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TWO AMERICAN LANE
GREENWICH, CONNECTICUT 06836-2571
(203) 861 3232

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Technical Director—File Reference No. 1201-100
Financial Accounting Standards Board
401 Merrit 7
PO box 5116
Norwalk, CT 06856-5116

Ladies and Gentlemen:

INTRODUCTION

I am responding to your Exposure Draft of a proposed Statement of Financial Standards on Fair Value Measurements (the "Draft").

I commend the Financial Accounting Standards Board ("FASB") for issuing the Draft. My experience has been in investment company financial assets and liabilities, and, therefore, I restrict my comments to that area only.[1] Although I am a CPA, I have tried to focus on the economic substance of this issue.

Many traders seek to buy and sell financial instruments that are mispriced relative to fair value. If FASB does not give proper guidance on how to measure fair value, accounting arbitrage opportunities will arise. This would be poor public policy. That is why your project is so important.

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[1] I write as an individual, but my experience is as an executive at a hedge fund operation, Paloma Partners Management Company ("Paloma"), with which I have been associated since 1988. I was principal editor and project manager of, "Valuation Concepts for Investment Companies and Financial Institutions and their Stakeholders," which was released by the International Association of Financial Engineers ("IAFE"), http://www.iafe.org/upload/IAFEValuationConcepts0604.pdf). Moreover, I chair the Committee on Investment Management of the New York State Society of CPAs (the "Society"), and chaired its Committee on Taxation of Financial Institutions and Products from June 2001 through May 2004. I am also a lecturer in the department of finance at the Wharton school of the University of Pennsylvania ("Wharton"). That said, the views expressed herein are solely mine. This response has not been reviewed or approved by, and does not necessarily reflect the views of Paloma or any of its affiliates, the IAFE, the Society, or Wharton.

I would be happy to participate in the public roundtable on September 21.

WHAT IS FAIR VALUE?

Fair value ("FV") is the estimated exit price that either the actual seller would receive from a willing buyer for the specific financial assets held by the seller, based upon the seller's intentions as well as its financial condition, or the actual buyer would pay to a willing seller for the specific financial liabilities sold short by the buyer, based upon the buyer's intentions and financial condition. The role of the exit price is critical because it represents what owners of an investment company that holds that asset or liability might receive if they sell their stakes in the company. While in some instances the exit price is the same as the liquidation price—at which one under duress settles—usually the exit price differs from the liquidation price. Similarly, in some instances the market price when multiplied by the number of units held could represent FV, while under other circumstances, it will not.

Accordingly, "One size does not fit all," in terms of calculating FV. Indeed, FV is affected by a host of factors related to the specific entities that holds the assets or owes the liability, even if they have the same credit standing. If not, FV would not be an exit price in the real world but an artificial price that does not necessarily reflect the realities of the marketplace.

The problem with the definition used in paragraph[2] 4 is that one set of knowledgeable, unrelated willing parties could simultaneously settle upon a price that differs from that another set of knowledgeable, unrelated willing parties, neither of which could reflect the exit price that the actual buyer could receive.

The following three examples illustrate that point. First, a market maker who sells a financial asset, in general, receives a higher price than a price taker. Second, a person who owns 100 shares might expect to receive a different price than someone who owns

[2] Unless otherwise specified, all references to the word, "paragraph," refer to the paragraphs in the Draft.

10,000 shares, or someone who owns 10 million shares. Third, an institutional investor typically trades at more favorable prices than a retail investor does in OTC markets that have wider spreads. Which price is correct? Obviously, what the owner is likely to receive is the best representation of FV.

Some say that market makers should mark their portfolios at the retail price-taker value. They argue that market makers typically sell their securities to other market makers. Furthermore, they claim that in case the market makers must liquidate their portfolios immediately, they would receive something close to another market maker's bid and asked prices. My definition resolves this question. If the market maker's current intention were to sell the instruments to another market maker tomorrow, its FV, depending upon the nature of the instrument and size of the block, would be either the retail or institutional price taker's value. And if the market maker intends to sell to an institutional investor, depending upon the size of the investor, the price might approach the mid of the retail price taker's and the market maker's price.[3] Obviously, if the market maker consistently valued its portfolio at the retail price taker's value, the market maker would be admitting that it was, in economic terms, really not a market maker.

