ISDA Safe, Efficient Markets

October 11, 2019

Mr. Shayne Kuhaneck
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

By email: director@fasb.org

Re: File Reference Number 2019-730, Exposure Draft, *Debt-Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging-Contracts in an Entity's Own Equity (Subtopic 815-40)*

Dear Mr. Kuhaneck,

The International Swaps and Derivatives Association's ("ISDA")[1] Accounting Policy Committee (the "Committee") appreciates the opportunity to comment on the Financial Accounting Standards Board's ("FASB") Proposed Accounting Standards Update, *Debt—Debt with Conversion and Other Options* (Subtopic 470-20) and *Derivatives and Hedging—Contracts in Entity's Own Equity* (Subtopic 815-40) (the "Proposed ASU" or "Exposure Draft"). Collectively, the Committee members have substantial professional and practical expertise addressing accounting policy issues related to financial instruments. This letter provides our organization's overall views on the Exposure Draft and our responses to the questions for respondents included within the Exposure Draft.

Overview

ISDA supports the FASB's efforts to simplify the US generally accepted accounting principles ("GAAP"), applicable to certain financial instruments with characteristics of liabilities and equity, including convertible instruments and the applicability of the derivatives scope exception for contracts indexed to an entity's own equity. The Exposure Draft will reduce complexity for preparers and improve the decision-usefulness of information provided to financial statement users,

---

[1] Since 1985, the International Swaps and Derivatives Association has worked to make the global derivatives markets safer and more efficient. ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. The Association has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool. Today, ISDA has over 850 member institutions from 67 countries. These members comprise of a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of the Association toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

International Swaps and Derivatives Association, Inc.
10 East 53rd Street, 9th Floor
New York, NY 10022
P 212 901 6000 **F** 212 901 6001
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

as the Exposure Draft will minimize form-over-substance-based accounting conclusions for certain instruments.

Among others, ISDA is supportive of the following targeted improvements:

- The elimination of three accounting models for convertible instruments under current GAAP;
- The simplification that any convertible instrument that does not contain a bifurcated embedded derivative should be a single unit of account;
- For Subtopic 815-40, the addition of a threshold whereby contingent events that could require net cash settlement and other potential adjustments that have a remote likelihood of occurring no longer drive the accounting for certain instruments, assuming certain conforming changes are made as noted further below. ISDA is also supportive of the Board's decision not to require a quantitative determination of whether several remote features would have a more-than-remote likelihood of occurring in the aggregate;
- For the settlement guidance in ASC 815-40-25, *Derivatives and Hedging—Contracts in Entity's Own Equity—Recognition,* the removal of three conditions that are currently required for stockholders' equity classification; specifically, the requirements related to the ability to settle in unregistered shares, lack of collateral, and priority relative to common equity shareholder rights.

In addition to our responses to the FASB's Questions for Respondents in the Exposure Draft, we believe certain sections of the Exposure Draft would benefit from additional clarification to avoid unintended consequences. Consistent with this, we provide the following comments in addition to our responses to the Questions for Respondents.

Recommendations for Clarification

Adding a Remote Threshold in Subtopic 815-40:

The Exposure Draft in ASC 815-40-25-9 states that "if the likelihood of an event occurring that would cause net cash settlement is remote, then that potential outcome shall be disregarded when applying the guidance in this Subtopic. Additionally, if the payment of cash is only required upon the final liquidation of the entity, then that potential outcome need not be considered when applying the guidance in this Subtopic."

We note that the Exposure Draft does not propose to add a similar remote threshold for instruments within the scope of Topic 480, *Distinguishing Liabilities from Equity*. Adding a remote threshold to the settlement guidance in ASC 815-40 but not in ASC 480 could cause an inconsistency within the debt-equity framework that could render the proposed threshold in ASC 815-40-25 virtually inoperable for certain instruments. Specifically, a provision requiring an unavoidable cash settlement of a freestanding instrument that is outside an entity's control would likely be a Topic 480 liability, even if it was remote. For example, a warrant with a feature that allows the holder to require the issuer to redeem an instrument for cash upon a merger event outside of the issuer's control, even if remote, would be considered indexed to an obligation to repurchase the Company's stock under Topic 480.

