Centre for Financial Market Integrity

11 November 2008

Mr. Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: SEC Study of Mark to Market Accounting (File No. 4-573)

Dear Chairman Cox:

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),[1] in consultation with its Corporate Disclosure Policy Council (CDPC)[2], appreciates the opportunity to comment on the SEC Study of Mark to Market Accounting (File No. 4-573).

CFA Institute represents the views of its investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics* and *Standards of Professional Conduct.*

INTRODUCTION

We are experiencing exceptional economic times and we generally support measures to contain the systemic risk that could arise from a financial meltdown. To that end we support the Commission's efforts to conduct a study of "mark-to-market" accounting applicable to

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[1] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With offices in Charlottesville, VA, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

financial institutions, including depository institutions, under the Emergency Economic Stabilization Act of 2008.

Our key message is that we do not consider current accounting standards and the application of fair value accounting by financial institutions, in particular, to be one of the causes of credit crisis. We therefore encourage the authorities to focus on the real causes of the crisis.

Therefore, it is troubling that some of the initial responses have focused on and overstated the role of accounting during the credit crisis.

On November 3, 2008, CFA Institute Centre for Financial Market Integrity submitted written testimony to The Treasury Select Committee of the United Kingdom Parliament in advance of the Committee's session dealing with accountancy and the banking crisis to be held on November 11, 2008. This written testimony is our comprehensive position and view of the matters surrounding the credit crisis and is attached for your review. In our written evidence we recommended the following:

KEY RECOMMENDATIONS

- Fair value standards which are critical to the integrity of the financial markets should be maintained.
- Any systemic circuit-breaker should be introduced through the regulatory capital regime.
- The emphasis should be on helping investors to interpret reported values. Rather than suspension, we recommend the improvement of fair value reporting presentation and enhancement of associated disclosures.
- Political leaders support and safeguard measures to ensure the independence of the standards setters and its accountability to its key stakeholders including investors.
- Political leaders should resist the temptation to impose regional carve-outs of financial reports as this will reduce the comparability of financial reports for investors.

FAIR VALUE MEASUREMENT

During the crisis, a debate has arisen on whether fair value reporting, by marking assets to their external market prices:

- provides a more reliable indicator of economic worth compared to alternative reporting methods during inactive markets, and

- is pro-cyclical and detrimental to the solvency of financial institutions.

A recently published, October 2008, IMF report has carefully studied these two questions and finds that on balance fair value is the best available approach for accounting for financial instruments. The pro-cyclical effects are overstated. The pro-cyclical effects can be managed by separating regulatory capital decisions from information required for transparency.

- CFA Institute's support for fair value accounting is backed by a poll conducted of our 12,000 person EU membership, which shows that ***79% were opposed to suspension of fair value and 85% believe that suspending fair value would decrease investor confidence in the banking system***. We acknowledge that there are some limitations and implementation difficulties associated with the fair value measurement approach including measurement error. But these limitations are not unique to the fair value approach. In fact, fair value has a well established history of application under US Generally Accepted Accounting Principles (US GAAP) for financial assets for 15 years. Considering its overall benefits, fair value is the best available alternative of measuring financial instruments and on balance, it significantly contributes to the overall transparency of financial institutions.

- Financial reporting information is used by investors for capital allocation and concurrently by regulators for the assessment of safety and soundness of financial institutions. Nevertheless, there is a need to disentangle these two objectives as there is a tension between the need to provide relevant information for investors versus information that is geared at stability and soundness. Pro-cyclical effects of fair value accounting often arise due to the failure to delink information required for overall transparency from that applied in the determination of capital adequacy. We note that bank write-downs would arise due to impairments under a historical cost approach.

- The anticipation that concealing mark-to-market losses will re-instil investor confidence and is an antidote to pro-cyclicality seems to be based on the misconception that observed net income volatility is the sole stimulus to investor perception of the risk of financial institutions. We argue that a more effective way of restoring confidence and ensuring investors do not misinterpret firm performance is to enhance financial statement presentation to enable investors to distinguish between core operating earnings from gains or losses of holding assets. This should be coupled with meaningful disclosures that can convey the inherent uncertainty and margin of error on the valuation of complex financial instruments.

