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Proposed ASU Fair Value Measurement and Disclosures (Topic 820), File Reference No. 1830-100

Dear Mr. Golden,

We appreciate the opportunity to comment on ASU 820, *Fair Value Measurement*. We support the joint efforts of the FASB and the IASB to reach a high level of convergence on this very important topic. Our responses to the specific questions on ASU 820 raised by the FASB staff are included in Appendix 1 attached to this letter.

UBS is a global financial institution that uses International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB) as its basis for financial reporting. We also have large US subsidiaries that are regulated and use US GAAP for stand-alone financial reporting; thus, we are greatly interested in the complete elimination of differences between IFRS and US GAAP.

We remain concerned that convergence does not appear to have been achieved with respect to the initial recognition of instruments classified in Level 3 of the hierarchy. As this is not a US GAAP issue, we have incorporated our views in Appendix 2 attached to this letter which addresses IFRS-specific issues.

As described more fully in Appendix 1, we find the guidance over "blockage factors" relating to instruments classified within Levels 2 and 3 of the hierarchy to be ambiguous. Accounting standards which are not clear and concise will lead to confusion and incomparability between similar entities in practice. Therefore, we strongly recommend that the FASB establish a single, uniform principle that is articulated with sufficient clarity as to be applied with consistency.

Although we fully agree with the objective of creating greater transparency over the valuation of instruments within Level 3, we believe that the proposed stress analysis disclosure requirement, including correlation among unobservable inputs, is more likely to obscure any meaningful representation of estimation error than enhance it. Because of the diversity of products and valuation variables that will exist amongst reporting entities, the inherent subjectivity of uncertainty measurement in financial valuation, and the lack of specific measurement guidelines in the ASU, we do not believe that this disclosure will achieve reliable or comparable sets of data across the financial industry.

Until a robust methodology has been accepted by the accounting and valuation professions, equivalent in its broad acceptance to a VaR or similar stress metric, we would encourage the FASB to remove this requirement from the ASU (and the IASB to correspondingly withdraw the disclosure currently mandated

pursuant to paragraph 27(e) of IFRS 7). As an alternative, we would be supportive of a qualitative discussion of the types of valuation risks faced by entities and their key valuation governance controls. We believe that indications of the relative robustness of an entity's control processes around fair valuation would be more informative to users than stress measures that are not derived from real-world models. Further, we recommend that the IASB and FASB should continue their dialogue with the financial sector, the Big 4 accounting firms and international valuation committees, in an effort to develop more useful and relevant quantitative metrics for risk management and disclosure purposes.

Once again, we appreciate the opportunity to participate in the FASB's due process. Independent standard setters and robust due process are the cornerstones of high quality accounting standards. If you have any questions regarding our comments, please call John Gallagher at (203) 719-4212 or Gabriel Melamed at (203) 719-7723.

Regards,

UBS AG

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Appendix

Question 1: This Exposure Draft represents the Board's commitment toward developing common fair value measurement guidance with the IASB. Do you think the proposed amendments:

a. Would improve the understandability of the fair value measurement guidance in U.S. GAAP? If not, why not?

b. Would result in any unintended consequences on the application of the proposed amendments? If so, please describe those consequences.

With the exception of the specific points noted below, UBS generally believes that the proposed amendments are reasonable and will result in more consistent application of US GAAP. We note that, although the proposed guidance is in vastly greater detail than that currently in effect under IAS 39 and may in some instances use different terminology, for the most part the net result should not deviate substantially from recognized best practice under IFRS.

Question 2: The Board has decided to specify that the concepts of highest and best use and valuation premise are only to be applied when measuring the fair value of nonfinancial assets. Are there situations in which those concepts could be applied to financial assets or to liabilities? If so, please describe those situations.

We believe that the proposals above are appropriate based on the rationale provided by the Board and considering the mitigating impact of the exception in paragraph 35-18I. However, see our response in Question 4 below.

Question 3: Do you agree with the proposed guidance for measuring the fair value of an instrument classified in shareholders' equity? Why or why not?

