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5th September 2008

The International Accounting Standards Board
1st Floor
30 Cannon Street
London
EC4M 6XH

Re: Discussion Paper (DP) on "Financial Instruments with Characteristics of Equity"

Dear Sirs,

The European and North American Accounting Policy Committees of the International Swaps and Derivatives Association ("ISDA") are pleased to jointly provide the following comments with respect to the above mentioned DP issued by the International Accounting Standards Board ("IASB").

ISDA has over 840 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, 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. As such, we believe that ISDA brings a unique and broad perspective to the IASB's work.

In our Appendix A, we address the questions outlined in the IASB's invitation to comment specific to International Financial Reporting Standards ("IFRS"). In our Appendix B, we enclose a copy of our response to the questions set out by the Financial Accounting Standards Board ("FASB") in its Preliminary Views (PV) document on the same topic.

In our response to the FASB, we stated that, of the three approaches set out in the PV document, we had a preference for the Ownership Settlement approach. However, we recommended modifying this approach by including a number of changes to better reflect the characteristics of equity instruments. We summarise these changes in our response to question 1a. in Appendix A to this letter, together with our reasons for preferring Ownership Settlement over the other two approaches.

While we recognize that there are a number of shortcomings with the current US GAAP literature on the classification of instruments as debt or equity requiring attention in the short term, IAS 32 has, for the most part, proven a successful standard. Indeed, one of our main reasons for preferring the Ownership Settlement approach over the other two proposed by the FASB is its similarity to IAS 32. Consequently we would encourage the IASB to start with IAS 32 and to amend it to address its weaknesses. We list our recommended changes to IAS 32 in response to question 1b in Appendix A to this letter. If IAS 32 were amended in this manner, it would approximate to the Ownership Settlement approach as modified in accordance with our recommendations. It would be inappropriate to attempt any more radical overhaul of the requirements on this subject before completion of the conceptual framework.

We hope you find ISDA's comments informative and beneficial. Should you have any questions or desire any clarification concerning the matters addressed in this letter please do not hesitate to contact the undersigned.

Yours faithfully,

Laurin Smith

Laurin Smith
J.P. Morgan Chase & Co.
Chair, North America Accounting Policy Committee

Melissa Allen

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Antonio Corbi

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Appendix A: ISDA response to the IASB

1. ***Are the three approaches expressed in the FASB Preliminary Views document a suitable starting point for a project to improve and simplify IAS 32? If not, why not?***

ISDA members believe that an alternative approach to the three expressed in the FASB Preliminary Views document would be to use IAS 32 as a starting point and to amend it to deal with its known weaknesses. This alternative approach is discussed in more detail as part of our response to question 1(b). The result of these changes would be similar to the Ownership Settlement approach as modified in accordance with our recommendations set out below.

a. ***Do you believe that the three approaches would be feasible to implement? If not, what aspects do you believe could be difficult to apply, and why?***

ISDA does not regard either of the Basic Ownership ("BO") approach or the Reassessed Expected Outcomes ("REO") approach to be a suitable starting point for a project to improve and simplify IAS 32.

The basis for our opinion is set out in our response to the FASB Preliminary Views document, attached as Appendix B.

1. Basic Ownership Approach:

In summary, our reasons for rejecting the Basic Ownership approach are as follows:

i. It assigns too much priority to simplicity in financial reporting, compared to relevance and reliability. It is not useful for decision-making purposes.

ii. While it may achieve simplification of classification, this would be at the expense of extra complexity in measurement and presentation, out of proportion to any increase in value to users of financial information, because of the significant number of financial instruments that would be revalued through profit or loss.

iii. Under this approach, changes in fair value of, for instance, a derivative on an entity's own shares, would be reflected in profit or loss, even though they result from what are merely a reallocation among the owners of an entity and is not indicative of, or relevant to, the entity's financial and operating performance. We believe the correct way to report allocations between owners is through the earnings-per-share disclosure.

iv. Users of financial information will need to adjust the reported profit or loss in order to assess the entity's financial performance, requiring them to be able to differentiate gains and losses attributed to equity instruments that are not permitted under the Basic Ownership approach to be recorded as equity.

v. The Basic Ownership approach is, in our view, rule-based and does not focus on the substantive economic attributes of the financial instruments. This is particularly evident in the treatment of a subsidiary's Basic Ownership instruments in the context of consolidated reporting, in which a minority interest would be reported as equity in the group accounts even though it does not represent the most basic ownership instrument for the group as a whole. This further illustrates the lack of conceptual basis for this approach.

vi. ISDA finds it inconsistent that certain redeemable Basic Ownership instruments, which may involve future obligations to sacrifice assets, can be classified as equity yet perpetual instruments, which have no settlement requirement (except in liquidation), must be classified outside of equity.

vii. ISDA is concerned that in certain jurisdictions there are statutory provisions which require payment of dividends on an entity's ordinary shares, based on a proportion of profits, which would otherwise be regarded as Basic Ownership instruments. Although these requirements are statutory rather than contractual, the Basic Ownership approach does not differentiate between these two classes of obligation. The majority, if not all, of such financial instruments would be recorded as liabilities, based on the obligation to pay the dividend in perpetuity. However, the statutory requirement to pay a dividend can be waived by shareholders at the entity's Annual General Meeting. Since the Basic Ownership approach determines classification from the standpoint of owners of the enterprise, it would, surely, be consistent to determine classification so as to reflect the owners' rights and obligations. Application of this approach would treat the owners, voting together at the Annual General Meeting, as an integral part of the entity, in determining whether or not the entity has an obligation to pay a dividend. Note that any payment of dividends to the ordinary shareholders is only a matter of timing in the distribution of profits that will accrue to them anyway at some time and does not affect their residual interests in the entity.

<u>2. Reassessed Expected Outcomes Approach:</u>

In summary, our reasons for rejecting the Reassessed Expected Outcomes approach are as follows:

i. It would introduce undue complexity in financial reporting, outweighing any perceived benefits. The approach would require financial statement preparers to expend significant resources on valuation techniques so that instruments can be measured each period. The approach would also require financial statement users to constantly analyse the impact of reassessment and the resultant effect on an entity's statement of financial position, liquidity and quality of earnings.

ii. It would introduce significant volatility in reported earnings, which would not be meaningful to financial statements users.

iii. It would introduce significant volatility in a company's capital structure, because of the constant remeasurement, which would constrain companies that manage their capital based on accounting-linked regulatory measures.

iv. It would require an unusual financial statement presentation for certain instruments. For example a written call option would be separated into its components – an asset (the present value of the strike price) and equity (the conditional obligation to issue shares).

3. Ownership Settlement Approach:

ISDA believes that, of the three approaches set out by the FASB, the Ownership Settlement approach is the most suitable starting point for a project to improve and simplify IAS 32.

Again, the reasons for our conclusion are set out in our response to the FASB Preliminary Views document, but in summary are as follows:

i. the approach is similar to, and builds upon the most successful features of the model set out in IAS 32;

ii. the approach more accurately reflects the economic substance of the instruments within the scope of the Discussion Paper and of the three approaches is the most consistent with a corporate finance theory;

iii. the approach has more conceptual merit than the Basic Ownership approach.

