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March 31, 2009





Technical Director Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, Connecticut 06856-5116

> RE: Proposed FASB Staff Position FAS 157-e, "Determining Whether a Market Is Not Active and a Transaction Is Not Distressed" (File Reference: Proposed FSP FAS 157-e)

Dear Technical Director:

We appreciate the opportunity to respond to the proposed FASB Staff Position FAS 157-e, "Determining Whether a Market Is Not Active and a Transaction Is Not Distressed" (the "proposed FSP"). We support the Board's efforts and additional standard setting to address the concerns expressed by constituents about the present requirement to measure securities that are transacted in inactive markets at an estimated current selling price, particularly when the investor would not be willing to sell those securities for prices that would be received in the current economic environment. With respect to the proposed FSP, we provide our views on certain issues in the Appendix to this letter that the Board will need to address in order to make that guidance operational as an alternative measurement attribute to fair value, the most significant one being the appropriate rate of return to apply to an estimate of a security's most likely cash flows.

Additionally, we believe that the proposed FSP would create confusion as to whether fair value, as defined in FASB Statement No. 157, Fair Value Measurements (Statement 157), is the appropriate measurement attribute for certain financial assets that are transacted in inactive markets. We would support a Board conclusion that it is appropriate to modify the existing fair value measurement objective for certain securities transacted in inactive markets, and that this revised measurement objective be clearly articulated and described as something other than a fair value measurement as defined in Statement 157. In the immediately succeeding paragraph we describe this alternative approach to address the above concerns expressed by constituents.

As currently written, we believe that the proposed FSP will be interpreted by many as establishing a different measurement objective than as currently required by Statement 157 and would result in measurements of financial assets that would not reflect the price that would be received if the assets were sold at the measurement date. In order to avoid confusion between the

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fair value measurement objective under Statement 157 and the objective of measurements under the proposed FSP, we believe that the measurement guidance in the proposed FSP should be further clarified and should be described as an alternative, fair-value-based measurement (e.g., "economic value" or "fundamental value") that would be permitted for specified classes of financial assets that are transacted in inactive markets. To address concerns about the potential impact of the proposed FSP on the ability to use broker quotes and pricing services (refer to the Appendix to this letter for additional discussion on this issue), entities should be permitted to make an accounting policy election for those assets to either apply the measurement alternative as described in the proposed FSP or to measure the assets based on their best estimate of a current exit price under Statement 157 (which may be developed using information provided by brokers or pricing services), with appropriate disclosures about the use of the alternative measurement. If the alternative measurement under the proposed FSP is elected, the fair values, as defined by Statement 157 (i.e., the current exit prices), of those assets would continue to be disclosed pursuant to the guidance in FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments. We believe that this approach would minimize the potential for confusion among users of financial statements that might otherwise result if measurements that do not reflect a current exit price were described as fair value measurements. It would also allow entities to elect to continue to use sources of pricing information and processes that are currently used in determining fair value measurements under Statement 157. We also believe that this alternative would achieve the intended objective of the proposed FSP while avoiding the confusion and operational challenges that will be created by the proposed FSP as currently drafted.

In a recent announcement, the FASB and the IASB indicated that their overall project efforts on financial instruments will result in proposals in the coming months. In this regard, and in light of the confusion and operational challenges that will be created by the proposed FSP as currently drafted, we note that as an interim action, the Board could consider whether to amend the guidance in FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, to require debt securities (other than trading assets) to be reported at amortized cost less credit losses, unless the entity expects to sell those securities prior to recovery. Securities that the entity intends to sell prior to recovery (or for which it is more-likely-than-not that the entity will be required to sell prior to recovery), would be measured at the lower of (a) amortized cost less credit losses or (b) a current exit price under Statement 157. This interim action would significantly reduce complexity in U.S. GAAP by better aligning the accounting for debt securities with the accounting for loans and would avoid creating confusion about the measurement objective under Statement 157. This interim action should also require that the fair value (i.e., the current exit price under Statement 157) of those debt securities be prominently displayed in a manner that provides information about both of those measurement attributes and enables users to identify the measurement attribute that they consider to be the most appropriate in the circumstances.



The Appendix to this letter includes further explanation of our views about the proposed FSP and identifies additional issues and concerns that we believe the Board should address in its further consideration of the proposed FSP.

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We would be happy to further discuss the specifics of these issues in more detail at the request of the Board or the staff.

Sincerely,

KPMG LLP

Cc: James Kroeker, Acting Chief Accountant, Office of Chief Accountant, SEC Martin Baumann, Director, Office of Research and Analysis, PCAOB Jennifer Rand, Acting Chief Auditor, Office of the Chief Auditor, PCAOB





Proposed FASB Staff Position FAS 157-e, "Determining Whether a Market Is Not Active and a Transaction Is Not Distressed" (File Reference: Proposed FSP FAS 157-e)

This Appendix to our attached letter includes further explanation of our views about the proposed FSP and identifies additional issues and concerns that we believe the Board should address in its further consideration of the proposed FSP.

