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SEC and FASB Relax Fair Value Rules

On September 30, the Office of the Chief Accountant of the Securities and Exchange Commission (“SEC”) and the Staff of the Financial Accounting Standards Board (“FASB Staff”) issued guidance on the determination of “fair value” under FAS 157 (the “FAS 157 Guidance”), addressing when internal assumptions can be used to measure fair value, when to use broker quotes, and when transactions in disorderly or inactive markets represent fair value. As announced at that time, on October 3, the FASB Staff published for comment a proposed FASB Staff Position (“FSP”) intended to clarify the application of the FAS 157 Guidance. FAS 157, which became effective in November 2007, defines “fair value” as the price that would be obtained in an orderly transaction between market participants in the principal or most advantageous market.

The FAS 157 Guidance and the FSP were issued in response to a campaign by the banking industry centered on the argument that the emphasis under FAS 157 on “fair market” valuations for financial assets is forcing banks to write down performing assets to “fire sale” or distressed prices, compelling them to sell more assets to raise capital, and thereby depressing prices further in a downward spiral. Conversely, many supporters of FAS 157, including investors’ groups, have expressed the view that current market values give a more accurate picture of the health of financial institutions than values based on cost or cash flow models. The SEC rarely involves itself in FASB policy-making, and the SEC’s action is clearly an attempt to reach a compromise between the two positions: it relaxed the interpretation of some of FAS 157’s market valuation provisions, but did not suspend market valuation, as some have requested.¹ There is great urgency to the finalization of the FSP (comments were due on October 9, 2008) in order that it can be applied in reporting third-quarter results.² In addition, although this guidance is directed towards the financial statements of publicly traded banks, registered investment companies and investment advisers will find it addresses many of the issues that they are facing in valuing portfolio assets.

Some of the more important elements of the FAS 157 Guidance are:

- Distressed or forced liquidation sales are not orderly transactions, and thus the fact that a transaction is distressed or forced should be considered when weighing the available evidence. Unfortunately, the only further guidance that the SEC and the FASB gave is that “determining whether a particular transaction is forced or disorderly requires judgment.” However, by placing this determination in the realm of judgment, the SEC is making it hard to second-guess the firm that follows in good faith a strong, well-documented, consistent and independent process.
- In some cases, using internal assumptions and unobservable inputs (*e.g.*, an internal discounted cash flow model) may be more appropriate than using observable inputs (*e.g.*, prices in markets for similar but not identical securities). For instance, if the observable inputs (say, prices in related markets) require too many adjustments and the internal model is more accurate, under the FAS 157 Guidance the Level 3 price would be more appropriate. FAS 157 sets forth a three-tier framework for disclosure of fair values, where Level 1 prices derive from trades in an active market, Level 2 prices derive from observable inputs, or prices in related markets, and Level 3 prices derive in part or whole from unobservable inputs such as models. Before this guidance, many

¹ Section 132 of the Emergency Economic Stabilization Act authorizes the SEC “to suspend, by regulation, or order, the application of [FAS 157 for any issuer] or with respect to any class or category of transaction if the [SEC] determines that is necessary or appropriate in the public interest and is consistent with the protection of investors.”

² Some in the industry believe that the FAS 157 Guidance and the FSP do not go far enough. On October 9, the American Bankers Association filed a comment letter with the FASB Staff expressing its concern that the FSP should more directly address what it believes is a bias towards observable market data, even when the quality or usefulness of that data is questionable.

market participants interpreted this disclosure hierarchy as implying that Level 3 prices were less appropriate than Level 2 prices.

- Broker quotes are not necessarily fair value, if there is no active market in the security, defined as a market in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis.
- A significant increase in the bid-ask spread or a relative small number of bidders are indicators in considering whether a market is inactive.
- Broker quotes based on models warrant less weight than those based on market transactions.
- Whether the broker is giving an “accommodation” quote (*i.e.*, one not binding on the broker) “should be considered”, which probably means that such quotes deserve less weight in pricing judgments.

The FSP provides an illustrative example to demonstrate how the fair value of a financial asset might be determined when there is a “disorderly” or “inactive” market and the basis on which a determination could be made that a market is, in fact, “inactive.” The FSP is intended to be consistent with, and amplify, the FAS 157 Guidance.

The example presented in the FSP will be familiar to firms dealing with the current crisis. An entity invested in a BBB-rated tranche of a collateralized debt obligation at the beginning of 2008, the underlying collateral for which is unguaranteed, nonconforming residential mortgage loans. Until the end of June, there were quoted prices in active markets for identical securities or quoted prices in active markets for similar securities. Accordingly, the investor was able to determine the fair value of the securities using a “market approach valuation” technique. Since the beginning of July, however, the market for the securities has become increasingly inactive.

Factors cited as evidencing that the market is “inactive” include: (i) a significant widening of the bid-ask spread in the brokered markets in which the securities and similar securities trade, and then a significant decrease in the volume of trades of the securities and similar securities relative to historical levels; and (ii) that there are few observable transactions, the prices for transactions that have occurred are not current, and the observable prices for those transactions vary substantially either over time or among market makers. Consequently, under the FSP, the investor would be reasonable if it were to value the securities using “significant unobservable inputs,” including management’s internal assumptions about future cash flows, appropriately risk-adjusted discount rates, and indicative quotes from brokers or independent pricing services based on proprietary pricing models. In this example, significant adjustments to market data are required to determine fair value at the measurement date. The FSP emphasizes that an entity is required to reconcile the beginning and ending balances, including separately presenting changes that occurred during the period, that are attributable to the change in the valuation technique applied.

The FSP provides helpful commentary on the FAS 157 Guidance, but does not eliminate the need for investors and auditors to make difficult judgment calls. Taken together, they will address some of the concerns that FAS 157 requires marking assets to fire sale values under current market conditions. The continuing need to exercise sound judgment also serves as a reminder that valuation is to a large degree a process that requires strong, well-documented, consistent and independent procedures.

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