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Divided Court in Jones vs. Harris Associates L.P. Excessive Fee Case

Over the strong objections of five of its judges, including Judge Richard Posner, the U.S. Court of Appeals for the Seventh Circuit recently denied plaintiffs' petition for a rehearing by the full Court in the *Jones v. Harris Associates L.P.* case. Earlier in the year, a three-judge panel of the Court led by Chief Judge Easterbrook rejected the "reasonableness" standard previously adopted in *Gartenberg v. Merrill Lynch Asset Management, Inc.* for determining whether an advisory fee is excessive. In that decision, the Court noted that "[t]he Trustees (and in the end investors who vote with their feet and dollars), rather than a judge or jury determine how much advisory services are worth . . . Just as plaintiffs are skeptical of *Gartenberg* because it relies too heavily on markets, we are skeptical about *Gartenberg* because it relies too little on markets." **Judge Posner's dissent attacks the *Jones* decision, insisting that a rehearing by the full Court is appropriate and that the decision ignores certain conflicts of interest, is of limited applicability and rests in flawed logic, precedent and procedure.**

Chief Judge Easterbrook reasoned in the panel decision that market forces satisfactorily regulate advisory fees since investors will avoid funds with excessive fees. **Judge Posner disagrees, explaining that as a general rule, mutual fund investors "neither benefit from arm's length bargaining nor from prices that approximate those that arm's length bargaining would yield were it the norm."** Accordingly, Judge Posner says, the markets alone will not prevent the imposition of excessive advisory fees.

On Competitive Market Forces. **Judge Posner notes that "competition in product and capital markets can't be counted on" to solve the problem of excessive mutual fund advisory fees because of "the feeble incentives of boards of directors to police compensation."** "Mutual funds," he writes, "are a component of the financial services industry, where abuses have been rampant."

On Comparative Fees. Judge Posner argues that the "the comparability approach" set forth by the Court in *Jones,* whereby the fees in question are measured against those of other mutual fund advisors, is inadequate because it assumes that suitably comparable industry data will be available. **Judge Posner also suggests that the *Jones* standard could have the unintended effect of causing mutual fund advisory fees to increase because that standard is even more difficult for a plaintiff to meet than the *Gartenberg* test and because it embodies greater subjectivity.** Under *Jones*, a fund's advisory fees would be deemed excessive if they are "so unusual that a court [will] infer that deceit must have occurred, or that the persons responsible for [the] decision have abdicated." This contrasts with the *Gartenberg* standard under which a fund's advisory fees will be excessive if they are "so disproportionately large" that they bear "no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." Judge Posner explains that *Gartenberg*, unlike *Jones*, provides an objective standard of reasonableness against which advisory fees may be evaluated without reliance on industry data. He maintains that such a standard is particularly important because "the governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide," and if widely followed, *Jones* would "allow those fees to become the industry's floor."

On Process and Use of Precedent. Judge Posner questions the authority cited in *Jones*, stating that the cases on which the Court relies do not focus on advisor compensation, excessive or otherwise, and do not suggest that "*Gartenberg's* treatment of the issue of excessive fees is

incorrect." **Judge Posner calls the Court's justification of the fees at issue in *Jones* "airy speculation," divorced from "anything having an evidentiary or empirical basis,"** and highlights the fact that "*Jones* is the only appellate opinion noted in Westlaw as disagreeing with *Gartenberg*." He says that while "the opinion is recognized to have created a circuit split" that could require resolution by the United States Supreme Court, the panel "did not acknowledge this or circulate its opinion to the full court in advance of publication, as is required when a panel creates a circuit split."

Treasury Insures Money Market Funds

In response to recent instability in the markets, **the Treasury Department established a temporary insurance program to cover participating money market funds that "break the buck."** Under its program, which is voluntary, the Treasury's insurance will protect investors of record as of September 19, 2008. Funds that broke the buck before September 19 are not covered.

