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SEC Study of “mark-to-market” accounting applicable to financial institutions, including depository institutions.

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I. SFAS 157 provides no guidance in a disorderly market

I am uncertain what was the cause of the October 2008 unprecedented market decline (financial panic), but I am certain that FASB 157 Fair Value Measurement made it more severe. It made it more severe because it introduced uncertainty into the valuation process, especially in a disorderly market. Further, just at the [quarter-end] moment when preparers and users were asking to resolve that uncertainty, the SEC and the FASB raised false hopes of resolutions of the uncertainty and the FASB, unendorsed by the SEC, issued FSP 157-3 as a final statement. That unendorsed statement provided no clarity or change and, therefore, introduced even **more** uncertainty into the process.

Evidence of that uncertainty in the valuation process was revealed by the number and quality of petitions for clarity **early on** and later after the issuance of SFAS 157 and after the issuance of FSP 157- 3 to the FASB and the SEC. I observe that the **uncertainty was compounded** by the FASB noting in their October 8 webcast (FASB.org/ October webcast; since retracted) that the SEC asked about including liabilities into the FSP. That begged of the issue of the status of FSP 157 - *c Measuring Liabilities under FASB Statement No 157* outstanding since January 18, 2008, and cast a doubt over the SEC’s commitment to accept FSP 157 -3.

SFAS 157 states that “fair value is the price that would be received to sell an asset or paid to transfer a liability **in an orderly transaction** between market participants at the measurement date” (5).

Orderly means “arranged or **disposed** in some order or **pattern**”. A pattern is defined as a **reliable sample** of ... other **observable** characteristics of a ... group.” (Webster’s Ninth Collegiate Dictionary). In a financial instruments market, I reason that an orderly market is where there are observable prices for a normal [pattern] population of offer and bid [reliable] transactions. Certainly, few would argue that the October 2008 financial panic should be considered an orderly market. Indeed, Robert Herz, Chairperson of the FASB stated in discussing FSP 157-3 that the decline was “unprecedented” (FASB.org/October FASB webcast; since retracted)”, and the SEC referred to the current environment as a

“credit **crisis**” (September 30, 2008 *SEC Office of the Chief Accountant and the FASB Staff Clarifications on Fair Value Accounting*).

I am uncertain of the degree to which **each** financial instrument market was disorderly. However, when a number of market people reported there were fewer buyers, i.e., unreliable observations, relative to historic norms, or **no** buyers, i.e., no observations, and various market prices declined dramatically, I thought that it was credible that some, if not all, financial markets were disorderly.

SFAS 157 provides no guidance for valuing in disorderly markets. Indeed the SEC and FASB staff noted that “the results of disorderly transactions are **not** determinative when measuring fair value” (September 30, 2008 *SEC Office of the Chief Accountant and the FASB Staff Clarifications on Fair Value Accounting*). In the absence of such guidance, preparers and users could either analogize to the guidance for orderly markets or reason to something else. A document named *Fair Value Measurement* suggests it is comprehensive, so it is unlikely one would think beyond SFAS 157. Further, in this accounting environment where the written standard is paramount, few are willing to not at least start with what is written. I infer that some realizing that SFAS 157 was inadequate guidance for a disorderly market, petitioned the FASB/SEC for new guidance. The FASB’s apparent response was to say in different words SFAS 157 (using vague phrases like “the Company determined” to use Level 3 valuation inputs without explaining how the determination was made, or how those Level 3 factors were applied). Thus, it ignored the request for guidance for valuing in disorderly markets and failed to follow through on the promise to “deliver additional interpretive guidance implied by the SEC and FASB September 30, 2008 release”.

The FASB and SEC have circled the issue of disorderly markets by discussing inactive markets. SFAS 157 covers inactive markets (28b.) SFAS157 has not covered disorderly markets, which may **also** be inactive... or active.

II. SFAS 157 Provides Contradictions and Confusion in the Valuation in an Orderly Market

Analogizing to an orderly market under SFAS 157 is difficult because the SFAS 157 guidance on orderly markets has significant contradictory or confusing elements.

A. SFAS 157 is Contradictory

For example, SFAS 157 asks for a valuation “at the **measurement date** [i.e., the balance sheet date], then requires “the use of quoted prices in an active market for identical assets or liabilities and it shall not be adjusted because of the size of the position relative to trading volume (blockage factor)... The use of a blockage factor is prohibited, even if the markets normal daily volume is not sufficient to absorb the quantity held and placing orders to sell the positions in a single transaction might affect the price” (27). This ignores the SFAS 157 definition of fair value (as well as the economics of the transaction).

In its Basis for Conclusions, the FASB acknowledge that the FASB appointed Task Force “affirmed that discounts involving large blocks exist, generally increasing as the size of the block is traded” (C76). Also, “the Board learned that for blocks held by broker-dealers, [broker-dealer] industry practice is often to sell the securities in multiple transactions involving quantities that might be large but that are not necessarily blocks; that is, the securities could be sold at the quoted price for an individual trading unit. Because of that selling practice, the **majority** [not all] of the Board decided that there was no compelling reason to allow the exception to P×Q in the [Audit] Guides to continue under this Statement.” (C79).

