Securities Industry Association

120 Broadway, New York, NY 10271-0080, (212) 608-1500, Fax (212) 608-1604
1401 Eye Street, NW, Washington, DC 20005-2225, (202) 296-9410, Fax (202) 296-9775
info@sia.com, http://www.sia.com

October 13, 1997

Mr. Timothy S. Lucas
Research and Technical Activities Director
FASB
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: File Reference 176 - A

Dear Mr. Lucas:

On behalf of the OTC Derivative Products Committee ("the Committee") of the Securities Industry Association ("SIA") [1] I wish to offer you the Committee's thoughts on the revised Exposure Draft on Accounting for Derivative and Similar Financial Instruments and for Hedging Activities (the "Revised Draft").

Overview

As noted in previous correspondence with the Financial Accounting Standards Board ("FASB") and the Financial Accounting Standards Advisory Council ("FASAC") SIA enthusiastically supports the goal of providing investors and financial statement users with more accurate and comprehensive information about issuers, and we acknowledge that FASB has been responsive to a number of criticisms of the earlier version of the Exposure Draft. However, the Committee believes that the Revised Draft still contains a number of very major problems -- briefly described below -- that must be corrected before FASB approves the Revised Draft. Fortunately, we believe that those problems could be remedied with relatively little effort and without creating any additional delay in finalizing the project. The existence of these problems, however, has meant that we could not limit our comments to issues relating merely to "the clarity and operationality" of the Revised Draft. Finally, we feel compelled to note that the very abbreviated time given for comments on the Revised Draft almost certainly guarantees that major difficulties with the Revised Draft will remain undiscovered until after FASB's final action on the project, which we understand is planned before year-end.

Below are four major issues that the Committee has identified as requiring urgent correction before FASB takes final action on the Revised Draft.

Major Problems with the Revised Draft

A. *Disclosure of Gains and Losses Arising from Derivatives*

Paragraph 41 d of the Revised Draft mandates that firms break out the gains and losses for those derivatives that have not been designated as hedging instruments. In our view, such information, presented in isolation from the gains or losses on related non-derivative instruments, is essentially useless, and could prove misleading to users of financial statements. In addition, the Committee believes that there isn't a single major securities firm that would be capable of complying with the literal language of such a provision. This is due to the fact that no firm of which we are aware keeps track of gains or losses by segregating financial instruments on the basis of whether they are called "derivatives" or "cash instruments." [2] We note that the requirement seems premised on the perception that "derivatives" are a class of *sui generis* financial instruments that are uniquely volatile. [3]

We do not wish to suggest that this problem would be limited only to financial firms. Indeed, the Committee suggests that it might prove even more difficult for conventional end-users. For example, read literally, 41 d would require a non-financial firm that wishes to purchase a convertible security and which is prepared to mark that instrument to market to determine and report a value for the "call" embedded in the security. Such firms might find it extraordinarily difficult to comply, even where they could fairly easily supply a value for the security as a whole. Fortunately, we believe that the problem could be quickly resolved by amending 41 d so as to permit gross disclosure of gains or losses whether arising from derivative or cash instruments.

B. *Treatment of Embedded Derivatives*

The provisions of paragraphs 9 and 10 dealing with embedded derivatives are new, and require that the reporting entity must disaggregate embedded derivatives from their "host" cash instrument. As suggested above, this may be quite a complex undertaking, and at least in the case of two instruments - convertible and inflation linked products -- the work involved seems very disproportionate to the potential for abuse. The Committee believes that FASB should provide both classes of instruments with an exemption from the requirement.

C. *Prepayment Risk*

Paragraph 25 e would prohibit hedge accounting treatment for the prepayment risk of held-to-maturity securities. The Committee understands that FASB is concerned that certain interest rate hedges may be inconsistent with a firm's assertion that it intends to hold a security until maturity, and should thus be indifferent to interim volatility. However, many debt instruments may be redeemed prior to maturity whatever the intentions of the investor, and we believe that it is entirely appropriate for an investor to hedge against that eventuality. The potential consequences of this prohibition, particularly with respect to mortgage related instruments, could be dramatic. We urge FASB to delete the prohibition against hedging prepayment risk.

D. *Limitation on Portfolio Hedging*

Innovation in the financial services industry in recent years has provided a much better insight into the various risks to which firms are subject, and permitted much greater management of such risks than was previously the case. Increasingly, risk management is a key business component for *all* corporations. However, the requirement that firms "pair off" or match hedging instruments to specific transactions will act as a deterrent for many firms that hedge on a portfolio basis -- such as firms whose inventory turns over rapidly - or that otherwise use "macro hedge" strategies. This limitation, of course, will also contribute to the economic costs that will be imposed by the Revised Draft, since the costs that will be incurred will arise not merely from the expense of directly implementing the Revised Draft, but perhaps more significantly, from the costs to firms of utilizing less than optimal hedging strategies in an effort to obtain more favorable accounting treatment. This is an example of how the Revised Draft may discourage prudential risk management, contrary to the lessons that we had hoped all market participants -- whether endusers, dealers or regulators -- would have learned from recent problems in the financial markets. [4] The Committee strongly recommends that FASB amend the Revised Draft so as to grant greater recognition to hedging on a portfolio basis.

Conclusion

The Committee believes that all the parties interested in the progress of this project would have been served by some additional time to review the Revised Draft. We hope that the sheer complexity of the project and the haste in which FASB is now moving will not lead to unintended results, such as the frightening possibility that the net effect of approving the Revised Draft may be to make "risk acceptance" more palatable than risk management. We fear that the speed with which the project is now moving has not given concerned parties sufficient time to consider the ramifications of all the changes to the Revised Draft. [5] In any event, we believe that the items we have discussed above must be rectified by FASB prior to taking any final action on the Revised Draft.

If you have any questions about our letter, or would like us to amplify our remarks, please feel free to contact us.

Sincerely,

Zachary Snow
Chairman
OTC Derivative Products Committee

Footnotes:

1 The Securities Industry Association is the trade association representing about 750 securities firms headquartered throughout North America. Its members include securities organizations of all types--investment banks, brokers, dealers, specialists, and mutual fund companies. SIA members are active in all markets, and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of investment services and account for approximately 90% of the securities business conducted in the U.S.

2 Classifying financial instruments for accounting purposes in this fashion is simply not the way that securities firms - or any other industry that we are aware of -- operates.

3 During the bear bond market of 1993-94, some cash fixed income instruments proved far more volatile than most derivative instruments. For example, measured from the height of the bond rally in 1993 to the bottom of the market in November 1994, the 30 year Treasury bond lost approximately 20% of its value. In this connection, we note with approval the position expressed in a recent SIA letter to FASAC wherein it was recommended "that the Board abandon efforts at a piecemeal approach to fair value accounting, and instead direct its limited resources to the development of a consistent and comprehensive approach to fair value accounting for all financial instruments." *Letter from Marc E. Lackritz to Robert Butler, Chairman, Financial Accounting Standards Advisory Council (June 12, 1997).* We continue to believe that this would have been a better course of action.

4 These incidents, such as the Orange County losses or the Barings fiasco, were the result of inadequate (in some cases, nearly non-existent) risk management, and were not in any real sense accounting related.

5 For example, an instrument which requires the exchange of an underlying that is not readily convertible into cash is not to be treated as a "derivative." Thus, an option on a thinly traded "pink sheet" stock is not a derivative, but an option on a listed stock is. We do not believe that commentators have had sufficient time to consider what that sort of demarcation between instruments will mean in the marketplace.