However, as set out in our response to the FASB, there are a number of areas in the way the approach is described which are unclear and areas in which the approach could be improved, to make it more suitable for the representation of financial instruments with characteristics of equity. These include:

i. Although paragraph A4 of the Preliminary Views sets out a basic principle as to whether indirect ownership instruments can be classified as equity, in which it is only necessary that there be a positive correlation between the outcomes of the indirect ownership instrument and the underlying basic ownership instrument, other paragraphs within the Preliminary Views, such as paragraph A8 are more restrictive and unduly rules-based. Paragraph A8 implies that indirect ownership instruments and components must have a payoff profile reflecting the same slope and direction, as the entity's basic ownership instruments, in order to achieve equity classification. The same slope implies a fixed-for-fixed payoff. If this is what is intended by the approach, ISDA believes it should be amended, since we do not agree that an indirect ownership instrument or a component must have a fixed-for-fixed payoff. Owners often agree to receive varying payoffs depending on their risk appetite or desire for participation in an entity's profits, and we do not believe that the allocation between owners should be reflected in the reported performance. The desire to be exposed to payoffs which are not identical to those of an entity's most residual equity instrument should not preclude equity classification for an instrument that embodies no obligation to the holder.

ii. To the extent that the entity has no obligation, ISDA does not believe that directional consistency between an indirect ownership interest and the underlying basic-ownership settlement should be required. For example, a purchased call option has substantially the same economics as a treasury stock purchase, but under the Ownership Settlement approach would be classified differently since it has a negative correlation with the pay off on the basic ownership instrument. If the instrument embodies no obligation, is indexed to the issuer's own stock and can be settled in shares, we believe that classification in shareholders' equity should be permitted.

iii. The Ownership Settlement approach requires classification of an instrument or a component that provides for a net cash settlement alternative outside of shareholders' equity, irrespective of which party controls the form of settlement. We find this inconsistent with the characteristics of an obligation. We believe that the form of settlement must incorporate who has the settlement obligation and whether there is an obligation. ISDA believes that the approach should be modified to allow equity classification for instruments that permit net share or net cash settlement where the issuer has the ability to control the form of settlement.

iv. ISDA finds the linkage criteria set out in paragraph 41 of the Preliminary Views unnecessarily complex and in need of clarification. For instance, it is not clear as to the order in which entities should apply the linkage criteria. As an example, consider a more complex transaction in which the entity issues convertible debt at the same time as purchasing a call option and warrants on its own stock. More critically, criterion (b) of paragraph 43 of the Preliminary Views disregards whether there is a substantive business purpose to the transactions, which is surely an important part of the assessment. We recommend that the linkage requirements be made closer to those set out in IAS 39 IGC B6, so that instruments are linked if they are contractually linked or: (i) entered into with the same counterparty; (ii) relate to the same or a similar risk; (iii) are entered into at the same time or in contemplation of each other; and (iv) when there is no apparent economic need or substantive business purpose for structuring the transaction separately.

v. It is not clear to what extent the principle of substance encompasses economic compulsion, a recognised issue under IAS 32. For example, a bond redeemable at the option of the issuer, that pays a dividend that increases after a certain number of years, but where the dividend is only payable if the entity pays a dividend on its ordinary shares, is required under IAS 32 to be treated as equity. It is unclear from the Preliminary Views document how such an instrument would be treated under the Ownership Settlement approach. The IAS 32 conclusion is regarded by many as counter-intuitive, since the instrument behaves like debt and is issued and traded as debt. While we appreciate that it would not be practical or desirable for the standard to set out bright lines as to what would, or would not, be classified as equity, and the evaluation would always require judgement, the principle on this issue needs to be articulated. This should include whether economic compulsion and substance should be considered only at inception or during the life of an instrument.

vi. ISDA finds the requirements in paragraph A.37 of the Preliminary Views document, relating to settlement, conversion, expiration or modification, difficult to understand.

More examples should be included to illustrate these principles under the Ownership Settlement approach. Also, we recommend that it is clarified that modifications, conversions and similar transactions that do not change the economics of the instrument by more than an insignificant amount should not be required to be accounted for as a modification.

vii. ISDA recommends that the Ownership Settlement approach should allow indirect ownership instruments that are derived from other equity instruments other than Basic Ownership to be classified as equity. For example, a written call option on a preference share should, in our view, be classified as equity where the preference share itself is classified as equity.

viii. The reason why transaction costs associated with instruments within the scope of the Preliminary Views should be expensed in earnings immediately is not explained. Consequently, ISDA does not understand why they are treated differently from costs under other accounting standards. Such a significant change should not be introduced without justification.

In addition:

ix. The treatment of convertible bonds that may be converted during the life of the instrument is not clear under the Ownership Settlement approach. Such instruments can give rise to questions as to what to bifurcate, what should be considered as equity at the outset and the accounting treatment on conversion.

x. One of the issues that have been encountered by organisations reporting under IAS 32 has been the treatment of convertible bonds denominated in a foreign currency (see also question 1b below). ISDA's reading of the proposals is that such convertible bonds do not contain an indirect ownership instrument and would be deemed to contain an embedded derivative rather than an equity component. The fair value of the conversion option does not necessarily change in the same direction as the underlying share if there are changes in exchange rates. Also, contrary to paragraph A4 (c) (2) of the Preliminary Views, the conversion option would contain a "contingent exercise provision" based on a price index that is unrelated to the price of the entity's basic ownership instrument or its own operations, since the price index varies with the foreign exchange rate. Given the importance of this issue to any entities currently reporting under IFRS, this treatment should be clarified in the eventual standard. As set out below, we believe that the currency of denomination of a convertible bond should not impact the classification of the embedded call option.

Also, as with IAS 32, the issue is not only how to account for a foreign currency denominated convertible bond in the financial statements of the issuer, but also on consolidation. For instance, a convertible bond may be issued by a subsidiary but denominated in the functional currency of the parent rather than that of the subsidiary. The treatment in these circumstances needs to be made clear.

xi. Issue (vii) of our concerns with the Basic Ownership approach is probably also applicable to the Ownership Settlement approach, although the approach, as worded, does not make this clear. Indeed, as worded, there appears to be no requirement to record as a liability any obligation to pay dividends, whether statutory or contractual. We believe that an obligation to pay a fixed amount of dividends should be recognised as a liability.

b. Are there alternative approaches to improve and simplify IAS 32 that you would recommend? What are those approaches and what would be the benefit of those alternatives to users of financial statements?

i. One of the most unsatisfactory aspects of the IAS 32 model is the requirement that, to be classified as equity, a derivative must involve the exchange of a fixed number of shares for a fixed amount of cash. This raises difficulties of interpretation and application in the following scenarios, amongst many:

- in situations where the conversion ratio is adjusted to reflect stocks splits and bonus issues or special dividends, or even ordinary dividends, in order to align more closely the economics of ownership of the convertible bond to that of the ordinary shareholders;
- where a convertible bond conversion rate varies over time, but not in such a way that the same value will be delivered to the holder, irrespective of the market value of the shares. For example, where the conversion ratio reduces at a pre-agreed rate over time in order to induce conversion of the instrument early in its tenor;
- if a convertible bond has a different conversion rate in the event of takeover, to compensate for loss of time value of the conversion option;
- situations where the conversion ratio is adjusted in line with an inflation index;
- wherever convertible bonds are issued in a foreign currency (see comment (x) on the Ownership Settlement approach).