Additionally, the FASB has not proposed to add a "remote" threshold to Step 1 of the equity indexation guidance under ASC 815-40-15. It is our understanding that one objective of the Exposure Draft is to avoid accounting determinations being made based on remote provisions within an instrument. If that is correct, the "remote" threshold should be consistent throughout the debt-equity framework by adding the same threshold to all applicable areas of the framework (i.e., Topic 480, ASC 815-40-15 Step 1 and Step 2, and ASC 815-40-25).

ISDA

While we are generally supportive of the addition of a remote threshold, we observe that it may be challenging in practice to evaluate certain common provisions under this threshold that are included in equity derivatives governed by the ISDA Equity Definitions (e.g., "Market Disruption Events," "Hedging Disruption," "Change in Law"). These events or concepts may be complex and/or a function of the counterparty (in a general sense) and, therefore, it may not be practical for an entity to develop a view on the relative probability of each. As such, to facilitate practical application of this remote threshold we suggest that the Board provide a rebuttable presumption that provisions or features related to events or circumstances that are outside the terms of the contract that will inform settlement in the normal course are considered remote.

Reclassification of Contracts:

The Exposure Draft removes the requirement to reassess the classification of a contract at each reporting period, except upon the occurrence of certain reassessment events. The Committee is supportive of this proposed change to only require reassessment based triggering events noted in ASC 815-40-35-8. However, it is unclear how this proposed guidance would interact with ASC 480-10-S99 (formerly EITF Topic D-98 ("D-98")), including:

1. Whether equity contracts that have a remote likelihood of cash settlement would be subject to the scope of D-98. Currently, equity contracts such as options and forwards are not in scope of D-98 and would be covered by the settlement guidance in ASC 815-40-25. With the addition of a remote threshold to the settlement guidance, it is unclear whether equity contracts that have a remote likelihood of cash settlement would now be scoped into D-98.
2. For instruments such as preferred stock that may be settled in cash or shares, D-98 references ASC 815-40-25 for an evaluation of whether the Company controls share settlement. It is unclear if the addition of the "remote" threshold to ASC 815-40-25 should be carried over into the D-98 analysis.

While we understand D-98 is SEC guidance, based on the FASB's proposed amendments, we recommend that the FASB work with SEC to make conforming changes to the existing D-98 guidance in order to make it consistent and operable.

Earnings per Share for Convertible Instruments:

The Exposure Draft proposes changes to the if-converted method in ASC 260-10-45-40 that require "for convertible debt for which the principal is required to be paid in cash, the interest charges shall not be added back to the numerator." This definition creates a modified if-converted method, which we do not believe is consistent with the objective of the Exposure Draft to simplify US GAAP. We believe the practical application of the proposed changes will effectively result in an EPS calculation that is no different than the treasury stock method.

In addition, while we acknowledge that GAAP currently precludes adding interest back to the numerator for these types of instruments, it is unclear as a conceptual matter why this approach is taken. In other words, although the principal is required to be paid in cash, contrary to the commentary included in paragraph 102 of the Basis for Conclusions, if a conversion is assumed to have occurred at the beginning of the period, no interest would have been accrued for the period. Paragraph 113 in the Background Information and Basis for Conclusions of *Statement of Financial Accounting Standard No. 128, Earnings per Share*, articulates a concept that convertible debt can participate in earnings through interest or dividends, either as a senior security or as common stock, but not both. And while the principal amount of this instrument will be settled in cash, *following conversion* the holder would not participate in earnings through interest – that is, it is not the case that the principal remains outstanding post conversion. If the FASB decides that interest should be included in the calculation, we believe the FASB should incorporate these instruments in the treasury stock method rather than creating a modified if-converted method.

