



One Franklin Parkway  
San Mateo, CA 94403-1906  
tel 650/312.2000  
franklintempleton.com

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VIA Email: [director@fasb.org](mailto:director@fasb.org)  
Technical Director,  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

Re: File Reference No. 1710-100  
Fair Value Measurements and Disclosures (Topic 820): Improving  
Disclosures About Fair Value Measurements

Dear Technical Director

Franklin Templeton Investments<sup>1</sup> appreciates the opportunity to comment on Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures About Fair Value Measurements (the “Exposure Draft”). Our responses to the questions for respondents in the proposed accounting standards update, together with additional comments, are set forth below.

## Introduction

Paragraph 820-10-50-1 is proposed to be amended, in part, by requiring a reporting entity to disclose information that, among other things, enables users of its financial statements to assess “For recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on earnings (or changes in net assets) for the period and the total effect(s) of changes in reasonably possible alternative inputs.”<sup>2</sup> [Emphasis added]

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<sup>1</sup> Franklin Resources, Inc., a global investment management organization, operates as Franklin Templeton Investments. Franklin Templeton Investments is engaged primarily, through various subsidiaries, in providing investment management, share distribution, transfer agent and administrative services to open- and closed-end Funds in the United States and overseas. At August 31, 2009 Franklin Templeton advised or subadvised approximately 7,700 Registered Funds (as defined in text below) and other accounts and managed \$495.7 Billion of assets around the world

<sup>2</sup> Paragraph 820-10-50-2, Subparagraph (f), as proposed to be amended further provides, in part, “For fair value measurements using significant unobservable inputs (Level 3)... In determining reasonably possible alternative inputs, the reporting entity shall consider the current economic environment(s) in which it operates, including the expected effects of correlation among changes in significant inputs if estimating the effect of more than one reasonably possible change. A reasonably possible change in inputs shall not include remote or worst case scenarios. The reporting entity shall disclose quantitative information about the significant inputs used and reasonably possible alternative inputs for each class of fair value measurement that uses significant unobservable inputs (Level 3). For example, for residential-mortgage-backed securities, the reporting entity's

As preparers of financial statements for registered open- and closed-end investment companies (“Registered Funds”), we believe this expanded disclosure of “the total effect(s) of changes in reasonably possible alternative inputs” (sometimes called a “sensitivity analysis”) will create a costly and difficult-to-manage process with few tangible benefits for shareholders or readers of the financial statements of Registered Funds. Secondly, we are concerned that a sensitivity analysis that quantifies a range of “reasonably possible” inputs, which is an inherently subjective analysis, may both confuse investors and undermine their confidence in the daily pricing of shares.

## **Questions for Respondents**

*Issue 1: With respect to the disclosure of the effect of changes in reasonably possible, significant, alternative inputs for Level 3 fair value measurements for each class of assets and liabilities (sometimes also referred to as sensitivity disclosures), the Board is seeking input from financial statement preparers about their operationality and costs.*

### *Increased burdens and costs*

Given the large number of potential investments identified as a Level 3 fair valuation for certain types of Registered Funds, the effect of this expanded disclosure requirement (sensitivity analysis) will be to significantly increase the cost and time required to prepare financial statements. We believe that this expanded disclosure will not be cost beneficial. Registered Funds would now be required to build and maintain multiple valuation models for a given investment, based on “reasonably possible alternative inputs.” Level 3 investments often employ very complex models with multiple inputs and assumptions. Maintaining separate and distinct models from what is used on a daily basis to value a Registered Fund’s holdings would be a costly endeavor, potentially requiring the employment of additional investment professionals simply charged with maintaining alternative models used to meet the proposed disclosure requirements. Ultimately, these added costs would be borne by the Registered Funds and their shareholders through increased fees.

### *Additional disclosures not meaningful*

These additional disclosures may confuse investors in Registered Funds. A sensitivity analysis does not describe the risks associated with a particular investment or class of investments, but rather may provide a lengthy list of inputs together with a hypothetical range of reasonably possible values. A sensitivity analysis will not have any bearing on the price at which an investor can purchase or redeem shares from a Registered Fund. Moreover, such an analysis may undermine the confidence of investors in the pricing of shares of Registered Funds. There is the added concern that readers of Fund financial statements will look to such sensitivity analysis as a measure of risk (or lack of risk) in lieu of a more careful reading of the risk disclosures contained in a Fund’s registration statement. For instance, a sensitivity analysis would have been unlikely to take into account the factors (alternative inputs) precipitating the recent financial downturn (the economic equivalent of a 100-year storm). In addition, Funds with

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quantitative disclosures may include inputs used and reasonably possible alternative inputs related to yield/discount rate, probability of default, loss severity, and prepayment rate.”

a large number of Level 3 securities will be challenged to not overwhelm readers with a lengthy disclosure table and pages of narrative descriptions of the possible values.

