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THE MARK-TO-MARKET ACCOUNTING CONTROVERSY

With markets for certain financial assets illiquid or distressed, critics of "fair value" accounting have attacked it as unnecessarily destructive of capital and deepening the financial crisis, while defenders have replied that the rules are needed to reflect current economic reality and inform investors. The debate has generated action and threatened action by Congress, a report by the SEC, and, in a compressed process, a modification of requirements by the Financial Accounting Standards Board.

By Thomas W. White and Nia M. Monroe *

As the economic crisis that began with the meltdown of the subprime mortgage market continued and deepened, a seemingly technical accounting principle emerged as a major flashpoint. That principle is often referred to as "mark-to-market" accounting, though strictly speaking the broader principle of "fair value" accounting is at issue. Briefly put, the principle is that an asset or liability should be reflected in a company's financial statements based on its fair value at a point in time, rather than its historical cost or other methodologies. Financial institutions and other critics of fair value accounting have asserted strongly that its application to mortgage-related securities and other financial assets where markets are not functioning has exacerbated the financial crisis by requiring unwarranted write-downs and reducing regulatory capital. Supporters have asserted, by contrast, that fair value accounting provides a more transparent and realistic picture of a company's financial position.

The controversy has generated strong rhetoric on both sides. The president of the American Bankers Association has contended that "The current application of mark-to-market has not just measured the fire, but it has poured gasoline on the fire."[1] Another commentator, by contrast, has said, "If mark-to-market accounting is to blame for the current financial crisis, then the National Weather Service is to blame for Hurricane Katrina; if it hadn't told us the hurricane hit New Orleans, the city would never have flooded."[2]

The mark-to-market controversy has placed great stress on the institutions that develop and enforce accounting standards, especially the Securities and Exchange Commission ("SEC") and the Financial Accounting Standards Board (the "FASB"). Congress has intervened in the matter, enacting provisions regarding mark-to-market accounting in the Emergency Economic Stabilization Act of 2008 ("EESA"). More recently, in March 2009, House

[1] *News Release*, American Bankers Association, *ABA Statement on Today's Mark-to-Market Hearing* (Mar. 12, 2009), *available at* http://www.aba.com/Press+Room/031209Markto MarketHearing.htm.

[2] Floyd Norris, *Bankers Say Rules Are the Problem*, N.Y. Times, Mar. 12, 2009, *available at* http://www.nytimes.com/2009/03/13/business/economy/13norris.html?_r=1.

* *THOMAS W. WHITE is a partner and NIA M. MONROE is an associate in the Corporate Practice Group in the Washington, DC office of Wilmer Cutler Pickering Hale and Dorr LLP. Their e-mail addresses are respectively, thomas.white@wilmerhale.com and niamarie.monroe@wilmerhale.com. Donna Willingham, a paralegal in the firm's Washington, DC office, contributed to the preparation of this article.*

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of Representatives committee hearings on mark-to-market accounting impelled the FASB to expedite its standard-setting process to adopt new guidance concerning accounting for troubled assets in illiquid markets.

This article begins with a brief overview of the standard-setting process and fair value accounting standards as in effect in 2008, when the controversy intensified. It then reviews the arguments of the proponents and opponents of fair value accounting. Finally, the article discusses the EESA, the SEC's fair value accounting study mandated by the EESA, subsequent developments in the standard-setting process, and the FASB's significant modifications to the standards in April 2009.[3]

THE FASB STANDARD-SETTING PROCESS

"An accounting standard-setting process is the foundation of a financial reporting system."[4] While the securities laws give the SEC the power to prescribe accounting standards,[5] throughout its history, the SEC has looked to private sector standard-setting bodies to develop and apply financial accounting and reporting standards. As noted by former SEC Chairman Christopher Cox, the reasons for relying on a non-governmental body are "to be fair and objective, based on expert analysis and judgment, and free of both political and business influence so that accounting standards could be applied consistently across all situations in thousands of different companies."[6] In 1973, the SEC recognized the FASB as an authoritative source of accounting principles, policies, standards, and practices referred to as generally accepted accounting principles ("GAAP").[7] In 2003, pursuant to the Sarbanes-Oxley Act of 2002, the SEC reaffirmed the FASB's status as a designated private-sector standard-setter and confirmed that the FASB's financial accounting and reporting standards would be recognized as "generally accepted" for purposes of the federal securities laws.[8] The SEC concluded that the FASB and its parent organization, the Financial Accounting Foundation ("FAF"), satisfied the criteria for recognition under the Sarbanes-Oxley Act. These included having an independent board of trustees, a dedicated source of funding, and due process procedures for consideration of changes in accounting principles.[9]