We agree with the guidance in paragraph 35-18E and believe that it will facilitate consistency in practice.

Question 4: The Board has decided to permit an exception to fair value measurement requirements for measuring the fair value of a group of financial assets and financial liabilities that are managed on the basis of the reporting entity's net exposure to a particular market risk (or risks) (that is, interest rate risk, currency risk, or other price risk) or to the credit risk of a particular counterparty.

a. Do you think that proposal is appropriate? If not, why not?

b. Do you believe that the application of the proposed guidance would change the fair value measurements of financial assets and financial liabilities that are managed on the basis of the reporting entity's net exposure to those risks? If so, please describe how the proposed guidance would affect current practice.

- a. Yes. We agree that it is most appropriate to reflect measurements of fair value in financial statements on a basis consistent with that used for risk management purposes. A financial institution continually manages its net risk exposures on a portfolio basis, for example, a portfolio's net risk exposures to various interest rates, asset prices, volatilities and foreign currencies. Portfolio

management of net risk exposures maximizes profits and minimizes risks that have been created by the business model. The in-use valuation premise appropriately and faithfully reflected how risk exposures are netted to maximize an entity's return. However, we understand the Board's conceptual basis for abandoning the "in-use" concept for financial assets and are supportive of the exemption to the extent it allows financial institutions to carry on existing best practice.

We are concerned that the condition relating to counterparty credit risk, as prescribed in paragraph 35-18L, may result in the over-statement of credit adjustments where mitigating arrangements, other than legal rights of offset, are used to manage counterparty exposure. For instance, collateral, security, legal isolation arrangements, etc. may all have the effect of accomplishing the same objective as a master netting agreement from a credit risk-management perspective. The gross up of underlying risk for purposes of credit valuation may conflict with risk management practice; for example, where agreements call for the exchange of collateral based on net mutual exposures, and thus the credit risk is effectively managed on a net basis although no formal right of offset exists. We would therefore encourage the Boards to articulate this requirement in the form of a principle rather than a rule; e.g., replace the words "when there is a legally enforceable right to set off one or more financial assets and financial liabilities with the counterparty in the event of default" with "in a manner consistent with its credit risk management practices".

- b. Aside from the aforementioned concern over credit risk adjustments, we do not believe that the proposed guidance will result in significant departures from current practice.

Question 5: The Board has decided to clarify the meaning of a blockage factor and to prohibit the use of a blockage factor when fair value is measured using a quoted price for an asset or a liability (or similar assets or liabilities). Do you think that proposal is appropriate? If not, why not?

We find the proposed ASU's guidance pertaining to blockage reserves at hierarchy levels 2 and 3 to be vague and ambiguous in its current state for the following reasons:

1. Mixing the blockage factor discussion with the discussion of other premiums and discounts is confusing. We understand that the Board's intention is to permit the application of a control premium when another Topic specifically characterizes the controlling interest as the unit of account. As such, we would recommend separating the concept of control premiums (and noncontrolling interest discounts) from blockage discounts in two distinct sub-sections to avoid confusion.
2. We understand that the language in paragraph 35-36D and paragraph BC43 could be interpreted to:
 - a.) preclude the application of any volume-related price adjustment to instruments within Levels 2 or 3 whenever an L1 input is present in a pricing model
 - or, alternatively,
 - b.) allow the application of volume-related price adjustments to instruments within Levels 2 or 3, except in the case that the position itself (or homogeneous units thereof) is actively traded and quoted in its entirety or is priced primarily from an identical L1 parameter.

It is not clear, however, which of these approaches is actually being prescribed.

3. We do not understand the motivation behind the statement in the Board's Questions for Respondents that,

“the Board does not expect that the proposed amendments would affect current practice for fair value measurements categorized within Level 2 of the fair value hierarchy or for fair value measurements categorized within Level 3 of the fair value hierarchy”

The Board provides no basis for having reached such a conclusion, however, the inference is that the Board adheres to the notion described in 2.b. above; i.e., that the Board intends to permit volume-based adjustments in L2 and L3 under certain circumstances, even when an L1 input is present.

