and Currency Exchange Rates” (proposed DIG Issue). We strongly support the issuance of guidance on these issues because we believe they are pervasive in cross-border financing transactions and are becoming more frequent as world capital markets become more integrated and sophisticated. Further, we agree with the conclusions in the proposed DIG Issue, requesting certain clarifications as discussed below, and oppose the Alternative View, for the reasons described below.

Denomination of Issued Equity Shares

The response to Question 2 in the proposed DIG Issue is predicated on the conclusion that an entity’s own shares are not inherently indexed to anything but the entity’s own shares. Specifically, the response notes that “An equity share is not inherently ‘denominated’ in a particular currency”. We do not disagree with this conclusion. However, the response goes on to say that “fair value is not affected by currency exchange rates” for the exercise price, which seems to be a different argument from “denomination”. If the identification of indexation was predicated on what could change the fair value of a contract, we are concerned that an equity derivative contract could be considered indexed to a variety of underlyings, including the currency in which the shares trade and the currencies in which the company does business (not to mention interest rates). We believe there is significant confusion in practice about the definitions of “indexation” and “underlying”, as well as whether any variable factor that affects the fair value of a contract is an underlying or causes indexation. We suggest that the discussion of indexation be more plainly tied to



FASB Technical Director
May 23, 2007
Page 2

the definition of an underlying in paragraph 7 of Statement 133 (in other words, a specified index that determines the payoff rather than something that could change fair value) and that references to determining indexation based on changes in fair value be eliminated. In other words, an underlying affects the calculation of the payoff of a derivative and does not extend to any factor that could change the derivative's fair value prior to exercise or payoff. While fair value may be changed by a variety of factors, indexation is generally limited to changes in an underlying that directly affect the calculation of the payoff of a derivative contract. This interpretation is consistent with footnote 6 of Statement 150 and paragraph 7 of Statement 133 (which makes reference to the fact that an underlying is a "specified" variable that, in concert with the notional, determines the settlement amount of a derivative contract). We further suggest that the Board consider clarifying that while a company's shares may vary in value based on changes in a number of factors, all of those factors are encompassed in the notion of "an entity's own stock".

Further, we note that paragraph 38 of Statement 133 allows an investor in an equity security to hedge foreign currency risk in a fair value hedge when certain criteria are met. In this regard, it appears the Board believes the evaluation of foreign currency exposure for purposes of an investor's hedging relationships and the evaluation of foreign currency indexation for purposes of determining whether a contract meets the equity scope exception are different types of analysis. We suggest that the distinction may relate to the difference between a hedgeable exposure (i.e., variability in fair value or cash flows) and the definition of an underlying, as discussed in the previous paragraph. In any case, we would like to better understand how the Board distinguishes between a hedgeable foreign exchange risk and indexation to something other than a company's own stock since proponents of the opposing view have historically argued that an entity's own stock can be dual indexed to a foreign currency by reference to this guidance.

Pervasiveness of Issue

Three Board members noted in their Alternative View that they do not believe this issue is pervasive enough to warrant guidance. We disagree. This issue affects many cross-border financing transactions that involve equity options, whether freestanding or embedded. For instance, the issues discussed in the proposed DIG Issue are already very common among Chinese Yuan and Canadian Dollar functional currency companies seeking to raise U.S. dollar denominated capital in the form of convertible debt or warrants. Further, these issues are likely to become more common as convertible debt and other equity-related instruments become more popular tools for raising capital by companies based outside of the United States, and as American companies seek more and more to raise capital abroad. Given the dramatic accounting impact of concluding that an instrument or feature does or does not qualify for the paragraph 11(a) scope exception in



FASB Technical Director
May 23, 2007
Page 3

Statement 133, and the fact that these financing transactions are often highly material to the financial statements of these entities, we believe guidance on this matter should be issued.