Separately, the proposed guidance in ASC 260-10-45-45 requires an assumption that convertible instruments will settle in shares when calculating diluted EPS, which eliminates the ability for preparers to assert their intent and ability to settle in cash or shares even though it is at their sole option. This change is not an improvement of US GAAP for reasons including the following:

- The current EPS models reflect the actual economics of the convertible instrument's settlement. Generally, the settlement of the instrument follows management's stated intent and ability. Application of the Proposed ASU could result in an inappropriately diluted EPS presentation while the instrument is outstanding, which would subsequently be altered upon settlement of the convertible instrument in cash. Such a volatile reporting of EPS would not be representationally faithful to the terms or intended settlement of the instrument. Additionally, as a result of introducing a new EPS model, entities may start to report an EPS calculation that reflects how they intend to settle the contracts, which may be a non-GAAP measure.
- Management usually follows its intent as it relates to settlement and historically has been able to support its intent. Practice generally has a strict approach to handling unsubstantiated changes in stated intent.
- More broadly, there are other areas of GAAP where accounting classifications are based in part or wholly on management's intent, including loans, debt securities, normal purchases and sales, and forecasted cash flows comprising cash flow hedge relationships. The relevance of intent in US GAAP is well understood, has a history of being supported by entities, and little abuse has occurred in practice.

Transition for Earnings per Share:

The Exposure Draft states that entities will be required to apply a full retrospective method of adjustment and presume share settlement when calculating diluted EPS for all comparative periods presented. The Committee believes it would be complex and costly to apply a full retrospective transition, and that there would be little incremental benefit to users of the financial statements. As such, the Committee supports a prospective transition with an option for entities to apply a full retrospective transition approach for the EPS amendments.

In addition, the FASB should be aware of certain practices that preparers are considering in response to this Exposure Draft that may create unintended consequences. Specifically, in applying this guidance, preparers may make an irrevocable election to settle a contract as an Instrument C (i.e., the principal settles in cash and the conversion premium settles in shares). If this election is made, such preparers would apply a full retrospective transition reflecting full dilution for all comparative periods (when the instrument provides the issuer flexibility to settle in cash or stock) and then would apply the proposed modified if-converted method prospectively once this legal irrevocable election is made. In this scenario, a full retrospective adjustment would result in inconsistencies in the presentation of prior periods compared to the current and future periods and would not reflect the economics of how the instrument was intended to be settled for the prior periods. Therefore, the Committee asks the FASB to allow prospective transition for the EPS amendments.

Disclosures:

The Committee notes that introducing additional disclosures is not consistent with the objective of simplifying the guidance related to the accounting for convertible instruments. Specifically, the Proposed ASU includes requirements to disclose information regarding:

1. events or conditions that occurred during the reporting period that significantly affected the conversion conditions

2. the provision of fair value disclosures in Topic 825, *Financial Instruments*, at the individual instrument level, rather than in the aggregate for public business entities.

In particular, ASC 470-20-50-1E(b) and ASC 470-20-55-1B require disclosure of events or conditions that significantly affect conversion conditions, including those that indicate that conversion contingencies *may be* met or the conversion terms *may be* changed in the following reporting period. Disclosures include only items that are known and not items that are not yet determined. We encourage the Board to clarify the meaning of conversion conditions and what constitutes a significant effect. In addition, our members are concerned that having to disclose such conditions and what can significantly affect the conversion conditions could lead to proprietary or forward-looking information being disclosed to competitors and financial statement users that preparers would not want in the public domain.

Additionally, our members believe the requirement to disclose the fair value of all instruments at an individual instrument level can be onerous pursuant to ASC 470-20-50-1D. This disclosure for convertible instruments would not represent a simplification and would be inconsistent with other disclosures under Subtopic 825-10 that only require disclosure at the aggregate level. Additionally, as contemplated in paragraph 9 of the Basis for Conclusions, the costs of devising, implementing and maintaining processes to provide additional disclosure requirements in a controlled manner would not be outweighed by the benefits of such disclosures.