We believe that IAS 32 should be amended so that it is not necessary for a fixed number of shares to be exchanged for a fixed amount of cash, in order for an instrument to be classified as equity. Instead, an instrument with correlation between its outcome and the value of the underlying shares should also be classified as an equity instrument. The current IAS 32 fixed-for-fixed requirement is a rule rather than a principle.

We note that in EITF 07-5: Determining whether an instrument (or embedded feature) is indexed to an entity's own stock, the EITF Task Force reached a consensus that a feature indexed to an entity's own shares would be classified as equity in certain circumstances even where the number of shares or the instrument's strike price used to calculate the settlement amount are not fixed.

We also recommend that IAS 32 is amended to clarify that the currency of issue of a financial instrument that is convertible into shares should not be relevant in determining whether there is an equity component.

ii. The treatment of convertible bonds that may be converted during the life of the instrument is not clear under IAS 32. The rules given in the Standard, and the examples provided, only deal with conversion at maturity (see also comment (ix) in relation to the Ownership Settlement approach, above).

iii. IAS 32 does not specify when and how reclassifications should be made between equity and debt, depending on changes in contractual terms or circumstances. The principles need to be established and set out in the standard.

iv. The circumstances when transactions should be linked in order to establish the appropriate accounting treatment under IAS 32 should be made clearer. As set out above, we recommend that the linkage requirements be made closer to those set out in IAS 39 IGC B6.

v. IAS 32 does not always reflect economic compulsion and therefore is, in some instances, an unduly form-based standard. An example is the accounting treatment of perpetual instruments on which fixed dividends, which step up after a number of years, are only payable in the event that a dividend is paid on ordinary shares, and which are required by IAS 32 to be treated as equity, notwithstanding the fact that payment of dividends and repayment of principal are economically near certain and so the instruments are, in practice, issued, purchased, traded, and managed as debt. (See comment (v) on the Ownership Settlement approach).

ISDA has also evaluated and considered the Loss Absorption approach as included in the Discussion Paper published by the European Financial Reporting Advisory Group (EFRAG), *Distinguishing between Liabilities and Equity*. ISDA concluded that this alternative approach is not preferable because:

i. its principles are not yet fully developed;

ii. it raises conceptual and practical issues that have yet to be resolved;

iii. its classification principles are not reflective of the economic realities of many instruments; and

iv. it would be complex and costly to apply in practice, both for preparers and users.

2. ***Is the scope of the project as set out in paragraph 15 of the FASB Preliminary Views document appropriate? If not, why? What other scope would you recommend and why?***

The scope of the project as set out in paragraph 15 of the FASB Preliminary Views document includes, as item b, “other instruments that are ownership interests in legal form”.

ISDA does not believe that it is appropriate for a standard that would be applied internationally to have reference to legal form, since legal form can vary significantly from one jurisdiction to another, meaning that the accounting treatment may be inconsistent, depending upon the jurisdiction.

To the extent that there are identifiable characteristics of financial instruments which are commonly regarded as equity in legal form, then these characteristics should be set out in the proposed standard, rather than restricting the scope according to an instruments' legal form.

If the Board wishes to amend or replace IAS 32 in the short or medium term then ISDA believes that the only practical options are to adapt the Ownership Settlement approach as we suggest(see our response to question 1a) or to maintain IAS 32 with appropriate amendments that address the known issues (see our response to question 1b). A more radical solution is probably not feasible in the next few years without the diversion of resources from more critical projects.

3. ***Are the principles behind the basic ownership instrument inappropriate to any types of entities or in any jurisdictions? If so, to which types of entities or in which jurisdictions are they inappropriate, and why?***

   Refer to our response under question 1, above, in particular regarding those jurisdictions where statute requires that a minimum proportion of profits be paid out by way of dividend to ordinary shareholders.

4. ***Are the other principles set out in the FASB Preliminary Views document inappropriate to any types of entities or in any jurisdictions? (Those principles include separation, linkage and substance). If so, to which types of entities or in which jurisdictions are they inappropriate, and why?***

   Refer to our responses to questions 1a and 1b.

5. ***Please provide comments on any other matters raised by the discussion paper.***

   a. ISDA recommends that the final standard should clarify that the guidance only applies to the accounting by the issuer of an instrument and not the investor.

   b. Should the Boards proceed with the Basic Ownership approach, ISDA believes that a number of issues must be addressed and resolved, including initial and subsequent measurement of perpetual instruments that are not Basic Ownership instruments, and how cumulative translation adjustments and other comprehensive income balances will be classified and presented in the financial statements under this approach.

   c. The Boards must clarify how physically or net settled share based payments within the scope of FAS 123R, *Share Based Payments* or IFRS 2 *Share Based Payment* will be classified and measured.

   d. Paragraph 35 of the FASB Preliminary Views document states that: "instruments for which there are no existing requirements are to be measured using the existing framework"; without making it clear what this means. The sentence should be amended to clarify the framework to which it refers and the specific attribute for other instruments and components classified outside of shareholders equity under the approach.

e. The Boards must consider the effect of the classification and measurement required under the Ownership Settlement approach on basic and diluted earnings per share.

f. The Boards must incorporate decisions made under the financial statement presentation project into the liabilities and equity project. The presentation of balance sheet and income statement elements of instruments within the scope of the Discussion Paper is important to the overall framework for distinguishing between liabilities and equity and ensuring transparency and comprehension of an entity's financial statements.

Appendix B: ISDA response to the FASB

1. Basic Ownership Approach

ISDA does not support the FASB's preliminary view that the Basic Ownership Approach is the most decision-useful approach for distinguishing financial instruments that are assets or liabilities versus those that are equity. ISDA finds the Basic Ownership Approach too narrow and believes that the adoption of such an approach for defining equity will compromise the usefulness and relevance of the financial statements.

We find the FASB's decision to prioritize simplicity in financial reporting to result in a framework that lacks any easily understandable link to the qualitative characteristics of accounting information included in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information* ("Concepts Statement 2"). While simplification has its merits, we believe that greater weight should be placed on developing an accounting model that improves the relevance and reliability of the financial statements, and which faithfully represents the economics of an entity's activities, its net assets, and changes therein. We urge the FASB to reconsider its decision to prioritize simplicity for determining classification over the other qualitative characteristics included in Concepts Statement 2. Also, we find that the simplified classification principles under the Basic Ownership Approach increase the complexity associated with the measurement and presentation of financial instruments with characteristics of equity, thereby reducing the benefit of classification simplicity. In this regard, ISDA recommends that the FASB seek feedback from and discuss the utility of the Basic Ownership Approach with financial statement users such as analysts and investors. In the paragraphs that follow, ISDA has provided responses to the questions regarding the Basic Ownership Approach posed by the FASB in the Preliminary Views.

