

September 7, 2010

**BY EMAIL TO: [director@fasb.org](mailto:director@fasb.org)**

Mr. Russell G. Golden  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

**Re: Proposed Accounting Standards Update to, *Fair Value Measurements and Disclosure* (Topic 820, File Ref No. 1830-100)**

Dear Mr. Golden:

The Dealer Accounting Committee of the Securities Industry and Financial Markets Association<sup>1</sup> is pleased to offer you our comments on the above-captioned proposed Accounting Standards Update (the “Proposed ASU”). The Committee consists of large, internationally active dealers that operate across the full spectrum of the global capital markets. Committee members have extensive practical experience in the application of fair value measurements.

The Committee commends the Board’s efforts to converge the meaning of fair value within U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS) and their respective measurement and disclosure requirements. However, the Committee does not believe the proposed additional disclosure requirements improve financial reporting or provide any incremental meaningful information to users of financial statements. While the proposed measurement uncertainty analysis may be straightforward for reporting entities with relatively few unobservable inputs, it raises legitimate cost-benefit concerns when applied to large, complex financial institutions operating across the full spectrum of the global capital markets. Its usefulness as a means to measure or present estimation error is also lost when applied to multiple financial instruments or when aggregated with the results from other financial instruments. Level 3 fair value estimates are complex and are based on multiple interrelated assumptions. The proposed measurement uncertainty analysis could give financial

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<sup>1</sup> The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit [www.sifma.org](http://www.sifma.org).

statement users a false sense of precision in areas that are inherently subjective, as well as a false sense of the comparability of disclosures of different companies, whose application of the measurement uncertainty analysis will necessarily be idiosyncratic. By focusing users on what will be a highly subjective quantitative analysis, the Board's proposed disclosure may distract from what, in our view, is the most important disclosure – that is, a qualitative discussion of the scope, nature and integrity of the procedures entities use to assure that their estimates and assumptions are reasonable as well as a clear, concise, qualitative discussion of the inputs and valuation techniques used in the fair value measurements

Additionally, as a broader based comment, we wish to convey our disappointment with the “piecemeal approach” to disclosure requirements on specific Accounting Standards Codification (ASC) Topics and our strong support for a more holistic, principles-based approach that would focus on the reporting entity as a whole. We understand the Board's objective is to converge with IFRS on a standard-by-standard basis. However, we believe this is not appropriate for convergence of disclosure requirements. We believe convergence on disclosures should be deliberated in the context of providing a disclosure framework with consideration given to all the Board's outstanding projects. At the very least, we urge the Board to align the effective date for incremental disclosures relating to financial instruments until all of the major convergence projects have been exposed for comment to allow preparers to assess the operational feasibility of the proposed amendments in the aggregate.

Our specific comments on the Proposed ASU are as follows:

**Effect of Reasonably Possible Alternative Inputs (820-10-50-2(f)) (“Measurement Uncertainty Analysis”)<sup>2</sup>**

For financial institutions operating in a mark-to-market environment, the proposed Measurement Uncertainty Analysis presents issues of both interpretation and complexity due to the number of factors involved in estimating fair value and the interaction of those factors, including, but not limited to, the following:

*Diversity of inputs*

As global dealers, our members are counterparties to millions of derivative contracts of which approximately 5-10% are classified as Level 3. We each have thousands of cash positions classified as Level 3. These positions reflect a broad set of product categories with valuations dependent on many diverse inputs and methodologies. These inputs and methodologies, and therefore the valuations, are not necessarily correlated with each

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<sup>2</sup> Some of our comments within this section are derived from our earlier comment letter, dated October 12, 2009, addressing the Board's Proposed Accounting Standards Update to Topic 820, *Improving Disclosures about Fair Value Measurements* (File Ref No. 1710-100).

other, expressed in similar units of measure, or additive. Additionally, transactions reported in Level 3 of the fair value hierarchy are generally sensitive to both Level 2 and Level 3 inputs. Often, transactions are classified within Level 3 for the very reason that they have sensitivity to multiple inputs.

#### *Model structure*

For most financial instruments, subjective estimates and assumptions relating to the estimate of fair value fall into three principal categories: (i) model structure; (ii) market data that are not directly observable or derived from reliable third-party quotation sources due to market illiquidity (Level 3 inputs); and (iii) assumptions regarding the correlation of these inputs. It is unclear how to apply the proposed Measurement Uncertainty Analysis to assumptions in the form of model structure. This element of uncertainty is not, of course, susceptible to variances that could be reflected in a meaningful quantitative way. One could simply vary the numeric result of the operation of a model (i.e., the “estimate” resulting from the assumption). However, nothing in the model provides a basis on which to inform the range within which it would be appropriate to vary the result of the computation for the purpose of generating an alternative range of outcomes. Disclosure in this area would be further complicated by the fact that valuation models, the assumptions underlying those models and the composition of a company’s portfolio all often involve highly sensitive and proprietary information.

