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Mr. Russell Golden
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference Number 1830-100, Proposed Accounting Standards Update: *Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*

Dear Mr. Golden:

The International Swaps and Derivatives Association's (ISDA) Accounting Policy Committee¹ appreciates the opportunity to provide comments and observations on the Financial Accounting Standards Board's ("FASB") Exposure Draft of Proposed Accounting Standards Update: *Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* (the "Exposure Draft"). Within the remainder of this letter we have summarized our key messages in response to the FASB's Exposure Draft and in the Appendix attached we have provided more detailed observations and responses to the questions included in the Exposure Draft.

Key Messages:

- ISDA applauds the FASB for acknowledging that market participants that hold groups of financial instruments manage the risks inherent in those instruments by considering the offsetting market and credit risks within the portfolio as a whole. The proposed guidance resolves the questions that were raised by practitioners since the issuance of FASB Statement No. 157, *Fair Value Measurements*, regarding the unit of valuation for a portfolio of financial instruments and will lead to alignment of the valuation principles for financial instruments under U.S. GAAP with IFRS.

¹ ISDA's Accounting Policy Committee members represent leading participants in the privately negotiated derivatives industry and include most of the world's major financial institutions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Collectively, the membership of ISDA has substantial professional expertise and practical experience addressing accounting policy issues with respect to financial instruments and specifically derivative financial instruments.

- We have concerns that the proposed guidance regarding blockage factors is very unclear and could lead to significant unintended consequences. We understand that the FASB's intention in proposing this new guidance was to clarify that entity-specific assumptions should not be used when measuring the fair value of an asset or liability and that inputs to any fair value measurement must reflect those that a market participant would consider. However, the current drafting of the proposed guidance could be interpreted to prohibit various valuation adjustments made today under the market participant view for financial assets and liabilities for which quoted prices are used as *inputs* when determining their fair value. This would include financial instruments such as derivatives that trade in over-the-counter markets.

As such, our key concern with the proposed guidance regarding blockage factors is that auditors and regulators may misinterpret common portfolio adjustments as potential blockage factors adjustments and thus reject them altogether which could lead to unintended consequences such as 1) overturning the proposed portfolio valuation guidance in paragraphs 820-10-35-18I through 18L of the Exposure Draft (which ISDA finds useful) and 2) reporting fair value measurements of financial instruments at amounts that do not reflect market participant assumptions (or result in an exit price as defined).

- ISDA has significant concerns regarding the usefulness and operability of the proposed measurement uncertainty disclosure. While ISDA supports the FASB's efforts to enhance the existing fair value measurement disclosures for instruments whose measurements rely heavily on unobservable inputs, we do not agree that the proposed measurement uncertainty disclosure requirements will provide financial statement users meaningful information for many financial instruments. The reliability of a Level 3 instrument's fair value is based on the strength of a company's valuation methodologies, procedures, and review of fair value estimates versus exit prices when positions are exited. In ISDA's view, the FASB should base the disclosure requirements on how a company manages and controls the risk of estimation error. If the FASB wants to enhance users understanding of the estimates involved in valuing Level 3 instruments, we believe this is more accurately represented through qualitative disclosures that discuss the inputs, valuation methodologies, and management's process surrounding valuation and subsequent validation of the fair value estimate through actual exit prices rather than quantitative disclosure of theoretical fair value measurements.
- We are also concerned with the proposed requirement to quantitatively disclose the effect of correlation risk inherent in Level 3 fair value measurements. Given the inherent judgment involved with reporting Level 3 fair value measurements, the proposed requirement to quantitatively disclose the effect of correlation risk among the interdependent unobservable inputs will introduce even more subjectivity and management estimates into the financial statements which will erode confidence in the comparability of financial statements and will introduce significantly more cost and effort into the financial reporting process. ISDA therefore believes that if the FASB moves forward with the disclosure of measurement uncertainty, the interdependency risk is best addressed through a qualitative disclosure that describes the various factors that drive correlation and their potential impact on a fair value measurement.
- Lastly, ISDA strongly recommends that the FASB exclude fair value measurements associated with investments in unquoted equity instruments and all investments for which net asset value is used as a practical expedient to measure fair value that are categorized in Level 3 of the fair value hierarchy from the scope of the measurement uncertainty disclosures. Requiring these instruments to be included in the measurement uncertainty disclosure each quarter will not be operational based on the nature of the valuation techniques and inputs used to measure fair value.

