



Securities Industry Association

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Mr. David Kaplan, Chairman
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Mr. Edmund Jenkins, Chairman
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Mr. Timothy Lucas, Director of Research and
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Financial Accounting Standards Board
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Re: Block Discounts

Dear Sirs:

On behalf of the Securities Industry Association's¹ Dealer Accounting Committee ("the Committee," a list of the membership is attached) I wish to express our views of the revised draft of the American Institute of Certified Public Accountants ("AICPA") audit and accounting guide entitled *Audits of Investment Companies* (the "Guide"). In particular, we are concerned by the provisions of the Guide having to do with "block discounts." We view the adoption of those provisions

¹ The Securities Industry Association brings together the shared interests of more than 740 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of more than 50-million investors directly and tens of millions of investors indirectly through corporate, thrift, and pension plans. The industry generates more than \$300 billion of revenues yearly in the U.S. economy and employs more than 600,000 individuals. (More information about the SIA is available on its home page: <http://www.sia.com>.)

as potentially having a very deleterious impact upon certain investment companies and securities firms, and are concerned that this change to current practice is being proposed without due process and more of an opportunity for feedback by those who will be impacted by it. We request that before final action is taken with respect to those provisions that we have the opportunity to meet with you to explain our concerns.

At Odds with Industry Practice

The Financial Accounting Standards Board (“FASB”) recently cleared the draft Guide for final issuance, and we understand that FASB did so on condition that the AICPA explicitly state that the “fair value” of a position in an otherwise unrestricted security (“unrestricted security”) for which a quoted market price on an active market is available (“market price”) is the product of the number of trading units of the security multiplied by the market price.

It is our understanding that the necessary consequence of this change in current practice would be that an entity subject to the Guide and holding a large block of an unrestricted security would be precluded from using “block” or “liquidity” discounts for purposes of determining the fair value of that position. We believe that such a requirement will have a very deleterious impact upon venture capital funds, investment partnerships, and other investment companies that may have a significant position in an unrestricted security.

It is a commonplace observation in the financial services industry that one can’t “execute in size” and expect that the price of the transaction will simply reflect the price of the last trade. Generally, the quoted market price of a security reflects marginal buyers and sellers, rather than the price at which a large block of the security would trade. Even for the most liquid securities, a trade of a large block will move the prevailing price. Indeed, over the last 25 years “block positioning” has become a significant business line for major dealers in the capital markets precisely because it requires special expertise to move large positions in a security.

Evidence for this proposition is abundant. For example, it is inevitably the case that when a prospective purchaser wishes to acquire a publicly traded company it will have to offer a premium to the prevailing price if it hopes to obtain control of the target. (Of course, in the case of a large sale the process reverses itself.)

All of the firms represented on the Committee are large dealers in the global capital markets, and universally share the belief that block discounts are warranted where an entity holds a significant quantity of the average daily trading volume of a fixed income or equity security, or a large percentage of the public float of a security. In such cases, the quoted market price is certainly *not* the price at which that position could be sold in a single or even a closely bunched series of trades. We are quite confident that if a quote was obtained from a broker for the sale of that position it would be discounted to reflect the blockage factor. In addition, we note that various net capital regulations require securities firms to take “marketplace blockage” haircuts (SEC Rule 15c3-1).

We understand the Board's concern about the perceived subjectivity of block discounts. However, we do not believe that requiring an institution to value a position at a price they know is not fair value is the appropriate response. Indeed, placing such a valuation on the position would actually be misleading to investors.

Concerns regarding subjectivity can best be addressed by requiring institutions to adopt a reasonable set of procedures governing discounts. Such an approach could be based on factors such as the percentage of the average daily volume represented by the position; market capitalization of the issuer; volatility of the security; and other relevant factors. The accuracy of these factors could be assessed through normal price testing procedures, and internal controls should be required to ensure that the discounts are applied on a consistent basis. Additionally, firms could be required to disclose their general policies regarding block discounts. Finally, any such set of procedures would be subject to audit. Auditors would have to pass judgment upon the assumptions built into the discount models used and the estimates derived. All in all, while some element of subjectivity would remain, we believe that such practices should go far to address the Board's concerns on point.

We also note that the proposal to abolish block discounts seems deeply at odds with what regulators and market practitioners are increasingly focusing on in the field of risk management. As a result of several recent disruptions in the financial markets, a variety of reports have been issued that have highlighted the importance of good risk management systems for investors, regulators, and market professionals. One essential element of such systems is directed at estimating and controlling liquidity risk, as a breakdown in such controls has featured prominently in a number of market disruptions.² Reports from both the private sector³ and the public sector⁴ have discussed the crucial importance that market participants must place upon managing liquidity risk. Adoption of an accounting practice that would effectively nullify block discounts is fundamentally incompatible with the tenor of those reports, and threatens to create yet another example of a gap between accounting requirements and prudent financial management.