The FASB is independent of other business and professional organizations, subject to the general oversight of the FAF, and its independence is ensured by its receipt of independent funding provided through an annual accounting support fee. The purpose of the FASB is "to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information."[10] The FASB develops broad accounting concepts as well as standards for financial reporting. Actions of the FASB have an impact on many organizations, so it is essential that the decision-making process is evenhanded. As a result, the FASB follows an extensive due process that is open to public observation and participation.

FAIR VALUE ACCOUNTING STANDARDS – 2008 AND BEFORE

Fair value accounting, especially for financial assets, is quite complex in its details; therefore, only an overview can

[3] This controversy has not been confined to the United States or U.S. generally accepted accounting principles. Similar issues and concerns have been raised under International Financial Reporting Standards. This article deals only with the United States side of the controversy.

[4] Office of the Chief Accountant, Division of Corporation Finance, Securities and Exchange Commission, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting,* at 157 (2008), *available at* http://www.sec.gov/ news/studies/2008/marktomarket123008.pdf. ("SEC Report").

[5] *See, e.g.*, Securities Act of 1933, § 19(a).

[6] Christopher Cox, Chairman, Securities and Exchange Commission, *Remarks Before the AICPA National Conference on Current SEC and PCAOB Developments* (Dec. 8, 2008), *available at* http://www.sec.gov/news/speech/2008/ spch120808cc.htm.

[7] Accounting Series Rel. No. 150 (Dec. 20, 1973), *available at* http://www.sechistorical.org/collection/papers/1970/1973_1220_SECAccounting.pdf.

[8] *Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard-Setter*, Rel. No. 33-8221 (Apr. 25, 2003), *available at* http://www.sec.gov/rules/policy/ 33-8221.htm.

[9] Securities Act of 1933, § 19(b), added by Sarbanes-Oxley Act of 2002, § 108(a), Pub. L. No. 107-204.

[10] FASB, *Facts About FASB*, *available at* http://www.fasb.org/ facts/.

be provided in this article. Our discussion focuses on accounting for debt securities (including mortgage-backed securities and other securitized debt instruments), which constitute most of the assets that are the subject of the mark-to-market controversy. This section focuses on the standards applied through 2008, before the recent modifications by the FASB (the "2008 Standards").

Generally speaking, debt securities are classified as trading, available-for-sale, or held-to-maturity, and the accounting for changes in fair value depends on the classification of the security.[11] *Trading securities* are securities that are bought and held principally for the purpose of selling them in the near term. Unrealized changes in fair value of trading securities are included in earnings. The changes in value of actively traded securities are the specific meaning of "mark-to-market" accounting. *Available-for-sale securities* are investments that are not classified as trading securities or as held-to-maturity securities. Under the 2008 Standards, unrealized changes in fair value of available-for-sale securities were not included in earnings, but were reported in other comprehensive income ("OCI")[12] until the gain or loss was realized (or an other-than-temporary impairment, as described below, occurred). *Held-to-maturity securities* were defined as securities that the reporting entity has the "positive intent and ability to hold . . . to maturity."[13] Held-to-maturity securities were carried at amortized cost – and changes in fair value were neither included in earnings nor reported in OCI – unless it was determined that a decline in fair value below amortized cost was other than temporary. If an other-than-temporary impairment ("OTTI") occurred, the cost basis of the security was written down to fair value and the entire amount of the write-down was charged to earnings.[14] Available-for-sale securities were also written down, and a charge to earnings recorded if an OTTI occurred; however, changes in fair value after the write-down were reported in OCI.

There are two key issues within this general framework. First, how is fair value defined and determined? Second, how does an entity determine if there has been an OTTI?