We hope you find ISDA's comments and responses to the FASB's questions for respondents included in the appendix attached hereto informative and useful. Should you have any questions or desire further clarification on any of the matters discussed in this letter please do not hesitate to contact the undersigned.

A handwritten signature in black ink that reads "Daniel Palomaki". The signature is written in a cursive style with a slight slant.

Daniel Palomaki
Citigroup
Chair, N.A. Accounting Policy Committee
International Swaps and Derivatives Association
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Appendix

ISDA's Detailed Comments on the Exposure Draft's Provisions

1. Blockage Factors and Other Adjustments

ISDA is unclear of what is meant by the last sentence in paragraph 820-10-35-36C of the Exposure Draft "A blockage factor is not relevant and, therefore, shall not be used 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)" and understands through the FASB's deliberations on this matter that the intention of the proposed guidance is to clarify that entity-specific assumptions should not be used when measuring fair value. However, the aforementioned sentence could be interpreted in a number of different ways given that the phrase "blockage factor" is not clearly defined and the fact that it could be deemed to be applicable to either securities or derivatives, or both concerns us.

Entities that hold a large number of financial instruments with the same or similar risk characteristics typically manage the risks associated with their individual positions on a portfolio basis. In most cases, the size of an entity's position comprising financial instruments, especially those that trade in over-the-counter markets (e.g., derivatives), impacts the size of the bid-offer spread for the individual instruments and thus the price at which it would be able to exit its overall position (represented by the portfolio). A market participant generally would consider not only the size of a position when determining the fair value of a portfolio of financial instruments but would also consider other factors such as liquidity, correlation and concentration risk. Such adjustments are appropriately used in determining fair value in accordance with the market participant view. The proposed guidance could be interpreted to disallow such factors from being considered in determining fair value, which we believe is inappropriate and also contradictory to what the Board intended. This could lead to unintended consequences such as 1) overturning the proposed portfolio valuation guidance in paragraphs 820-10-35-18I through 18L of the Exposure Draft (which ISDA finds useful) and 2) reporting fair value measurements of financial instruments at amounts that do not reflect market participant assumptions.

Accordingly, we strongly recommend that the FASB remove the last sentence in paragraph 820-10-35-36C of the Exposure Draft and focus on the principle that the determination of fair value should include only factors that market participants would use (i.e., that entity specific inputs are prohibited). The proposed guidance could also consider incorporating examples of adjustments to inputs market participants might consider when determining fair value, including model adjustments, liquidity adjustments, credit risk adjustments, and other risk adjustments (although appropriate caution should be reflected within such examples so that they are not interpreted as a definitive list of permissible adjustments). We also recommend that the FASB clarify in this section of guidance that adjustments to inputs used to measure the fair value of financial instruments managed on a portfolio basis must reflect market participant assumptions, which may include offsetting market and credit risk within a portfolio, with a corresponding cross reference to paragraph 820-10-36-18I of the Exposure Draft. This would clarify that adjustments to inputs used to determine the fair value of a portfolio of financial instruments can reflect how an entity would exit its entire position.

2. Measurement Uncertainty Disclosure

Usefulness

While ISDA supports the FASB's efforts to enhance the existing fair value measurement disclosures for instruments whose measurements rely heavily on unobservable inputs, we do not agree that the proposed measurement uncertainty disclosure requirements will provide financial statement users meaningful information for many financial instruments. We agree with the FASB's focus in Topic 820 on market participant assumptions as a determinant in what is the relevant fair value information to report. We believe that the determination of relevant disclosures related to estimation error, quality of earnings, or the risks in the valuation of illiquid instruments should be similarly based on information currently used by market participants (i.e., the best practices regarding the management of the aforementioned attendant risks). Management uses various controls to manage the risk of estimation error, which may include valuation teams independent of the risk taking function, backtesting of valuations to exit prices, value-at-risk ("VAR") analysis, stress testing, and identification of risk exposures not captured by VAR or stress tests. However, the sensitivity analysis proposed by the Exposure Draft introduces requirements which are unrelated to the approach management uses to assess the risk of estimation error in the reported fair value measurements. Given that the information required by the proposed disclosure is not the basis for assessing the risk of estimation error, we question how this disclosure could be insightful in the investment decision making process. For example, the sensitivity disclosure for the same class of financial instrument as well as the underlying valuation assumptions will not be comparable across preparers, since portfolio composition/geography/collateral differ and the distinctions among peers could not be articulated in concisely in any meaningful way. ISDA therefore believes that the FASB has not sufficiently demonstrated how the proposed disclosures would be utilized by investors in their analysis and therefore how such quantitative information could be presented in a fashion that would be meaningful and practically useful to them and other users.