How the program works. **The program aims to protect shareholders from losses on the value of their shares if their money market fund's net asset value (NAV) drops below $0.995 (which the Treasury refers to as a "guarantee event").** Should this occur, the Treasury will pay to the fund (to then be distributed to holders of covered shares) the difference between its actual NAV and an NAV of $1.00 per share.

If a guarantee event does occur, the money market fund must notify the Treasury the next day and begin liquidation within 5 business days, unless it can, within those 5 business days, raise its market-based NAV to at least $0.995.

If the money market fund is unable to raise the NAV, it must stop issuing new shares and paying dividends and must liquidate its holdings within 30 days. Once liquidated, the fund must provide the Treasury with a "Payment Request Notice." The Treasury's Exchange Stabilization Fund, which is funded with $50 billion to cover all claims made under the insurance program, will then pay the amount of the NAV shortfall to the affected fund.

Should the money market fund have an NAV support agreement from the adviser or its parent in effect at any time after September 19, it cannot amend, terminate, or withdraw the support agreement. Also, if the fund is able to renew the agreement, it must do so. If a guarantee event occurs, a fund must take all necessary action to seek payment under the support agreement. Finally, a fund must use its "best efforts" to obtain a support agreement if it does not already have one. Many fund groups that do not currently have support agreements in place have interpreted that requirement to be triggered only upon the occurrence of a guarantee event.

Eligible funds. The program is available to money market funds which are those (i) regulated under Rule 2a-7 of the Investment Company Act, (ii) publicly offered, and (iii) registered with the SEC.

Effective date. Funds had to enroll in the program by October 8, 2008. The program is scheduled to terminate on December 18, 2008, but the Secretary of the Treasury retains the option to extend it for any length of time up to a year, ending no later than September 18, 2009. If the program is extended, participating funds will not be automatically re-enrolled, but must renew their participation. Funds that did not enroll in the program by the October 8 deadline cannot participate in any extension of the program. Participating funds may continue in the program only if their NAV per share remains at least $0.995.

Costs. Participating money market funds paid a fee to the Treasury Department according to the following scale:

- **Funds with an NAV per share of $0.9975 or more paid 1 basis point on eligible assets.**
- **Funds with an NAV per share equal to or greater than $0.995 but less than $0.9975 paid 1.5 basis points on eligible assets.**

These fees do not cover any extension of the program. If the Treasury extends the program beyond December 18, 2008, the fees to participate in the extension will be published at that time.

Covered shares. Shareholders may receive insurance proceeds only with respect to the lesser of (a) the number of shares held on September 19, 2008 or (b) the number of shares held on the date of the guarantee event. An investor who sold shares after September 19 but repurchased shares before the guarantee event would be protected pursuant to the same "lesser of" formulation.

SEC Temporarily Relaxes Money Market Fund Shadow Pricing Requirements

The SEC recently issued a no-action letter, in response to a request from the Investment Company Institute (ICI), temporarily allowing money market funds to "shadow price" certain portfolio securities by reference to their amortized cost value rather than using available market quotations.

Background of Shadow Pricing

To help maintain a stable NAV of $1.00 per share, most money market funds use the amortized cost method of valuation, under which securities are valued at acquisition cost rather than market value, and interest earned on each

security (plus any discount received or less any premium paid) is accrued uniformly over the remaining maturity. Because, as the SEC notes in the no-action letter, "[u]se of the amortized cost method for portfolio securities with longer maturities increases the likelihood that a significant deviation will occur between the amortized cost value of the securities and their market value," **a money market fund using the amortized cost method must adopt written procedures requiring the fund to periodically calculate "the extent of deviation**, if any, of the current NAV per share calculated using available market quotations (or an appropriate substitute that reflects current market conditions) from the money market fund's amortized cost price per share." This process, known as "shadow pricing," is typically performed weekly by the fund's investment adviser, with more frequent calculations if the deviation exceeds a predetermined trigger point (for example, $0.0025 per share).