Rebuttal of Alternative Approaches for Embedded Features

The Alternative View discusses two alternative approaches that would result in a conclusion that a conversion option embedded in a foreign currency bond is not dual indexed. We do not agree with either of these approaches.

Alternative Approach #1: Ascribe Foreign Currency Element to the Host Contract Only

Alternative approach #1 describes an approach whereby an embedded feature in a foreign currency denominated contract may not itself be considered denominated in a foreign currency. The Alternative View notes: "When a conversion feature is embedded in a debt instrument, the debt instrument (host) is denominated in a currency, rather than the conversion feature per se." We disagree. In order to conclude that the embedded written call option in a foreign currency convertible bond has an exercise price other than the denomination of the bond, a second embedded feature must be identified that "swaps" the currency of the bond tendered to exercise the conversion option for the functional currency of the writer of the option. That approach seems inconsistent with DIG Issue B19, which notes that "an entity may not express the characteristics of the debt host contract in a manner that would result in identifying an embedded derivative that is not already clearly present in a hybrid instrument".

If the bond is denominated in a foreign currency, and the option exercise price of the embedded option is the surrender of that foreign currency bond, it seems difficult to escape the conclusion that if the embedded option were a freestanding written call option its exercise price would be stated in that same currency. Further, it is unclear to us how a functional currency exercise price can be ascribed to the written call option without simultaneously assuming the existence of another embedded feature (the currency swap described above). Otherwise, the combination of a foreign currency bond host contract and a functional currency exercise price embedded call option would not "add up" to the hybrid foreign currency convertible bond instrument taken as a whole.

Alternative Approach #2: Implicit Scope Exception for Currency Indexation in a Convertible Bond

Alternative approach #2 proposes that currency indexation be viewed in the same way as interest rate indexation and credit indexation in evaluating conversion features in convertible instruments; that is, that it be ignored. In other words, this approach proposes



FASB Technical Director

May 23, 2007

Page 4

to expand the implicit scope exception for embedded conversion options in convertible debt from considering the fact that the debt itself (which represents the exercise price on the conversion feature) is exposed to changes in fair value related to interest rates and credit risk.

We disagree with this approach. While it is clear from the examples in Statement 133 that indexation of convertible debt to interest rates and credit risk is not viewed as a form of dual indexation under paragraph 11(a) and paragraph 286 of the standard, no such implicit scope exception currently exists for currency. If the Board were to conclude that currency indexation should be ignored for embedded features, we would ask that paragraph 11(a) be amended to make it clear what types of indexation should be considered and what should not in evaluating embedded equity features. Further, we question why an additional scope exception, explicit or implicit, should be provided for embedded features when DIG Issue C8 makes it clear that foreign currency indexation is a form of dual indexation for purposes of evaluating freestanding features. We believe that currency indexation should be addressed in a similar manner whether or not a feature is embedded or freestanding.

If the proponents of the Alternative View believe that unleveraged currency indexation should not drive whether an instrument or feature is considered an equity instrument or a derivative liability, we suggest that this view be positioned as a possible amendment of paragraphs 11(a) and 286 of Statement 133 rather than derived from analogies to implicit guidance on other issues or clever ways of identifying the host contract and embedded features. If this path is pursued, we further recommend that the Board consider ways in which the currency issue can be addressed broadly to obtain as much consistency as possible between footnote 19 of Statement 123(R), paragraph 15 of Statement 133, and the evaluations of whether a feature is solely indexed to a particular underlying in paragraphs 11(a) and 13 of Statement 133. Finally, whether an alternative view or amendment to Statement 133 is pursued or not, it would be helpful to acknowledge the existing implicit scope exceptions for indexation of conversion features in convertible debt to credit risk and interest rate risk (which are fundamental to determining the value of the debt and, therefore, the "proceeds" of conversion feature exercise) to bring clarity to this issue.

* * * * *

If you have any questions about our comments or wish to discuss any of the matters addressed herein, please contact Enrique Tejerina at (212) 909-5530.

Sincerely,

KPMG LLP