Fair Value. For purposes of accounting for debt securities, fair value is determined according to the framework established by Statement of Financial Standards No. 157, *Fair Value Measurements* ("SFAS 157"). SFAS 157 was adopted by the FASB, after much consideration, in 2006. It took effect for most companies on January 1, 2008. Although much of the current controversy has revolved around SFAS 157, it is important to note that SFAS 157 itself does not establish substantive accounting standards. Other standards, including those applicable to debt securities described above, prescribe when and how fair value accounting is to be employed. Prior to the adoption of SFAS 157, however, fair value was described and applied inconsistently among the various accounting standards that prescribed its use. SFAS 157 was designed to provide a clear and consistent definition of fair value, establish a framework for measuring fair value under GAAP, and require expanded disclosures about fair value measurements.[15]

SFAS 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."[16] SFAS 157 establishes a framework for determining fair value by prioritizing the types of "inputs" available to determine fair value in a three-level hierarchy. The hierarchy can be summarized as follows:

- *Level 1* inputs are quoted prices in active markets for identical assets, and are considered the most reliable evidence of fair value.[17]
- *Level 2* inputs are inputs, other than quoted prices included within Level 1, that are "observable," such as quoted prices for similar assets in active markets; quoted prices for identical or similar assets in inactive markets;[18] "inputs other than quoted prices that are

[11] FASB, Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (May 1993), *available at* http://www.fasb.org/pdf/aop_FAS115.pdf ("SFAS 115").

[12] OCI is an "accounting construct" under which some unrealized changes in fair value (among other things) are not included in net income but instead are recorded in the equity section of the balance sheet. SEC Report at 18. Thus, a decline in fair value of an asset that is reported in OCI will not reduce net income but will reduce stockholders' equity.

[13] SFAS 115 ¶ 7.

[14] *Id.* ¶ 16. *See* FASB Staff Position Nos. FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (Nov. 3, 2005), *available at* http://www.fasb.org/pdf/fsp_fas115-1&fas124-1.pdf.; SEC Staff Accounting Bulletin: Codification of Staff Accounting Bulletins, Topic 5M: *Miscellaneous Accounting, Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities*, *available at*

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http://www.sec.gov/interps/account/sabcodet5.htm#5m.

[15] FASB, Statement of Financial Standards No. 157, *Fair Value Measurements* ¶ 1 (Sept. 2006), *available at* http://www.fasb.org/pdf/aop_FAS157.pdf.

[16] SFAS 157 ¶ 5.

[17] *Id.* ¶ 24.

[18] The standard defines inactive markets as "markets in which there are few transactions for the asset or liability, the prices are not current, or price quotations vary substantially either over time or

observable;"[19] or other "inputs derived principally from or corroborated by observable market data."[20] Level 2 inputs are subject to adjustment based on factors specific to the asset, including, among other things, the volume and level of activity in the markets in which the inputs are observed.[21]

- *Level 3* inputs are "unobservable" inputs, which shall be used to the extent that observable inputs from market activity are not available. Level 3 enables the reporting entity to develop its "own assumptions about the assumptions that market participants would use in pricing the asset . . . (including assumptions about risk)" based on the best available information in the circumstances.[22]

OTTI. Under the 2008 Standards, an OTTI could exist where it was probable that the holder of the security would not collect all of the contractual or estimated cash flows from the investment.[23] The FASB rejected a bright line, formulaic approach to determining the probability of collection. Among other things, the FASB stated that it would be inappropriate to conclude that an OTTI had not occurred just because all scheduled payments from a debt security had been received to date. At the same time, the FASB indicated that it would also be inappropriate to conclude that every decline in fair value represented an OTTI. Relying on an SEC staff statement, the FASB also stated that "'the length of time and extent to which the [fair] value has been less than cost' can indicate a decline is other than temporary."[24] The FASB also indicated that an OTTI would be present where there is an unrealized loss (*i.e.*, the fair value of the investment is less than cost) and the holder did not have "the intent and ability . . . to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value."[25] In short, under the 2008 Standards, the OTTI analysis looked at both collectability of the security as well as its fair value. Importantly, an OTTI might be triggered by credit impairment issues with the security, but in that event, the measure of the write-down is the difference between the cost of the security and its fair value. Thus, the measure of the amount of the write-down could reflect factors, such as changes in interest rates or other market conditions, besides credit impairment.