Closing

We hope you find ISDA's comments and responses 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.

Jeannine Hyman
Citigroup Inc.
Chair, North America Accounting Committee

Antonio Corbi
ISDA, Inc.
Director, Risk and Capital

Appendix

Responses to FASB's Questions for Respondents

Question 1: Should convertible instruments be accounted for as a single unit of account, except in circumstances in which the conversion features are required to be bifurcated by guidance in Topic 815? Please explain why or why not. Under this simplification, would any specific information about convertible instruments be missing in order to understand an entity entity's financial position and financial performance? If so, please explain what information would be missing and how that information is used.

Yes, our members agree that convertible instruments should be accounted for as a single unit of account when bifurcation is not required under Topic 815. We believe that separation of single instruments into multiple components does not result in useful information because typically an entire instrument is settled concurrently (i.e. the different components are not settled separately). Users also noted that cash interest is more relevant than the imputed interest that results from separation.

The proposed disclosures in ASC 470-20-50-1A through 50-1I and ASC 505-10-50-12 through 50-18 appear sufficient and appropriate in order to understand an entity's financial position and financial performance. However, as discussed above, certain disclosures may be judgmental and may present implementation challenges to preparers.

Question 2: Do the disclosure amendments in this proposed Update for convertible debt instruments in paragraphs 470-20-50-1A through 50-1I and for convertible preferred stock in paragraphs 505-10-50-12 through 50-18 provide decision-useful information? Should any of these disclosures be required for every annual and interim period for which a statement of financial position and a statement of financial performance are presented? Should any other disclosures for convertible instruments be required? Please explain why or why not.

Please see the Committee's response above to this question.

Question 3: Should remote settlement features be disregarded for purposes of determining the classification of a contract in an entity s own equity (for both indexation and settlement)? Is remote an operable threshold? Please explain why or why not.

Please see the Committee's response above to this question.

Question 4: Should a requirement to settle a contract in registered shares not affect the classification of a contract in the entity s own equity? Please explain why or why not.

Yes, based on outreach, instruments rarely, if ever, settle in cash when registered shares are not available and the contract is silent on whether unregistered shares may be delivered. Further, our members believe this is a difficult aspect of the guidance to apply and there is often disagreement between legal counsel and accountants regarding the ability to issue/settle a contract in unregistered shares. The removal of this condition will simplify the accounting analysis and would align the guidance on registered shares in Topic 815, *Derivatives and Hedging* with Topic 718, *Share-based Payments*. First, it would remove the condition on settlement in unregistered shares and second, similar to ASC 718-10-25-15, the requirement to deliver registered shares does not imply that an entity does not have the ability to deliver shares.

Question 5: Should a requirement to post collateral not affect the classification of a contract in an entity s own equity? Please explain why or why not.

Yes, we agree with the Board's decision to remove the classification requirement. Although posting collateral requires the use of assets in the short term, the nature of the collateral is that it may be returned and does not directly represent a settlement of the instrument as collateral is a separate unit of account. This condition is misaligned with other concepts in the existing guidance about settlement. Additionally, removing this classification requirement is more aligned with the proposed 'remote threshold' in the equity indexation guidance, as we do not typically see contracts being settled with the posted collateral. The removal of this condition from the equity classification guidance would also allow U.S. financial entities that report their financial statements under GAAP to enter into share forward and accelerated share repurchase contracts (which under the European uncleared margin rules are subject to ongoing variation margin requirements) and not be subject to mark to market accounting. This would lead to an improvement in financial reporting and in some cases allow financial entities that have foregone compelling economic transactions due to accounting to reexamine optimal shareholder capital return programs.

Question 6: Should the hierarchy of a counterparty's rights or shareholder rights not affect the classification of a contract in an entity s own equity? Please explain why or why not.