Board Responsibilities

A money market fund's monitoring procedures must also provide that **the fund's board periodically "review… the amount of the deviation as well as the methods used to calculate the deviation."** Most boards review the range of deviation of amortized cost value from market-based NAV on a quarterly basis and the methods used to calculate the deviation annually. If the deviation exceeds 0.5%, the board is required to "promptly consider what action, if any, should be initiated by the board." In addition, if the board believes that the extent of any deviation may result in material dilution or other unfair results to investors or existing shareholders, the board must "cause the fund to take such action as it deems appropriate to eliminate or reduce to the extent reasonably practicable such dilution or unfair results."

Temporary Relief

In requesting no-action assurance, the ICI stated its belief that the current regulatory requirements for shadow pricing "are not working as intended" and that "the markets for short-term securities, including commercial paper, may not necessarily result in discovery of prices that reflect the fair value of securities the issuers of which are reasonably likely to be in a position to pay upon maturity." **The SEC responded by temporarily allowing money market funds to fulfill the shadow pricing requirements for certain portfolio securities by reference to their amortized cost value rather than using available market quotations**, "unless the particular circumstances…suggest that amortized cost is no longer appropriate." The SEC's position is limited to securities that:

- have a remaining maturity of 60 days or less;
- are "first tier" securities, which include U.S. government securities, shares of other money market funds and securities that have received the highest short-term rating from a credit rating agency such as S&P or Moody's; and
- the fund reasonably expects to hold to maturity.

The temporary relief from the shadow pricing requirements for certain securities will remain in effect **through January 12, 2009.**

Federal Reserve Will Provide Liquidity to Money Market Investors

On October 21, 2008, **the Federal Reserve Board announced the creation of the Money Market Investor Funding Facility (MMIFF) to "support a private-sector initiative designed to provide liquidity to U.S. money market investors."** The announcement followed a period of "considerable strain" on short-term debt markets as money market mutual funds and other investors faced difficulties selling assets to meet redemption requests and portfolio rebalancing requirements.

The Facility

Under the program, the Federal Reserve will lend up to $540 billion to five private-sector special purpose vehicles (PSPVs) to purchase up to $600 billion of "eligible assets" from "eligible investors." An investor who sells securities to a PSPV will receive 90 percent of the purchase price in cash and 10 percent in the form of asset-backed commercial paper. All purchases will be at amortized cost..

Terms and Conditions

The key terms and conditions of the MMIFF as stated by the Federal Reserve include the following:

- *Eligible investors* - Initially, **eligible investors will include "U.S. money market mutual funds and over time may include other U.S. money market investors."**
- *Eligible assets* – Assets eligible for purchase under the MMIFF include **"U.S. dollar-denominated certificates of deposit and commercial paper issued by highly rated financial institutions and having remaining maturities of 90 days or less."** Each PSPV may purchase instruments issued by 10 different financial institutions designated in its operational documents with short-term debt ratings of at least A-1/P-1/F1 from two or more major nationally recognized statistical rating organizations (NRSROs).
- *Concentration limit* – The **debt instruments** of a financial institution **"may not constitute more than 15 percent of the assets"** of the PSPV at the time of purchase.

- *Financing* – **Each PSPV will finance its purchase of an eligible asset by borrowing under the MMIFF and issuing asset-backed commercial paper.** The asset-backed commercial paper must have a maturity equal to the maturity of the asset and be rated at least A-1/P-1/F1 by two or more major NRSROs. Financing received under the MMIFF will be on an overnight basis at the primary credit rate until the maturity of the asset. Funding provided by the Federal Reserve will be senior to the asset-backed commercial paper, with recourse to the PSPV, and will be secured by all of the assets of the PSPV.
- *Downgrades & Defaults* – If a debt instrument ceases to be an eligible asset as a result of a short-term rating downgrade, **the PSPV must cease all asset purchases until its assets issued by that financial institution have matured.** Similarly, upon a default of any asset held by a PSPV, the PSPV must cease all asset purchases and repayments on outstanding asset-backed commercial paper.
- *Use of Proceeds* – Proceeds from the maturation of a PSPV's assets **will be used to repay the Federal Reserve.** Upon maturation of all assets in the PSPV, any remaining available cash will be used to repay principal and interest on the asset-backed commercial paper. A small fixed amount of any excess spread remaining in the PSPV will be allocated proportionally among investors in the asset-backed commercial paper, with the remainder due to the Federal Reserve.
- *Termination* – The PSPVs will cease purchasing assets on April 30, 2009, unless the MMIFF is extended by the Federal Reserve.

