ISDA®

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March 27, 2009

Mr. Russell G. Golden
Director, TA&I
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Proposed FASB Staff Position FAS 157-e, *Determining Whether a Market Is Not Active and a Transaction Is Not Distressed*

Dear Mr. Golden:

The International Swaps and Derivatives Association ("ISDA") appreciates the opportunity to comment on the proposed FASB Staff Position FAS 157-e, *Determining Whether a Market Is Not Active and a Transaction Is Not Distressed* (the "Proposed FSP"). ISDA members represent leading participants in the privately negotiated derivatives industry. Collectively, the membership of ISDA has substantial professional expertise and practical experience addressing accounting policy issues with respect to financial instruments.

While we believe the need for clarification of FASB Statement No. 157, *Fair Value Measurements* ("SFAS 157") principles to be limited, particularly given the recent issuance of FSP FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* ("FSP FAS 157-3"), we commend the FASB's efforts to address practice issues still facing certain constituents. ISDA understands that some preparers have been pressured to place an inappropriate level of emphasis on the last available, externally-generated price quotations (which may include distressed transactions) in determining the fair value of positions that trade in inactive markets. The Proposed FSP would provide relief to those financial statement preparers compelled to "mark to last transaction price" by allowing them to consider other valuation information and pricing techniques.

In relation to the proposed framework for determining whether the price for a financial asset that trades in an inactive market is associated with a distressed transaction, ISDA agrees that the factors provided as examples for reaching a conclusion under Step 1 are valid and should not be considered to be all-inclusive. ISDA is concerned that the guidance in paragraph 15 may be applied more broadly than the FASB intended, as the Step 2 factors may not be readily evidenced, even when the quotations do not relate to distressed transactions. We understand that the FASB's intent was to address the practice issues faced by certain constituents and was not to require a fundamental change to the operational processes of preparers not currently facing those same practice issues. Therefore, we recommend certain drafting changes to ensure that the application of paragraphs 13 and 15 will not have the unintended consequences of requiring pricing information to be disregarded even if the preparer considers those inputs to be relevant to the fair value measurement. Such consequences, which may be applicable to entire portfolios of inactively traded financial instruments, could lead to measurements and disclosures that do not faithfully represent an entity's best estimate of fair value.

With these unintended consequences in mind, ISDA recommends that the FASB revise the Proposed FSP to clarify that preparers should exercise judgment when evaluating whether a financial asset's price is associated with a distressed transaction. The two conditions in Step 2 could represent factors that are considered when making that judgment. We believe that our proposed changes would ensure consistency with the principles within SFAS 157 and FSP FAS 157-3 yet meet the FASB's objectives of resolving the fair value measurement practice issues facing certain constituents. In the event that the FASB does not modify paragraphs 13 and 15 of the Proposed FSP to eliminate the aforementioned unintended consequences, the effective date would not provide financial statement preparers sufficient time to implement changes to fair value measurement processes and methodologies for those instruments for which the Step 2 presumption cannot be overcome.

In the paragraphs that follow, we have made recommendations to improve the usefulness and operationality of the Proposed FSP. We hope you find ISDA's comments informative and beneficial. Should you have any questions or desire any clarification concerning the matters addressed in this letter please do not hesitate to contact the undersigned.

Sincerely,

Laurin Smith

Laurin Smith
JPMorgan Chase & Co.
Chair, N.A. Accounting Policy Committee
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Paragraph 13 of Proposed FSP

In the current markets, application of Step 2 as currently drafted, may have the unintended consequence of automatically categorizing pricing information for a large number of financial instruments that trade in inactive markets as associated with distressed transactions. The factors in Step 2 are generally not provable in today's markets (and may not have been provable for some asset classes and markets pre-dating the current economic situation). We believe that there should be a functional as well as theoretical differentiation between inactive versus distressed pricing information. In the absence of evidence of the Step 2 factors, we are concerned that a literal interpretation of the second sentence of paragraph 15 would require an entity to either make a significant adjustment to a quoted price for a financial asset trading in an inactive market or revert to an alternative valuation approach, regardless of whether an entity otherwise judges the price to be the best representation of fair value. The requirement to apply a significant adjustment could lead to measurements and disclosures that do not faithfully represent an entity's best estimate of fair value.

