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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
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Re: Exposure Draft of Proposed Amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement

Ladies and Gentlemen:

Thank you for the opportunity to comment on the Proposed Amendments to IAS 32, *Financial Instruments: Disclosure and Presentation* and IAS 39, *Financial Instruments: Recognition and Measurement* (collectively, the Proposed Amendments).

As a leading underwriter and distributor of securities for our corporate clients, as well as an issuer of and investor in securities, Merrill Lynch is keenly aware that transparent and reliable disclosure of material information is essential to market liquidity and investor confidence in public markets. Accordingly, we fully support the IASB's efforts to improve the transparency and quality of financial reporting.

Merrill Lynch has previously expressed our views on the Proposed Amendments to IAS through our participation in industry groups including ISDA, LIBA, the European Securitisation Forum and the Bond Market Association. In addition, Merrill Lynch has commented on the guidance proposed by the Joint Working Group of Standard Setters, *Recommendations on Accounting for Financial Instruments and Similar Items*, portions of which appear to have been incorporated in the proposed amendments. Given our level of involvement in these efforts, we would very much appreciate the opportunity to participate in the public roundtable discussions of the Proposed Amendments in early March. Accordingly, we highlight for your attention our thoughts regarding fair value measurement of financial instruments, bifurcation of financial instruments, the proposed derecognition model, disclosure enhancements, and macro-hedging. However, in order to avoid unnecessary duplication with other comment letters which provide detailed information on a variety of technical and implementation issues regarding the Proposed Amendments, we are focusing our comments in this letter on the key conceptual issues, which we believe merit further discussion and debate.

Measurement of Fair Value

Merrill Lynch strongly believes that fair value is the most appropriate measure for financial instruments. We believe it is the most relevant measure to financial statement users for assessing the liquidity or solvency of an entity, as it depicts the market's assessment of the present value of net future cash flows of the contracts and the market's assessment of the risk that the cash flows will not occur. It also provides the most accurate understanding of the way institutions manage their business.

However, we have specific concerns regarding the valuation guidance prescribed in paragraphs 95 to 100D. While much of the proposed guidance is set out in terms of a "pricing hierarchy" and speaks in terms of quoted market prices for individual transactions, it is important to note that this approach is more relevant for "cash" instruments (e.g., equity securities). In contrast, derivative contracts are typically 1) valued based on models and 2) valued on a portfolio basis. We discuss each of these points below.

Valuation Models and Reliability

As noted above, the concept of a price quote is more relevant for instruments that are regularly traded in the market place. Derivative contracts, on the other hand, are unique contracts that are held to maturity and consist of a series of cash flows that are valued by taking into account the present value of those flows. Indeed, valuation methodologies based on multiple market inputs are in practice deemed to be more reliable than subjectively adjusting a quote obtained for a similar instrument. The valuation models are based on interest rates and other market inputs that are readily observable in the market, such as the credit worthiness of the counterparty, liquidity of the transaction, etc.

We believe that for the purposes of applying IAS 39 to very liquid derivatives, a valuation approach that prices derivatives using observable inputs is simply the means by which the quoted price referenced in paragraph 99 is determined. Requiring financial institutions to obtain quotes for these instruments would be impractical and operationally burdensome given the size of their portfolios. Prices derived using such models are typically verified by regularly testing the market inputs used in the models or by comparing the models' prices to quotes for similar instruments that give an indicative value for the instruments. However, the model is the primary pricing tool, and the comparison to quoted prices for similar instruments is merely a secondary model testing technique.

While the majority of derivatives are priced based on observable inputs, there are instances where a derivative instrument in its entirety cannot be priced based on quoted or observable inputs. Some inputs must be extrapolated or inferred, and these extrapolation techniques may require the application of judgment. While it is important to be sensitive to concerns regarding subjectivity and reliability, limiting the fair value approach for certain trading contracts, simply because the valuation technique requires judgment, is fraught with potential pitfalls. Fair value for all financial instruments provides for consistent treatment among a company's contract positions. If fair value measurements are not used, losses on contracts may be obscured, as companies could have contract positions with unrealized losses that are carried at cost. Additionally, asymmetry in a company's accounting and the resultant financial reporting is introduced if certain contracts are maintained at historical cost, but offsetting positions are treated on a fair value basis, solely due to the nature of the contract. Accordingly, we fully support fair value as the basis of accounting for *all* financial instruments.