Yes, the Committee agrees with the Board's decision. This condition is unrelated to the concept of settlement. Additionally, the notion of shareholders' rights is not defined in the Master Glossary (other than as described in ASC 815-40-25), which makes this condition difficult to apply.

Question 7: Are the proposed amendments about reassessment of the derivatives scope exception operable? Should reassessment of the derivatives scope exception occur only upon a reassessment event (as defined in paragraph 815-40-35-8)? If not, should the reassessment be performed more frequently even if a reassessment event has not occurred, for example, on an annual basis? If performed annually, should the likelihood threshold be remote or should a different threshold be applied? Please explain your rationale for each of the answers provided.

Please see the Committee's response above to this question.

Question 8: Do the proposed disclosure amendments for contracts in an entity's own equity in paragraph 815-40-50-5(f) through (g) provide decision-useful information? Please explain why or why not. Should any other disclosures for contracts in an entity s own equity be required? Please explain which disclosures should be required and why.

The Committee believes that the proposed disclosure amendments in ASC 815-40-50-5(f) and (g) above provide decision-useful information that is readily available for most entities.

Question 9: Under current guidance in Topic 825, fair value disclosures are required for financial instruments that are classified as liabilities but are not required for financial instruments that are classified as equity. Should new fair value disclosures be considered for public business entities for all equity-classified instruments, including those outside the scope of the proposed amendments (such as employee stock options)? If yes, how would you use that information? If yes, which equity-classified instruments should the disclosures be required for?

The Committee believes the disclosure requirements under the current guidance in Topic 825 are appropriate. Fair value disclosures for equity instruments would be onerous and would not provide any additional decision-useful information for the users of financial statements beyond what is already provided in footnotes as required by Topic 820.

Question 10: Should diluted EPS for all convertible instruments be calculated using the if-converted method of diluted EPS? Is the revision to the if-converted method in paragraph 260-10-45-40(b) operable? Please explain why or why not.

Please see the Committee's response above to this question.

Question 11: For a contract that may be settled in either cash or shares (except for certain share-based payment arrangements that are classified as liabilities), should an entity presume (and not be allowed to overcome the presumption) share settlement when calculating diluted EPS? Please explain why or why not.

Please see the Committee's response above to this question.

Question 12: Should the Board consider a project about the effect of antidilutive instruments on the diluted EPS calculation (for example, the effect of call options used to offset the potential dilution from convertible instruments)? Should any other EPS improvements be considered? If yes, please provide details.

Our members are supportive of the Board considering a separate project about the effect of antidilutive instruments. This project should reconsider the treatment of antidilutive contracts broadly, avoiding targeted guidance for specific instruments or transactions. In addition to the example provided, the Board should also consider various stock repurchase instruments and activities (e.g., instruments used for share buy-back transactions) which may or may not be linked to a corresponding dilutive instrument.

To provide a specific example of why the Board should consider a project on antidilutive instruments, consideration should be given to convertible instruments concurrently executed with a bond hedge. Due to the current guidance, there is substantial precedent for companies disclosing cash EPS for these instruments as this is how investors evaluate the cash flows and earnings per share of the issuer. In addition, there are many entities that elect mandatory cash settlement of their convertibles and bond hedges to avoid the noneconomic diluted EPS impact of the convertible (which is 100% hedged by the bond hedge). However, this results in mark-to-market accounting for both the embedded conversion option and bond hedge, which introduces complexity in financial reporting (and disclosure) and earnings volatility due to the differences in fair value measurement (e.g., own credit risk). If the FASB allowed certain anti-dilutive contacts to be factored into diluted EPS, we believe companies would no longer deliberately structure the two instruments to be cash settled which would eliminate a substance over form outcome.

Question 13: Should the proposed amendments that affect classification, recognition, and measurement be applied on a modified retrospective basis, with an option for full retrospective application? Do you agree with the Board s proposed transition expedient? Please explain why or why not.

