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April 9, 2003

Ms. Tara L. McKenna
Assistant Project Manager
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: SIA Comments on Fair Value Measurement Decisions Made to Date

Dear Ms. McKenna:

On behalf of the Securities Industry Association's[1] Dealer Accounting Committee, we are writing to express our views about the fair value measurement decisions made to date by the FASB (the "Decisions") as set forth in your letter to Matt Schroeder received on January 10, 2003.

We appreciate the opportunity to comment on the Decisions because fair value is critical to how we manage risk and report performance. For decades, SIA member firms have successfully applied fair value accounting across a variety of markets in different stages of development. A key reason for that success has been the ability to apply sound judgment when quoted market prices in active markets were not available. We believe that "real world" experience makes us uniquely qualified to provide valuable input to the FASB on this important issue.

Overall, we are concerned the application of the Decisions will result in measurements that do not reflect fair value. We believe the Decisions, if implemented, will have a significantly adverse effect on the quality of our financial statements because reported balance sheet amounts will not reflect the amounts we would receive or pay if assets were sold or liabilities were settled – the essence of fair value.

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[1] The Securities Industry Association brings together the shared interests of more than 600 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 employs more than 700,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated $214 billion in U.S. revenue and $285 billion in global revenues. (More information about SIA is available on its home page: www.sia.com .)

In particular, we are concerned about the:

- Requirement to mark longs and shorts to mid-market levels instead of to bid and ask prices, respectively
- Prohibition on using block discounts for unrestricted securities, and
- Inclusion of a relationship component in fair value measurements

Marking to Mid-Market Levels

The Committee strongly disagrees with a pricing approach that requires transactions to be marked to mid-market levels because we believe this would be a departure from the fundamental principle of fair value—that is, fair value should be an exit price. The mid-point is rarely an exit price for dealers. Consistent with current practice for dealers, the Committee believes that long positions should be marked to observable bid prices and short positions to observable ask prices. That is because dealers, by definition, stand ready to buy at the bid and sell at the ask price. Marking both long and short positions to mid-market levels will therefore result in a dealer recording an immediate unrealized gain. For example, assume the current bid-ask quoted by a dealer is 99 bid and 101 ask. If a dealer purchases an instrument at its bid price of 99 and revalues its position at 100 (mid-market), the dealer will record an immediate unrealized gain of 1 (100 less 99). In short, revenue would be recognized prior to realization.

This issue is critical for the industry as it represents a significant departure from current practice. This is especially true in active markets. The FASB's proposal would create "instant" P&L as dealers buy at or near bid and sell at or near ask. We would not support an accounting model that results in this type of inappropriate revenue recognition.

Block Discounts for Unrestricted Securities

This issue has received a lot of attention. As you know, the AICPA established a task force that recommended block discounts be permitted using a judgment-based approach. The FASB initially concluded block discounts should be allowed when an entity has a demonstrated history of buying and selling blocks of unrestricted equity instruments and when the size of the discount can be measured with sufficient reliability. The FASB later decided to prohibit the use of block discounts to measure the fair value of unrestricted equity securities.

If block discounts ultimately are prohibited, dealers that purchase a block at a discount to the observable market price will record an immediate unrealized gain when the block is marked to the observable market price. We believe this result is inappropriate because as the dealer sells the block (whether at once or over time), the increased supply will negatively affect the observable market price, which will result in a reversal of the unrealized gain.

Some FASB members have noted the issue of block discounts is a unit-of-measure issue. We agree and believe the unit of measure for a dealer should be the entire block and not pieces of the block because of the revenue recognition issues discussed above.

A chief criticism of block discounts is their subjectivity. We observe the accounting literature requires preparers of financial statements to make numerous complex judgments that result in subjective estimates, such as pensions, stock compensation, asset retirement obligations, impairment of long-lived assets, loss contingencies and environmental liabilities. Few measurements can claim absolute reliability but as the FASB has observed "most parties agree that financial statement recognition of estimated amounts that are approximately right is preferable to the alternative – recognizing nothing." Therefore, we do not understand why block discounts should be treated differently.

We believe one way to address the issue of subjectivity would be to require the consistent application of the observed block discount until the quantity held could be rapidly absorbed by available market liquidity.

The FASB has acknowledged that block discounts are clearly observable in the market- i.e., large blocks of securities can be observed to trade at a discount from the observable market price. In our view, reflecting block discounts in the valuation is a necessary adjustment needed to arrive at a relevant estimate of exit value for the block and should be permitted. Finally, we note the AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*, explicitly permits the use of block discounts.

Including a Relationship Component in Fair Value Measurements

Substantially all members of the Committee believe the value attributed to customer relationships, such as demand deposits, credit card receivables and lending relationships is of the nature of an intangible asset and should not enter into the determination of the fair value of a financial instrument. To the extent there is value associated with these relationships, it should be recognized when realized, for example, when sold to a third party as is currently consistent with GAAP.

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Our detailed comments about the Decisions are attached to our letter. We have either marked up each Decision to reflect our suggested improvements or provided commentary immediately following each Decision.