We also do not fully understand the basis behind the Board’s statement in BC43 that,

“the Board concluded that a blockage factor would not be relevant when fair value is measured using a valuation technique that does not use a quoted price for the asset or liability (or similar assets or liabilities).”

It is not clear whether the Board believes that volume should not be considered when pricing an L2 or L3 position or thinks that volume in the context of L2 or L3 inputs is an acceptable pricing consideration given the lack of observable evidence of a unit of account. We believe there is justification for the latter view, but are generally confused by the language the Board has chosen.

4. We do not understand the conceptual difference between volume-related adjustments pertaining to instruments that have L1 inputs and those that do not (refer to BC43). We believe that this is a significant inconsistency that highlights a fundamental conceptual flaw in the Board’s approach to blockage reserves.

We are very concerned that these ambiguities will lead to disparities in practice. As such, we recommend that the Board consider providing more clarity and supplemental examples for the purpose of ensuring consistent application.

To provide more granular context to our recommendations, please see the examples provided in appendix 3. We believe that these examples highlight situations in which the application of the proposed guidelines is challenging, as written. We would be happy to discuss these directly with the Board or Staff.

Question 6: The Board has decided to specify that other premiums and discounts (for example, a control premium or a noncontrolling interest discount) should be taken into account in fair value measurements categorized within Level 2 and Level 3 of the fair value hierarchy when market participants would take into account those premiums or discounts when pricing an asset or a liability consistent with the unit of account for that asset or liability.

a. Do you think that proposal is appropriate? If not, why not?

b. When the unit of account for a particular asset or liability is not clearly specified in another Topic, how would you apply that proposed guidance in practice? Please describe the circumstances (that is, the asset or liability and the relevant Topic) for which the unit of account is not clear.

We believe that it is difficult to disassociate the above mentioned pricing adjustments from the same entity-specific intentions that formed the basis for the Board’s position on blockage factors. As such, we believe that any departures from the basic fair valuation principles of Topic 820 should instead be incorporated as exceptions into the Topics for which the Board intends them to apply.

Question 7: The Board has decided to require a reporting entity to disclose a measurement uncertainty analysis that takes into account the effect of correlation between unobservable inputs for recurring fair value measurements categorized within Level 3 of the fair value hierarchy unless another Topic specifies that such a disclosure is not required for a particular asset or liability (for example, the Board has decided in its project on the accounting for financial instruments that a measurement uncertainty analysis disclosure would not be required for investments in unquoted equity instruments). Do you think that proposal is appropriate? If not, why not?

UBS notes that reporting material valuation uncertainty is a matter of increasing importance to financial institutions, their regulators and users of valuations. While we generally agree with the Board's objective of providing enhanced information about the measurement uncertainty associated with instruments whose valuations include the greatest levels of subjectivity, we do not believe that the proposed sensitivity disclosure will produce either incremental decision utility for users of financial statements or comparability across reporting entities.

We believe that the current Level 3 measurement-sensitivity disclosure prescribed by IFRS 7 is not theoretically useful if computed without consideration of the potential inter-relationships among the unobservable variables. However, layering on the proposed requirement to disclose the effect of correlation between unobservable inputs will not in itself add decision-useful value for a number of reasons.

- For large financial institutions, unobservable Level 3 inputs are often multi-dimensional, incorporating model selection, input selection and input correlation. In valuing a complex Level 3 instrument, an entity inherently makes subjective judgments in each dimension based on input data of varying degrees of quality – the selection of the most appropriate inputs is unlikely to follow a simple rule for identifying a fixed point within a finite distribution. Attempts to quantify a dispersion around a best estimate within and among parameters will therefore simply compound uncertainty with more uncertainty.
- Currently, there are no robust, industry standard metrics (such as, for instance, VaR, in the context of market risk) that provide a basis on which a standardized articulation of the interrelationship among dimensions can be formed. As such, even entities with highly sophisticated valuation functions are unlikely to arrive at a consistent view of the same event.
- Further, were a standardized approach currently available on an instrument-by-instrument basis, there will still be correlation and diversification factors amongst the instruments themselves that either increase or decrease the overall impact of estimation error on the Level 3 portfolio. Thus an aggregation of the possible estimation error on individual instruments would be a flawed representation of risk. To further exacerbate the problem, uncertainty exists within all levels of the hierarchy; thus, to focus on Level 3 alone would be an incomplete exercise as financial risk management generally follows a holistic, portfolio-level risk-based approach rather than a stratified instrument/product approach.