The accounting for an OTTI of a debt security under the 2008 Standards differed from the accounting applicable to impairments of a whole loan. A loan is impaired if it is probable that the creditor will be unable to collect all amounts due according to the contractual terms of the loan. When a loan is impaired, the creditor measures the impairment based on the present value of expected future cash flows. The creditor accrues a loss reserve based on the impairment. However, fair value of the loan is not relevant to the amount of the accrual.[26]

THE DEBATE ABOUT FAIR VALUE ACCOUNTING

As the financial crisis developed, beginning in 2007 and intensifying in 2008, many financial institutions, trade associations, and other commentators asserted that fair value accounting for debt securities held by banks and other financial institutions, particularly SFAS 157 and the standards for OTTI, had exacerbated the financial crisis. The arguments raised by the critics of fair value accounting for financial assets include:

- Fair value accounting and the measurement framework of SFAS 157 do not work when markets for financial assets become illiquid or distressed, as is currently the case. SFAS 157's emphasis on observable inputs has compelled companies and their auditors to value non-trading financial assets using "market" prices that are based on unreliable or artificially depressed inputs, such as isolated price quotes or unrepresentative transactions. Where markets are not operating, the more appropriate way of measuring asset values is by estimating future cash flows.[27]

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among market makers (for example, some brokered markets), or in which little information is released publicly (for example, a principal-to-principal market)." *Id.* ¶ 28.b.

[19] These inputs include "interest rates and yield curves observable at commonly quotable intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates." *Id.* ¶ 28.c.

[20] *Id.* ¶ 28.d.

[21] *Id.* ¶ 29.

[22] *Id.* ¶ 30.

[23] FASB Staff Position No. EITF 99-20-1, *Amendments to the Impairment Guidance of EITF Issue No. 99-20*. ¶¶ 7-12 (Jan. 12, 2009), *available at* http://www.fasb.org/pdf/fsp_eitf99-20-1.pdf.

[24] *Id.* ¶ 9 (*quoting* SEC Staff Accounting Bulletin: Codification of Staff Accounting Bulletins, Topic 5M, *Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities*).

[25] *Id.* ¶ 11 (*quoting* SEC Staff Accounting Bulletin: Codification of Staff Accounting Bulletins, Topic 5M, *Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities*).

[26] FASB, Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (May 1993), *available at* http://www.fasb.org/pdf/aop_FAS114.pdf.

[27] Peter J. Wallison, *Fair Value Accounting: A Critique,* American Enterprise Institute for Public Policy Research (July 28, 2008), *available at* http://www.aei.org/publications/pubID.28389/pub_detail.asp. Many critics note, in particular, the impact of the OTTI rules that require a full write-down to fair value even if only

- Application of SFAS 157 in the current market conditions results in large reported losses by financial institutions. These losses have been reported even though many financial assets are continuing to generate cash flow. To the extent bank capital requirements are tied to the amount of reported stockholders' equity under GAAP, the write-downs have unnecessarily destroyed capital, creating regulatory issues and doubts about the safety and soundness of many financial institutions.[28]

- Mark-to-market accounting is "pro-cyclical." It overstates values in good times and understates them in bad times.[29]

Others have criticized the FASB standard-setting process and suggested that companies' auditors were contributing to the problem by taking an unduly conservative approach to SFAS 157 and requiring unwarranted write-downs.[30]

Supporters of fair value accounting respond to these arguments in several ways:

- The purpose of financial accounting and financial reporting is to provide a reliable and transparent picture of the financial condition of the reporting enterprise to investors and other users of financial statements. Fair value accounting, measured through the framework of SFAS 157, provides more relevant and comparable information reflecting current economic reality than other methods. Fair value determinations under SFAS 157 need not be based on "fire-sale" values.[31]

- To the extent that asset write-downs under fair value accounting affect bank capital adequacy for regulatory purposes, that concern is more appropriately addressed through regulatory action, not changes in accounting principles.[32]

- Similarly, "pro-cyclicality" concerns should be addressed through regulatory mechanisms and via fiscal and monetary policy, not by altering the financial information reported to investors.[33]

Proponents also strongly support the independence of the FASB as the accounting standard-setter.[34]

MARK-TO-MARKET AND THE POLITICAL PROCESS

Fair value accounting became a major political issue in the fall of 2008. Following the bankruptcy of Lehman Brothers and the bailout of American International Group in September 2008, the Bush Administration proposed emergency economic stabilization legislation to provide $700 billion in funding to acquire troubled assets. On September 29, 2008, the House of Representatives rejected the stabilization bill. The next day, September 30, 2008, 65 House Republicans wrote to SEC Chairman Cox urging him to immediately "suspend" the use of mark-to-market accounting and replace it with "a form of mark-to-value that more accurately reflects the true value of the asset." The letter continued by stating that in the current economic climate, mark-to-market accounting is "counterproductive" and "is simply making the situation worse."[35]