Complementary Facilities

The MMIFF complements two other previously announced facilities:

- The Commercial Paper Funding Facility (CPFF) backs purchases of highly rated, U.S. dollar denominated, three-month, unsecured and asset-backed commercial paper issued by U.S. issuers; and
- The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) extends loans to banking organizations to purchase asset-backed commercial paper from money market mutual funds.

As stated by the Federal Reserve, "The AMLF, CPFF, and MMIFF are all intended to improve liquidity in short-term debt markets and thereby increase the availability of credit."

The full text of the Federal Reserve's press release is available at http://www.federalreserve.gov/newsevents/press/monetary/20081021a.htm.

IDC and MFDF Comment on SEC's Best Execution and Soft Dollars Proposal

The Independent Directors Council (IDC) and the Mutual Fund Directors Forum (MFDF) recently commented on the SEC's proposed guidance regarding the duties of fund directors in overseeing portfolio trading practices. In its release, the SEC proposed sixteen questions on which it believes boards should focus, noting that it is **"imperative that fund directors both understand and scrutinize the payment of transaction costs by the fund"** and monitor the fund adviser's trading practices to "assist them in evaluating the adviser's procedures regarding its best execution obligations."

IDC Comments

Stating that it supports the "Commission's objective of providing guidance that is relevant," the IDC advocated the following:

- Confirming "that **the board's role is to provide oversight and not to make specific determinations** about specific trading practices or soft dollar services."
- Avoiding adopting "mandatory checklists" for fund directors, because **"listing suggested factors to be considered by fund boards and others tends to be interpreted as creating a list of required factors."** The IDC noted that "it is imperative that fund directors have the flexibility to approach their oversight responsibilities in the context of the specific circumstances of the funds they oversee." The IDC encouraged the SEC to make it clear in its final guidance that any list of questions put forth by the Commission is only a "suggested" list "and not mandatory."
- "[Clarifying] that **each board may determine for itself the frequency with which it will evaluate [soft dollars] data and information**."
- Confirming "that a fund board may use its discretion to determine whether the fund is benefiting from the soft dollar services acquired by the adviser and **the fact that other clients, including other mutual funds, are receiving benefits should not lead to the conclusion that 'services are inappropriately benefiting another of the adviser's clients at the fund's expense**.'"
- **Avoiding a possible blurring of directors' duties under the Investment Company Act and an adviser's obligations under the Securities and Exchange Act**—highlighting the Commission's suggestion that fund boards evaluate whether

"the fund's brokerage commissions could be used differently so as to provide greater benefits to the fund," the IDC noted, "We are not sure what this means and are concerned it could be interpreted as establishing a new [legal] standard [for boards]."

Responding to the request for comment on whether the information the SEC proposed that boards consider entails disclosure changes, the IDC stated that it does not "believe that additional disclosure to fund investors is warranted at this time**. The disclosure** regarding brokerage practices, including the use of soft dollars, **that currently is required in fund registration statements**, **combined with fund board oversight of portfolio trading, which includes evaluation of soft dollar arrangements, provide a sound and balanced regulatory approach**."

MFDF Comments

The MFDF stressed that **the Commission should provide "appropriate guidance," but also "recognize the importance of the directors' business judgment in managing . . . conflicts."** Urging the SEC to "protect [a director's] informed exercise of that business judgment," the MFDF weighed in as follows:

- "A majority of our members continue to believe that, **because of the difficulty inherent in protecting against the conflicts posed by soft dollars, the Commission should seek ultimately to eliminate their use,"** the MFDF also recognized, however, "that at least in the short run, soft dollars are not likely to be eliminated and that many management companies will continue to use soft dollars as part of advising their funds."
- **"The proposed guidance fails to address the needs of directors."** The MFDF acknowledged that the Commission's proposals are a response to the directors' request for guidance, but stressed that **a list of questions (albeit suggested) "will be deemed to be required and may even form the basis for regulatory reviews."** The MFDF also noted its concern that a list of questions creates a checklist that, if not followed, can lead to "increased litigation and compliance risk." The MFDF urged the SEC to "clarify that the list of questions is not mandatory, and emphasize that **what is more important is the framework within which the data is considered and the business judgment of directors."**
- **"The Commission's proposed guidance says virtually nothing about what directors should do with the information they obtain.** We are encouraged by this, in that it implicitly assumes that boards can exercise their oversight and best judgment. The proposed guidance would be improved were this more expressly stated."
- The proposed guidance "implies that directors must develop a means of at least estimating what value the fund receives in return for its soft dollars," yet it **"provides little assistance to directors on the key issue of quantifying the value received in return for soft dollars."** The omission of this guidance, according to the MFDF, "renders the proposed guidance incomplete."
- **"The proposed guidance fails to address unbundling** . . .. As with the Commission's failure to address the difficulty of quantifying the value of soft dollars, this failure seriously weakens the proposed guidance."
- **"The proposed guidance fails to emphasize and protect the business judgment of directors . . .** [i]f the Commission is going to rely on directors to balance and manage the conflicts posed by soft dollars, it must protect their decision-making process . . . we urge the Commission to address this important issue."
- **Regarding best execution, the MFDF explained that** its concerns with the proposed guidance "largely mirror those expressed . . . with respect to soft dollar transactions." The MFDF reiterated its opposition to ". . . effectively replacing directors' business judgment with a checklist approach . . . [and a] [s]lavish adherence to a list of questions [that] may fail to recognize current trading practices." The MFDF suggested tha[t] **"what directors could most benefit from is better and more nuanced guidance from the Commission** regarding how to weigh any concerns and risks they uncover in the course of their analysis, and, ultimately, how far they should go to satisfy themselves that trades are being conducted in the best interest of fund shareholders."

Boards Oppose Money Market Rule Changes

In July, the SEC proposed to amend Rule 2a-7 under the Investment Company Act to, among other things, **eliminate references to NRSROs**. The proposed amendments generated significant interest in the industry as evidenced by the dozens of comment letters submitted to the SEC. It appears, based on those letters, that many boards are concerned that the practical effect of the proposed amendments would be to **replace NRSRO credit determination with determinations made by fund directors in the board room**.

Some of the **most commonly cited concerns in the comment letters** are summarized below:

- the amendments would expand board responsibilities into day-to-day matters in a way that is **inconsistent with a board's oversight responsibilities**;

- **boards are not well suited to make credit quality and tier determinations**;
- expanding board responsibilities in the manner proposed is **inconsistent with Director Division Donohue's efforts to lessen the burdens on fund boards**;
- the **time and costs** associated with the amendments **would place an undue burden on fund boards**;
- eliminating references to NRSROs would **expose funds to more subjective risk assessments and potentially more liquidity risk**; and
- removing references to NRSRO ratings **would effectively eliminate all objective indicia of credit quality** and open the door to greater opportunity for abuse.

Some comment letters **also offered suggestions that would stop short of completely abandoning NRSRO references in the Rules**. The suggestions included that the SEC:

- revise Rule 2a-7 to permit a board, acting on a recommendation from the investment adviser, to select the NRSROs that would be included in the universe of NRSROs whose ratings would be considered when determining whether a security is eligible under the Rule (currently, an investment adviser must consider the ratings of all NRSROs that rate a security); and
- adopt a process that more clearly announces the designation of a new NRSRO by highlighting the notice of that designation prominently on the SEC's Web site.

One of the **few comment letters submitted in support** of the SEC's proposal was that of **Mr. Bruce Bent, founder and Chairman of the Reserve Fund, which is currently in liquidation**. In his letter, Mr. Bent noted that "the benefit of this action will either **be increased credit expertise at money fund providers or a winnowing of the funds offered**, both of which would increase the integrity of money market funds . . .. The money market fund's board of trustees and its investment adviser has a **fiduciary duty to the shareholders; this responsibility is not diluted by the presence of ratings for securities in the fund** . . .. Lest we forget, the purpose of the money fund is to bore the investor into a sound night's sleep."