Factors That May Indicate an Inactive Market

We agree that many of the factors included in paragraph 11 of the proposed FSP would be appropriate to consider when evaluating whether a market is inactive. However, the Board should consider whether those factors are sufficiently robust to not only enable entities to determine whether a market is inactive in the current economic environment, but also to determine when an inactive market recovers such that it becomes active in a future period. In addition, as described in the following paragraphs, we believe that certain items could be clarified to improve the understandability of that guidance.

Paragraph 11(a) of the proposed FSP indicates that a factor to consider when evaluating whether a market is inactive would include "Few recent transactions (based on volume and level of activity in the market). Thus, there is not sufficient frequency and volume to provide pricing information on an ongoing basis." However, paragraph 24 of Statement 157 defines an active market as "a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis." Rather than an "indicator" of an inactive market, the absence of ongoing pricing information by definition would result in a market being considered inactive under Statement 157. Therefore, the Board should consider whether the guidance in paragraph 11(a) should be moved from the list of factors and included in the introductory section of paragraph 11 as a reminder of Statement 157's definition of an active market.

Paragraph 11(c) of the proposed FSP specifies that "Price quotations vary substantially either over time or among market makers (for example, some brokered markets)" is an indicator that a market is inactive. We understand why substantial variations in price quotes among market makers would be viewed as an indicator of an inactive market. However, the Board should clarify why price quotations that vary substantially over time would suggest an inactive market, given that substantial price volatility is often present in active markets as well, especially in the current economic environment. Similarly, it would be helpful for the Board to clarify why the factor included in paragraph 11(e) of the proposed FSP ("Abnormal or significant increases in liquidity risk premiums or implied yields for quoted prices when compared with reasonable estimates (using realistic assumptions) of credit and other nonperformance risk for the asset class") is a characteristic of an inactive market. In the current economic environment, abnormal

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or significant increases in risk premiums or implied yields are often associated with securities that are actively traded in liquid markets (for example, the market for credit default swaps on corporate bonds). The Board should consider whether those factors should be revised or removed from paragraph 11 of the proposed FSP.

Determining if Quoted Prices Are Associated with Distressed Transactions

The proposed FSP is not clear as to whether the guidance in paragraph 13 on determining whether transactions are assumed to be distressed is intended to require entities to actively seek out evidence about the transactions in circumstances where it is reasonably available without undue cost and effort. The Board should clarify its intended meaning in that regard.

To improve the operationality of the guidance in paragraph 13 of the proposed FSP on evaluating whether a quoted price for a financial asset in an inactive market overcomes the presumption that it is a distressed transaction price, the Board should clarify how that guidance is intended to apply to broker quotes and information from pricing services. The conditions in paragraph 13 of the proposed FSP appear to be primarily focused on evaluating whether an observed transaction in an inactive market was distressed. However, the proposed FSP does not indicate how those conditions should be considered in evaluating whether a broker quote (either an indicative price or a binding offer) is assumed to be associated with a distressed transaction price. While it is possible that an entity could obtain multiple binding broker quotes (i.e., multiple bids) for an asset, it is not clear whether an entity would be required to obtain multiple binding broker quotes in order to use that information to measure a financial asset in an inactive market. Also, the Board should clarify how an entity should determine whether the asset was exposed to market for a sufficient period of time for purposes of evaluating a broker quote as a potential fair value input given that the transaction has not occurred. In addition, the proposed FSP does not indicate how the conditions in paragraph 13 should be applied in evaluating information that is obtained from a pricing service, which would frequently be based on multiple observed transactions in an inactive market and each of those transactions may differ with respect to the period of time in which the asset was exposed to the market and the number of bidders.

Measurement Guidance

Measurement Objective

We are concerned that the measurement objective of the proposed FSP has not been clearly articulated for a financial asset that is transacted in an inactive market (when available pricing information is deemed to reflect distressed transactions). If the measurement objective for those assets is intended to be the price that would be received by selling an asset currently in an orderly transaction that takes place in an inactive market (a current exit price), then that objective should

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be explicitly stated. As currently written, we believe many readers will interpret the proposed FSP as establishing a different measurement objective. If the Board did intend to establish a new measurement objective for those assets, then that objective needs to be more clearly articulated.