We understand that the FASB's intent was to address the practice issues faced by certain constituents and was not to require a fundamental change to the operational processes of preparers not currently facing those same practice issues. We support the FASB's efforts to address these practice issues. However, we are concerned with the evidence gathering costs that may be required under a literal interpretation of the Proposed FSP in order to permit a reporting entity to continue to utilize pricing sources that had been applied consistently over time and compared and back tested against other relevant information.

Therefore, ISDA strongly urges the FASB to allow preparers to exercise judgment when evaluating whether a financial asset's price is associated with a distressed or orderly transaction. Our recommended changes to paragraph 13 of the Proposed FSP and proposed paragraph 29A of SFAS 157 are noted immediately below. [Inserted text is <u>underlined</u> and deleted text is ~~stricken~~]

> 13. If the reporting entity concludes in step 1 that the market for the asset is not active, then the reporting entity will proceed to step 2. In step 2, the reporting entity must <u>apply judgment when determining whether</u> ~~presume that~~ a quoted price is associated with a distressed transaction<u>.</u> ~~unless the reporting entity has evidence that~~ <u>In making that determination, then the reporting entity should consider whether the following factors, as well as other evidence available to the entity at the measurement date, may indicate whether the quoted price is associated with a distressed transaction:</u>
>
> (a) there was sufficient time before the measurement date to allow for usual and customary marketing activities for the asset and
>
> (b) there were multiple bidders for the asset.
>
> c. Paragraph 29A is added as follows:

Step 2: Evaluate the quoted price (that is, a recent transaction or broker price quotation) and other pricing information in the reporting entity's possession to determine whether the quoted price is associated with a distressed transaction. The reporting entity shall apply judgment when determining whether ~~presume that~~ the quoted price is associated with a distressed transaction. ~~unless the reporting entity has evidence that indicates that both of the following factors are present for a given quoted price~~ The following factors, and others the reporting entity may have in its possession, may indicate whether a quoted price is associated with a distressed transaction. These factors are not all-inclusive:

a. There was a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities (for example, there was not a regulatory requirement to sell).
b. There were multiple bidders for the asset.

~~If the reporting entity has evidence that both factors are present for a given quoted price, then that quoted price is presumed not to be associated with a distressed transaction~~. If the reporting entity determines that the quoted price is not associated with a distressed transaction ~~In that case~~, the quoted price may be a relevant observable input ~~that~~ ~~shall~~ to be considered in estimating fair value. However, the reporting entity should consider whether any other factors or conditions warrant making an adjustment to the quoted price (see paragraph 29). For example, if a quoted price that is not associated with a distressed transaction is not current or is a consequence of a trade with an insignificant volume relative to the total market for that asset, the reporting entity should consider whether that quoted price is a relevant observable input (that is, whether the quoted price requires adjustment).

Paragraph 15 of Proposed FSP

Related to our comment above regarding paragraph 13 of the Proposed FSP, we recommend that the FASB remove the requirement to make a significant adjustment to a quoted price or to revert to an alternative valuation approach for a financial asset deemed to be distressed, as we believe that this requirement may result in disregarding pricing information that preparers consider relevant to a fair value measurement. We understand that it was not the FASB's intent to create an unnecessary operational burden to create and run a secondary valuation methodology to generate inputs to replace those relevant inputs required to be discarded. We believe that the goals of the FSP may be attained by inserting a third step to determine whether the price quotation determined to be associated with a distressed transaction may be a relevant input to the fair value measurement. This Step 3 would not presume whether or not an adjustment to the price quotation must be significant or insignificant.

