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VIA ELECTRONIC MAIL

Mr. Timothy S. Lucas
Director of Research & Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference 204-B, Preliminary Views, *Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value*

Dear Mr. Lucas:

The Bond Market Association (the "Association")¹ appreciates the opportunity to comment on the above-referenced document (the "PV" or "the proposal"). The Association represents securities firms and banks active in the bond markets and as a result has a particular interest and expertise in fair value measurements of financial assets and liabilities. We have elected to comment primarily on the PV's proposals as they apply to the definition and measurement of fair value (issue 2) and issues regarding implementation (issue 4). Because of the complex and diverse nature of the businesses our members conduct, there is not at this time a consensus among them with respect to the Board's general goal of fair value reporting for all financial instruments, nor with respect to the questions raised by issues 1, 3, and 5. (The instruments discussed in issue 6 are outside the normal purview of the Association, and at this time we have no specific comments regarding issue 7.) We understand that a number of our members do intend to communicate their viewpoints on some or all of these issues to the Board in individual comment letters.

Definition of Fair Value

In general, we agree with the overall definition of fair value as articulated in paragraph 47 of the proposal: "Fair value is an estimate of the price an entity would have realized if it had sold an asset or paid if it had been relieved of a liability on the reporting date in an arm's-length exchange motivated by normal business considerations. That is, it is an estimate of an exit price determined by market interactions." However, we have serious concerns regarding certain of the proposed methods of determining this "exit price", particularly with respect to financial instruments traded in the securities and derivatives markets.

In particular, we are troubled by the proposed guidance in paragraph 53 that would require dealers who "normally receive the ask price" to mark assets to the "ask" price and liabilities to the "bid" price. Although not explicitly stated, presumably the rationale for this is that these are the prices at which a dealer would liquidate its portfolio with a retail customer. However, we believe that this does not represent the true "exit price" for a dealer, because it incorporates two unrealistic assumptions: first, that the entire portfolio will be sold to retail customers, and second, that the entire portfolio can be liquidated on any given day at the retail customer (bid/ask) price. In actual practice, it is much more likely that some portion of the portfolio will be sold to retail customers at the retail price, some portion will be sold to institutional customers at something less than the retail price, and some portion will be sold to other dealers at the bid price. Moreover, if the portfolio has to be liquidated relatively quickly, the dealer's exit price is likely to approximate the bid rather than the ask. Therefore, the effect of pricing to the retail customer price for all positions would be to overstate the selling price of many assets, resulting in upfront gain recognition on many positions, only to be offset by losses when those positions were actually sold. While we believe that a more conceptually accurate approach would be to estimate which positions are intended to be sold to retail customers, which positions are intended to be sold to institutional customers, and which positions are intended to be sold to dealers, and then to price each portfolio accordingly, we believe that such an approach would be operationally complex and would also introduce an element of subjectivity that we do not believe would be palatable to the Board.

Therefore, we believe that it is most appropriate for dealers to price their positions at the amount at which they would be able to liquidate their portfolio over a relatively short period of time, i.e., by selling to other dealers at the dealer price (assets to the bid price and liabilities to the ask price). This is in fact how many dealers price their portfolios today, and is a methodology that is permitted by the AICPA Audit and Accounting Guide for Brokers and Dealers in Securities ("Broker-Dealer Guide"). In fact, we note that the approach recommended by the proposal is specifically prohibited by the Broker-Dealer Guide. This methodology is also in accordance with the G-30 recommendations on derivatives pricing. We note that these recommendations have been adopted widely in the marketplace and are generally acknowledged to be a useful and accepted approach to determining fair value, and we recommend that the FASB consider incorporating those principles into this proposal.

Blockage Factors/Use of Most Advantageous Price

We are also concerned regarding the proposed guidance in paragraph 68, which would not permit a quoted price to be adjusted for potential blockage factors regardless of the size of the entity's holdings. We believe that blockage adjustments are necessary in order to arrive at the entity's true exit price for large concentrations of positions, because experience demonstrates that liquidating a large holding of a security may depress the market price. For example, dealers regularly enter into block trades as a facilitation for customers who want to sell a large block of securities and will avail themselves of a dealer's ability to place the block via their institutional sales force. The dealer will often actually purchase the block at a discount to the quoted market price, in effect charging the

customer for part of the loss that will be incurred upon disposition. Thus, it would be distortive to write the block up to quoted market value, realizing an immediate gain on acquisition, only to incur a loss shortly thereafter when the position is liquidated. Dealers regularly provide for such valuation adjustments today, as permitted by the Broker-Dealer Guide, in order to appropriately reflect the dealer's exit price. As suggested by the guidance in paragraph 60(d), the market price is adjusted because it is not considered representative of a market exit price.