*Guidance is vague*

The phrase “reasonably possible alternative inputs” is vague and likely to be construed in different ways. First, it could be read to require parallel valuation models using different inputs to what is being used on a daily basis to value a Registered Fund’s holdings. Second, it could be read to only require the identification of the key inputs and then moving them back and forth over a reasonable range to arrive at a valuation window. The example contained in Paragraph 820-10-50-2, Subparagraph (f), concerning residential-mortgage-backed securities is suggestive of this second approach. Third, this phrase could be read to require some combination of these first two approaches, depending upon the particular facts and circumstances. Were the sensitivity analysis to be adopted, we suggest enhancing the definition of “reasonably possible alternative inputs” to clarify that it contemplates utilizing the current inputs at reasonably possible alternative levels.

*Disclosure of quantitative information for each class conflicts with instrument-specific approach*

The Exposure Draft’s proposal that the “reporting entity shall disclose quantitative information about the significant inputs used and reasonably possible alternative inputs for each class<sup>3</sup> of fair value measurement that uses significant unobservable inputs...”<sup>4</sup> will prove challenging, and often conflict with, the practice of valuing Level 3 instruments using an instrument-specific approach as opposed to a broader “macro” approach. Although the “class” can be a fairly broad categorization, standardized models and inputs are not necessarily used by class of asset. Appropriate inputs into the valuation of one instrument may not be appropriate for the valuation of another. For example, in valuing private equity investments, models may incorporate revenues, EBITDA, book value, cash flow, upcoming capital offerings, or some other metric as deemed to be appropriate for the particular situation. Accordingly, this disclosure requirement, depending on the number of Level 3 investments in a given Registered Fund’s investment portfolio, could create a complex and lengthy schedule for inclusion in the financial statements. We believe any such schedule would not be meaningful or useful to shareholders of a Registered Fund, given the potential volume of such disclosures.

*Proprietary information*

The key inputs utilized in valuing Level 3 investment are often proprietary information. In an instance where there are relatively few of these types of Level 3 instruments, required disclosure of these key inputs in financial statements may cause a Registered Fund to publicly disclose information (in the nature of such key inputs) that the Fund believes is proprietary, thus giving up part of its competitive advantage.

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<sup>3</sup> Class is defined in 820-10-50-2A of the Exposure Draft for debt and equity securities as being the same as “major security type.”

<sup>4</sup> See, footnote 2.

*Alternative approach: an enhanced qualitative discussion*

While we believe Registered Funds should not be required to include a sensitivity analysis with their financial statements for the reasons discussed, if the current level of disclosure is deemed inadequate, we would suggest expanded qualitative disclosure regarding valuation inputs and techniques with respect to particular classes of Level 3 securities. Such qualitative disclosure would be more informative than a lengthy list of alternative valuation inputs.

**Issue 2:** *With respect to the reconciliation (sometimes referred to as a roll forward) of fair values using significant unobservable inputs (Level 3), the amendments in this proposed Update would require separate disclosure of purchases, sales, issuance, and settlements during the reporting period. Is this proposed requirement operational? If not, why?*

*Proposed requirement is operational*

As it relates to the preparation of the financial statements for Registered Funds, we believe that this proposal is operational. Although a less granular level of detail is currently being provided through various nettings, we do not believe that the new requirement creates an onerous level of additional effort and believe that the grossing up of these movements within Level 3 will help the financial statement reader to better understand the breadth of transactions within Level 3.

**Issue 3:** *Is the proposed effective date operational? In particular, (1) will entities be able to provide information about the effect of reasonably possible alternative inputs for Level 3 fair value measurements for interim reporting periods ending after March 15, 2010?*

*Adopt an effective date of no sooner than for periods ending after June 15, 2010*

We note that the initial implementation of FASB 157 allowed a longer period of time to prepare for the required disclosures. The recent updates to FASB 157 have required a relatively short period of time between issuance and adoption, thus putting pressure on both issuers of financial statements, as well as their auditors. We believe that, should the sensitivity analysis requirements be adopted as currently contemplated by the Exposure Draft, the effective date of March 15, 2010 would be very challenging. Registered Funds with large quantities of investments categorized as Level 3 likely will need increased lead time in order to assess workflow and resources and, where appropriate, build new and/or enhanced valuation models capable of providing the data inputs required for the disclosures. Although our suggestion would be to not require Registered Funds to include a sensitivity analysis in their financial statements, we suggest that, if adopted, it be deferred for at least an additional three months and become effective no sooner than for periods ending after June 15, 2010.

