Merrill Lynch

Cynthia A. Rumpza
Director of Accounting Policy
Merrill Lynch Europe Plc
Cynthia_Rumpza@ml.com

2 King Edward Street
London EC1A 1HQ
+44 (0)20 7995 0128

22 July 2004

Sandra Thompson
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom
CommentLetters@iasb.org.uk

Re: Exposure Draft of Proposed Amendment to IAS 39 Financial Instruments: Recognition and Measurement, the Fair Value Option

Dear Ms. Thompson:

Merrill Lynch appreciates the opportunity to comment on the Exposure Draft ("ED") of *Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement, the Fair Value Option,* issued in April 2004 by the International Accounting Standards Board ("IASB").

Merrill Lynch supported the Fair Value Option when it was introduced in June of 2002, and we have actively encouraged the FASB to introduce a similar provision in the US. Many entities, especially financial institutions, manage a substantial part of the risk of their business on a fair value basis. We believe that the Fair Value Option, prior to the amendments as proposed in this ED, enables such institutions to ensure that their financial reporting more closely matches the risk and underlying economics of their business. Accordingly, we believe that an unrestricted Fair Value Option enables companies to provide the users of their financial statements the most accurate understanding of their business.

We also supported the IASB in its efforts to devise a "full fair value" set of financial accounting standards. We believe that the Fair Value Option, prior to the amendments as proposed in this ED, is an integral step toward a "full fair value" set of financial accounting standards. While we appreciate the European Central Bank's concerns over the use or perceived potential "misuse" of the Fair Value Option, Merrill Lynch believes that the restrictions, as proposed in the ED, on the use of the Fair Value Option will not alleviate the regulator's concerns over volatility in profit and loss. On the contrary, we believe that the restrictions as proposed in the ED would introduce additional volatility in profit and loss, as further described below. Further, limiting the Fair Value Option due to concerns regarding the reliability of information is not consistent with other areas of accounting where estimates are required. Therefore, Merrill Lynch does not support this ED as we believe the Fair Value Option should remain unrestricted. We recommend that the Board revert to the Fair Value Option as outlined in the December 2003 version of IAS 39.

Additionally, we believe that many of the concerns raised in the ED can be adequately addressed via financial statement disclosures. These disclosures could include the policies and procedures regarding the fair value process, and a discussion of the instances in which the Fair Value Option is applied and the rationale therefore.

Application of Fair Value
In support of our recommendation, we believe that, currently, the Fair Value Option allows entities to ensure that their financial reporting more closely matches their risk management policies and procedures. In addition, we feel that restricting the use of the Fair Value Option as contemplated by the ED will actually increase earnings volatility resulting from the mixed measurement model inherent in IAS 39. Under the mixed measurement model, there is diversity in the accounting for the change in fair value of financial assets and liabilities (e.g., through profit and loss, equity, or carried at amortised cost). In many situations, the risk of the change in fair value of assets or liabilities is economically hedged; however, volatility is recorded in profit or loss as a result of the mixed measurement model. Prior to the ED, the Fair Value Option alleviated much of the earnings volatility resulting from this mixed measurement model. Restricting the use of the Fair Value Option, as the ED suggests, may significantly increase the amount of earnings volatility that is reported in earnings.

For example, suppose Merrill Lynch holds a fixed rate loan which is not quoted in an active market. Merrill Lynch is exposed to the fair value risk attributable to the variability in market interest rates and credit spreads. Integral to our risk management policies and procedures is our requirement to economically hedge our exposures to these risks through the use of derivative products, which are accounted for on a fair value basis. The employees of this business are also compensated for managing the business on a fair value basis. By restricting the use of the Fair Value Option as proposed by the ED, the financial statements will show greater volatility than actually exists. Thus, they will not accurately reflect the underlying economics of the business, nor will they accurately show how the business is managed for risk and compensation purposes.

Verifiable Fair Value
We also note that this ED only allows a financial asset or financial liability to be designated at fair value through profit or loss if its fair value is *"verifiable"* (paragraph 9). The Board clearly indicates that this standard of measurement should convey a *"stricter test than that of 'reliably measure' contained in paragraphs 46(c) and 47(a) of IAS 39"*. We believe it is unnecessary and potentially confusing to have

two separate fair value approaches to the same financial instrument depending upon the purpose for which the instrument is held. Although we believe that certain elements of the fair value provisions established in IAS 39 could be improved (as noted in our letter dated 17 January 2003, re: *Exposure Draft of Proposed Amendments to IAS 32 and IAS 39),* we find no conceptual basis for applying a different standard to instruments valued under the Fair Value Option. We understand that there may be concerns regarding the inappropriate application of the Fair Value Option to instruments for which fair value is not considered to be reliable. However, we feel that the concerns surrounding the application of the Fair Value Option to financial assets or financial liabilities whose fair value is not verifiable is adequately addressed by the fair value criteria already contained in IAS 39. As paragraphs AG69-AG82 of Appendix A of IAS 39 currently provide a framework for the valuation of financial instruments, we see no practical reason why this framework would not be applied to those financial instruments to which the Fair Value Option is applied. We believe that the application of this framework, combined with appropriate disclosure regarding the application of the Fair Value Option, should be robust enough such that the creation of a separate threshold for the Fair Value Option should not be necessary.