If the Board ultimately decides to proceed with the measurement guidance in paragraph 15 of the proposed FSP (and in paragraph 29A and Example 11 of the proposed amendments to Statement 157), the Board should describe that measurement as a fair-value-based measurement (e.g., "economic value" or "fundamental value") rather than fair value in order to avoid confusion as to whether the measurement objective of Statement 157 continues to be an exit price at the measurement date. The background information included in the proposed FSP suggests that the measurement guidance in the proposed FSP is intended to be consistent with the exit price measurement objective in Statement 157. If the Board believes that measurements under the proposed FSP are consistent with Statement 157's measurement objective, the Board should provide explanations on how the guidance reconciles with Statement 157's exit price objective.

The proposed FSP's apparent shift in focus away from market-based inputs for measurements of financial assets that are not transacted in active markets appears to be inconsistent with Statement 157, which states that its fair value measurement objective remains the same, even in situations where there is little, if any, market activity for an asset at the measurement date. Additionally, the proposed FSP contains guidance that appears to normalize the assumptions that are used in the measurement of certain financial assets in a manner that may not reflect current market conditions.

- For example, if, based on the guidance in paragraph 15 of the proposed FSP, a reporting entity were to conclude that the risk premiums being demanded in the current market environment are not reasonable, how did the Board conclude that a measurement that adjusts the risk premiums demanded by market participants to a more reasonable level would result in a current exit price measurement?
- Similarly, the guidance in the proposed amendment to Example 11 of Statement 157 (paragraph A32F) specifies that the entity considers "the estimated rate of return for the collateralized debt obligation in a **hypothetical active market** at the measurement date." [Emphasis added.] Because that guidance would apply in circumstances where the actual market is inactive, it would appear to permit an entity to base its measurement, in part, on the price that would be received to sell the asset in a different economic environment. It is not clear how the Board concluded that the resulting measurement would reflect the price that would be received if the asset were sold in an orderly transaction at the measurement date.

If the Board ultimately decides not to characterize the measurement guidance in paragraph 15 of the proposed FSP (and in paragraph 29A and Example 11 of the proposed amendments to



Statement 157) as a fair-value-based measurement (e.g. "economic value" or "fundamental value") rather than as a current exit price, it is important that the final FSP clearly explain the guidance in a manner that addresses these perceived differences from the requirements of Statement 157, with a goal of achieving some consistency in the application of the guidance.

Measurement Assumptions

The measurement guidance in paragraph 15 of the proposed FSP (and in paragraph 29A and Example 11 of the proposed amendments to Statement 157) specifies that reasonable assumptions should be used in estimating cash flows and determining the risk premiums reflected in a discount rate. If a measurement does not incorporate risk premiums that are currently being required by market participants because they are determined to be unreasonable, should a reasonable risk premium be determined based on historical risk premiums, projected future risk premiums, the risk premium that the entity believes a reasonable market participant should require in the current economic environment, or the risk premium that the entity believes a reasonable market participant would require under better economic conditions? Additional clarification of the Board's intent will be needed to attempt to achieve some consistency in the objective of the measurements.

In addition, the measurement guidance in paragraph 15 of the proposed FSP (and in paragraph 29A and Example 11 of the proposed amendments to Statement 157) indicates that the inputs used in a valuation technique should be reflective of an orderly transaction between market participants at the measurement date. It also clarifies that market participants represent willing buyers and willing sellers. Statement 157 requires consideration of the assumptions that current market participants would use in pricing an asset. However, the proposed FSP does not address how assumptions of the current market participants involved with transactions in inactive markets that are assumed to be distressed should be considered.

In the current economic environment, the primary market participants for certain classes of investment securities have changed. For purposes of applying the proposed guidance, the FSP should address whether the "willing buyers" are current market participants (for example, hedge funds), historic market participants (for example, financial institutions), market participants that would be expected to be buyers in a hypothetical active market, or some combination thereof. To improve the operationality of the proposed measurement guidance in paragraph 15 of the proposed FSP (and in paragraph 29A and Example 11 of the proposed amendments to Statement 157), we believe that the Board should clarify its intent regarding the characteristics of a market participant when that measurement guidance is applied.



Pricing Information for Similar Securities

The measurement guidance in the proposed FSP specifies that if a quoted price in an inactive market is assumed to be associated with a distressed transaction, the reporting entity must use a valuation technique other than one that uses that quoted price without significant adjustment. While that guidance addresses the evaluation of quoted prices for similar or identical assets in inactive markets, the proposal does not discuss how quoted prices for *similar* securities traded in active markets should be incorporated. For example, an entity may hold a mezzanine security in a particular securitization structure that is not actively traded, but the AAA security in that structure might be traded in an active market. It may be reasonable to conclude that the liquidity spread for the mezzanine security would exceed the spread implied by the quoted market price of the actively traded AAA security. However, if the Board does not intend for entities to consider information about similar securities when applying the measurement guidance in paragraph 15 of the proposed FSP (and in paragraph 29A and Example 11 of the proposed amendments to Statement 157), then it should clarify that intent.