The confluence of these factors will result in disclosures that are subject to high levels of subjectivity, lack comparability across similar reporting entities, and artificially purport to measure risk in a manner that is not employed in generally accepted valuation management practices. Overall, it is doubtful that such highly subjective and non-comparable disclosures would enhance the information value of financial statements or be of any practical use to readers of financial statements.

Given the limited value of the information requested in the proposal and the disproportionate burden on preparers to compile and collate data for the sole purpose of disclosure, we recommend that the FASB remove this requirement from the ASU (and the IASB withdraw the corresponding disclosure currently mandated pursuant to paragraph 27(e) of IFRS 7).

Question 8: Are there alternative disclosures to the proposed measurement uncertainty analysis that you believe might provide users of financial statements with information about the measurement uncertainty inherent in fair value measurements categorized within Level 3 of the fair value hierarchy that the Board should consider instead? If so, please provide a description of those disclosures and the reasons why you think that information would be more useful and more cost-beneficial.

Instead of the quantitative disclosure currently proposed, the Boards may want to consider requiring the qualitative discussion of key valuation risks, the methods and assumptions used in determining fair value for instruments with significant unobservable inputs, and the reporting entity's governance and control processes around fair valuation. In our view, the relative robustness of an entity's control processes around fair valuation would be more informative to users than stress measures that are not derived from real-world models.

We further suggest that the IASB and FASB continue their dialogue with the financial sector, the Big 4 accounting firms and international valuation committees, in an effort to develop more useful and relevant guidance for disclosure in line with risk management best practices.

Question 9: The Board has decided to require limited retrospective transition. Do you think that proposal is appropriate? If not, why not?

We agree with the Board's conclusion that full retrospective adoption would be impracticable. We support the limited retrospective adoption approach (i.e., cumulative catch-up through retained earnings without comparative period restatement) proposed in the ASU.

Question 10: There is no link to the transition guidance for the proposed amendments that the Board believes would not change practice. Are there any proposed amendments that are not linked to the transition guidance that you think should be linked? If so, please identify those proposed amendments and why you think they should be linked to the transition guidance.

NA.

Question 11: The amendments in this proposed Update would apply to public and nonpublic entities (that is, private companies and not-for-profit organizations). Should any of the proposed amendments be different for nonpublic entities? If so, please identify those proposed amendments and describe how and why you think they should be different.

NA.

Question 12: How much time do you think constituents would need to prepare for and implement the amendments in this proposed Update?

We believe the time required to comply with the L3 sensitivity analysis, as currently proposed, would be substantial. In addition to the quantitative research effort required to develop measurement routines, the design and development of shadow systems would inevitably be required to gather and process information that, for the most part, does not reside in current risk systems.

Further to our discussion above, we suggest that a collaborative effort between the Boards, the Big 4 accounting firms, preparers and users be first initiated to determine whether uniform quantitative analytics can be developed to address measurement uncertainty. In this way, the risk of a substantial expenditure of resources in pursuit of disparate solutions can be minimized.

Appendix 2 IFRS Comments

Comment addressed to IASB - non-convergence in respect of initial recognition of instruments classified as Level 3 within the fair value hierarchy:

We believe that the four cases in which the fair value of an asset or liability at initial recognition (Day 1) might differ from the transaction price (paragraph 30-3A of proposed ASU) are appropriate. Given the Board's position, we are extremely disappointed that the Board did not follow its position to its ultimate logical conclusion: that is, differences between fair value and the transaction price should be recognized in profit or loss on Day 1.