Operationality

As proposed, for those instruments for which ranges of fair value measurements are not currently used, the sensitivity analysis will require companies to rerun transaction systems to recalculate each fair value measurement using multiple alternate inputs, assuming such inputs exist. Rerunning valuation systems that are designed to be generated once for books and records purposes is a significant operational cost that must be justified. Further, we are unclear as to how to implement the requirement for certain illiquid asset classes such as private equity investments and investments in units of hedge funds for which no range of inputs may exist and where valuations are based on a single price best estimate. While certain large financial institutions with in-house valuation departments may have ready access to the inputs underlying the fair values, many institutions rely on third-party pricing services for fair values; therefore, compliance with the proposed disclosure will create significant operational challenges and cost for many entities.

The reliability of a Level 3 instrument's fair value is based on the strength of a company's valuation methodologies, procedures, and review of fair value estimates versus exit prices when positions are exited. In ISDA's view, the FASB should base the disclosure requirements on how a company manages and controls the relevant risks. If the FASB wants to enhance users understanding of the estimates involved in valuing Level 3 instruments, we believe this is more accurately represented through qualitative disclosures that discuss the inputs, valuation methodologies, and management's process surrounding valuation and subsequent validation of the fair value estimate through actual exit prices rather than quantitative disclosure of theoretical fair value measurements.

Correlation Risk

ISDA has further concerns about the requirement to consider the effect correlation has on Level 3 fair value measurements within the measurement uncertainty disclosure. We do not believe that correlation can be adequately captured in a sensitivity analysis; in our view, the only way to handle correlation in a reliable and comparable manner would be to remove it from the calculation and clearly disclose that it is not captured in the analysis. The inclusion of significant subjective assumptions about an entity's financial instruments—which may differ by entity depending on access to data, views about correlation risk, and the level of sophistication—will erode confidence in the comparability of fair value measurements reported by different entities. However, the issue is further complicated by the fact that without consideration of the interdependency of inputs, we believe the information rendered in such analysis would be of limited value.

ISDA therefore believes that interdependency risk is best addressed through qualitative disclosures that describe the various factors that drive correlation and their potential impact on a fair value measurement. Accordingly, if the FASB decides to require quantitative disclosure of the uncertainty inherent in Level 3 fair value measurements, ISDA recommends that the FASB remove the requirement to quantitatively disclose the effect of correlation risk amongst the interdependent inputs to the aforesaid fair value measurements and instead require entities to qualitatively disclose how changes in the various interdependent unobservable inputs affect the fair value measurement. Qualitative disclosure of correlation risk would reduce the concerns about including additional significant, subjective estimates in the financial statement footnotes and would provide users the information needed to understand the potential risk of estimation error inherent in Level 3 fair value measurements.

3. Application of Measurement Uncertainty Disclosures to Unquoted Equity Instruments

The exposure draft in which the measurement uncertainty disclosures were originally proposed (issued by FASB in August 2009) did not require fair value measurements based on net asset value consistent with ASU 2009-12, *Investments in Certain Entities that Calculate Net Asset Value per Share* (many of which would be categorized in Level 3 of the fair value hierarchy) to be included in the measurement uncertainty disclosure. Additionally, the *Financial Instruments* exposure draft has proposed that entities need not include investments in unquoted equity instruments in the aforesaid disclosure.

We strongly disagree with the FASB's decision to require investments in unquoted equity instruments to be included in the measurement uncertainty disclosures under the Exposure Draft but not require such disclosures in the *Financial Instruments* exposure draft. Therefore, ISDA recommends that this inconsistency be eliminated through an amendment to the Exposure Draft that excludes all investments in unquoted equity investments from the scope of its measurement uncertainty disclosure. We also strongly recommend that the Exposure Draft and the *Financial Instruments* exposure draft explicitly state that investments for which net asset value (NAV) is used as a practical expedient to estimate fair value are not required to be included in the measurement uncertainty disclosure as a large population of these instruments do not have readily available fair values. Without an exception for investments for which fair value is measured based on NAV, the proposed disclosure will be largely inoperational as preparers will not have sufficient information to make informed and reasonable judgments about what inputs should be assessed in the sensitivity analysis. Additionally, the requirement to include these instruments in the proposed measurement uncertainty disclosure effectively nullifies the practical expedient provided in Topic 820 to use NAV when measuring fair value as the level of effort that would be required to identify and analyze the various inputs that are used to derive the fair value of such instruments would be significant.