Given the importance of fair value measurement to SIA-member firms, we would appreciate the opportunity for representatives of our Committee to meet with you and members of the FASB to discuss our comments. Accordingly, we will contact you to schedule a meeting on this topic. If you have any questions on this letter, please feel free to call our staff adviser at the SIA, Jerry Quinn, or me.

Sincerely,

Joanne Pace
Chair
Dealer Accounting Committee

Copy to: Members of the FASB
Suzanne Bielstein
Attachment

Attachment

FASB Fair Value Measurement Decisions to Date

SIA Mark-Ups and Commentary

1. Fair value of a financial instrument or a portfolio of instruments should be an estimated exit price – the price that would have been received or paid between a willing buyer and seller if the instrument or the portfolio had been sold, exchanged, or settled on the measurement date.

   SIA Comments

   - This Decision should be expanded to explicitly address the valuation of both a single unit as well as a portfolio of instruments.

   - In particular, the Committee strongly believes that liquidity reserves or "block discounts" should be permitted for dealers for the following reasons:

     a) Academic research has clearly demonstrated that if an entity holds a sufficiently large position in an unrestricted instrument compared to its trading volume, any attempt to quickly liquidate that position will negatively affect the observable market price. Therefore, multiplying the observable market price times the quantity held will overstate fair value. A block discount is necessary to measure the block at its exit value.

     b) Occasionally, block positions result from a failed underwriting. In these cases, the block discount is equivalent to recording an impairment charge on the asset. This is consistent with GAAP, which requires companies to review assets for other-than-temporary impairment.

     c) For large blocks of securities acquired at a discount to the observable market price, a prohibition on block discounts will result in immediate gains that may never be realized (regardless of whether the purchased block is sold as a block, or over time).

     d) Block discounts are explicitly permitted under the current AICPA Guide *Brokers and Dealers in Securities*, and it was the recommendation of the AICPA committee charged with studying the issue to permit block discounts, using a judgment-based approach.

     e) Block discounts have been appropriately, consistently, and judiciously applied in practice, taking into account factors such as:

        - Market capitalization/float of the company in which the equity investment is held in relation to the size of the block to be traded (expressed as a percentage of the average daily trading volume);

- Whether the position or a portion thereof was recently acquired at a discount from current market prices (as is common at block desks of security dealers);
- Company specific characteristics (for example, blue chip versus start-up);
- Types of markets or exchanges where the securities are traded and how actively traded the security is;
- Restrictions or lockups on the stock;
- Ability to hedge the position

f) Although some judgment is involved, estimates and judgments are an inherent part of the accounting process and are perhaps less subjective than many other estimates and judgments required by GAAP.

- This Decision is inconsistent with the requirement in Decision 3 to value instruments based on the mid-point of a bid-ask spread.

2. Commissions paid on acquisitions, originations, sales, incurrences, or settlements of financial instruments should not be included in the determination of fair value; they should be reported as expenses in the period in which they are incurred.

SIA Comments

- This Decision only considers agency transactions (where transaction costs take the form of commissions) and not principal transactions (where transaction costs are included in the price paid or received). Market structure will inform the manner in which transaction costs are incurred, i.e., broker versus dealer market. For example, most equities are purchased on a commission basis (broker market) and most fixed income securities on a principal basis (dealer market) but both products can be transacted outside their normal market structure.

- This Decision also is inconsistent with existing market practice, which records transaction costs associated with acquisitions as part of the initial value, but records transaction costs of sales as a period cost. The industry believes current market practice is acceptable as long as the practice is consistent. FASB's proposal would require major changes in practice for the sake of theoretical purity where relatively immaterial items are concerned, i.e., the proposal is not cost-beneficial.

- This Decision also is inconsistent with the last sentence of Decision 4, which suggests transaction costs should be included in the calculation of fair value.

3. The mid-point of a bid-asked spread should be used as the basis for estimating fair value if the bid and asked prices are firm offers to buy or sell in an active market.

SIA Comments

- This issue is critical for the industry as it represents a significant departure from current practice. The Committee strongly disagrees with this approach because it is inconsistent with the fundamental principle that fair value should be based on an exit price. The mid-point is rarely an exit price. This is especially true in active markets. The FASB's proposal would create "instant" P&L as dealers buy at or near bid and sell at or near ask. In short, an unrealized gain would be inappropriate because the mid-point is rarely an exit price.

- Current industry practice is to mark long positions to bid and short positions to ask as this approach best represents the exit price.

4. The appropriate unit of measure for a group of similar, but not identical, financial instruments is the unit that would be expected to yield the highest price for assets and the lowest price for liabilities in a market to which the entity has reasonable access. The incremental direct costs of sale or settlement must be considered in determining which unit of measure yields the optimum price.

SIA Comment

- Substantially all Committee members believe institutions should value financial instruments at a price at which they are most likely to liquidate even if a more advantageous price is possible. Pricing an instrument based on the hypothetical ability to go outside the established channels seems inconsistent with the concept of exit price and could lead to distortions and inconsistencies in pricing. In addition, the Committee believes Decision 4 is inconsistent with Decision 1 because Decision 1 focuses on a single instrument while Decision 4 focuses on a group of instruments.