We agree with the proposed transition guidance that affects classification, recognition and measurement. Requiring full retrospective application would be costly to many entities when assessing the likelihood of contingent events at contract inception and for each of the reporting periods between the current period and contract inception.

Additionally, we agree with the proposed transition expedient. As stated above, a requirement to reassess each contract at inception and throughout the life of the contract until the current reporting period would be costly.

Question 14: Should the proposed amendments to EPS be applied as of the initial date of adoption for the transition from treasury stock method to if-converted method and applied retrospectively for instruments that may be settled in cash or shares? Please explain why or why not.

Please see the Committee’s response above to this question.

Question 15: How much time would be needed to implement the proposed amendments? Should the amount of time needed to implement the proposed amendments by entities other than public business entities be different from the amount of time needed by public business entities? Should early adoption be permitted? Please explain your response.

The changes to the debt-equity model and earnings per share guidance, as proposed, would require enhancements to policies, procedures, and reassessment of transactions to comply with the full retrospective adoption. In order to implement the requirements, particularly for entities other than public business entities, the Committee believes the effective date should be one year from the issuance of the final guidance. In addition, we believe private companies should be provided additional time given the significant changes in practice noted above and suggest two years from the issuance of the final guidance. Regardless of the effective date, we believe that early adoption should be permitted for entities that wish to take advantage of these improvements immediately.

Question 16: The proposed amendments would affect all entities that issue convertible instruments and/or contracts in an entity's own equity. Are there any specific private company considerations, in the context of applying the Private Company Decision Making Framework, that the Board should be aware of?

Yes, private companies are likely to be significantly impacted by the proposed amendments. In addition to the comment above regarding D-98, the subsequent measurement for instruments that do not meet the indexation criteria and do not meet the definition of a derivative will be fair value. Most SEC filers likely have been carrying these instruments at fair value, consistent with the SEC staff's longstanding position regarding written options. However, private companies may have historically accounted for these instruments as a cost-basis liability. This guidance could represent a significant change and present measurement complexity.

Given that the impact of this change is largely to private companies, the FASB may consider this as a reason for providing different transition guidance (e.g., prospective or longer time period) for these entities. Please refer to our comments below for further views on relief for private companies.

Question 17: The proposed amendments would supersede various areas of guidance (such as the guidance on certain accounting models for convertible instruments). Do you expect that superseding that guidance will result in any unintended consequences? For example, is there guidance that is currently analogized in practice to account for transactions for which there is no explicit guidance under current GAAP? Please explain what those unintended consequences are and potential solutions, if applicable.

The proposed guidance has the potential to change current industry accounting practice for traditional over-allotment options (referred to as "greenshoes") on convertible debt, common stock, and preferred stock issuances. Traditional over-allotment options are rights granted by the issuer of the aforesaid financial instruments to underwriters of such securities that allow them manage demand in the market typically for a 30-day period. These options are only exercisable by the underwriter if demand for the securities exceeds the securities allotted to it by the issuer at pricing.

Practitioners generally conclude that traditional over-allotment options do not meet the definition of a derivative given that there is no notional amount (there is no minimum greater than zero and the notional amount is not readily determinable as the amount depends on the underwriter's market stabilization activities). To the extent that a practitioner concluded that an over-allotment option on convertible debt did not have a notional amount, such arrangements would not be considered indexed to an entity's own stock. In this case public companies would be permitted to avoid mark-to-market accounting because the SEC staff has not historically applied its longstanding position on written options to traditional over-allotment options (resulting in accrual accounting for such arrangements). However, the Proposed Amendments could have unintended consequences for both public and private companies that grant overallotment options to underwriters by requiring such arrangements to be accounted at fair value on a recurring basis. Consequently, we recommend that the FASB examine the potential implications of the Proposed ASU to over-allotment options and also consult with the SEC staff on whether the staff's longstanding view on these arrangements can be incorporated into GAAP.

Please also see the Committee's response above related to the transition guidance for EPS and unintended consequences of a retrospective transition methodology.