I would add one final observation about the exit price. For an investor that owns a large exchange-traded position relative to the total open position, the volume-weighted average price ("VWAP") for a time segment in that trading day for that security is a measure of what was actually bought and sold on a given day, and represents a clear advantage over the mark to last price, which, some allege, is often manipulated. VWAP can be obtained from Bloomberg. Large institutions rate brokerage executions using this measure because it addresses the whole quality issue raised by using the last transaction for valuation purposes. In other words, the institution, which can assemble its position through multiple fills, compares that day's VWAP to the average price of its security transactions on the same day. Especially for larger blocks, the VWAP might better indicate FV than the last price of the day. Of course, if, say, a significant announcement that causes the stock to move is made during mid-day, the VWAP between the time of announcement and the close of trading would better reflect FV. Hence, for larger positions that do not rise to

[3] This information should already be captured by market makers that have robust risk management systems.

the level of large blocks, there should be a rebuttable presumption that VWAP better reflects an exit price.

In a situation where an investment company has two traders, T_1 and T_2, who both trade security XYZ, if T_1's portfolio holds 1,000 shares of XYZ and T_2's owns a block marked at the VWAP, T_1's should also be marked at the VWAP because the investment company's exit price would be the VWAP, unless it is clear that T_1 intends to hold his position for a shorter duration than T_2. There should be a rebuttable presumption that the entity's exit price should be for the whole and not the sum of the traders.

TRANSACTION COSTS

Rule 5b-3 of the Investment Company Act of 1940 in defining the term, "collateralized fully," says that value of securities is reduced by transaction costs that an investment company could reasonably expect to incur.

Moreover, paragraph 2.40 of the AICPA Audits of Investment Companies Guide (the "Guide") says that costs of investment securities include "commissions and other charges that are part of securities purchase transactions."[4]

Furthermore, paragraph 7.44 of the Guide says, "Net realized gains or losses resulting from sales or other dispositions should be reported net of brokerage commissions.

Clearly, the accounting literature treats securities transaction costs as part of the net value of the security and not as current expenses. Therefore, paragraph 53 of your preliminary views (the "Preliminary Views") correctly concludes that exit prices are based upon closing prices less commissions.[5] Unfortunately, paragraphs 16, B9, and C26 of the Draft, which say that price used to estimate FV would not be adjusted for costs to transact, erroneously contradict the

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[4] Audit and Accounting Guide, Audits of Investment Companies, With Conforming Changes as of May 1, 2003, American Institute of Certified Public Accountants.
[5] Financial Accounting Series Preliminary Views on major issues related to Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value, File Reference 204-B, December 14, 1999, Financial Accounting Standards Board.

Preliminary Views. The Preliminary Views advocate the better standard than does the Draft.

One can classify transaction costs into two categories: explicit and implicit. Explicit costs can include commissions, transfer fees, and stamp and other taxes. Implicit ones include liquidity, market impact, and others. Liquidity is measured by the bid-asked spread, market impact is the slippage in price resulting from a large block, and other costs can include the impact of holding a restricted security.[6]

With regard to transaction costs, the Draft is internally inconsistent. For example, paragraph 17 says that FV should be estimated by marking longs at the bid and shorts at the asked. I agree that this is the proper rebuttable presumption[7] for retail price takers. Such treatment, however, is inconsistent with excluding commissions, as both are transaction costs. In fact, the commission, which is compensation to a broker in an exchange-traded market, resembles the compensation that the OTC dealer receives in the form of the bid-asked spread. To treat liquidity differently from commissions can lead to distortions. For example, consider two funds, F_1 and F_2, whereby F_1 invests in exchange-traded stocks while F_2 trades in the dealer market. If transaction costs are not treated identically, a prospective investor might opt to invest in F_1, which appears to have a higher rate of return than F_2, when in truth if all economic costs are taken into account, F_2 is a better investment.