Further, limiting the fair value approach due to concerns regarding the reliability of information is not consistent with other areas of accounting where estimates are required. For instance, judgment is required in estimating pension and post-retirement liabilities which require the use of actuarial methods; providing for loan loss impairments; estimating loss contingencies; and even for seemingly straightforward matters such as determining the useful lives of depreciable assets and evaluating long-lived assets for impairment. Many of these concerns are addressed via controls regarding the application of these estimates and via appropriate disclosure of policies and procedures regarding the estimation process. We suggest a similar approach be pursued in this area to mitigate concerns regarding fair value measurement.

In particular, proper controls and best practices are critical to ensuring that fair value measurements are reliable. Such practices include: consistent application of models and principles across products and over time; independent review of models, inputs, and valuation outputs; and independent pricing review procedures that require frequent back testing (*i.e.,* comparing internal pricing with actual market data for similar transactions).

The following is our suggested approach to determining valuation. However, underlying this approach is the principle that the best information available should be used to arrive at the entity's estimate of fair value. Thus, the following should not be interpreted as a strict hierarchy if there is evidence to suggest that one approach is superior to another in determining fair value:

- Prices or inputs observed in liquid, active markets should always be the primary source for valuation, *e.g.,* electronic quotations or published prices.

- When prices or inputs cannot be discovered from the above approach, prices or inputs observed in less liquid markets should be used, *e.g.*, broker quotes or market transactions.
- When prices or inputs cannot be discovered from the above approaches, prices or inputs from similar instruments should be used, with adjustments for identifiable differences between the reference valuation and the similar instrument, *e.g.,* observed spreads.
- When prices or inputs cannot be discovered from the above approaches (for example, because the portfolio includes long-dated contracts), prices or inputs may be constructed if supported by historical observations or statistical analysis that are rational and reasonably expected to persist (*e.g.,* correlation factors).
- When prices or inputs cannot be discovered or constructed from the above approaches, the price or input implied from the most recent transaction is likely to be the best indicator of fair value, taking into account the size of the transaction, and absent observable market movements that could reasonably be expected to impact the price or input.

Portfolio Approach to Valuation
Our second major concern with the guidance on fair value measurement in the Proposed Amendment to IAS 39 is that, while it speaks about fair value in terms of individual transactions, in the derivatives market, valuation is most appropriately performed on a **portfolio basis**. A portfolio basis represents the exit price for a dealer, as it is the approach a "willing buyer" (*i.e.,* another dealer) would consider in setting a price. Under the portfolio approach to pricing, each new trade in the portfolio provides pricing information that should be used to arrive at the value of the entire portfolio. In other words, a portfolio approach considers the incremental effect of each new transaction on the existing positions.

The portfolio approach to valuation fits hand in glove with model valuation, as it ensures that model inputs are applied consistently throughout the portfolio so that valuation can be performed on a consistent basis. Further, a portfolio approach emphasizes economic substance over form. For example, a portfolio consisting of a three-year swap contract and a forward-starting two-year swap contract beginning in three years can replicate a five-year swap contract. (The number of practical permutations is obviously quite large.) Trading positions are also risk managed at fair value on a portfolio basis without regard to form, and are therefore valued in the same manner. The portfolio approach to pricing is also supported both in the US and internationally as the best practice by a large body of literature, including studies by the Group of Thirty Report, Counter Party Risk Management Policy Group, Derivatives Policy Group, and the US Office of the Comptroller of the Currency. We therefore believe it should be the accepted basis for fair value measurement.

The issue of portfolio valuation also arises in the context of cash instruments, most notably when an institution holds a large block of equity or debt securities. In a trading environment, financial institutions often hold large blocks of securities in order to facilitate customer transactions or as a result of an incomplete underwriting transaction. Paragraph 99 of the Proposed Amendment to IAS 39 states that the fair value of a portfolio is the sum of its units and their quoted market price. However, the fact that large blocks of securities trade at a discount is an observable market phenomenon that has been studied and documented. We believe that this phenomenon should not be ignored when determining the proper value at which to reflect securities.

We believe that measuring fair value based on the block rather than the unit for these positions is consistent with paragraph A15 of the Basis for Conclusion, which states (in the context of valuation techniques) that it is expected that a realistic estimate of fair value will reasonably reflect how the market could be expected to price the instrument; and with paragraph A17, in regard to inputs on valuation techniques, which states that a technique would incorporate available market information about the market conditions and other factors that are likely to affect the instrument's fair value. These two statements seem to imply that "liquidity discounts" can be used in valuation techniques to arrive at fair value. We believe that "block discounts" are essentially the same as liquidity discounts, and that not applying this discount to large blocks of trading positions will overstate fair value and reported results.