While the stabilization bill was pending, on September 30, 2008, the SEC staff and the FASB staff issued a joint release that provided a series of clarifications of fair value accounting. This release addressed the applicability of SFAS 157 in situations where markets may not be functioning – confirming that distressed or forced sales are not indicative of fair value and maintaining that the concept of fair value assumes an orderly transaction between market participants. The release also recognized that management's internal assumptions about expected cash flows can be used to measure fair value when there is no other relevant market evidence. It also reviewed factors relevant to the determination whether or not an OTTI had occurred.[36]

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a portion of the write-down is attributable to impairment of credit quality. *See* Mark-to-Market Accounting: Practices and Implications: Hearing Before the Subcomm. On Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Fin. Servs., 111th Cong. (Mar. 12, 2009) (statement of John A. Courson, President and CEO, Mortgage Bankers Ass'n).

[28] *E.g., id.* (statement of Robert McTeer, PhD, Nat'l Center for Policy Analysis).

[29] *E.g., id.* (statement of Tanya S. Beder, Chairman, SBCC Group, Inc.).

[30] *E.g.*, William M. Isaac, Prepared Remarks for SEC Roundtable on Mark-to-Market Accounting (Oct. 29, 2008), *available at* http://www.sec.gov/comments/4-573/4573-79.pdf.

[31] Mark-to-Market Accounting, *supra* note 27 (statement of Jeffrey P. Mahoney, Gen. Counsel, Council of Institutional Investors).

[32] *E.g., id.* (statement of Cynthia Fornelli, Executive Dir., Center for Audit Quality).

[33] *E.g., id.* (statement of Robert H. Herz, Chairman, FASB).

[34] *E.g., id.* (statement of James Kroeker, Acting Chief Accountant, SEC).

[35] Letter from Rep. John Shadegg, et al. to Christopher Cox, Chairman, SEC (Sept. 30, 2008), *available at* http://johnshadegg.house.gov/UploadedFiles/093008SECLetter.pdf.

[36] Press Release, SEC Office of The Chief Accountant and Financial Accounting Standards Board Staff, *Clarifications on Fair Value Accounting* (Sept. 30, 2008), *available at* http://www.fasb.org/news/2008-FairValue.pdf.

Following a compressed process, on October 10, 2008, the FASB issued FASB Staff Position No. FAS 157-3 ("FSP 157-3"), which also sought to clarify the application of SFAS 157 in inactive markets. Some of the key considerations outlined in FSP 157-3 include, first, "[d]etermining fair value in a dislocated market depends on the facts and circumstances and may require the use of significant judgment about whether individual market transactions are forced liquidations or distressed sales;" second, when relevant observable market data is not available, the use of assumptions about future cash flows and discount rates may be appropriate in determining fair value; and finally, the value of broker quotes in determining fair value depends on facts and circumstances, particularly when an active market does not exist for the financial asset.[37]

The issuance of these clarifications spawned public reactions by various constituencies. The American Bankers Association ("ABA") wrote to Chairman Cox asking the SEC, among other things, to immediately override FSP 157-3 and replace it with new guidance, and to provide guidance on OTTI.[38] The ABA objected that the FSP's inclusion of liquidity risk as part of a cash flow projection in effect required consideration of distressed prices. This spurred a counter-reaction from the Council of Institutional Investors, Center for Audit Quality, CFA Institute, and Consumers Federation of America, all of which felt that suspension of mark-to-market accounting was not in the public interest and would harm the credibility and independence of the standard-setting process.[39]

The FAF, in particular, rejected calls to overturn SFAS 157. A letter, dated October 27, 2008, from Robert E. Denham, the Chairman of the FAF, states the FAF's belief that "action by the SEC to overturn a FASB standard . . . and political pressure from some industry interest groups seeking to reduce transparency, will exacerbate investors' concerns about the reliability of financial information and further erode market conditions."[40] Mr. Denham sent a similar letter to Representative Barney Frank, the Chairman of the House of Representatives Financial Services Committee, asserting that overturning SFAS 157 would threaten the independent process of establishing accounting standards.[41]

THE EMERGENCY ECONOMIC STABILIZATION ACT

On October 3, 2008, the Emergency Economic Stabilization Act was signed into law.[42] The EESA contains two provisions regarding mark-to-market accounting:

- Section 132 gave the SEC authority "to suspend, by rule, regulation, or order, the application of [SFAS 157] for any issuer . . . or with respect to any class or category of transaction."
- Section 133 required the SEC, in consultation with the Board of Governors of the Federal Reserve System and the Secretary of the Treasury, to conduct a study of mark-to-market accounting as provided in SFAS 157, as such standards are applicable to financial institutions. The study was required to address six issues:
    1. the effects of such accounting standards on a financial institution's balance sheet;
    2. the impacts of such accounting on bank failures in 2008;
    3. the impact of such standards on the quality of financial information available to investors;
    4. the process used by the FASB in developing accounting standards;
    5. the advisability and feasibility of modifications to such standards; and
    6. alternative accounting standards to those provided in SFAS 157.

The SEC was required to submit the report to Congress by January 2, 2009, setting forth its findings and any recommendations regarding administrative and legislative actions. The SEC invited public comment on the matters to be covered by the study, on whether other subjects should be included in the study, and on any other matter related to the use of fair value accounting in the U.S. financial reporting system. The Commission also conducted public roundtables to obtain input into the study from investors,

[37] FASB Staff Position No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active* (Oct. 10, 2008), *available at* http://www.fasb.org/ pdf/fsp_fas157-3.pdf ("FSP 157-3").

[38] Letter from Edward L. Yingling, President and CEO, American Bankers Association, to Christopher Cox, Chairman, SEC (Oct. 13, 2008), *available at* http://www.aba.com/aba/documents/press/ ChrmnCoxLtr.101308.pdf.

[39] Letter from Cynthia M. Fornelli, Executive Director, Center for Audit Quality to Christopher Cox, Chairman, SEC (Oct. 15, 2008), *available at* http://www.sec.gov/comments/4-573/4573-65.pdf.

[40] Letter from Robert E. Denham, Chairman, Financial Accounting Foundation to Christopher Cox, Chairman, SEC (Oct. 27, 2008), *available at* http://www.sec.gov/comments/4-573/4573-83.pdf.

[41] Letter from Robert E. Denham, Chairman, Financial Accounting Foundation to Hon. Barney Frank, Chairman, Committee on Financial Services, U.S. House of Representatives (Oct. 2, 2008), *available at* http://www.fasb.org.

[42] Pub. L. No. 110-343, 122 Stat. 3765.

accountants, standard-setters, business leaders, and other interested parties.

THE SEC'S MARK-TO-MARKET REPORT

The SEC report was prepared by its Office of the Chief Accountant and Division of Corporation Finance and was delivered on December 30, 2008.[43] The 209-page report (plus appendices) addressed the subjects specified in the EESA and made various recommendations. The report's most significant findings included:

- "[F]air value, on an overall basis, is used to measure less than a majority of assets and liabilities of financial institutions, with mark-to-market accounting (for which changes in fair value are recognized in income) applied to a significantly smaller population of instruments, generally composed of trading securities and derivatives. However, the impact of changes in fair value on the income statement is significant to those institutions using mark-to-market accounting."[44]
- Fair value accounting did not appear to play a meaningful role in bank failures during 2008. According to the report, "bank failures in the U.S. appeared to be the result of growing probable credit losses, concerns about asset quality, and, in certain cases, eroding lender and investor confidence."[45]
- "[I]nvestors generally support measurements at fair value as providing the most transparent financial reporting of an investment, thereby facilitating better investment decision-making and more efficient capital allocation among firms . . . [but] many [investors] also indicated the need for improvements to the application of existing standards."[46]
- "[A]n independent accounting standard-setter is best positioned to develop neutral and unbiased accounting guidance." While the FASB's process works well for this purpose, its procedures could be enhanced, particularly with respect to the timeliness and transparency of the process.[47]

The report also considered alternatives to fair value accounting and the advisability and feasibility of modifications to fair value accounting standards.

The SEC report's recommendations largely upheld the basic structure of fair value accounting; emphasized that the primary purpose of GAAP is to meet the needs of investors, not to serve regulatory or other purposes; and reaffirmed the importance of maintaining an independent, unbiased standard-setter. At the same time, the report also identified specific areas where additional guidance as to the application of fair value accounting should be considered and where accounting for OTTI should be readdressed; suggested the need for guidance regarding the exercise of sound judgment; and recommended improvements in the FASB standard-setting process.