ACCOUNTING STANDARD SETTING PROCESS

- Admittedly fair value measurement basis is not without limitations and there is clearly more work to be done to ensure the consistent application of current accounting literature on fair value for illiquid financial instruments. However, consideration of the application rules needs a deliberative process that necessarily draws upon the expertise and mandate of independent standard setters.

- A rigorous and inclusive due process is important because of the complexity of the amendments required

- Any rushed or partisan influence of minority interests that forces the standards setters to adjust accounting standards will be detrimental to the overall quality of financial reporting. In addition, it can derail the ongoing convergence and improvement of global financial reporting.

CLOSING REMARKS

If you, other board members or your staff have questions or seek further elaboration of our views, please contact Patrick M. Finnegan, CFA, by phone at 212-754-8350, or by e-mail at patrick.finnegan@cfainstitute.org.

Sincerely,

/s/ Kurt N. Schacht

Kurt N. Schacht, CFA
Managing Director

/s/ Patrick M. Finnegan

Patrick M. Finnegan, CFA
Director, Financial Reporting
Policy Group

Centre for Financial Market Integrity

CFA INSTITUTE MEMORANDUM TO THE TREASURY SELECT COMMITTEE

'ACCOUNTING AND THE BANKING CRISIS'

3rd November 2008

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1. INTRODUCTION

The CFA Institute Centre[1] represents the views of its members, including portfolio managers, investment analysts, and advisors, worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protection. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics and Standards of Professional Conduct.*

The Centre is involved in policy formulation, advocacy and thought leadership on financial reporting matters. To fulfil its mandate the centre actively engages with accounting standard setters and with its membership.There are several strands to the centre's work on financial reporting. These include ensuring investor considerations are factored into accounting standard setting process, communicating to members and pooling their views on key financial reporting issues and public awareness on financial reporting transparency.

[1] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With headquarters in Charlottesville, VA, and offices in New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 98,000 members. The membership comprises of investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. In addition we have a network of 136 member societies organised across 57 countries and territories.

2. EXECUTIVE SUMMARY

2.1. The causes of the current financial crisis are poor lending practices, inappropriate risk management, model failure, asymmetrical compensation schemes and poor governance, not fair value or mark-to-market reporting. In fact, fair value reporting has helped to reflect the true severity of these problems.

2.2. **At the crux of the debate on fair value reporting by banking institutions is whether it provides a more reliable proxy of economic worth compared to alternative reporting methods during inactive markets.** We believe that where available, market prices provide the best proxy of underlying economic worth. Including a discount for both liquidity and non performance risk in observable market prices enables the reflection the economic reality and conveys information to investors about the effects of these risk factors.

2.3. Considering the bespoke structured products that significantly contributed to the credit crisis, there are lessons to be learnt about the high likelihood of model error due to over-optimistic assumptions when relying largely on internal models. See 7.2.5

2.4. A summary of our key messages follows:

A. Fair value provides the best representation of economic reality. It provides an early warning system and is the only accounting regime that can facilitate the timely correction from previous bad decisions.
B. Investors are opposed to the suspension of fair value and believe fair value contributes to transparency in financial institutions.
C. The pro-cyclical effects of fair value accounting arise because of the failure to delink information required for overall transparency from that applied in the determination of capital adequacy. Please see paragraph 7.8 for elaboration.
D. Rather than reducing the application of fair value, the focus should be on improving and expanding its current application across all financial instruments.

3. RECOMMENDATIONS

We recommend the following for the Committee's consideration:

3.1. Attention should be focused on the causes of the financial crisis as highlighted in paragraph 1.1 and 6.1, not financial reporting.

3.2. Support the expansion and development of fair value across all financial instruments. See sections 6

3.3. That any systemic circuit-breaker should be introduced through the regulatory capital reserve. See section 7.8.

3.4. That political leadership should be directed at safeguarding the integrity and independence of the international financial reporting standard setting framework, and supporting the ongoing convergence and improvement of financial reporting quality under the auspices of the International Accounting Standards Board (IASB). See sections 8 and 9.