If the Board's unwillingness to permit adjustments for blockage factors centers on a concern about the verifiability of such adjustments, then we note that in practice dealers "backtest" these adjustments by comparing the price at which the block is sold to the amount at which it was originally valued. Backtesting is an important control, as it tests the accuracy of a model's output when transactions are unwound and the actual final settlement is compared to the price determined by the model. In most cases, the value estimated by the model is close to actual settlement amount. If differences do occur, models are adjusted appropriately for the factors that caused the differences.

On a related point, we also find the guidance in paragraph 63 to be somewhat confusing, and potentially at odds with the guidance in paragraphs 55² and 68. Paragraph 63 notes that "The exit price of the portfolio as a whole might be higher than the total of the exit prices of the individual notes. If so, fair value should be based on the market with the most advantageous price." This seems to suggest that in certain cases, it would be appropriate to factor in a premium for holding a portfolio of instruments. Although it is not clear from the example what the premium is attributable to (and presumably it is not attributable to any of the potential benefits of a planned securitization in view of paragraph 55), the permitted addition of a premium seems logically inconsistent with the prohibition on a discount for a portfolio of items.

Moreover, from a broader conceptual point of view we disagree with the proposal's requirement to mark to the most advantageous price, particularly in circumstances where this price cannot be realized. We believe this guidance is inconsistent with the overall definition of fair value in paragraph 47, which is "an estimate of the price an entity would have realized if it had sold an asset ... in an arm's length exchange motivated by normal business considerations" (emphasis added).

For example, we take issue with the guidance in paragraph 72, inclusive of footnote 12, which indicates that the debtor's present financial inability to exercise a prepayment option on its debt should not prevent the prepayment value from being reported as the debtor's most advantageous exit price. We are concerned that such an approach will produce artificial gains and losses that could not foreseeably be realized by the entity. Moreover, this approach fails to take "normal business considerations" into account as the overall "fair value" definition requires.

Treatment of Commissions and Other Transaction Costs

Paragraph 53 indicates that exit prices should be based on the closing price for the instrument in question, less any commissions. We believe that commissions are transaction costs and should continue to be treated as a period cost rather than as a component of fair value.

Furthermore, if commissions are to be included in the computation of fair value, then questions arise as to the treatment of many other similar transaction costs, such as whether the cost to an entity of repurchasing its own debt should be included in the estimation of fair value. Although this would be logically consistent with accruing commissions, we believe it would lead to some unusual results. For example, an entity whose debt is due to mature in one month would be required to accrue an expense related to the expected repurchase cost today, and then to record a gain when its debt matures a month later. Another example is that a salesman's variable compensation, which is a type of transaction cost, would be included in the computation of the fair value of a financial instrument. Again, we believe that these costs are more appropriately accounted for as period costs.

We acknowledge that from a strict theoretical point of view this may create a discrepancy between financial instruments for which a sales commission is charged and those instruments that trade in dealer markets where the cost of selling the instrument is effectively incorporated into a bid/ask spread. However, we believe that because the cost of selling the instrument is not explicit in the spread it would be impractical to try to break it out and treat it separately, and therefore it should remain as a component of fair value.

Taking Into Account Events After the Close

The proposal notes in paragraph 50 that events may cause the price of an instrument to change after the close of a market, and goes on to suggest in footnote 8 that "an entity would not be expected to go to great lengths to unearth information about after-hours trading, but it should not ignore any information that is available, for example, a large change in price in another market after the close of the principal market in which an instrument trades." We note that many firms have a "regional pricing" approach, whereby instruments are priced at the close of the principal market in which the instrument trades. Firms have adopted "regional pricing" because continuous pricing is not operationally feasible, especially for financial institutions that deal in a multitude of instruments traded in numerous markets around the world, and therefore we urge the Board to consider a pricing approach that involves regional cutoffs. Under such an approach, any discrepancies in prices noted after the regional cutoff would be accounted for in the next period's pricing, and any large discrepancies in valuation for material items would be disclosed as a subsequent event.