**Additional Comments on Exposure Draft**

*Transfers between Level 1 and Level 2: often temporary*

We believe the requirement to add disclosure relating to the amounts and reasons for significant transfers between Level 1 and Level 2 within the fair value hierarchy will provide little benefit to readers of financial statements and should be removed as such movements are

often temporary. Paragraph 820-10-50-2, Subparagraph (bb), proposes new disclosures related to the amounts and reasons for significant transfers between Level 1 and Level 2 within the fair value hierarchy.<sup>5</sup> In our experience, the typical cause of a transfer of an investment from Level 1 to Level 2 and then back again for a Registered Fund is due to a pricing process known as market level fair valuation (MLFV). This typically occurs for foreign equity holdings where the foreign stock market closes before the New York Stock Exchange and thus does not reflect market movement based on the U.S. market. In the event that the U.S. market were to move significantly on a given day, the foreign stocks' values, which are normally based on the closing price on the foreign exchange and typically considered Level 1, are adjusted via MLFV based on certain proxies that trade in the U.S. market. These securities are then considered Level 2 and remain as such until they again return to being valued based on the close of the local market on which they trade and thus categorized as Level 1.

In the instance of MLFV, the movement from Level 1 to Level 2 is not indicative of a decrease in the liquidity of the investment or a heightening of the investment risk, but rather an effort by the Registered Fund to minimize opportunities for arbitrage and market timing for short term traders. Assuming that this technique was employed on the balance sheet date, we believe that requiring this type of disclosure for a Registered Fund would provide little benefit to the shareholders. This process is typically outlined in both the Registered Funds' notes to financial statements, as well as their annual registration statements. Furthermore, an investor in the Registered Fund could only derive from disclosures related to the movement of investments from Level 1 to Level 2 and back due to MLFV that relative price movement reflected in the US markets had not been fully captured in the foreign markets before their close on the balance sheet date; this information would already be widely available to a reasonable investor exercising diligence.

*Disclosure of specific changes in valuation techniques for Level 2 investments*

In a Registered Fund, a large percentage of fixed income securities are considered Level 2 in the fair value hierarchy due to the valuation methodologies employed. The volume of fixed income securities being priced daily creates operational constraints under the proposed requirements of the Exposure Draft.<sup>6</sup> A Registered Fund does not automatically know when an independent pricing service changes its inputs from one methodology or key input to another. In selecting a pricing service, a Registered Fund performs due diligence and verifies pricing techniques, but won't necessarily know what inputs are used to value a particular security on a given day, making disclosure of specific valuation technique changes within Level 2 to be burdensome and not operational. In addition, an unintended consequence of requiring such disclosures might be less reliance by Registered Funds on use of independent pricing services when valuing thinly traded securities.

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<sup>5</sup> Paragraph 820-10-50-2, Subparagraph (bb) states: "The amounts of significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for the transfers. Significant transfers into each level shall be disclosed separately from transfers out of each level. For this purpose, significance shall be judged with respect to earnings and total assets or total liabilities or, when changes in fair value are recognized in other comprehensive income, with respect to total equity. Also, for this purpose, any significant transfers shall be presumed to have occurred as of the beginning of the interim period in which the transfer occurred."

<sup>6</sup> For instance, Franklin Templeton Investments values approximately 64,000 instruments daily, of which approximately 48,000 are fixed income instruments, valued with the assistance of pricing services.

*Presumption of transfers between levels as of the beginning of the period is problematic*

Were this requirement relating to transfers between Level 1 and Level 2 to be adopted as currently contemplated by the Exposure Draft, we would suggest replacing the presumption contained in the last sentence of Subparagraph (bb), as well as the presumption added in Subparagraph (c3), and replacing it with the presumption (or allowing as an alternative presentation) that the transfers between Levels occurred at the actual point within the period, given the specific facts and circumstances surrounding the transaction. This alternative will allow the disclosures to be tailored to a Registered Fund's particular circumstances and provide more accurate disclosure.

Our concern with the beginning of period presumption as currently included in the Exposure Draft stems from the fact that, due to the nature of a Registered Fund which is buying and selling securities on a continuous basis, it is not always the case that particular securities moving between levels were held at the beginning of the reporting period. Registered Funds mark their investments to market daily; as such, the market value on the date of the transfer between levels is readily available and more reflective of the economic reality at the time of transfer. Further, and specifically related to the Level 3 rollforward outlined in Subparagraph (c), using a beginning of period value for an investment which transferred into Level 3 during the period for the purpose of the rollforward may tend to skew the ultimate gains or losses disclosed in Subparagraph (c1) and not ultimately be reflective of the actual amounts since the point of transfer. Our suggestion would allow the use of the date at which the movement between levels took place.

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We appreciate your time and consideration of our comments. If you have any questions or wish to discuss any of the issues addressed in this letter, please contact the undersigned at (916) 463-5030.

Very Truly Yours,

/s/

Laura F. Fergerson  
Senior Vice President  
Franklin Templeton Services