Our final concern on the fair value measurement guidance relates to paragraph 100A of the Proposed Amendment which states that, "when an instrument being valued is purchased or sold in an arm's length transaction, the valuation technique would be expected to result in an amount that equals the fair value of the consideration given or received". Applying this guidance to derivatives where no initial consideration is received would result in recognizing a valuation of zero at inception. However, if portfolio valuation principles and practices are properly applied, portfolio gains and losses will be computed from changes in the fair value of the portfolio.

Such gains or losses may result for a number of reasons, including the simple fact that dealers incorporate a profit margin into their pricing structure. A dealer, by virtue of the fact that it is in the business of buying and selling financial contracts, is able to command different entry (bid) and exit (offer) prices in the market. Dealer profit is inherent in both liquid markets and less liquid markets, and in fact, may be greater in less liquid markets, where customers demand tailored solutions to their risk management needs and are willing to pay dealers a premium for that service. In addition, a profit or loss may be recognized as new information arising from the most recent transaction is used to update the valuation of the existing portfolio. A new transaction may have an effect on the rest of a dealer's portfolio, providing a natural offset to existing positions, and thereby reducing the need for liquidity or other adjustments. We do not believe that it would be appropriate to ignore any of these recognition events, as they are the result of a consistently applied valuation methodology.

We strongly urge you to reconsider the guidance on fair value provided in the Proposed Amendments, to explicitly acknowledge the appropriateness of portfolio valuation as a valuation technique, and to emphasize that, if there is evidence to suggest that one approach is superior to another in determining fair value, that evidence should be used.

Bifurcation of Financial Instruments

Both IAS 32 and IAS 39 establish models that require financial instruments to be bifurcated into component parts. Through the adoption of SFAS 133, US corporations have witnessed firsthand the ramifications of discarding simplicity for theoretical purity that is inherent in the bifurcation process. Under the bifurcation requirements of SFAS 133, enterprises are required to report and measure artificial instruments that do not exist in the market. This can be exceptionally challenging for complex financial instruments with many interdependent component parts, which can be bifurcated in a variety of ways.

We believe that the Board's decision to allow an entity to designate any financial instrument as held for trading, that is, to permit fair value accounting for the entire financial instrument, will go a long way towards simplifying the application of the standard and avoiding the many complex issues that bifurcation of financial instruments poses. It should also alleviate some of the issues associated with the asymmetrical accounting that results from the current mixed attribute system, and advance progress towards the eventual goal of fair value accounting for all financial instruments.

We would also encourage the Board to consider pursuing a similar practical solution for accounting for convertible debt and other financial instruments, which contain both liability and equity features. For example, the Board might consider an approach that requires the reporting entity to assess an instrument's predominant economic and legal features and account for the instrument as either a liability or equity instrument in its entirety, with appropriate disclosures of critical features of the instrument. Though we understand this solution may not be ideal, we believe that by keeping the reporting simple, readers of financial statements will better understand the basic accounting for the instrument and will have transparent information from the footnotes to determine the potential effects of market movements on the ultimate extinguishment of the liability. In contrast, bifurcation may cloud a reader's analysis of an instrument by requiring entities to measure and report interdependent components as separate, artificial instruments that cannot be traded separately in the marketplace.

Fair Value Disclosures

The use of estimates and assumptions and the application of judgment is an inherent part of the accounting model, and accordingly, such estimates and assumptions form the basis of the financial statements. We therefore believe that a thorough qualitative discussion of the significant areas in which estimates are used to measure the amounts reported in the financial statements is essential to providing useful and meaningful financial statements and that enable users to make informed investment decisions.

The proposed disclosure requirements have been significantly expanded to include additional qualitative information and quantitative information regarding the impact of changing estimates using a range of reasonably possible alternative assumptions (i.e., scenario analysis). The Board has stated that this change is necessary to provide users of financial statements with a sense of the potential variability of fair value estimates.

As noted above, we support the additional qualitative requirements as they will provide readers with a basis to assess the risks inherent within the financial statements. However, we do not believe that the requirement to provide quantitative scenario analysis would be helpful or useful to readers. It would be very difficult to capture the interaction of important estimates and observable information in a way that would provide meaningful information. We are concerned that the proposed expanded disclosures will result in the disclosure of accounting scenarios that may, in fact, cause considerable confusion rather than increased transparency. In addition, we note that large portfolios of financial instruments do not remain static; thus, the predictive quality of any scenario analysis is inherently limited given the dynamic nature and large degree of turnover in such portfolios.