All comment letters can be viewed at http://www.sec.gov/rules/proposed.shtml.

SEC Addresses Short Sale Concerns

Temporary Actions

The SEC recently took steps **"to address concerns regarding short sales in light of the ongoing credit crisis."** The steps "focused particularly on the securities of financial institutions whose health may have an impact on financial stability" and were "designed to ensure the continued smooth operation of orderly markets." Specifically, the temporary measures covered the following:

- *Temporary ban on short selling in financial companies.* The first of the emergency orders imposed a ban on selling short the securities of financial companies, including banks, savings associations, investment advisers, insurance companies and broker-dealers. In a release extending the original order, the SEC stated that it intended the ban to **"restore investor and market confidence by preventing short selling from being used to drive down the prices of securities in financial institutions."** The order expired as scheduled on October 8, three days after the President signed the Emergency Economic Stabilization Act of 2008.
- *Temporary requirement that institutional money managers report to the SEC their new short sales of certain publicly traded securities.* The SEC also issued an order requiring institutional money managers that exercise investment discretion over $100,000,000 or more to file with the SEC a weekly report on securities sold short during the prior week beyond a threshold amount. In extending the order, the SEC stated that the nonpublic submission of the short sale reports **"may help prevent artificial volatility in securities as well as further downward swings that are caused by short selling."** Although the reporting requirement was scheduled to expire on October 17, the SEC extended it as an interim final temporary rule through August 1, 2009 and has requested comments as to whether it should remain in effect beyond that date.
- *Temporary easing of restrictions on the ability of securities issuers to repurchase their securities.* The third emergency order was designed to provide flexibility to issuers conducting repurchases of their own securities pursuant to a regulatory safe harbor. The SEC stated that the purpose of the order was to **"give issuers more flexibility to buy back their securities, and help restore liquidity during this period of unusual and extraordinary market volatility."** The order expired as scheduled on October 17.

Naked Short Selling

In addition to these emergency orders, the SEC has taken action to strengthen the existing ban on "naked" short selling (that is, selling short without first arranging to borrow the securities to make delivery) and to increase the penalties against naked short selling. The SEC intended these actions to **"provide a powerful disincentive to those who might otherwise exacerbate artificial price movements through 'naked' short selling."** These actions include the following:

- *Hard T+3 close-out requirement for naked short selling*. The SEC adopted, on an emergency basis, a new rule requiring that short sellers and their broker-dealers deliver securities by the settlement date (three days after the sale transaction date, or "T+3") and imposing penalties for failure to do so. Although the reporting requirement was scheduled to expire on October 17, the SEC extended it as an interim final temporary rule through July 31, 2009.
- *Repeal of exception for options market makers from short selling close-out provisions.* This exception had permitted options market makers to maintain fail positions indefinitely. It was repealed effective on September 18, through a final rule to eliminate the options market maker exception from regulatory close-out requirements.
- *Naked short selling anti-fraud rule.* The new rule, which became effective on September 18, covers short sellers who deceive broker-dealers or any other market participants about their intention or ability to deliver securities in time for settlement. The rule makes clear that such persons are violating the law when they fail to deliver.

The SEC has stated that it "will continue to monitor the impact of the rules regarding short selling."

Regulators Act to Clarify Securities Valuation Rules

The SEC and the Financial Accounting Standards Board (FASB) recently clarified the use of market value, or mark-to-market, accounting under FASB Statement No. 157, Fair Value Measurement (FAS 157) **noting that "the current environment has made questions surrounding the determination of fair value particularly challenging."**

Overview of FAS 157

FAS 157 requires companies (including investment companies) to value securities at the prices at which they can be sold "in an orderly transaction between market participants . . . in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability." It establishes a fair value hierarchy "that distinguishes between (1) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (2) the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs)."