1. ***Do you believe that the basic ownership approach would represent an improvement in financial reporting? Are the underlying principles clear and appropriate? Do you agree that the approach would significantly simplify the accounting for instruments within the scope of this Preliminary Views and provide minimal structuring opportunities?***

   As discussed in the introduction to ISDA's comment letter above, we do not believe that the Basic Ownership Approach would represent an improvement in financial reporting. Specifically, ISDA does not believe that the Basic Ownership Approach is the most decision-useful approach for distinguishing financial instruments that are assets or liabilities versus those that are equity. Paragraph 51 of the Preliminary Views summarizes the FASB's basis for concluding that the Basic Ownership Approach is preferable to the alternative approaches it evaluated and provides, "Simplicity (reduction of complexity) in financial reporting was an overriding consideration for some Board members in choosing the basic ownership approach." ISDA finds the range of instruments classified as equity under the Basic Ownership Approach too narrow. While simplification has its merits, we believe that the transfer of complexity from classification to measurement and presentation to reduce, if not eliminate, the assumed benefits of the Basic Ownership Approach. We urge the FASB to reconsider its decision to prioritize simplified classification over the other qualitative characteristics included in Concepts Statement 2, and over simplicity in measurement and presentation. In this regard, ISDA strongly recommends that the FASB seek feedback from and discuss the utility of the Basic Ownership Approach with financial statement users such as analysts and investors.

ISDA is also troubled that changes in fair value of instruments which entitle the holder only to an allocation of an entity's net assets (for example, preferred stock, stock purchase warrants, etc.) are reflected in an entity's statement of financial performance because such measurements are merely allocations among owners of an entity and are not indicative of or relevant to an entity's financial and operating performance. We believe that the accounting standards for calculating and presenting earnings-per-share should address allocations and transfers among owners. We do not agree that gains and losses on non basic ownership instruments linked to an entity's own stock must be reflected in the statement of financial performance and urge the FASB to alter its decision accordingly.

ISDA believes that the many types of financial statement users will likely find that the classification principles of the Basic Ownership Approach diminish the relevance of an entity's reported financial position and create complexity due to the distinction drawn between equity and non equity instruments. That is, the classification required for many equity-linked instruments (e.g., equity derivatives) that are not Basic Ownership instruments, but which economically share few, if any, characteristics of instruments that embody a debtor-creditor relationship or which are senior to the rights of an entity's equity holders in bankruptcy, erodes the usefulness of the Basic Ownership Approach.

In terms of usefulness, ISDA views the number of constituents that would favor and benefit from the simplified principles of the Basic Ownership Approach to be limited; those constituents would likely only comprise a narrow subset of financial statement preparers as well as independent auditors. ISDA is aware that some of the most sophisticated of financial statement users have indicated publicly that the classification dictated by Basic Ownership Approach is not intuitive, and therefore will necessitate adjustments to derive meaningful and relevant balance sheet and income statement information. We find this feedback counterintuitive to the purpose of financial reporting and the FASB's stated objective for the liabilities and equity project. This feedback may also be indicative of the challenges the FASB's preferred approach may present to the remaining population of financial statement users.

Under the Basic Ownership Approach, financial statement users will also be burdened with differentiating gains and losses attributed to equity-linked instruments that are not classified in shareholders' equity and earnings attributed to an entity's financial performance. Additionally, the measurement of nonbasic Ownership instruments, such as equity derivatives, at fair value with changes reported in earnings will obscure financial performance and likely will lead to additional complexity in financial reporting. For example, credit analysts will invariably be required to adjust their models to assess an entity's financial performance for re-measurements required under the Basic Ownership Approach.

For the reasons discussed above as well as in our response to question six below, we strongly encourage the FASB to meet with and seek feedback from financial statement users, such as regulators, and credit analysts which may find the Basic Ownership Approach's classification requirements a barrier to fully understanding an entity's true liquidity and creditworthiness.

ISDA finds that the Basic Ownership Approach and the FASB's implicit desire to minimize structuring opportunities creates an unnecessary bias towards the lowest residual interests. We also consider the Basic Ownership Approach to be in conflict with the stated objective of developing principles-based accounting standards by creating a rule for what instruments can be classified as equity. Rather, the framework to be chosen should provide for classification that focuses on the substantive economic attributes of an instrument. An approach for determining classification of instrument with characteristics of equity that is based on substance should sufficiently address the concerns constituents have regarding structuring opportunities and also result in classification that is consistent with the economics of the instrument. Also, while simplification significantly reduces structuring opportunities, it does not completely eliminate all opportunities. For instance, ISDA finds the FASB's conclusion in paragraph 29 of the Preliminary Views that classification of a Basic Ownership instrument issued by a subsidiary of a reporting entity is the same on a consolidated basis inconsistent with the FASB's objectives of simplification and limitation of structuring opportunities, as it may permit classification of an instrument within consolidated shareholders' equity for instruments that do not necessarily meet the characteristics of a basic ownership instrument. In addition, we do not fully understand the conceptual basis for this conclusion under the Basic Ownership Approach. We note that this decision is inconsistent with the IASB's recent amendment to IAS 32 regarding redeemable financial instruments, which does not permit a redeemable instrument that is issued by a subsidiary to be classified as equity in the consolidated financial statements of the parent company. The IASB's basis for conclusions in the amendment to IAS 32 states, "The Board decided that such instruments were not the residual interest in the consolidated financial statements and therefore that non-controlling interests that contain an obligation to transfer a financial asset to another entity should be classified as a financial liability in the consolidated financial statements."

2. ***Under current practice, perpetual instruments are classified as equity. Under the basic ownership approach (and the REO approach, which is described in Appendix B) certain perpetual instruments, such as preferred shares, would be classified as liabilities. What potential operational concerns, if any, does this classification present?***

ISDA does not agree with the FASB's decision that perpetual, nonbasic ownership instruments with characteristics of equity must be classified outside of equity. This classification would be inconsistent with the economic substance of many perpetual instruments with characteristics of equity. Many perpetual instruments that must be classified outside of shareholders' equity under the Basic Ownership Approach (such as perpetual preferred stock) have loss absorbing characteristics similar to an entity's residual equity interests. ISDA considers assets and liabilities to be only those contracts that embody a right to receive or an obligation to forgo cash or other assets. Conversely, contracts that do not embody a right to receive or an obligation to forgo cash or other assets, and which are more akin to residual interests because they either (i) absorb the entity's losses or (ii) have a payoff profile consistent with an entity's equity residual interests, should be considered equity.

The distinction between liabilities and equity, including perpetual instruments, should reflect the core theories shared by academics and finance professionals, especially in light of the FASB's and IASB's goal of developing a single set of accounting standards that can be understood and applied globally.