#### *Correlation*

As noted above, any fair value estimate includes assumptions regarding the correlation of individual inputs within the model. The Proposed ASU would require consideration of the expected effects of correlation among changes in significant inputs if estimating the effect of more than one reasonably possible alternative input. It is reasonable to consider correlation of inputs when changing one or several inputs within one fair value estimate. However, the Measurement Uncertainty Analysis will be aggregated and thus correlation within the asset class and between asset classes would also need to be considered, even though we see no practical way to incorporate correlation within and between asset classes.

The Board is attempting to require precision for an inherently imprecise estimate. The assessment of how one unobservable input varies when concurrent changes are made to another unobservable input is subjective and difficult to quantify in a rational manner. Incorporating the effect of correlation will introduce another layer of substantial judgment to characterize the risk of inputs that already rely on a significant degree of judgment in their original assessment. This will lead to unreliable or distorted results that will lack comparability across the industry. Lastly, the analysis is further complicated by

the fact that for many Level 3 instruments, correlation itself is an unobservable input that is significant to the fair value of the instrument.

We believe the only practical way to deal with correlation is to exclude it explicitly from the Measurement Uncertainty Analysis and disclose that interdependency of the inputs has not been considered. We do not believe the Board should require an entity to take into account the effect of correlation between unobservable inputs.

*Lack of alignment with risk management practices*

Our risk management generally is based on net risk exposure to a particular sensitivity. For example, our members actively hedge single name credit derivatives with indices. Risk management and risk limits tend to be based on sensitivity to changes in the same inputs across different types of derivative contracts and cash instruments which span various levels within the fair value hierarchy. Building the infrastructure needed to comply with the proposed Measurement Uncertainty Analysis disclosure would be done solely for this disclosure rather than to support risk management or to satisfy other management reporting objectives.

The potential for data that can easily be misinterpreted by financial statement users or that overstates the true risks involved would be significant in our view. For these reasons, we question the usefulness of this disclosure for large, complex financial institutions with numerous financial instruments across the full spectrum of capital markets, especially given the cost to comply with the proposed disclosure and the lack of comparability of the disclosure among similar financial institutions.

We question the utility of the information if it is aggregated across the reporting entity, which users will invariably do. While a measurement uncertainty analysis does provide some benefit at a position level, it quickly loses its relevance when aggregated, because aggregation assumes all positions have the same degree of potential estimation error at the same time. In short, aggregation assumes valuation uncertainty is perfectly correlated across all positions and ignores the benefits of portfolio diversification. The aggregate impact is not the sum of the underlying variances. By their nature, these judgments do not translate well to aggregated disclosure, given their subjective nature and uniqueness.

As noted above, our members do not currently perform a measurement uncertainty analysis or otherwise attempt to measure estimation error in this way, so any system build-out to disclose the proposed Measurement Uncertainty Analysis will be done purely to comply with the disclosure requirement. Instead, management mitigates estimation error through the strength of the company's internal controls around the valuation process. In order for a financial statement user to understand potential estimation error, they should understand the scope, nature and integrity of the procedures a company uses to assure that its estimates and assumptions are reasonable. This

cannot be conveyed via the proposed Measurement Uncertainty Analysis, but rather through a clear, concise qualitative discussion of the company's valuation processes and controls, including the subsequent validation of its estimates through actual sales activity.

Moreover, the proposed Measurement Uncertainty Analysis has limited value in predicting changes in market liquidity, a perceived underlying concern of financial statement users. We note that most AAA-rated structured credit tranches, as well as auction rate securities, were classified in Level 2 of the fair value hierarchy prior to the onset of the credit crisis. Further, we understand that the Board believes that users would benefit from information about a range of fair value for Level 3 measurements because of the greater degree of uncertainty and subjectivity of Level 3 measurements. We note that the subjectivity of Level 3 measurements is the chief reason why disclosure of fair value measurements by their classification within the fair value hierarchy is required by ASC 820. The fact that a measurement is classified as Level 3 is indicative of the measurement's level of subjectivity. A Level 3 classification, along with qualitative disclosure of the inputs and valuation techniques, seems sufficient to convey the level of subjectivity of the fair value measurement.