"Day One Gains" Recognized by Purchasers of Securities in Distressed Transactions

Paragraph 17b of Statement 157 specifically indicates that a distressed transaction is an example of a circumstance in which a transaction price may not represent fair value at initial recognition. An entity purchasing a financial asset in an inactive market may not have evidence about the period of time in which that asset had been marketed to potential buyers and how many competing bids were provided to the seller. Consequently, it would appear that transactions involving a financial asset in an inactive market may be deemed by the purchaser to be distressed transactions. By applying the measurement guidance in paragraph 15 of the proposed FSP (and in paragraph 29A and Example 11 of the proposed amendments to Statement 157) it would appear that significant "day one gains" could potentially be generated by purchasers of distressed assets. If that was not the Board's intent, the final FSP should clarify how it should be applied by the purchaser of financial assets in a distressed transaction.

Determining the Fair Value of a Financial Asset in an Inactive Market When Quoted Prices Are Determined to Be Associated with Distressed Transactions

Paragraph 15 of the proposed FSP states that if a transaction occurs in an inactive market and the quoted price is associated with a distressed transaction, "the reporting entity **must** use a valuation technique other than one that uses that quoted price without significant adjustment." [Emphasis added.] It appears that the proposed FSP may preclude some entities from using pricing services and broker quotes to estimate fair values for assets that are transacted in inactive markets. Many entities with significant holdings of financial assets that are transacted in inactive markets rely heavily on information from pricing services and brokers to determine the fair value of those

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securities. Because pricing information from those sources is based on current transaction prices and entities may not have sufficient information to overcome the presumption in the proposed FSP that the quotes represent distressed transactions, the proposed FSP may preclude entities from using those traditional sources of pricing information in many circumstances. Those entities may experience operational difficulties and incur significant costs (including the use of third-party specialists) if they are precluded from using information from pricing services and brokers.

There may be circumstances in which equity securities are thinly traded on over-the-counter markets (e.g., "pink sheets") and the entity is unable to obtain sufficient information to overcome the presumption that those quotes represent distressed transaction prices. In that circumstance, the FSP should address whether the entity is required to use a present value technique or another approach to value those equity securities.

As discussed in our attached letter, allowing an accounting policy election for the measurement of financial assets that are transacted in inactive markets if observed transaction prices and quotes from brokers or pricing services are assumed to be associated with distressed transactions would permit entities to elect to measure those assets based on their best estimate of a current exit price under Statement 157. That accounting policy election would continue to permit the use of information from brokers and pricing services, rather than requiring entities to apply the alternative measurement guidance in the proposed FSP.

Scope

The scope of the proposed FSP specifies that it would apply to financial assets within the scope of accounting pronouncements that require or permit fair value measurements in accordance with Statement 157. However, the proposed amendment to add paragraph 29A of Statement 157, including the alternative measurement guidance contained in that paragraph, has not been limited to financial assets. In practice, for financial liabilities that are measured at fair value, entities often use the same measurement that would be applied if they were an investor holding that identical financial instrument as an asset. If the Board believes that measurements of financial liabilities would not be affected by the guidance in the proposed FSP, the final FSP should state that explicitly.

With respect to the measurement guidance in paragraph 15 of the proposed FSP (and in paragraph 29A and Example 11 of the proposed amendments to Statement 157), we believe that the Board should consider whether to limit the scope to certain asset classes such as asset-backed securities. Application of the proposed guidance to those asset classes would appear to address constituent concerns about the effects of measuring those asset classes at a current exit price, while avoiding confusion about the application of Statement 157 to fair value measurements of assets and liabilities that would not be within the scope of the proposed FSP.



In addition, the proposed FSP should clarify if it is applicable to all entities, including mutual funds, other investment companies, and pension plans. We believe that the Board should consider the implications on those entities if they were required to value their assets at amounts that exceed a current exit price. For example, fair value measurements of investment securities affect the net asset values of open-ended funds, which are then used to determine amounts received and paid for share purchases and redemptions.

Disclosures

In some cases, it appears that the measurement guidance in paragraph 15 of the proposed FSP (and in paragraph 29A and Example 11 of the proposed amendments to Statement 157) would result in fair-value-based measurements (e.g., "economic value" or "fundamental value") that exceed the amount that the entity would realize if the related assets were sold currently. In those circumstances, we believe that the Board should consider whether a qualitative disclosure providing that information might be appropriate. See "Measurement Guidance – Measurement Objective" above for further discussion of our concerns relative to this issue.

Effective Date

If the proposed FSP is finalized and effective for interim periods and fiscal years ending after March 15, 2009, given the short period of time between the issuance of the proposed FSP and SEC filing deadlines for periods ending on March 31, 2009, the Board should discuss with the SEC whether an extension of the quarterly filing deadlines for the first period ending after March 15, 2009 would be appropriate.

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