Further, we find it inconsistent that certain redeemable basic ownership instruments, which may involve future obligations to sacrifice assets, can be classified as equity yet perpetual instruments, which have no settlement requirements (except in liquidation of the entity), must be classified outside of equity. Because of this requirement, ISDA is also concerned that certain entities that are capitalized predominantly by preferred stock investments may have no equity under the Basic Ownership Approach, which may have significant implications for these entities.

Lastly, while ISDA supports fair value as the most relevant measurement attribute for many financial instruments, we note that most perpetual instruments are not re-measured at fair value under U.S. GAAP and IFRS. We ask the FASB to carefully consider whether a fair value measurement attribute for perpetual instruments will faithfully represent their economics. Use of a fair value measurement attribute for perpetual instruments will invariably increase complexity in financial reporting, as companies (many of which may not have deep valuation expertise) will be required to obtain complex valuations on a recurring basis.

3. ***The Board has not yet concluded how liability instruments without settlement requirements should be measured. What potential operational concerns, if any, do the potential measurement requirements in paragraph 34 present? The Board is interested in additional suggestions about subsequent measurement requirements for perpetual instruments that are classified as liabilities.***

We urge the FASB to develop a measurement attribute for perpetual instruments classified outside of shareholders' equity that is relevant to the terms of these instruments, and which meets the project's simplification objectives. ISDA would not support alternative 'c' within paragraph 34 of the Preliminary Views which states, "Determine an expected retirement date and an expected dividend stream and discount using a market-based rate" as this methodology is complex and would be extremely difficult to apply in practice. For instance, to determine the expected retirement date at the inception of an instrument would require significant judgment, and may require a hypothetical estimate of when the entity is expected to redeem the instrument or when it is expected to liquidate as well as the dividends that may be paid over the instrument's life. A hypothetical estimate may not faithfully represent the ultimate payoff of the instrument, may be less reliable, and may lead to the inconsistencies among financial statement preparers.

4. ***Basic ownership instruments with redemption requirements may be classified as equity if they meet the criteria in paragraph 20. Are the criteria in paragraph 20 of the Preliminary Views operational? For example, can compliance with criterion (a) be determined?***

   As noted in our response to question number two above, ISDA finds it inconsistent that certain redeemable basic ownership instruments, which may involve future sacrifices of assets, can be classified as equity yet perpetual instruments which have no settlement requirements (except in liquidation of the entity) must be classified outside of equity. As to operationality, we find that the criteria of paragraph 20 within the Preliminary Views overly stringent, and because they may require a hypothetical analysis for determining the value a holder would be entitled to receive upon liquidation, we find that these criteria will be costly to apply in practice.

5. ***A basic ownership instrument with a required dividend payment would be separated into liability and equity components. That classification is based on the Board's understanding of two facts. First, the dividend is an obligation that the entity has little or no discretion to avoid. Second, the dividend right does not transfer with the stock after a specified ex-dividend date, so it is not necessarily a transaction with a current owner. Has the Board properly interpreted the facts? Especially, is the dividend an obligation that the entity has little or no discretion to avoid? Does separating the instrument provide useful information?***

   ISDA is aware of equity instruments, such as certain classes of common stock and other perpetual instruments, which provide the issuing entity with full discretion over payment of dividends on the shares. ISDA is also aware that in certain international jurisdictions, statutory provisions require payment of dividends on an entity's common or ordinary shares, based on a proportion of profits, which would otherwise be regarded as basic ownership instruments. However, the statutory requirement to pay a dividend can be waived by shareholders at the entity's annual shareholders' meeting. Since the Basic Ownership Approach determines classification from the standpoint of an owner of the enterprise, we would argue that the classification should also reflect the owner's rights and obligations. Consequently, FASB should require that the shareholders, voting together at the annual general meeting, be regarded as an integral part of the entity in determining whether there is an obligation to pay a dividend.

6. ***Paragraph 44 would require an issuer to classify an instrument based on its substance. To do so, an issuer must consider factors that are stated in the contract and other factors that are not stated terms of the instrument. That proposed requirement is important under the Ownership Settlement approach. However, the Board is unaware of any unstated factors that could affect an instrument's classification under the basic ownership approach. Is the substance principle necessary under the basic ownership approach? Are there factors or circumstances other than the stated terms of the instrument that could change an instrument's classification or measurement under the basic ownership approach? Additionally, do you believe that the basic ownership***

approach generally results in classification that is consistent with the economic substance of the instrument?

Please refer to ISDA's comment on question number five above regarding classification of basic ownership instruments based on unstated terms. Additionally, ISDA supports the need to consider all stated and unstated terms, as discussed further in response to Ownership Settlement Approach question three.

Furthermore ISDA believes that the Basic Ownership Approach will generally result in classification that is inconsistent with the economic substance of many instruments with characteristics of equity. Specifically, precluding certain types of preferred stock (for example, perpetual preferred stock) and equity derivatives with ownership-like characteristics and payoffs (for example, written call options, physically or net share settled forward sale contracts, etc.) from being classified in shareholders' equity is counterintuitive and inconsistent with the economics of these instruments. Many instruments that must be classified outside of shareholders' equity under the Basic Ownership Approach have loss absorbing characteristics similar to entity's residual equity interests. As referred to above, ISDA considers assets and liabilities to be only those contracts that embody a right to receive or an obligation to sacrifice cash or other assets.

The Preliminary Views does not explain the FASB's decision to create a distinction between treasury stock transactions, the economics of which many equity derivatives are designed to replicate, and nonbasic ownership instruments linked to an entity's own stock. We believe that the different accounting treatment for these two sets of transactions created by the Basic Ownership Approach should be reconsidered, as this distinction is rules-based and creates an inconsistency in financial reporting.

Individuals within organizations responsible for capital raising efforts are likely to find the Basic Ownership Approach confusing, as many instruments considered to be equity capital will instead be classified as either an asset or a liability. Logically, the classification and earnings volatility that results from the Basic Ownership Approach will reduce companies' appetites for issuing many equity-linked instruments currently classified as equity and will hamper necessary liquidity. Further, many instruments that would be classified outside of shareholders' equity will likely receive full equity credit from rating agencies and other similar organizations.

ISDA also observes that the Basic Ownership Approach will increase the disparity between the tax and accounting treatment for many of the instruments that will be within the scope of the final standard that results from the liabilities and equity project. Additionally, the Basic Ownership Approach will significantly impact regulated companies and companies subject to financial covenants and ratios (for example, the leverage ratio imposed by the Federal Reserve), and may have adverse consequences on the sources of liquidity these companies can utilize. We urge the FASB to seek feedback from and discuss the impact of its preliminary views and preferred approach with these constituencies well in advance of developing an Exposure Draft.