We have a number of concerns regarding the Board's position. As noted, it is logically inconsistent with its own principles, that is, that changes in fair value should be recognized in profit or loss. If such changes are supported by observable or unobservable information, then those changes should be recognized in profit or loss. The Board's position means that some assets or liabilities will be recognized at the transaction price rather than at the exit price according to the fair value measurement objective, for example, some financial assets and financial liabilities that purport to be at fair value on the balance sheet will in reality be measured at transaction price on Day 1 and at a hybrid of the transaction price and fair value subsequently.

In the basis for conclusions of ED 2009/5, the Board explained that it was beyond the scope of the project to change the recognition threshold in paragraph AG76 of IAS 39. Because measurement is a function of recognition, we respectfully remind the Board that all changes in fair value measurement resulting from this standard should impact recognition as a consequence. Further, the Board is using the ED to add new disclosures, which represent in substance significant changes to existing standards. We raise these points to note that it is well within the Board's mandate to change the recognition threshold as part of this project, especially given that financial instruments make up a substantial proportion of assets and liabilities that will be subject to the final standard.

The Board has failed to clearly articulate why its position is superior to that taken in US GAAP and is perpetuating a key point of non-convergence with US GAAP without appropriate justification. We believe that the Board's decision to prohibit recognition of Day 1 gain or loss is based on anti-abuse concerns that do not justify a substantive override of fair value measurement principles by IAS 39. UBS does not believe that those concerns are justified. As evidence, in 2008, ISDA conducted a survey on the treatment of Day 1 gains or losses by banks reporting under US GAAP and the majority of respondents answered as follows:

- The Day 1 fair value of an unobservable instrument is generally the transaction price, in the absence of presumptive evidence to the contrary;
- The Day 1 gain or loss is generally only recognized once there is corroborative evidence to support the model inputs.

Furthermore, we note that the restriction on the recognition of Day 1 gains or losses for measurements with unobservable inputs could theoretically lead to perverse results, for example, not recognizing a loss in earnings. We believe that this may be misleading for users.

We strongly request that the Board make appropriate consequential amendments to IAS 39 consistent with its objective of establishing consistent fair value measurement principles that are faithfully applied at the standards level.

Restricted Stock Positions

Example 8 of the IASB's "Staff draft of a forthcoming IFRS on fair value measurement", posted on the IFRS website on 20 August (refer to Example 6 in the FASB ED) refers to a scenario where a restriction is a characteristic of the instrument and, therefore, "would be transferred to market participants." We suggest the Board strike the quote in the preceding sentence and replace it with the words "would be considered by a market participant (to the extent that it would be encumbered by a similar restriction as holder of the same instrument)".

We note that there are many circumstances (IPO's of previously closely-held entities, privatizations, underwriters' allotments, etc.) in which the holders of restricted positions are prohibited from transferring them to a third party during a specified period. In these cases, restricted parties are typically aware that their investments will likely be subject to such constraints when executing their initial involvement with the investee.

We understand that practice under US GAAP is currently to report a discount against the valuation of similarly restricted assets under such circumstances. However, we believe the language above could be construed to prohibit any reasonable valuation adjustment in these circumstances since the asset cannot be transferred during the restriction period. We are especially sensitive to the IASB's guidance on this topic given the views discussed by the IFRIC in 2008.

Measuring the FV of certain investments that calculate NAV per share (or its equivalent)

In the FASB's comparison of the proposed Topic 820 amendments vs. IFRS, a potential difference is noted regarding the practical expedient that permits a reporting entity with an investment in an investment company to use the reported net asset value (NAV) without adjustment as a measure of fair value in specific circumstances (820-10-35-59). Specifically, the IASB appears to have decided to not incorporate a similar practical expedient under its IFRS proposal because "IFRSs do not have accounting requirements that are specific to investment company entities" and "it would be difficult to identify the circumstances in which such a practical expedient could be applied given the different practices for calculating net asset values in jurisdictions around the world".