While we do not support the quantitative disclosure approach proposed in the amendment, we do support a full discussion of the risks inherent in the portfolio and recommend that the Board consider requiring disclosure of the tools and measures that management uses to assess the enterprise's risk of loss. In the US, Value at Risk (VaR) has become an established analytical tool and is reported in the Management's Discussion and Analysis section of the Annual Report as an indicator of the risk profile of the financial institution. The Joint Forum Working Group on Enhanced Disclosures, an international, multidisciplinary group of regulators, is currently working to develop an enhanced framework to quantify and report risk measures for financial institutions, by building on the current VaR disclosure framework. We recommend that the Board work with this group to determine the appropriate requirements to provide a consistent and comprehensive framework that will prove most useful to investors.

Derecognition

As noted above, we have participated in a number of industry associations in commenting on the Proposed Amendments. Many of those letters voice serious concerns regarding the proposed balance sheet derecognition framework. Rather than reiterating those concerns, we would merely like to emphasize the fact that we believe that the continuing involvement approach to derecognition represents a radical departure from US practice and will raise a host of serious implementation issues. We strongly encourage the IASB to consider adopting existing approaches that are based on control, with modifications where deemed necessary. If the Board intends to pursue the approach proposed, we strongly suggest that it be subject to field testing prior to approval, to ensure that it can be applied to most standard derecognition transactions and is operationally practicable. We would be happy to assist in this effort.

Hedge Accounting - Third Party Offset Requirement

We would also like to take this opportunity to reiterate our position regarding the offset requirement imposed by IAS 39 as it applies to dealers in derivatives. IAS 39 paragraph 134, as clarified in implementation guidance Question 134-1, states that internal derivative contracts between separate entities within the consolidated group can qualify for hedge accounting only if the internal contracts are offset with an external party to the consolidated group. We continue to strongly disagree with this requirement because it does not take into account the fundamental nature of our industry and state-of-the-art portfolio risk management techniques.

Upon adoption of SFAS 133, US corporations were required to enter into third party matched offset derivatives for inter-company derivatives. This requirement resulted in a major change to our risk management strategies. Prior to SFAS 133 implementation, Merrill Lynch's risk management strategies were executed using a derivative dealer subsidiary responsible for managing risks on an entity-wide basis. A centralized risk management function was responsible for evaluating the aggregate risk position of the company and entering into the appropriate transactions to manage interest rate, credit, and foreign exchange risks to the desired level. The centralized function, by virtue of its sophistication and market access, can enter into transactions that transfer risk to third parties in a manner that is significantly more cost effective and operationally efficient than if each affiliate were to lay off its risk directly with third parties. Furthermore, managing risk in the aggregate reduces counterparty credit risk.

The requirement to offset certain inter-company derivatives with third party transactions required us to disaggregate risks arising from inter-company derivatives from risks arising from derivatives with unrelated third parties, and manage such risks separately. Thus, the effect has been to reduce the efficiency of current risk management practice and increase operational and credit risks due to the increase in the number of required transactions.

Furthermore, we do not believe that our investors or readers of our financial statements have derived any benefit from this requirement.

We believe that carrying forward this requirement in IAS 39 perpetuates many of the weaknesses with SFAS 133. We believe the requirement is unwarranted for dealers in derivatives, in that derivative dealers account for their activities on a mark-to-market basis, such that any retained risk not laid off to a third party is recognized in earnings. In addition, we note that the Board made an exception to the requirement for a third party offset derivative for foreign currency risk where a central treasury function is employed (Implementation Question 134-1-b). We believe there are parallels between the way a central treasury function and a derivative dealer manage risk, and there is no conceptual distinction between the nature of currency risk and interest rate risk which would warrant a different accounting approach for these transactions.

Although this issue was not addressed in the Proposed Amendments, we strongly recommend the Board take this opportunity to reconsider this issue and amend IAS 39 to exempt an entity from the offset requirement, provided that (1) an entity is able to quantitatively demonstrate that risk has been laid off via risk measurement tools and (2) any retained risks are recognized in earnings.

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Again, we thank you for allowing us to provide feedback on the Proposed Amendments, 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 me at 212.449.2048 in New York, or Cynthia Rumpza at 020.7995.0128 in London.

Sincerely,

/s/ Esther Mills
First Vice President