If FASB issues the final standard as currently drafted, we are unclear as to how to implement the measurement uncertainty disclosure for certain illiquid asset classes such as private equity investments and investments in units of hedge funds for which no range of inputs may exist and where valuations are based on a single best estimate price. For those instruments for which ranges of fair value measurements are not currently used for internal or external reporting, the sensitivity analysis will require companies to reperform fair value measurement using multiple alternative inputs, assuming such inputs exist. Rerunning time consuming valuations intended to be generated once for books and records purposes represents a significant operational cost that must be justified.

4. Effective Date

In light of the number of significant proposed accounting standards aimed at changing the accounting for and classification of financial instruments that are expected to be issued in the forthcoming year, including those within the *Financial Instruments* exposure draft and the overlap in certain disclosure requirements within the various proposed accounting standards, we strongly encourage the FASB to set the effective date of the proposed amendments to Topic 820 so it coincides with the effective date of the *Financial Instruments* exposure draft. This would provide financial statement preparers ample time to evaluate the various measurement and disclosure changes and redesign processes, systems, and controls in order to comply with the new requirements at one time. Alignment in the effective date of the two aforesaid proposed standards is critical to the forthcoming financial reporting changes preparers will be faced with because a significantly greater number of financial instruments will be measured at fair value (many of which will be categorized in Level 3 of the fair value hierarchy) under the *Financial Instruments* exposure draft. Also, without coordinated effective dates, there is a risk certain financial instruments (e.g., investments in unquoted equity instruments) will need to be included in the proposed measurement uncertainty disclosures for only a short period of time (if the measurement and disclosure guidance within the Exposure Draft is effective prior to the disclosure guidance within the *Financial Instruments* exposure draft). This would require companies to expend significant cost and effort on obtaining information about certain financial instruments for inclusion in the measurement uncertainty disclosures that will only be needed in the short term, which fails to meet even the most basic of cost benefit tests.

If the Board decides to require the proposed measurement uncertainty disclosure prior to the effective date of the *Financial Instruments* exposure draft, entities will need at least one to two years from the date the final fair value measurement standard is issued to evaluate, collect, aggregate and review the information required by the new and expanded disclosures and therefore we recommend that the effective date be no earlier than for fiscal periods beginning on or after December 15, 2012.

5. Inputs based on Quoted Prices from Active Markets

Paragraph 820-10-35-18M provides “If there is a quoted price in an active market (that is, a Level 1 input) for a financial asset or a financial liability within a group of financial assets and financial liabilities, a reporting entity shall use that quoted price without adjustment when measuring fair value, except as specified in paragraph 820-10-35-41C.”

ISDA questions the relevance of including the guidance in paragraph 820-10-35-18M (which discusses the measurement requirements for a fair value measurement that is based on a quoted price from an active market) in the section of the guidance on measuring a portfolio of financial instruments. As the guidance on the selection of inputs for measuring an individual asset or liability for which there is a quoted price from an active market is aimed at addressing a different issue, the inclusion of paragraph 820-10-35-18M in the section of the standard intended to address the measurement of financial instrument portfolios may create confusion in practice. Further, as the core

principles articulated in paragraph 820-10-35-18M are already cited in paragraph 820-10-35-41C c of the Exposure Draft, we believe that paragraph 820-10-35-18M creates a redundancy. Therefore, we recommend that the FASB remove this paragraph from the section of Topic 820 intended to provide guidance on measuring the fair value of financial instruments managed as part of a portfolio.

6. Definition of Principal Market

The Exposure Draft proposes to amend the definition of the *principal market* in the Master Glossary of the Codification which differs from the description of the principal market in paragraph 820-10-35-6A which is consistent with the current definition of a principal market in Topic 820 and the Master Glossary. Therefore we recommend that the FASB incorporate the following changes into the final standard and amended Master Glossary. [Text added is underlined]

Principal Market

The principal market is the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. The principal market is a market the reporting entity can access at the measurement date. The principal market (and thus market participants) should be considered from the perspective of the reporting entity. Because different entities (and businesses within those entities) with different activities may have access to different markets, the principal market for the same asset or liability might be different for different entities (and businesses within those entities).

7. Transition

As indicated by the Board within the Exposure Draft, the clarifications contained within the Exposure Draft should not change current practice. We therefore believe that if any adjustments are required as a result of the clarifications, these should be considered to be a change in accounting estimate within the associated valuation techniques and treated as such in the period of initial adoption. Therefore, no cumulative adjustments (to opening retained earnings) should be required in the period of initial adoption.