



1401 H Street, NW, Washington, DC 20005-2148, USA  
202/326-5800 www.ici.org

VIA ELECTRONIC DELIVERY

March 31, 2009

Mr. Russell G. Golden  
Technical Director  
FASB  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

Re: FSP FAS 157-e, *Determining Whether a Market Is Not Active and a Transaction Is Not Distressed*

Dear Mr. Golden:

The Investment Company Institute<sup>1</sup> appreciates the opportunity to comment on FSP FAS 157-e (the "Proposal"). Our comments are primarily from the perspective of SEC registered investment companies as issuers of financial statements and reflect concerns we have on the application of the Proposal to daily security valuation processes funds apply to their holdings when calculating net asset value per share. We also comment from the perspective of funds as investors. We have two overarching concerns with the Proposal as structured. First, the two-step analysis required to assess whether markets are inactive and associated quotes are distressed will be particularly difficult for funds to implement into their daily valuation process. Second, we believe the Proposal will, in certain instances, require funds and other reporting entities to disregard market quotes that may be the best indicator of fair value in favor of alternative valuation techniques. We provide background on mutual funds and elaborate on our concerns below.

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<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$9.88 trillion and serve over 93 million shareholders.

### *Background*

All open-end investment companies (*i.e.*, mutual funds) must stand ready to redeem shares upon demand by the shareholder. In order that purchase and redemption transactions may be effected at appropriate prices on an ongoing basis, funds are required to value their portfolios and price their shares daily.<sup>2</sup> Proper valuation of fund portfolio securities is critical to ensure that the fund share prices derived from those valuations will be fair to purchasing, redeeming and existing shareholders. For example, if fund shares are sold and redeemed based on a net asset value that is overstated in comparison to the amount at which the underlying portfolio instruments could be sold, redeeming shareholders will receive a windfall, purchasing shareholders will pay more than they should and, if the amount of redemptions exceeds the amount of purchases, the interests of existing shareholders will be diluted.

SEC registered mutual funds must comply with Investment Company Act of 1940 valuation requirements and related Commission guidance when valuing their securities both for purposes of calculating daily net asset value and for purposes of preparing financial statements. The Commission has stated that, as a general principle, the fair value of a security is the price which the fund might reasonably expect to receive upon its current sale.<sup>3</sup> Ascertaining fair value requires a determination of the amount that an arm's length-buyer, under the circumstances, would currently pay for the security. Fair value cannot be based on what a buyer may pay at some later time, such as when the market ultimately recognizes the security's true value as currently perceived by management.<sup>4</sup> The exit value notion is critical to the open-end fund structure where shareholders can redeem their proportionate share of the fund's net assets daily.

The Commission's general adherence to a rigorous exit value notion is not absolute, however. For example, the Commission has stated that disorderly transactions are not determinative when measuring fair value and that determining whether a transaction is forced or disorderly requires judgment.<sup>5</sup> Also, the Commission precludes the application of discounts to readily available market quotes where the fund holds a large quantity of the outstanding shares of an issuer or holds an amount that is a significant portion of the security's average daily trading volume.<sup>6</sup>

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<sup>2</sup> Funds apply generally accepted accounting principles to both the valuation of their portfolio holdings and the calculation of net asset value per share daily.

<sup>3</sup> See Accounting Series Release No. 118, Investment Company Act Release No. 6295 (December 23, 1970) ("ASR 118").

<sup>4</sup> See *In the Matter of Parnassus Investments*, Initial Decision Release No. 131, Administrative Proceeding File No. 3-9317 (September 3, 1998).

<sup>5</sup> See SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting, Press Release No. 2008-234 (September 30, 2008).

<sup>6</sup> See Letter from Lynn E. Turner, Chief Accountant, Securities and Exchange Commission to Mark V. Sever, Chair, Accounting Standards Executive Committee, AICPA (April 11, 2001).

Questions Raised in the Proposal

2. *Will this proposed FSP meet the project's objective to improve financial reporting by addressing fair value measurement application issues identified by constituents related to determining whether a market is not active and a transaction is not distressed? Do you believe the amendments to Statement 157 in this proposed FSP are necessary, or do you believe the current requirements in Statement 157 should be retained?*

At a broad conceptual level, the Board's effort to expressly recognize a mechanism that would enable a reporting entity to not use fire sale prices is commendable, particularly in the current environment. Further, we recognize the need for improved clarity surrounding markets that are inactive and transactions that are distressed. However, we believe the Proposal is too prescriptive in its presumption that transactions in inactive markets are distressed. We favor the current requirements in Statement 157 that allow for the reasonable application of judgment. Constituent requests for guidance on assessing inactive markets and distress sales may be attributable to the failure of certain reporting entities, industries, or auditors to exercise appropriate judgment. In this regard, we urge the SEC and the PCAOB to implement judgment frameworks, as called for by the Committee on Improvements to Financial Reporting and the SEC staff study on mark-to-market accounting required by the Emergency Economic Stabilization Act of 2008.