5. The effects of changes in an entity's own creditworthiness and credit risk premium should be included in determining the fair value of that entity's liabilities.

SIA Comment

- Several Committee members expressed concerns about recognizing unrealized gains or losses from marking long-term debt for changes in their own credit worthiness, primarily because the ultimate realization of any such gains or losses will usually require refinancing at higher or lower rates, respectively, thus "giving back" P&L.

- For example, consider a going concern that repurchases $100 million of outstanding fixed-rate debt in the marketplace. Given recent movements in credit spreads (assuming the risk-free interest rate has remained constant), the entity is able to repurchase the debt for $90 million. For ongoing funding purposes, the entity, however, still needs to maintain existing long-term debt of $100 million and reissues new liabilities at the then current market rate. While the entity may have reported a $10 million gain on debt extinguishment from this transaction, it has now had to issue debt at a much more costly rate given the fact that credit spreads would have had to widen in order to be able to repurchase it's previously existing debt for $90 million. The replacement cost of the entity's debt was not $90 million but rather $100 million. In keeping with the concept of valuing financial instruments at their exit price, the replacement cost of $100 million would appear more indicative of the exit price given the entity's need to maintain a constant capital structure.

6. Contracts that provide settlement options and are exchanged in portfolios at prices that cannot be approximated by conventional option-pricing models should be measured at the total price of the contracts and related relationships if transferred as part of a portfolio. (Some examples of such contracts are credit card contracts, certain mortgage loan commitments, demand deposits and the related deposit agreement, outstanding credit card balances, prepayable loans, and loan servicing contracts.)

   SIA Comments

   - Substantially all Committee members believe the value attributed to customer relationships, such as demand deposits, credit card receivables and lending relationships is of the nature of an intangible asset and should not enter into the determination of the fair value of a financial instrument. Further, the determination of this value could be viewed as recognizing revenue prior to completion of the earnings process. To the extent there is value associated with these relationships, it should be recognized when realized, for example, when sold to a third party.

   - One member firm believes that calculating the fair value of demand deposits including the nonfinancial component is the appropriate measure of fair value of the exit price for these instruments. This member believes the fair value of demand deposits would be meaningless without the significant nonfinancial component. To bifurcate the related financial instruments and fair value them separately does not reflect the correct economics or proper fair value of the activity.

7. Portions of the prices of those portfolios should be displayed separately as intangible assets. (The Board has not yet decided how to allocate the total price to the separate pieces.)

   SIA Comments

   - See comment on Decision 6.

   - If the Board determines the valuation of these assets and liabilities should include an intangible component, the Committee would not support the separate display of the component as an intangible asset. The Committee does not support the separate display of the intangible portion because it is very difficult to measure with any level of reliability.

8. The objective is to measure the fair value of an instrument at the end of the reporting period. An entity should establish and consistently apply a policy on how to reflect significant events, if any, after the close of business but before the end of the reporting period in measuring fair value.

9. The basic principles in estimating fair value are (a) maximize reliable market inputs and minimize internal estimates and assumptions and (b) change estimation techniques only if

an improvement can be demonstrated or if a change is necessary because of changes in availability of information.

10. ~~Estimates of~~ F~~f~~air value should be based on quoted market prices in active markets, if available, taking into account the size of the position and market volumes ~~for identical instruments if they are regularly available at or near the measurement date~~.

11. Circumstances in which observed prices may not be reliable indicators of a market exit price and may require adjustment include, but are not limited to, ~~are (~~a) the negotiating position of the seller or settler was negatively affected by severe financial difficulties or regulatory or legal requirements, (b) the price was affected by other arrangements or transactions between the parties, (c) the two parties are related, (d) acknowledged errors in transmitting orders, reporting prices or illegal acts affected the price for a particular instrument, (e) the instrument is thinly traded, (f) the counterparty to the observed prices lacks credibility, and (g) the price is not reflective of the price at which a transaction could be executed.

12. When using estimation techniques not based on observable prices, the following general guidelines should determine which technique to use:

    a. Use an estimation technique that incorporates the factors that market participants would consider in setting a price.

    b. Use an estimation technique commonly used by market participants to negotiate prices of the type of instruments being measured if such a technique is available.

    c. Internally developed techniques should be consistent with accepted economic methodologies for pricing the type of financial instruments being measured and should be tested for validity using prices from actual transactions.

    d. The guidance in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, should be applied when using discounted cash flow computations to measure fair value.

SIA Comment

- The Committee observes recent FASB pronouncements incorporate the "expected cash flow approach" to present value described in CON 7. The Committee believes this approach is not consistent with many accepted economic methodologies. The traditional approach to present value is widely accepted and incorporated within many accepted models. The Committee believes any final measurement guidance should expressly permit both approaches.

13. Portfolios of instruments that are freestanding options with net asset values should be reported as single assets (for example, credit card contracts). Separately report related financial instruments that result from exercise of the options (for example, credit card receivables).

<u>SIA Comment</u>

- Same comments as on Decisions 6 and 7.