Finally, we believe that the FASB should clarify whether the objective is to arrive at a fair value reflective of an orderly transaction in an active (hypothetical) market, or an orderly transaction in an inactive market. Our recommended changes to paragraph 15 of the Proposed FSP and proposed paragraph 29A of SFAS 157 are noted immediately below. [Inserted text is underlined and deleted text is ~~stricken~~]

> 15. If the reporting entity concludes ~~does not have evidence that both factors in paragraph 13 are present for a given quoted price, then the reporting entity shall consider~~ that a quoted price is ~~to be~~ associated with a distressed transaction, ~~. When that is the case,~~ then the reporting entity must use an appropriate valuation technique other than one that uses that quoted price without an ~~significant~~ adjustment that reflects the preparer's best estimate of market participant assumptions as of the measurement date. For example, the reporting entity could use an income approach, such as a present value technique to estimate fair value. The inputs to the present value technique should reflect an orderly transaction between market participants at the measurement date. An orderly transaction would reflect all risks inherent in the asset, including a reasonable risk premium for bearing uncertainty that would be considered by willing buyers and willing sellers in pricing the asset in a nondistressed transaction, within an inactive market, at the measurement date.
>
> c. Paragraph 29A is added as follows:
>
> If the reporting entity concludes that ~~does not have evidence that both factors are present for a given quoted price (including because there is insufficient information on which to base a conclusion),~~ ~~then the reporting entity shall consider~~ the quoted price is ~~to be~~ associated with a distressed transaction, then the reporting entity ~~and~~ shall use an appropriate valuation technique other than one that uses the quoted price without ~~significant~~ an adjustment that reflects the preparer's best estimate of market participant assumptions as of the measurement date (~~that is,~~ if a significant adjustment is required, this may result~~ing~~ in a Level 3 measurement). For example, the reporting entity could use an income approach (that is, a present value technique) to estimate fair value. However, the fair value resulting from the present value technique shall not be derived solely from inputs based on the quoted price associated with a distressed transaction without appropriate adjustment to ~~The inputs should~~ be reflective of an orderly (that is, not distressed or forced) transaction between market participants at the measurement date. An orderly transaction would reflect all risks inherent in the asset at the measurement date, including a reasonable risk premium for bearing uncertainty that would be considered by market participants (that is, willing buyers and willing sellers) in pricing the asset in a nondistressed transaction within an inactive market.

Example Illustration Application of Proposed FSP

We interpret paragraph A32F of the Proposed FSP to allow a reporting entity to define two endpoints of the range of discount rates to be used in a discounted cash flow valuation, and to allow the reporting entity to use its best estimate of the point within the range that is the most representative of fair value. We agree that the lower end of the range would not represent fair value; the 7% rate represents the rate of return in a hypothetical active market, but the fair value measurement objective here is to determine the value of an orderly transaction in a market that has been determined to be inactive. Thus citing that Entity A used the midpoint within the range may cause confusion in practice and result in a departure from the principle reflected in paragraph 31 of SFAS 157. We believe that the paragraph would be improved by clarifying that Entity A chooses 11% as the price within the range that it believes is most representative of fair value in the circumstances.

Effective Date

Should the FASB modify the final guidance to reflect our comments above on allowing preparers to apply judgment when determining whether a financial asset is inactive and its price distressed, ISDA supports the Proposed FSP and its transition provisions but recommends that the effective date be changed to fiscal periods beginning on or after June 15, 2009, with early application permitted, to allow preparers sufficient time to understand how their fair value measurements may be impacted and evaluate whether changes to current valuation methodologies would be necessary. However, if the FASB does not agree to change the proposed requirements within Step 2 of the proposed framework, the proposed effective date would not provide sufficient time to implement the guidance given that preparers may be pressured to discard pricing information for entire trading portfolios and develop new valuation methodologies and the associated controls. This transition could pose a significant operational challenge that would likely be insurmountable by the proposed March 15 effective date. As discussed above, we therefore recommend that the FASB amend the presumptions and requirements in step 2 in order to provide operable relief to the affected preparers as soon as practicably possible with the least impact to valuation methodologies that include pricing information that preparers believe is not based on distressed transactions.