Embedded Derivatives
Permitting the application of the Fair Value Option to financial assets and financial liabilities which contain embedded derivatives where those embedded derivatives do not meet the paragraph 11 requirements for bifurcation (and related guidance) provides entities with the flexibility to present reported earnings in a manner which is more consistent with its risk management policies and procedures. By restricting the application of the Fair Value Option to instruments containing embedded derivatives only where the embedded derivative is “qualifying” under paragraph 11 (and related guidance) we feel the Board may be inadvertently increasing the volatility in reported earnings of certain entities.

For example, Merrill Lynch issues many types of structured notes which, due to their terms, do not qualify for embedded derivative treatment. An example of this is a structured note where the underlying is an interest rate index which does not more than double holder’s initial rate of return on the host contract. Though this type of note would not qualify for bifurcation under paragraph 11, it is nevertheless risk managed and hedged the same way as those structured notes that are considered to have a “qualifying” embedded derivative – that is, on a fair value basis. As a result, we think it is inappropriate not to permit fair value accounting for these types of structured notes.

Transition
As we do not believe the Fair Value Option should be amended as proposed in the ED, we will not comment on the appropriateness of the transitional adjustment. We would, however, like the Board to consider what we believe may be a technical flaw in the ED’s proposed transitional impact on financial assets that are no longer designated as fair value instruments with changes in value recorded through profit or

loss, and which are subsequently classified as available-for-sale, described in paragraph 103A(b).

Specifically, at maturity of an available-for-sale debt instrument, its mark-to-market movements over its term would net to zero. If this instrument was first reported under the Fair Value Option and subsequently reclassified to available-for-sale and the guidance in 103A(b) were applied, we believe an amount would remain in the separate component of equity at its maturity. This is because, under the ED's proposed approach, the fair value movements prior to reclassification are not reclassified to equity. We would suggest an approach to transition similar to that of US GAAP SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Specifically, the unrealised holding gain or loss, net of tax effect, for securities classified as available-for-sale as of the date that the ED is first applied is recognised as an adjustment of equity.

Other Matters
In reviewing the previous amendments to IAS 39 we did not voice concerns about the scope of the IAS 39.9(a) and ICG B.12 "held-for-trading" definition as it would apply to a broker or dealer in securities; our thinking was that even if the definition was too restrictive, then the Fair Value Option could be applied. This ED has forced us to now reconsider this definition. We believe that the definition is too restrictive, in particular, with respect to the requirement that the instrument be acquired or incurred principally for the purpose of selling or repurchasing it *in the near term*, or is part of a portfolio of identified financial instruments for which there is evidence of a recent actual pattern of *short-term profit-taking*. This definition will exclude many instruments that are actively managed on a fair value basis. Generally broker-dealers carry inventory and make a profit or loss on the spread between bid and ask prices and market movements. Profit taking is not determined by adherence to a strict holding period. We would therefore recommend that, in describing the held-for-trading category, the IASB qualify the references to the holding periods with the terms "generally" and "principally" such that there is not a strict requirement for a particular holding period in all cases.

We also believe that the revised wording of Paragraph 9 of the ED related to the powers of prudential supervisors and their oversight of the application of the requirements of the ED and relevant risk management systems and policies are unnecessary and inconsistent with the conceptual framework of IFRS. Specifically, we feel that the process for determining the appropriate accounting standards and related policies for implementing those standards should rest with accounting standard setters and the reporting entities themselves as opposed to giving regulators this authority. As regulators have the power to request reports and submissions in their own specific format and in accordance with their rules, Merrill Lynch feels it is unnecessary for accounting standard setters to provide provisions for regulatory oversight within the standards themselves.

****

Again, we thank you for allowing us to provide feedback on the ED, and we hope you find our comments helpful. If you have any questions regarding the content of this letter, please do not hesitate to call Esther Mills at +1.212.449.2148 or me on +44 (0)20.7995.0128.

Sincerely,

/s/ Cynthia A. Rumpza
Director of Accounting Policy
Merrill Lynch Europe Plc