The use of unobservable inputs "is intended to allow for situations in which there is little, if any, market activity for the asset or liability at the measurement date." However, because FAS 157 emphasizes an exit versus an entry price in determining fair value, there has been concern that FAS 157 does not provide sufficient guidance on how to determine fair value in markets that are inactive and may force companies to write down assets that are not in danger of default, merely because an active market for the security no longer exists.

Key Elements of Recent Clarifications

The clarifications recently issued by the SEC and FASB give companies greater latitude to use proprietary financial models and their own judgment if no market exists, or if the market currently reflects only forced liquidation pricing. **The key elements include the following:**

- **When an active market for a security does not exist, the use of management estimates** that incorporate current market participant expectations of future cash flows, and include appropriate risk premiums, **is acceptable**.
- When significant adjustments to available observable inputs are required, **a company may be justified in using an estimate based primarily on unobservable inputs**.
- **Broker quotes are not necessarily determinative if an active market does not exist for the security.** In weighing a broker quote as an input to fair value, a company should place less reliance on quotes that do not reflect the result of market transactions and should consider whether the quote is an indicative price or a binding offer.
- **Distressed or forced liquidation sales are not orderly transactions**, and thus are not determinative when measuring fair value.
- **A quoted market price in an active market for the identical asset is most representative of fair value and thus is required to be used (generally without adjustment).** Prices in an inactive market that do not reflect current prices for the same or similar assets, however, may require adjustment to arrive at fair value.

- **A significant increase in the spread between the amount sellers are "asking" and the price that buyers are "bidding,"** or the presence of a relatively small number of "bidding" parties, are indicators that should be considered in determining whether a market is inactive.

The joint release by the SEC and FASB also discussed the factors to consider in determining if an investment is other-than-temporarily impaired. In general, "the greater the decline in value, the greater the period of time until anticipated recovery, and the longer the period of time that a decline has existed, the greater the level of evidence necessary to reach a conclusion that an other-than-temporary decline has not occurred."

As noted in the joint release, while existing U.S. GAAP does not provide "bright lines" or "safe harbors" in making a judgment about other-than-temporary impairments, factors to consider include:

- The length of the time and the extent to which the market value has been less than cost;
- The financial condition and near-term prospects of the issuer; or
- The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.

FASB Issues Additional Interpretative Guidance

On October 10, 2008 **FASB issued Staff Position No. FAS 157-3 to further clarify the application of FAS 157 in an inactive market** and provide an illustrative example of how to determine fair value of a financial asset when the market for the asset is not active. The example emphasized the following points:

- **Even where there is little, if any, market activity for an asset, the fair value measurement objective remains the price that would be received by the holder in an orderly transaction** that is not a forced liquidation or distressed sale (an exit price notion).
- **Even in times of market dislocation, it is not appropriate to conclude that all market activity represents forced liquidations or distressed sales.** However, it is also not appropriate to automatically conclude that any transaction price is determinative of fair value.
- **The use of a company's own assumptions** about future cash flows and appropriately risk-adjusted discount rates **is acceptable when relevant observable inputs are not available.** In some cases, a company may determine that observable inputs require such significant adjustment based on unobservable data so as to render them unobservable inputs. Regardless of the valuation technique used, an entity must include appropriate risk adjustments that market participants would make for nonperformance and liquidity risks.

SEC to Study the Effects of Mark-to-Market Rules

The recently enacted Emergency Economic Stabilization Act of 2008 permits the suspension of mark-to-market accounting under FAS 157 and directs the SEC to conduct a study on the effects of the mark-to-market rules on major financial institutions. The study is to be completed by January 2, 2009, in consultation with the Secretary of the Treasury and the Board of Governors of the Federal Reserve System.

The full text of the recent clarifications provided by the SEC and FASB can be found on the SEC's Web site at http://www.sec.gov/news/press/2008/2008-234.htm. The full text of the FASB Staff Position No. FAS 157-3, including the illustrative example, can be found at http://www.fasb.org/pdf/fsp_fas157-3.pdf.

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