In summary, while a Measurement Uncertainty Analysis may be relevant for reporting entities with relatively few unobservable inputs, it is both potentially misleading and raises legitimate cost-benefit concerns when applied to large, complex financial institutions operating across the full spectrum of the global capital markets. Level 3 fair value estimates are complex and are based on multiple interrelated assumptions. In most cases, the potential impacts of using reasonably possible alternative inputs in Level 3 measurements cannot simply be summed. We believe that an investor would be better informed by a clear, concise qualitative discussion of the inputs, valuation techniques, and uncertainty of the measurements than by a lengthy, complex Measurement Uncertainty Analysis. For these reasons, we recommend that the Board remove the proposal to disclose a Measurement Uncertainty Analysis for Level 3 fair value measurements.

### **Blockage Factors**

We recommend that the Board clarify the proposed guidance on the use of blockage factors in paragraph 820-10-35-36C. We understand that the Board intended to clarify that an entity-specific assumption should not be used when measuring the fair value of an asset or liability and that inputs to any fair value measurement must be those that market participants would use, regardless of where within the fair value hierarchy the measurement is classified. The proposed change, as currently drafted, could be misinterpreted to disallow common portfolio valuation adjustments that market participants would use in measuring the fair value of derivative financial assets and financial liabilities that are managed on a portfolio basis, even though the intent of that language is to measure derivatives on a portfolio basis. We recommend either clarifying the guidance in 820-10-35-36C or removing the last sentence in that paragraph.

## **Measuring the Fair Value of Financial Assets and Financial Liabilities When a Reporting Entity Has Offsetting Risks**

We are concerned that the condition limiting the measurement of net open counterparty credit risk only to those financial assets and financial liabilities that are subject to a legally enforceable right of set off, as proposed by 820-10-35-18L, will overstate credit adjustments. Mitigants, other than legal rights of offset, are frequently used to risk manage, value and settle counterparty exposures. For example, collateral, security, legal-isolation arrangements, and other arrangements frequently accomplish the same objective as a legally enforceable right to set off. Additionally, while the requirement that a reporting entity's right of set off be enforceable at law is an appropriately high hurdle for purposes of net presentation on the balance sheet, market participants may consider a lesser standard when measuring fair value if there is a reasonable basis to do so (e.g., law in the given jurisdiction is supportive but untested). Grossing up of the resulting credit risk for purposes of determining fair value conflicts with most existing market practices. We would therefore encourage the Board 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 counterparty credit risk management practices".

## **Alignment of the Disclosure Requirements and Effective Date with Other Correlated Projects**

Given the proposed changing landscape to accounting and reporting under US GAAP, we ask the Board to consider aligning incremental disclosure requirements and the effective dates of these various projects that are inter-connected such as those that relate to financial instruments. Each proposed additional disclosure requires a preparer to develop, implement and test processes, including systems changes, particularly when the data are not gathered or evaluated for internal purposes in a manner consistent with the disclosure.

By way of example, this Proposed ASU includes a requirement to disclose a Measurement Uncertainty Analysis for recurring fair value measurements categorized within Level 3 of the fair value hierarchy. The proposed ASU, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities (AFI)*, makes reference to this disclosure in paragraph 109; however, the proposal on the guidance for this disclosure requirement was issued on a different date and has a different comment/deliberation period. If the Board chooses to move forward with the Measurement Uncertainty Analysis disclosure, we suggest that both proposals be evaluated together and have the same effective date so that the adoption of the Measurement Uncertainty Analysis disclosure can be assessed in the context of the requirements of the proposed ASU on AFI. For example, when evaluating the disclosure, consideration should be given to the fact that many financial institutions will have a significant increase in the population of Level 3 assets if the proposed ASU on AFI is issued in its current form and many of these financial instruments will be accounted for as fair value through OCI

rather than net income. Although we strongly disagree with the proposed Measurement Uncertainty Analysis, if the Board ultimately concludes that such a disclosure is appropriate and if the final ASU on AFI requires additional new positions be recognized at fair value, care should be taken to ensure that preparers have ample time to adopt the provisions of both ASUs and that preparers have the ability to adopt both ASUs together.

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If you have any questions about the comments above, please feel free to contact the undersigned (212-357-8437; [matthew.schroeder@gs.com](mailto:matthew.schroeder@gs.com)) or Kyle Brandon (212-313-1280; [kbrandon@sifma.org](mailto:kbrandon@sifma.org)), the staff advisor to the Committee.

Sincerely,

A handwritten signature in black ink that reads "Matthew L. Schroeder". The signature is written in a cursive style with a large initial "M".

Matthew L. Schroeder  
Chair  
SIFMA Dealer Accounting Committee