The contradiction is that the valuation must be as of one day, the measurement date, but virtually all the time the sale of a block can not be accomplished in one day. (The FASB offered other reasons for eliminating volume considerations from valuation for Level 1 inputs, but a reading reveals that they are not based on economic facts and rest solely on precedent the FASB effectively created.)

The financial panic resulted in a number of illiquid markets. Sometimes, illiquidity is factored into a valuation by assuming when a financial instrument can be sold, then taking the present value of that future settlement assumption. However, to take a future settlement date is to ignore the requirement to provide a value at the measurement date. The fact is: The FASB is suggesting that SFAS 157 requires one to value something that has no value on the measurement date because it is illiquid. It is literally and figuratively a SFAS 157 contradictory “catch (22)”.

B. SFAS 157 is Confusing

As another example, SFAS 157 defines fair value level 2 inputs, in relevant part, as “28 b. Quoted prices for identical or similar assets or liabilities in markets that are not active, that is, markets in which there are **few transactions** for the asset or liability, the prices are not current, or price quotations vary substantially either over time or among market makers (for example, some brokered markets), or in which little information is released publicly (for example, a principal-to-principal market). Further, “Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition and/or location of the asset or liability, the extent to which the inputs relate to items that are comparable to the asset or liability, and **the volume and level of activity in the markets within which the inputs are observed**. An adjustment that is significant to the fair value measurement in its entirety **might** render the measurement a Level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall” (29). So, if there are few transactions, one is in Level 2; then, if there is effectively now “less than few”, then it is in Level 3.

This is confusing because “few” is vague and “less than a few” is also vague. Confusion also exists because Level 2 inputs with few transactions implies there is an orderly market, so “less than a few”, using the definition of orderly above, is a disorderly market.

But SFAS 157 says ‘An adjustment [to a Level 2 measurement] that is **significant** to the fair value measurement in its entirety **might** render the measurement a Level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall. The SFAS 157 statement is confusing because it implies a disorderly market can be measured with Level 3 inputs. Also, the use of the term “might” when, by definition (i.e., “the level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is **significant** to the fair value measurement in its entirety” (22)), the item is significant; therefore, it **must** be a Level 3 valuation.

III. SFAS 157 is Not the Only Thing FASB Did Wrong

The FASB maintains that SFAS 157 “did not require new fair value measurements” (Summary). In fact, SFAS 157 eliminated the use of broker dealer blockage factors, required the recognition of dealer profit and the recognition of “Day One” profit, the recognition in net income of the valuation of company liabilities, required the production of SFAS 141R that changed a number of aspects of purchase business combination accounting, and as noted, created uncertainty in how to determine a fair value. But the real problem is that the FASB has been producing an increasing number of accounting standards that require fair value accounting. SFAS 157-3 did one good thing in that it surfaced that fair value is actually done a number of different ways. Unfortunately, some of the fair values for the same item are equally valid, especially those that rely on unobservable inputs.

IV. What Should Have Been Done?

OK. Maybe my criticisms are valid, but what would one do? Maybe, one could think, one can see my criticisms are valid if one sees the solution!

The proposed solution: The FSP 157-3 should be rescinded and a new FSP 157 – 3R installed. It should say “Fair value is the price that would be received to sell an asset or paid to transfer or settle a liability at the measurement date” (5). If unusual market conditions exist and a more limited or virtually no market or no market exists, the impaired value should be determined considering the probable use of the item., and recorded.

(Also, none of the above-noted faulty SFAS 157 distinctions should be made.)

(If you thought this idea has Merritt, please deposit the FASB Chairman’s salary to my [Swiss] bank account.)

At the least, no SFAS 157–3 should have been released. And the SEC and FASB should have said they did not provide guidance on disorderly markets.

Note that the draft IASB’s Expert Advisory Panel’s September 16, 2008 draft referred to by the SEC in their September 30, 2008 release defined a “forced transaction” as a “legal

requirement to transact, a necessity to dispose of an asset immediately or the existence of a single potential buyer. Only the latter can be seen in a disorderly market with one or non participants. If that report had any authority it would provide objective proof of a disorderly market.

V. Beyond the current accounting

I am uncertain what was the cause of the October 2008 financial panic, but I am certain that there were some fundamental economic issues at play, including the degree of effective regulation. The SEC seemingly has the ability to halt trading, e.g., ban short sales, or modify trading activity, e.g., use circuit breakers to limit trading. Those real actions should have an accounting effect. What is the point of classifying an item as trading when it can not be traded? The accounting should change for those economic events and not be hidebound by accounting rules that effectively assumed an orderly market.

I am also certain that various parties are not interested in recording losses and are seeking any way to avoid that or making the valuation process easier. But that is not my concern; my concern is with the theoretical and drafting inadequacies in SFAS 157 *etc.*.

As you may be aware, SFAS 157 was significantly modified from its original Exposure Draft (as noted by several, but not the majority, Board members in issuing FSP SFAS 157-2) and, despite protests from **financial services companies** and non-financial services companies, no re-exposure draft was issued and no Field Test was run. Surprise!

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