4. PREAMBLE

4.1. CFA Institute's support for fair value accounting is backed by a poll conducted of our 12,000 person EU membership, which shows that **79% were opposed to suspension of fair value and 85% believe that suspending fair value would decrease investor confidence in the banking system**. We acknowledge that there are some limitations and implementation difficulties associated with the fair value measurement approach (see paragraph 6.5). Nevertheless, fair value has a well established history of application under International Financial Reporting Standards (IFRS). Fair value is the best available alternative of measuring financial instruments and on balance, it significantly contributes to the overall transparency of financial institutions. **Hence, fair value standards are critical to the integrity of the financial markets and should be maintained.**

4.2. Financial reporting information is used by investors for capital allocation and concurrently by regulators for the assessment of safety and soundness of financial institutions. Nevertheless, there is a need to disentangle these two objectives as there is a tension between the need to provide relevant information for investors versus information that is geared at stability and soundness. Pro-cyclical effects of fair value accounting often arise due to the failure to delink information required for overall transparency from that applied in the determination of capital adequacy (see paragraph 7.8). **Any systemic circuit-breaker should be introduced through the regulatory capital regime.**

4.3. The anticipation that concealing mark to market losses will re-instil investor confidence and is an antidote to pro-cyclicality seems to be based on the misconception that observed net income volatility is the sole stimulus to investor perception of the risk of financial institutions. We argue that a more effective way of restoring confidence and ensuring investors do not misinterpret firm performance is to enhance the financial statement presentation so as to enable investors to distinguish between core operating earnings from gains or losses of holding assets. This should be coupled with meaningful disclosures that can convey the inherent uncertainty and margin of error on the valuation of complex financial instruments. **The emphasis should be on helping investors to interpret the reported values. Rather than suspension, we recommend the improvement of fair value reporting and associated disclosures.**

4.4. As stated the fair value measurement basis is not without limitations and there are clearly challenges on how to consistently apply fair value for illiquid financial instruments. However, consideration of the application rules needs a deliberative process that necessarily draws upon the expertise and mandate of an independent standard setter, namely the IASB. Any rushed or partisan influence of minority interests that forces the IASB to adjust accounting standards will be detrimental to the overall quality of financial reporting. It can derail the ongoing convergence and improvement of global financial reporting. **There is a pressing need for our political leaders to support the work of the IASB and to separately address the causes of the credit crisis.**

4.5. EU has provided global leadership in the path to the realisation of converged, high quality accounting standards. Given the considerable progress that has been made and resources invested in the convergence process, it will be hubristic, wasteful and contrary to the welfare of investors, auditors and financial statement preparers if European authorities take any measures to undermine the IASB

5. PURPOSE AND INTENDED AUDIENCE OF FINANCIAL ACCOUNTS

5.1. We consider financial accounting information to be the '*lifeblood of capital markets* and a key part of the mosaic of information applied by investment analysts and portfolio managers when they are assessing the performance prospects and risks of reporting entities. Financial accounting information is an important conduit for corporate managers to convey and communicate the past, current and prospective economic reality of their reporting firms.

5.2. We concur with the objective of financial reporting articulated by the IASB conceptual framework[2] identifying the primacy of investors as users of financial statements. The framework states

> *"The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions"* and that "*Financial reporting should provide information to help present and potential investors and creditors and others to assess the amounts, timing and uncertainty of the entity's future cash inflows and outflows."*

5.3. An updated pronouncement, contained in the exposure draft 'Preliminary views on improved financial reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision Useful Financial Reporting Information', states

> *"The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit and similar resource allocation decisions".*

5.4. The framework further delineates the primary qualitative characteristics of useful financial information namely relevance (i.e. decision useful), reliable (faithful

[2] International Accounting Standards Board: Framework for the Preparation and Presentation of Financial Statements; London 1989.