3. *Do you believe the proposed two-step model for determining whether a market is not active and a transaction is not distressed is understandable and operational? If not, please suggest alternative ways of identifying inactive markets and distressed transactions.*

We are concerned that the criteria for assessing inactive markets and distress sales described in the Proposal are burdensome and impractical, particularly in the context of funds and other entities that apply FAS 157 to value large numbers of securities on a daily basis. Funds may hold hundreds or thousands of different securities and it is unrealistic to think that they could undertake the evidence gathering process described in step two of the Proposal within the limited time period available to calculate net asset value per share.<sup>7</sup> As described below, we recommend modifying step two so that quotes from inactive markets are presumed not distressed absent evidence to the contrary.

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<sup>7</sup> Generally funds value portfolio securities and calculate net asset value per share within several hours after the close of the New York Stock Exchange. This limited time frame is necessary so that brokers, transfer agents, and retirement plan record keepers can receive fund share prices in order to process shareholder transactions and update shareholder account balances in an overnight processing cycle.

5. *What costs do you expect to incur if the Board were to issue this proposed FSP in its current form as a final FSP? How could the Board further reduce the costs of applying the requirements of the FSP without reducing the benefits?*

Funds generally contract with pricing vendors for “evaluated” prices for their fixed income securities. We expect funds would incur significant costs if they were required to undertake the evidence gathering process described in step two of the Proposal before using prices received from pricing vendors.

#### *Factors for Assessing Whether Markets are Inactive*

Paragraph 11 of the Proposal describes seven factors for assessing whether a market is not active, including, in paragraph 11a, that there have been “few recent transactions.” Is this factor intended to be an absolute or a relative concept? For example, current markets for certain asset classes may have much less volume compared to two years ago. However, they have more volume than six months ago. The level of trading in certain asset classes may never return to levels experienced two years ago and that level of trading should not be the baseline for concluding current markets are inactive.

#### *Distressed Transactions*

The Proposal presumes transactions from inactive markets are distressed absent evidence to the contrary. Paragraph 13 of the Proposal requires that a reporting entity gather evidence of both “usual and customary marketing activities” and multiple bidders in order to conclude a transaction from an inactive market is not distressed. We believe it will be difficult and burdensome to gather evidence necessary to conclude a transaction from an inactive market is not distressed and, as a result, the Proposal creates a bias to move away from quotes from inactive markets and toward valuation through the use of internal assumptions. We recommend that the presumption be reversed, so that transactions from inactive markets are presumed not distressed absent evidence to the contrary. This change would place the evidence-gathering burden on those who wish to disregard quotes from inactive markets.

Paragraph 15 of the Proposal indicates that where an entity concludes a transaction is distressed it *must* use a valuation technique other than one that uses the quoted price without significant adjustment. We are concerned that the *requirement* to use a valuation technique other than one that uses the quoted price without significant adjustment will cause reporting entities to disregard quotes from inactive markets, even though they may be legitimate indicators of value. Further, we are concerned that such requirement may be contrary to regulatory duties imposed on SEC registered investment companies and their directors to “take into consideration all indications of value available to

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them in determining the fair value assigned to a particular security.”<sup>8</sup> If the Board determines not to reverse the distress presumption as recommended, we strongly urge that the requirement to use an alternate valuation technique be made permissive, so that an entity may determine that the quote is the best indicator of value.

Funds as Investors

The Institute strongly supports the Board’s efforts to ensure that financial reporting provides investors with information that fairly presents the financial position and results of operations of companies accessing our capital markets. We have concerns that certain elements of the proposal may enable divergence in practice that will raise issues of consistency and comparability across reporting entities. For example, we note that paragraph 13 of the Proposal specifies no level of diligence or duty to search for evidence that a quote from an inactive market is not distressed. We have concerns that a reporting entity may not thoroughly search for evidence that a quote from an inactive market is not distressed in an effort to move toward valuation through internal assumptions, enabling fair value determinations at prices higher than market conditions would otherwise suggest. Similarly, we have concerns that the Proposal will enable reporting entities to purchase securities in markets that they can easily conclude are inactive and recognize “day one gains” by writing up the value of the security through the use of internal assumptions.

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We appreciate the opportunity to comment on the Proposal and would be pleased to provide any additional information you may require. Please contact the undersigned at 202/326-5851.

Sincerely,

/s/

Gregory M. Smith  
Director – Operations/  
Compliance & Fund Accounting

cc: John J. Brennan, Chairman  
Financial Accounting Foundation

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<sup>8</sup> See ASR 118.

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Robert H. Herz, Chairman  
Financial Accounting Standards Board

Mark W. Olson, Chairman  
Public Company Accounting Oversight Board

James Kroeker, Acting Chief Accountant  
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Division of Investment Management  
U.S. Securities and Exchange Commission