7. ***Under current accounting, many derivatives are measured at fair value with changes in value reported in net income. The basic ownership approach would increase the population of instruments subject to those requirements. Do you agree with that result? If not, why should the change in value of certain derivatives be excluded from current-period income?***

   ISDA does not support the FASB's decision to require substantially all equity derivatives to be classified as either assets or liabilities and marked-to-market with changes reported in earnings. Precluding equity derivatives with ownership-like characteristics and payoffs (for example, written call options, physically or net share settled forward sale contracts, etc.) from being classified in shareholders' equity does not accurately reflect the economics of these transactions. Many equity derivatives that must be classified outside of shareholders' equity under the Basic Ownership Approach have loss absorbing characteristics similar to entity's residual equity interests. As referred to above, ISDA disagrees with the change to the conceptual definitions of assets and liabilities. ISDA believes that the distinction between liabilities and equity under GAAP should preserve the core theories shared by academics and finance professionals, especially in light of the FASB's and IASB's goal of developing a single set of accounting standards that can be understood and applied globally.

   As noted in the response to question one, ISDA believes that the accounting standards for calculating and presenting earnings-per-share should address allocations and transfers among owners, and that such allocations and transfers should not be reflected in the statement of financial performance.

8. ***Statement of financial position. Basic ownership instruments with redemption requirements would be reported separately from perpetual basic ownership instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. Are additional separate display requirements necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?***

   If the FASB does not alter its decision on the classification of perpetual preferred stock and equity derivatives with a payoff profile consistent with basic ownership instruments, we believe that separate classification of and distinction between nonbasic ownership instruments that are cash settled versus those that are share settled is necessary. This is particularly important so that financial statement users can easily evaluate an entity's true liquidity, the priority of an entity's claims, and its financial position.

   Further, ISDA strongly believes it is necessary to consider financial statement presentation concurrently with classification and measurement of instruments within the scope of the Preliminary Views. Thus, we encourage the FASB to incorporate the decisions made under its Financial Statement Presentation project with Phase 2 of its Liabilities and Equity project (focused on classification and measurement) as neither can be completed successfully in isolation.

9. ***Income statement. The Board has not reached tentative conclusions about how to display the effects on net income that are related to the change in the instrument's fair value. Should the amount be disaggregated and separately displayed? If so, the Board would be interested in suggestions about how to disaggregate and display the amount. For example, some constituents have suggested that interest expense should be displayed separately from the unrealized gains and losses.***

   Under the Basic Ownership Approach, ISDA finds that separate classification of and distinction between instruments that are cash settled versus those that are share settled is needed in order to allow financial statement users to easily evaluate an entity's true operating performance. Without knowing how the FASB will require companies to measure and classify gains and losses attributable to non basic ownership instruments in earnings, it is difficult to conclude how gains and losses should be characterized and classified in the statement of financial performance. As noted above, we urge the FASB to coordinate its financial statement presentation project with its liabilities and equity project.

10. ***The Board has not discussed the implications of the basic ownership approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the computation. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?***

    ISDA urges the FASB to consider how non basic ownership instruments are to be reflected in earnings-per-share. ISDA is unable to indicate a preference for how financial instruments with characteristics of equity should be reflected, if at all, in basic and diluted earnings per share without knowing how all such instruments will be measured, classified and reported in the statement of financial performance and statement of financial position. However, consistent with the principles underpinning the Basic Ownership Approach we recommend that the FASB develop a simple approach to measuring earnings-per-share which limits the need to adjust net income and weighted average shares outstanding for instruments within the scope of the Preliminary Views.

2. Ownership Settlement Approach

ISDA firmly supports the development of an approach for determining the classification of financial instruments within the scope of the Preliminary Views consistent with the Ownership Settlement Approach. ISDA believes that the Ownership Settlement Approach in conjunction with earnings-per-share standards could provide a more accurate reflection of the economic substance of the instruments within the scope of the Preliminary Views and could better meet the FASB's simplification objective without compromising the quality of an entity's earnings (due to fair value measurements of non basic ownership instruments), and usefulness of the financial statements as would be the case under the Basic Ownership Approach. ISDA also finds the classification that results from the Ownership Settlement Approach's principles is most consistent with corporate finance theory. For example, the Ownership Settlement Approach permits equity classification for most equity derivatives that have rights (or lack thereof), payoff profiles, and economic characteristics consistent with ownership of an entity's residual interests. Unlike the Basic Ownership Approach, the Ownership Settlement Approach does not require many instruments that share the same or similar economics as basic ownership instruments to be measured at fair value with changes reported in earnings (compromising the faithful representation of earnings). Additionally, ISDA finds that the Ownership Settlement Approach reflects improvements to the current accounting models for equity-linked instruments that exist under current U.S. GAAP and IFRS. However, ISDA acknowledges that several aspects of the Ownership Settlement Approach require further consideration in order to fully realize improvements to both the current U.S. GAAP and IFRS classification and measurement standards for instruments within the scope of the Preliminary Views.

As ISDA believes that the Ownership Settlement Approach has the most conceptual merit, the focus of our attention is on the suggestions for improvement to this model. Our suggestions will be further developed in our response to the IASB's discussion paper on this topic; however, our responses to the questions put forth in the Preliminary Views are intended to highlight the aspects of the Ownership Settlement Approach that warrant further consideration by the FASB.

ISDA's comments notwithstanding, we favor the Ownership Settlement Approach over the Basic Ownership and Reassessed Expected Outcomes approaches and would fully support a decision by the FASB to develop a framework for classifying financial instruments with characteristics of equity using the principles of the Ownership Settlement Approach.

1. ***Do you believe the Ownership Settlement approach would represent an improvement in financial reporting? Do you prefer this approach over the basic ownership approach? If so, please explain why you believe the benefits of the approach justify its complexity.***

   As noted above, ISDA supports the Ownership Settlement Approach because it provides the most accurate reflection of the economic substance of the instruments within the scope of the Preliminary Views as well as for the reasons mentioned above. The Ownership Settlement Approach also simplifies the accounting for equity-linked instruments under current IFRS and U.S. GAAP, which meets the FASB's stated objective for the project. Therefore we believe that the Ownership Settlement Approach is conceptually superior to the Basic Ownership Approach and any complexities that may arise in the application of its measurement principles are justified by its faithful representation of instruments within the scope of the Preliminary Views. While there are merits to simplifying the classification of financial instruments with characteristics of equity under the Basic Ownership Approach, ISDA believes that complexity in measurement will increase under that approach. The Basic Ownership Approach will also create complexity for financial statement users and will detract from the usefulness of financial statements. As such, we find the Ownership Settlement Approach to be no more complex than the Basic Ownership Approach.

2. ***Are there ways to simplify the approach? Please explain.***

Classification/Measurement

ISDA finds the classification and measurement criteria for instruments that are not Basic Ownership instruments as well as indirect ownership instruments and components with equity characteristics rules-based. For example, in order for a contract to sell one share of a company's own stock to be classified entirely in shareholders' equity, the contract must be (i) settled in the company's basic ownership instruments, (ii) have exactly the same payoff profile (and slope) of the company's most residual interests, and (iii) can not have any cash outcomes (for example, the contract can not provide for a dividend pass-through to either the holder or company). Such an instrument rarely exists in the market. Rather than basing the framework for determining equity classification on rules-centric criteria, ISDA recommends the FASB to limit the distinguishing characteristics of an equity instruments or components to a few clear principles. Since one of the FASB's stated objectives in the Preliminary Views is to provide a simplified framework for determining equity classification, we strongly encourage simplification of the Ownership Settlement Approach's classification criteria, particularly for instruments that provide for alternatives for settlement.