Market makers should mark those longs and shorts that they reasonably expect to transact with retail customers at the asked and bid prices, respectively; those longs and shorts that they reasonably expect to transact with other market makers[8] at the bid and asked, respectively; and those longs and shorts that they reasonably expect to transact with institutional customers near the mid, unless they can

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[6] I do not consider financing costs as transaction costs.

[7] This is a rebuttable presumption because there are instances when the bid and asked prices do not represent the exit price. For example, "crossed trades" are usually closer to the mid. Moreover, "Pink Sheet" dealers are required to buy or sell only 100 shares at the prices they quoted. In other words, Pink Sheet quotes are more expressions of interest than representations of exit prices. Furthermore, institutional investors are much more likely able to transact at prices much within the retail bid-asked spread.

[8] This assumes that the first market maker is functioning as a price taker in this particular transaction because of, for example, a liquidity constraint, and, therefore, is not, in essence, acting as a market maker in this transaction.

rebut the presumption that these are the right prices.[9] To those that would argue that this introduces an unacceptable degree of subjectivity, I respond that the auditors should compare actual trades to the projected customer distribution to verify that the projected distribution is reasonable.

Say, a men's clothing store pays $350, the bid, for a suit that it retails for $700, the asked. If a customer who buys one suit there every three years tries to negotiate a lower price, most likely he will not succeed. A customer, however, who buys 1,000 suits every three months is more likely to pay a per suit price that is much closer to $525, the mid. Hence, the institutional investor is likely to receive a better price than a retail one.

If one lists her home with a broker, the listed price, which is what she might dream to receive, probably exceeds her reservation price. Similarly, a prospective buyer of her home might bid at a price lower than her reservation price. If seller's reservation price is below the buyer's reservation price, they will strike a deal.

These examples illustrate why the valuations of the retail investor, institutional investor, and dealer could differ. And while one would expect that institutional investors mark their securities owned, on a per share basis, at a higher price than retail investors, one also would expect, in general, that larger institutional investors mark at better prices than smaller institutional investors. Thus, there is symmetry to my exit-price approach.

What should a price taker do when different dealers quote different prices for the same OTC securities? Paragraphs 16 and B9 tell companies to use the price from the most advantageous market. At first glance, this seems to be an ideal approach to value OTC dealer market securities. In reality, however, because the OTC dealers might be offering indicative quotes only and not the prices at which they might actually trade, the most "advantageous market" may not necessarily reflect an exit price. Accordingly, management should be

[9] This sentence refers to OTC negotiated financial instruments. For those NASDAQ stocks that trade over electronic communication networks (ECNs) institutional investors typically transact at the same price as retail customers. ECNs match the highest bid orders and lowest asked orders, while avoiding the market makers and their wide spreads.

charged with arriving at its best estimate of an exit price, which, for example, could be an average of a number of dealer quotes.

Paragraph 17 itself is inconsistent when it suggests that offsetting positions should be marked at the mid. If the exit prices for longs are the bid prices and for the shorts are the asking ones, to mark offsetting positions at the mid means that they will not be valued at the exit prices. While paragraph C53 explains that FASB believes that the investor "potentially could sell [sic][10] the matched position without incurring the bid-asked spread," most matched positions are not sold as "crossed trades." If the investment company believes that it can unwind the offsetting position closer to the mid, then, indeed, the mid better represents the exit price, and, therefore, there should be a rebuttable presumption that offsetting positions should be marked at the spread.

If FASB disagrees with my last point, at a minimum, it must define what an offsetting position is. For example, assume that an investment company is long a foreign convertible bond, short the underlying stock into which the bond can be converted to the extent of 80 percent of the parity value of the stock, has hedged the interest rate and credit risks of the bond contract through the use of futures contracts and credit default swaps, has hedged the stock volatility of option built in to the bond, but has not hedged the foreign exchange exposure. Is this considered an offsetting position? If not, is it a partially offsetting position? If so, how does one measure what is offsetting?

In paragraph C38, FASB "punts" on the question of how to treat large blocks. Often, the exit price of a very large block held, if one intends to sell it one or more smaller large blocks, will be lower than if one sold it piecemeal, 100 shares at a time. Conversely, if one holds a controlling large block, the exit price might very well exceed that of selling off the stock in units of 100 shares. Recall that earlier I pointed out that market impact was an explicit transaction cost. If FASB treats the cost of liquidity, i.e., the bid-asked spread, as a reduction of FV, it is logical that non-controlling large blocks, which are intended to be disposed not piecemeal in small units, should also reduce FV.