We assert that the availability of this practical expedient is just as relevant to an IFRS filer who may not be consolidating all of its underlying investments, and its use under IFRS would be no less consistent than a US GAAP filer that is permitted to use NAV for underlying international investments based on measurement being "similar" to Topic 946 (i.e. applying consistent fair value measurement principles, although not necessarily the same exact accounting literature). Not including the scope exception under IFRS would seemingly preclude the use of NAV even when an underlying investment is reported under IFRS or US GAAP. Whilst we understand the IASB's point regarding local country GAAP potentially differing, we do not believe it should be the IASB's intention to entirely preclude the use of NAV on this basis. Therefore, we recommend that the IASB incorporate a similar practical expedient under its fair value measurement standard to afford the use of NAV by investment companies whose unconsolidated underlying investments report under fair value measurement principles that are consistent with IFRS and US GAAP.

Appendix 3

Blockage Factors: Examples for Consideration

Example 1.

Company A has a portfolio of long and short positions in Company B shares. Company A has a net long position of 1 million Company B shares. Company B's shares are volatile (thereby implying a more frequent hedge rebalancing necessity), actively traded, and quoted. Daily trading volume in Company B is approx. 100,000 shares. As such, it would be difficult for Company A to dispose of its net position on the balance sheet date without incurring a penalty for the size of its holding. The quoted price for Company B is \$100/sh (we assume no bid-offer for simplicity). Company A has determined that market participants would apply a haircut of \$1/sh in order to purchase a position of the magnitude held by Company A.

Example 2.

Company A purchases and sells call options in the OTC market on Company B shares. Company B's shares are volatile (thereby implying a more frequent hedge rebalancing necessity), actively traded, and quote. The net notional long exposure of Company A's option portfolio is \$500MM of Company B's shares, comprising over 5% of Company B's outstanding shares. Options on company B shares are liquid and trade in a 2 way market in lot sizes generally ranging from \$1-3mm. It is therefore not possible to manage the risk by trading in larger amounts.

Company A prices its net open position using volatility quotes from the OTC market (generally on lot sizes in the range of \$1MM - \$3MM) and uses a basic Black-Scholes option pricing model to translate the quote into a dollar value. Other model inputs include the spot price for Company B shares and the risk free rate. Only the shares input is derived directly from active and quoted trades in price terms (L1), although the other parameters can either be directly observed or inferred through interpolation (i.e., L2). Due to the general availability and application of the pricing model and the observability of the inputs, it is highly likely that other market participants would place substantially the same value on the position (setting aside the volume aspect).

Because the notional amount of the shares that is needed to hedge the option exposure is significant, both compared to market capitalization of Company B and the average daily trading volume in its shares, Company A believes that it would not be able to exit its position at the implied model price given the cost to hedge such a large position; e.g., a delta hedge using traded shares could not be sourced in a timely fashion without moving the market price of the shares to the detriment of the option value.

Example 3.

Company A has a portfolio (long and short positions) of Yuan-denominated bonds issued by Company B, a US corporate. The market for Company B's USD denominated bonds is quite deep and quoted prices are available in sufficient frequency to justify a Level 1 classification. However, trading in the Yuan bonds is only sporadic, bid & offer spreads are dispersed, trading lot sizes vary, and the bid-offer is very wide. Further, dealers are not providing pricing runs regularly on these securities.

Company A uses the USD bonds (L1) as a proxy valuation input for the Yuan bonds, the USD/Yuan FX rate (which is a L1 input), and a Yuan bond basis that is calibrated from time to time. It also considers the pricing uncertainty induced by:

- The infrequency of quotes in the Yuan market, dispersion in bids and offers, and the wide bid-offer spread*
- The instability of the basis observed historically between the instrument and its USD proxy when quotes were available on both bonds*
- Sector volatility*

In this case, pricing uncertainty may be significant. Company A believes that market participants would generally scale the uncertainty factor based on the size of the position; i.e., tolerance for uncertainty would decrease as the position size increases.