As submitted to FASB.

RE: Proposed FSP FAS 157-d

October 6, 2008

This offers an enhancement to the term “Inactive” market(s).

I suggest the concept be expanded to include:

A) Extreme volatility relative to the market’s historical volatility (as measured by an appropriate variance metric) due to:
   1. Perturbations external to the market
   2. Perturbations internal to the market
   3. Many transactions are not reflected in the observable market, but are bi or multi-lateral transactions, invisible to outside observers (e.g. private placements)
   4. Markets involving “like kind” exchanges bypassing any price related reporting mechanisms

B) The instrument being valued is different from the “Market” instruments in one or more crucial respects. For example:
   1. The instrument is a portfolio of debt securities and the investment grade (default risk) of the instrument in question differs from the market’s assumptions
   2. The instrument is a private placement of an instrument with unique features making comparability a stretch (strippable equity warrants on a debt instrument under specified conditions)
   3. Part of one or both sides of the contract requires specific performance on the part of one or more parties that is difficult to monetize
   4. The contract has an exit clause triggered by events unrelated to the market or related markets or the ability of any party to complete the contract
   5. The list is endless.

C) The market has reached such a degree of uncertainty on the part of participants that market behavior is extremely erratic. This is also known as a panicked market.

Volatility:

Volatility is an important concept. In a volatile market no single closing price or bid-ask range is likely to be a measure reflecting the real value of the instrument in question.

Volatility that is in excess of “normal” for that market measures all kinds of things indirectly, including, but not limited to the examples above.
I suggest a mark to model concept rather than any data point.

The model attempts to use observable data to estimate the “true underlying value”.

One class of methods uses one of several time series analysis approaches. My preferred methods treat the time series as being composed of a deterministic component and a stochastic (random) component, also known as the noise component. The greater the noise in the series the less likely any given measurement reflects the “true underlying value”.

In the first figure the noise is represented as a continuous sine like wave form and the deterministic value by the straight line. The task is to measure the position of the line by taking data samples as depicted by the wave form. Since the noise is low almost any data point is close to the true underlying value. Level I or II would seem appropriate if all other conditions are met.
In the second figure (below), the opposite is the case. The noise is so great that almost all data points do not come close to reflecting the true value.

In such cases, clearly Level III is preferable to pretending you have data reflecting the intent of Level I or even Level II. In such cases Level I & II represent greater uncertainty that the considered judgments called for in Level III.

Disclosure:

In such exercises, transparency requires full disclosure of assumptions and methods. If the user of the analysis has the assumptions and methods and the raw data, the user can apply his or her assumptions and methods if they do not agree with the reported assumptions and methods.