² "An adverse cost or return variation stemming from the lack of marketability of a financial instrument at prices in line with recent sales. Liquidity risk may arise because a given position is very large relative to typical trading volumes, or because market conditions are unsettled." *Dictionary of Financial Risk Management*, Gastineau & Kritzman, p. 171 (1996).

³ *Improving Counterparty Risk Management Practices* ("the Report"), The Counterparty Risk Management Policy Group, June 21, 1999. The Policy Group is comprised of 12 major commercial and investment banks, and was formed to develop flexible standards for strengthened risk management practices. The Report discussed a wide variety of risk mitigation techniques and practices, and offered a set of principles designed to enhance industry practices with respect to the management of market, counterparty credit, and liquidity risk.

⁴ *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*, Report of The President's Working Group on Financial Markets, April 1999. The Report clarifies that although Long Term Capital Management and its counterparties practiced mark-to-market with respect to their transactions, the models for determining future exposures and close out costs were inadequate given the size of LTCM's positions in often illiquid instruments, particularly in volatile markets.

Applicability to Restricted Securities

We also seek confirmation that the prohibition on block discounts would not apply to securities subject to certain restrictions. For example, Rule 144 applies to securities acquired in a transaction not involving a public offering, and imposes resale restrictions. In general, an investor under the Rule is restricted from selling shares for a one year holding period and is then subject to certain limitations on the amount of shares that can be sold at any one time. Given the inability to liquidate the entire position at the quoted market price, we believe that an adjustment to the market price would be necessary in order to determine the fair value of the position.

Similarly, we believe that securities subject to underwriter compensation and IPO lockups; other contractually-imposed restrictions; and limitations arising from an investor's status as an "insider" all impose restrictions that should cause such securities to be considered "restricted" for the purposes of applying the requirements of the Guide.

Departure from Current Accounting Practice

A prohibition on block discounts would be a substantial departure from the current draft Guide (September 1998). The September draft states that investment companies must report their investments at fair value (§ 2.28), but continues that although "quoted market prices in active markets are the best evidence of the fair value of a financial instrument... if the price is determined not to be representative of fair value, fair value should be estimated." (§2.30) In cases where an estimate of fair value is to be made the draft Guide provides that "fair value should be estimated in good faith by the investment company's board of directors (or by management under procedures established by the board of directors) based on consistent application of the company's established pricing policy... The SEC's Codification of Financial Reporting Policies provides guidance on the factors to be considered,... [including]...size of position held and the liquidity of the market." (§2.33-2.35) Accounting Series Release 118 (SEC section 404.03bii; which covers RICs) further suggests that when public markets are thin: "consideration should be given to whether 'market quotations are readily available.'" We believe that such an approach is still appropriate.

While not as explicit as the September draft, the existing Guide (May 1997) suggests that block discounts may be appropriate. It states that "a security traded on the valuation date generally is valued at the last quoted sales price." (§2.29) The guidance in this section states that it is based on the SEC's Codification of Financial Reporting Policies which, as mentioned above, describes circumstances in which an investment company's board or management may determine fair value without solely relying upon the last quoted price.

Conclusion

As we believe that the fundamental issue involved in the decision on block discounts is one of valuation, we strongly believe that the right venue for dealing with it is FASB's Fair Value project. As the final product of the Fair Value project would apply to a far broader category than just investment companies, we do not think it appropriate to establish *de facto* gaap on a piecemeal basis until FASB has considered the subject in the context of the comprehensive Fair Value project. Until FASB has done so with the appropriate due process to interested parties, current industry practice with respect to blockage should not be changed. Hence, we urge the removal of the proposed language from the Guide.

If that recommendation should be rejected, as an alternative we propose that the FASB and AICPA consider delaying the release of the Guide until the determination of its scope is decided. Our understanding is that that process is nearly complete and would not mean a long delay. Doing so would give all constituents -- including those that might be subject to the Guide under a revised scope -- the opportunity for comment. At a minimum, given the very significant impact that abolishing block discounts will have on the investing community, we believe that the Guide should be open for comment by the entire public. Thus, we believe that the Exposure Draft should be re-exposed, or at least that portion of it dealing with blockage.

This issue is complex, and in our view merits further consideration and deliberation by the AICPA and FASB. Given the relatively short period of time within which we have had to prepare our letter, we have had to make our response fairly brief. Therefore, before taking final action, we would very much appreciate the opportunity for representatives of our Committee to meet with you so that we might amplify our views. Accordingly, we will contact you to assess the feasibility of a joint meeting on this topic.

If you have any questions on this letter, please feel free to call our staff adviser at SIA, Jerry Quinn (212)618-0507 or me at your convenience (212) 902-4610. Thank you.

Sincerely,

Doug Fuge
Chairman
Dealer Accounting Committee

cc: Mr. Alan Latshaw, AICPA Investment Companies Committee

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