Financial Instrument Pricing Models

We believe that the Proposal should not impact the valuation approach for many types of financial instruments, including derivatives, which are currently valued using financial

models that use objective market inputs as a starting point but are ultimately valued by using various modeling techniques. Such models are the primary pricing tools used by dealers for a wide variety of instruments, and therefore we believe that the proposal should give much greater prominence to these techniques in the pricing hierarchy.

Financial institutions use quoted swap rate spreads and other market inputs in order to build a curve which is used to discount swap cash flows. The resulting swap value is then adjusted to reflect the particular attributes of the swap in question: for example, an adjustment is made to reflect the credit risk of the counterparty to the swap, if it is not the same as the AA-rating on which the swap quote is based. Even plain-vanilla swaps, for which a quote from another dealer could theoretically be obtained, are regularly priced using a model approach because it would be impractical and operationally burdensome for dealers to obtain dealer quotes for every single swap, given the size of their portfolios. Prices derived using such models are typically verified by regularly price testing the market inputs used in the models or by comparing the model's prices to quotes for similar instruments that give an indicative value for the instruments. However, the model is the primary pricing tool, and the comparison to quoted prices for similar instruments is merely a secondary model testing technique.

A requirement that dealers obtain price quotes for all of their swaps would be a bit circular, since dealers arrive at their quotes by reference to their models. Therefore, we strongly encourage the Board to more explicitly emphasize the validity of valuation models as a primary pricing tool, at least for the dealer community.

Implementation

We would also like to point out some issues associated with implementation. As you are aware, broker-dealers have been on a mark-to-market basis for certain assets for many years, and have arrived at this point via a combination of market forces and regulatory requirements. The G-30 recommendations, as noted above, have provided useful directional guidance, and our members have spent considerable time and resources adapting this guidance and developing specific pricing methodologies, valuation models, and price verification techniques in order to ensure that their portfolios are priced accurately on a daily basis. This is obviously critical not only to ensure compliance with GAAP but for risk management purposes as well. As a result, our members have both extensive theoretical and practical experience in applying the concept of fair value to large, diverse portfolios that include some very complex financial instruments. As this letter can give only an overview of the general concepts that we espouse, our members would welcome the opportunity to meet with you to share their experiences with you in more detail and to describe their methods and procedures currently applied in practice, as well as the underlying rationale.

In addition, we note that, if the proposal goes into effect, many entities will likely look to financial institutions to provide pricing information (i.e., price quotes). The document appears to assume that price quotes from dealers are readily available, but we feel it important to point out that there will likely be a resource constraint on financial

institutions as they may be deluged with requests for pricing information. In applying the guidance to instruments that trade in dealer markets, it is not clear whether obtaining one quote would be deemed sufficient for determining a value, or whether more than one quote would be required, but in either case there would be a tremendous increase in pricing inquiries. Financial institutions would also have to review their current policies on providing such information to both customers and non-customers, and would have to address concerns about potential legal exposure associated with providing price quotes in response to valuation inquiries.

Conclusion

Again, the Association appreciates the opportunity to provide input on the foregoing issues associated with the proposal. Should you have any questions regarding the matters discussed herein, or if you would like to arrange a follow-up discussion with some of our members, please do not hesitate to contact me at 212.357.8437, or Wendy Fried, Vice President and Associate General Counsel of the Association and Staff Advisor to the Accounting Policy Committee, at 212.440.9431.

Sincerely,

/s/ Esther Mills

Esther Mills, Goldman, Sachs & Co.
Chair, Accounting Policy Committee of
The Bond Market Association

cc: Wendy Fried, George Miller - *The Bond Market Association*
James Johnson - *Deloitte & Touche*, Special Accounting Advisors to The Bond Market Association

Notes

1. The Bond Market Association represents securities firms and banks that underwrite, distribute, and trade debt securities, and participate in the repurchase agreement and securities lending markets, both domestically and internationally. This letter was prepared with the participation of the Association's Accounting Policy Committee, which is comprised of in-house accounting professionals at the Association's member firms. More information about the Association and its members can be found at its internet website www.bondmarkets.com.
2. Paragraph 55 states that "value enhancements" such as guarantees and securitizations should not be considered in determining the exit price.

