S7-~~26-09~~
S7-26-08 243
4-573
E5128786 231

McElveen, Josephine

From: Paul D. Mendelsohn [paulm@windhamfinancial.com]
Sent: Friday, March 06, 2009 9:08 AM
To: CHAIRMANOFFICE
Subject: Mark To Market & Uptick Rules

March 6, 2008

Chairman Mary Schapiro
US Securities & Exchange Commission
Washington, DC

RECEIVED
APR 14 2009
OFFICE OF THE SECRETARY

Dear Mary:

We are now approaching the point in time where the suspension of FASB 157 mark to market accounting and the reinstatement of the uptick rule become critical if we are to save our financial system and the survive as a nation. Mary, It is time to stop studying these topics and take action.

Mark to Market of illiquid mortgage backed assets on bank balance sheets does not work when markets are impaired, as they are now. This rule is causing tremendous stress in that they mandate a vast understatement of a bank's capital. Many securities on the books of banks will eventually prove to be worth far greater than what they must now be valued at. They should be marked to intrinsic value (see article below). This change would not cost taxpayers a dime, and a two year immediate suspension, which can be implemented by the SEC, or perhaps by congressional action supported by the President,would provide plenty of time to evaluate the impact of the ruling on the markets and banking institutions.

In addition, the suspension of the uptick rule has opened a security hole into our financial system. Under the old rules, a short seller needed to have a buyer on the other side of a trade as indicated by a zero or positive uptick before another order could be executed. This protected the system. Now short sellers from who knows where, or with what motives can drive stocks that are fundamental to our economy down to almost zero, wiping out critical equity capital. Since this is a zero sum game, someone somewhere in the world is making a lot of money at our expense. These two problems mark to market and unlimited short selling have now combined to drive our financial system into insolvency.

Without bold action now, we are in continuing danger of a complete market meltdown and a total collapse of our financial system. Do we have to wait for the Dow Jones Industrial to fall to 3,000 because all worldwide shipping and trade has stopped because banks cannot issue letters of credit, as a result of these past rulemaking errors before we act. I have included below an article I produced on this problem. This is a national security issue, It's time to stop studying the problem and take action.

Paul D. Mendelsohn - President
Windham Financial Services, Inc.
Member FINRA, SIPC & MSRB
3078 Hawkins Road
Ferrisburgh, VT 05456
Tel: 802-877-6589
Fax: 802-877-6906
E-Mail: paulm@windhamfinancial.com

TIME TO END MARK TO MARKET

By Paul D. Mendelsohn

We are at a critical point in time in our economic history, where if we do not understand the trigger points that brought us to this level of crisis, there will be little hope of solving our current dilemma. It is easy to look back at the 1930's and see that the Smoot-Hawley Tariff Act and Federal Reserve monetary policy played a major roll in creating and prolonging the worldwide depression. So, why is it so difficult for policy makers to understand the roots of our current crisis and address today's problem. One of the major trigger points of the current disaster is FASB 157, better known as the "Fair Value Rule" or "Market To Market Rule" that took effect for corporate financial statements produced after November 15, 2007. This rule shifts the burden of accounting for assets under "GAAP" to market participant based assumptions, as opposed to an intrinsic model or theoretical based assumptions.

Here's the problem. Let's say a bank has purchased a series of geographically diversified securitized mortgage backed securities. How do we value them? Let's say that within that mortgage series, 20% of those mortgages have defaulted and the prices of those defaulted houses have declined and can be sold at roughly 50% below what they were valued at when the securities were originally issued. What is the intrinsic (theoretical) value of the security? The answer is approximately 90 cents on the dollar. 100 - (0.20 x 0.50). Now it gets a little more complicated, because we have to discount the adjusted stream of interest payments over the life of the issue and we also have to adjust for the credit rating that makes the lower quality traunches of these securities more responsible for the losses than the higher quality tranches. Also, the derivative side of this market complicates things a little further. However, let's keep it simple for the time being and assume that 90 cents is somewhere near the correct value.

However, banks bought these securities and borrowed money through the issuance of short-term commercial paper (usually maturing in 180 day or less) and leveraged their positions 10 to 1, 20 to 1 and sometimes even 30 to 1 in order to profit from the spread between their short-term cost of money and the long-term income stream produced from these securities. Not unusual, this is what banks do. But at a 20 to 1 leverage ratio, a 10% decline in the value of those securities calculated above ($1.00 - $0.90) equals a catastrophic 200% loss of principal. Now let's take this one step further. As defaults grew and housing prices declined, the investors that bought the commercial paper sold by the banks that were supporting these mortgage securities, decide to cash-in their loans as they came do. However, there was no liquid market for the longer-term mortgage backed securities held by the banks and they, therefore, could not easily be sold. The banks were now left holding these securities with no collateral to support them. The banks made the classic mistake of borrowing short and lending long, ran out of short-term money and had to use their own capital in an attempt to support these positions.

Now let's look at the absurd position we now find ourselves in. Some of the banks are forced to sell these long-term securities, but because of extreme credit market conditions they can only get 20 cents on the dollar. Now FASB 157 kicks in and says that this is the fair market value of these securities. Now we have an 80% ($1.00-$0.20) real loss on these bank held assets instead of the 10% intrinsic (theoretical) decline, which means at a 20 time levered ratio, the holder has suffered a catastrophic 1600% total loss on their investment. But has the intrinsic (theoretical) value of the security really changed? No, it is still worth whatever the current or projected default rate is times the adjusted value of the home prices in default, then further adjusted for the level of exposure in the tranche and then discounted by the income streams forward. Now, while it's hard to recover from a 200% loss on the intrinsic (theoretical) value of these securities, there is not enough money in the world available either through the Federal Reserve, US Treasury, Bank of England, Bank Of Japan, European Central Bank or Peoples Bank of China to cover a 1600% loss in the bank capital tied to these securities at mark to market accounting.

The argument that defenders of FASB 157 make is that it provides market transparency. This is nonsense. These securities were bought by the banks on the expectation that they would be held to maturity, and an accounting footnote at the bottom of the banks' balance sheet describing how the intrinsic (theoretical) value was calculated, would give investors and analysts who value the companies holding these securities, a very good picture as to whether there was or was not any merit to those calculations. Investors could then make their own decisions as to what these companies were really worth. I suspect they would value them higher than current prices, making it easier for the banks to raise much needed capital from the private markets and requiring less from world governments to bridge their capital gap. FASB's attempt to create a one size fits all accounting approach, has played a major role in creating this crisis through the law of unintended consequences, just as the Smoot-Hawley Tariff Act did in the 1930's.

We do not have the time to wait for FASB to study this problem and recommend changes to these rules sometime late in the 2nd quarter. Time is running out and we need a temporarily suspension of this rule until they can come up with a longer term solution. This would go a long way in calming the markets and buying some much needed time to resolve our credit problems.

Paul D. Mendelsohn is President and Chief Investment Strategist at Windham Financial Services, Inc. Windham Financial provides econometric forecasting and quantitative, fundamental and technical analysis of markets worldwide