Paragraph A8 of the Preliminary Views, which illustrates how an indirect ownership instrument is classified under the Ownership Settlement Approach, also presents an opportunity for simplification. Although paragraph A4 of the Preliminary Views sets forth a basic principle for what indirect ownership instruments can be classified as equity, paragraph A8, adds rules to this principle that are not fully explained. We recommend that the FASB solely base classification of indirect ownership instruments on the three characteristics (principles) within paragraph A4 and remove the additional rules in paragraph A8, which will reduce complexity when applying this approach.

Additionally, paragraph A8 implies that indirect ownership instruments and components must have a payoff profile reflecting the same slope and direction— a fixed-for-fixed payoff— as an entity's Basic Ownership instruments in order to achieve equity classification. ISDA disagrees that indirect ownership instruments and components must have a fixed-for-fixed payoff because owners often times agree to receive varying payoffs depending on their risk appetite, or desire for participation in an entity's profits. The desire to be exposed to payoffs that are not identical to holders of an entity's most residual interests should not preclude equity classification. However, ISDA supports the requirement of an instrument that could embody an obligation to the issuer to have a payoff that is directionally consistent with the issuer's Basic Ownership instruments.

However, in contrast to instruments that could embody an obligation, directional consistency should not be required to achieve equity classification for instruments under which there is no obligation. For example, a purchased call option has substantially the same economics as a treasury stock purchase but would be classified differently under the

Ownership Settlement Approach. If the instrument embodies no obligation, is indexed to the issuer's own stock, and can be settled in shares, classification in shareholders' equity should be permitted.

Alternative Outcomes

We find that the rule within the Ownership Settlement Approach requiring classification of an instrument or component that provides for a cash settlement alternative (for example, an instrument that provides for either net share or net cash settlement at the issuer's option) outside of shareholders' equity, irrespective of which party controls the form of settlement, inconsistent with characteristics of an obligation. This aspect of the Ownership Settlement introduces prescriptive rules into the classification model, which do not improve financial reporting, and which conflict with the FASB's objectives for this project. We challenge the merits of this rule as it could dictate classification of an instrument or component that deviates from the ultimate outcome at settlement. In summary, ISDA objects to requiring different classification for instruments with the same economic payoff profile solely because of the form of settlement, as long as the issuer has the ability to control the form of settlement. ISDA strongly encourages the FASB to modify the Ownership Settlement principles to allow equity classification for instruments that have share settlement as one alternative, as long as the issuer of the instrument can control the form of settlement and the payoff of the instrument is consistent with ownership.

Linkage

Paragraph 41 of the Preliminary Views sets forth certain criteria for linking instruments or components under the Ownership Settlement Approach. ISDA finds these criteria unnecessarily complex and in need of additionally clarity. For instance, the order in which companies must apply the linkage criteria to instruments that must be separated under the Ownership Settlement Approach is not clear. An example of why the linkage criteria will create complexity includes convertible debt issued by a company at the same time it enters into a separate call spread overlay transaction (a purchased call option and warrants on its own stock). The interaction of linkage and separation would seem to introduce unnecessary complexity.

Further criterion (b) of paragraph 43 within the Preliminary Views disregards whether there is a substantive business purpose for such transactions and this aspect is not considered in the example illustration of the linkage criteria within in paragraph 43. Generally speaking, criterion (b) of paragraph 43 above would be inoperable for companies that trade large volumes of financial instruments with the same or related counterparty on a frequent basis. Also, the linkage guidance within paragraph 43 of the Preliminary Views is inconsistent with current GAAP which prohibits linkage of transactions that are consummated with two different counterparties (for example, a floating rate debt instrument and an interest rate swap issued/entered into on the same date with two different parties).

Accordingly, we strongly recommend that the FASB amend the linkage requirements to only require that two or more financial instruments within the scope of the Ownership Settlement Approach be linked if they are (i) contractually linked, or entered into with the same or related counterparty, (ii) pertain to the same or similar risk, (iii) were entered into at or near the same time, and (iv) are co-dependent upon each other (for example, are coterminous or must be exercised simultaneously).

3. ***Paragraph A40 describes how the substance principle would be applied to indirect ownership instruments. Similar to the basic ownership approach, an issuer must consider factors that are stated in the contract and other factors that are not stated in the terms of the instrument. Is this principle sufficiently clear to be operational?***

   The principles regarding substance in the Ownership Settlement Approach require an evaluation of all stated and unstated terms of an instrument, and therefore imply that economic compulsion must be considered when evaluating the classification of a financial instrument with characteristics of equity. ISDA supports the need to consider economic compulsion. However we acknowledge that this issue may create additional complexity because an entity's compulsion may change multiple times over the life of an instrument. The FASB should clarify that economic compulsion is required to be evaluated when determining the classification of an equity-linked instrument and that this evaluation will require judgment. Also, it is not clear whether companies must consider their economic compulsion and substance only at inception or during the life of an instrument. Thus, the FASB should also clarify when during an instrument's tenor companies must consider the effects of economic compulsion.

4. ***Statement of financial position. Equity instruments with redemption requirements would be reported separately from perpetual equity instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. What additional, separate display requirements, if any, are necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?***

   If the FASB were to adopt the Ownership Settlement Approach as published in the Preliminary Views, ISDA believes that separate classification of and distinction between instruments with equity characteristics classified as assets or liabilities and which are cash settled versus those that are share settled would be necessary, in order for financial statement users to easily evaluate an entity's true liquidity, the priority of an entity's claims, and its financial position.

5. ***Are the proposed requirements for separation and measurement of separated instruments operational? Does the separation result in decision-useful information?***

   The Ownership Settlement Approach will require a significant number of instruments issued in the market place today and which are accounted for as unitary instruments (for example, physically convertible debt, prepaid forward purchase contracts that can be net share or net share settled at the option of the issuer, etc.) to be separated. The separation and related measurement criteria for separated components proposed under the Ownership Settlement Approach is somewhat rules based and could give rise to complexity when applied in practice. Therefore we recommend the FASB consider any issues that arise from the implementation of proposed FSP APB 14-1, which requires separation of cash settled convertible debt in substantially the same manner as would be required under the Ownership Settlement Approach, in its liabilities and equity project.

6. ***The Board has not discussed the implications of the Ownership Settlement approach for the EPS calculation in detail. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?***

We refer you to ISDA's comments above regarding earnings-per-share under the Basic Ownership Approach. In summary, ISDA is unable to indicate a preference for how financial instruments classified outside of equity under the Ownership Settlement Approach should be reflected in basic and diluted earnings per share without knowing how all such instruments will be measured, classified and reported in the statement of financial performance and statement of financial position. However, consistent with our response to a similar question under the Basic Ownership approach, we recommend that the FASB develop a simple approach to measuring earnings-per-share which limits the need to adjust net income and weighted average shares outstanding for instruments within the scope of the Preliminary Views. Also we recommend developing earnings-per-share guidance for instruments within the scope of the Preliminary Views that are separated that does not require the application of the if-converted method to reduce complexity.