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[10] Unwind would be a better word choice than sell because an offsetting position includes a security sold short, which must be bought back to unwind the hedge.

Yet, paragraph B17 says that the FV of restricted securities, which reflects the lack of liquidity, should be adjusted to consider that factor. I agree with FASB's conclusion that this transaction cost be reflected. I fail to see, however, how this differs from large blocks.

EARNINGS MANAGEMENT/PRICE SMOOTHING

Some express concern that by not using an objective hypothetical price, investment companies will be able to manage their earnings or smooth prices. For example, because there is no objective way to compute large block discounts, might an investment company super conservatively value them during exceptional performance years and use more liberal valuations during lean years? Moreover, might a market maker say that for most of its securities it is a price taker? Furthermore, perhaps a company will mark its books under the presumption that it can cross its matched position trades.

If an investment company wants to smooth prices, it can do so in other places. For example, for complex financial instruments like mortgage-backed securities, distressed debt, and convertible bonds, whose FV are calculated by proprietary pricing models, there is enough leeway for varying input assumptions, that such company need not use large blocks to snow farm earnings.

Recently, FASB has proposed a rule that would require companies to expense employee stock options. I agree with FASB that this is the better accounting treatment. I find it difficult, however, to distinguish the subjectivity in valuing options from the subjectivity in arriving at FV. For example, while Black Scholes may be the most famous option pricing models, it is far from the only one. Moreover, even if FASB mandated that Black Scholes is the best model for all financial instruments, which would be a bad directive, according to Black Scholes, an option is a function of several variables, including the current price, exercise price, time to maturity, expected volatility, and expected risk-free rate of return,. While the first three of those inputs are objective, the others are based upon subjective assumptions. FASB must be consistent—either it accepts subjectivity in valuations or it does not. Clearly, it cannot endorse subjectivity for options but not for other instruments.

The recent market timing imbroglio resulted from the use of objective prices rather than subjective exit prices. This demonstrates the danger of relying completely on "objective" rules. For a detail explanation how I believe market timing could be eliminated, see http://www.sec.gov/rules/proposed/s71104/lmmetzger050704.pdf.

By its definition, an exit price is a subjective one. To the extent that FASB wants objectivity, it distances itself from true FV.

UNIT OF ACCOUNT

There should not be any objective unit of account. While multiplying the price of one share by the number of shares will arrive at an objective value, because the exit price could differ, that will not necessarily be the FV. In fact, the better answer is that the unit of account is the total units held because the exit price is a function of one unit. In valuations, often the sum of the parts is greater or less than the whole. An objective unit of account only looks at the sum of the parts.

DISCLOSURES

The table shown in paragraph B22 suggests that FV not derived from quoted prices of identical items is suspect. A better approach would be the use of a footnote to the financial statements that explained, when quoted prices for identical items were not used, what methods were used and why they better reflect FV. For a better understanding of this approach, please see http://www.iafe.org/upload/IAFEValuationConcepts0604.pdf.

TENSION

It may appear as if I am advocating a methodology that will exaggerate income of market makers because I support the concept of their valuing at the opposite of price takers. The tension between tax objectives, *i.e.*, minimizing taxable income, and financial statement reporting, *i.e.*, maximizing income, however, should lead to the right result. I note, however, that recent media reports suggest that some companies rather than maximize their income smooth their income to

report consistent growth in earnings. One expects, however, that Sarbanes-Oxley will help eliminate such behavior.

CONCLUSIONS

The exit price best reflects FV.

A transaction cost is a transaction cost is a transaction cost.

FV is an objective concept that relies upon subjective estimates. To the extent that the valuations do not reflect the exit prices that the investor actually could achieve, FV is an artificial measure. If FASB's goal is to introduce simplicity and one-size-fits-all pricing for all players in the market, the resulting accounting principle will support the principle of "Objective Value," rather than that of FV.

Respectfully submitted,

Leon M. Metzger