7. ***Are the requirements described in paragraphs A35–A38 of the Preliminary Views operational? Do they provide meaningful results for users of financial statements?***

ISDA finds the requirements in paragraph A37 difficult to understand and urges the FASB to incorporate examples in further exposure documents that illustrate the principles for modifying, derecognizing and settling instruments under the Ownership Settlement Approach. Additionally, we recommend the FASB to clarify that modifications to instruments that do not change the economics of the instrument by more than an insignificant amount should not be required to account for the modification based on the provisions of paragraph A37. Otherwise, changes to non-financial terms of an instrument could require recognition of a gain or loss in earnings, which would not faithfully represent the economics of the modification.

ISDA has the following additional comments on the Ownership Settlement Approach:

Indirect Ownership Instruments

Paragraph A6 of the Preliminary Views provides the following:

> "An indirect ownership instrument would be classified as equity by the issuer of the related basic ownership instrument if it is settled in either of the following ways:
>
> a. By issuing or delivering the basic ownership instrument from which its return is derived; or
> b. By delivering another indirect ownership instrument that is part of a chain of indirect ownership instruments, all of which have returns derived from the same basic ownership instrument and the last of which will be settled by delivering that same basic ownership instrument."

Paragraph A6 of the Preliminary Views seems to imply that equity classification for indirect ownership instruments (e.g., equity derivatives) under the Ownership Settlement Approach is granted only to such instruments whose payoffs are derived from a Basic Ownership instrument and which are settled through the issuance or delivery of the same Basic Ownership instrument. Since perpetual instruments, such as preferred stock, can be classified as equity under the Ownership Settlement Approach, ISDA recommends the FASB to allow equity classification for any indirect ownership instruments linked to another instrument that is classified as equity.

Transaction Costs

Paragraph A30 of the Preliminary Views provides that, "With one exception, instruments not separated into components would be initially measured at their transaction prices, and transaction costs and fees would be charged or credited to income immediately." Paragraph A32 of the Preliminary Views provides that, "Instruments separated into components would initially be measured in total at their transaction prices." Paragraph 30 of the Preliminary Views further provides that, "the term transaction price does not include transaction costs, whether they are included in the price paid by the seller (to the buyer) or billed or paid separately."

Because the FASB's basis for concluding that transaction costs associated with instruments within the scope of the Preliminary Views (including equity and nonequity instruments and components) are to be recognized in earnings immediately is not explained, ISDA does not understand why the Preliminary Views will treat transaction costs differently than under other GAAP (e.g., APB No. 21). We do not agree that different accounting models for transaction costs should be introduced into GAAP without justification.

3. **<u>Reassessed Expected Outcomes Approach</u>**

ISDA does not support the Reassessed Expected Outcomes (REO) approach for the following reasons:

- It would introduce undue complexity in financial reporting outweighing any perceived benefits. The approach would require financial statement preparers to expend significant resources on valuation techniques so that instruments can be remeasured each period. The approach would require financial statement users to constantly analyze the impact of reassessments and their impact to an entity's statement of financial position, liquidity, and the quality of its earnings.

- It will introduce significant volatility in reported earnings, which would not be meaningful to financial statement users.

- It will introduce significant volatility in a company's capital structure because of the constant remeasurements, which could constrain company's that manage their capital based on regulatory measures.

- It will require an unusual financial statement presentation. For example, a written call option will be separated into its components – an asset (the present value of the strike price) and equity (the conditional obligation to issue shares).

4. **<u>Other Approaches</u>**

ISDA evaluated and considered the Loss Absorption Approach in conjunction with its review of the three approaches included in the Preliminary Views. After careful consideration of the principles and other information available regarding the Loss Absorption Approach, including the Discussion Paper published by the European Financial Reporting Advisory Group (EFRAG), *Distinguishing between Liabilities and Equity*, ISDA concluded that this alternative approach is not preferable for the following reasons:

(i) its principles are not fully developed and
(ii) it raises conceptual and practical issues that have not yet been resolved,
(iii) it classification principles are not reflective of the economic realities of many instruments, and
(iv) it would be complex to apply in practice.

ISDA members may, however, reconsider its conclusion should a more fully developed version of this approach be proposed at a later date.

5. **<u>Other Comments</u>**

- While it appears that the Preliminary Views would only be applicable to issuers of financial instruments within its scope, ISDA recommends that subsequent exposure documents clarify that the guidance only applies to the accounting by the issuer of an instrument, and not the investor. Not doing so will only cause confusion and create operational issues when determining whether one or more embedded derivatives must be separated from the "host" of a hybrid instrument that is within the scope of the Preliminary Views.

- FASB must address and resolve the approach for initially and subsequently measuring perpetual instruments that are not Basic Ownership instruments.

- FASB must address how cumulative translation adjustments and other comprehensive income balances would be classified and presented in the financial statements under the Basic Ownership Approach.

- FASB must clarify how physically or net settled share based payments (e.g., employee stock options) within the scope of SFAS 123R, *Share Based Payments*, would be classified and measured under the Basic Ownership Approach. Currently, paragraph 30 of the Preliminary Views indicates that such instruments would not be subject to the initial measurement criteria of the Basic Ownership Approach; however, Instrument 8 in Table 2 of Appendix C indicates that such instruments would be classified as liabilities and subsequently measured at fair value with changes reported in earnings. It is unclear why share based payments within the scope of SFAS 123R would not be subject to the Basic Ownership Approach's initial measurement criteria but would be remeasured each period under the Basic Ownership Approach.

- The first sentence of paragraph 35 of the Preliminary Views provides, "Instruments for which there are no existing measurement requirements should be measured using the existing framework". This sentence is not understood by ISDA and should be corrected to clarify the framework to which the FASB is referring and the specific measurement attribute for other instruments and components classified outside of shareholders' equity under the Basic Ownership Approach.

- The FASB should develop and incorporate in the Exposure Draft that follows the Preliminary Views principles regarding whether a company's common shares or equity instruments are a viewed as a currency and whether and how the strike price of an entity's equity instruments affect the classification of such instruments in the statement of financial position.

- FASB must consider the effect of the classification and measurement required under the Ownership Settlement Approach on basic and diluted earnings per share. Earnings-per-share measures must be evaluated and considered as the FASB makes progress under its Liabilities and Equity Project.

- FASB must incorporate the decisions made under its Financial Statement Presentation project into the Liabilities and Equity project as presentation of balance sheet and income statement elements of instruments within scope of Preliminary Views is important to the overall framework for distinguishing between liabilities and equity and ensuring transparency and understandability of an entity's financial statements.

- The FASB must determine how it will amend the scope and transition provisions of SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities, for separated components that will be eligible for the fair value option.