Based on its findings, the report made detailed recommendations, including:

- *SFAS 157 should be improved, but not suspended*. The report noted that the guidance in SFAS 157 does not itself determine when fair value should be applied, but only provides a common definition of fair value and a framework for its application. Suspending SFAS 157 would only revert practice to prior fair value measurements.[48]
- *Existing fair value and mark-to-market accounting requirements should not be suspended*. The report stated that removing fair value and mark-to-market accounting would "erode investor confidence in financial statements."[49]
- *Additional measures should be taken to improve the application of and practice related to existing fair value requirements (particularly as they related to both Level 2 and Level 3 estimates).* The report emphasized that fair value requirements should be improved through development of guidance for determining fair value in illiquid or inactive markets. It identified various areas of possible change, including: (i) how to determine when markets become inactive; (ii) how to determine if a transaction or group of transactions is forced or distressed; (iii) how and when illiquidity should be considered in the valuation of an asset or liability, including whether additional disclosure is warranted; (iv) how the impact of a change in credit risk on the value of an asset or liability should be estimated; (v) when observable market information should be supplemented with and/or reliance placed on unobservable information in the form of management estimates; and (vi) how to confirm that assumptions utilized are those that would be used by market

[43] Office of the Chief Accountant, Division of Corporation Finance, Securities and Exchange Commission, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting,* at 157 (2008), *available at* http://www.sec.gov/news/studies/2008/marktomarket123008.pdf.

[44] *Id.* at 43.

[45] *Id.* at 4.

[46] *Id.* at 5.

[47] *Id.*

[48] *Id.* at 7.

[49] *Id.*

participants and not just by a specific entity. The report also noted that existing disclosure and presentation requirements related to the effect of fair value in financial statements should be enhanced.[50]

- *Accounting for financial asset impairments should be readdressed*. The report noted that accounting for impairment was identified as one of the most significant areas of necessary improvement and recommended that consideration be given to narrowing the number of models that currently exist in GAAP with respect to the impairment of financial instruments. In particular, the report indicated that the FASB should evaluate the need for modifications (or elimination) of current OTTI guidance and discussed other alternative models to address the problem in the present environment of current fair value diverging from the value expected from holding investment positions until markets return to normal levels. The report also suggested improvements in presentation of OCI and other information.[51]

- *Further guidance should be implemented to foster the use of sound judgment*. The report emphasized that SFAS 157 requires the exercise of significant judgment, particularly in valuations of Level 2 and Level 3 assets. The report recommended that the SEC and the Public Company Accounting Oversight Board ("PCAOB") consider whether statements of policy related to the application of judgment in making fair value measurements would be appropriate.[52]

- *Accounting standards should continue to be established to meet the needs of investors*. The report stressed that "financial reporting is intended to meet the needs of investors. . . . U.S. GAAP should not be established or modified to serve the needs of others at the expense of investors." In particular, the report addressed "pro-cyclicality":

  > [T]o the extent that the interaction of fair value accounting and regulatory capital requirements has resulted in concerns about pro-cyclicality (including whether accounting standards are resulting in the sale of assets or the need to raise capital in down markets), such concerns should not be addressed through changes . . . that would reduce investor confidence.[53]

- Additional formal measures to address the operation of existing accounting standards in practice should be established. The report endorsed the importance of an independent standard-setting body:

  > The accounting profession has always been associated with independence and neutrality. An occasionally overlooked aspect of the independence of the accounting profession is the important role of the independent standard-setter. Standard-setting that solicits input and feedback from all interested parties, yet places the interests of no particular party above the needs of investors relying on the standards, is critical to investor confidence.[54]

At the same time, the report stressed the need for the standard-setter to be able to respond to challenges identified in practice in applying standards, particularly the potential need to act in circumstances – like the present economic crisis – that necessitate near immediate response. While stating that it believes the FASB standard-setting process works well, the report made specific recommendations regarding improvements to the FASB processes.[55]

- *The need to simplify the accounting for investments in financial assets should be addressed*. Finally, the report emphasized the need to reduce complexity in accounting for financial instruments. It recognized that there were significant obstacles to such a move. The report recommended that the use of fair value measurement should not be significantly expanded until obstacles related to such reporting are further addressed.[56]

THE CONTROVERSY CONTINUES AFTER THE SEC REPORT

On February 18, 2009, the FASB announced new projects intended to address the recommendations in the SEC report. One project would have provided "application guidance" to address the determination of when a market for an asset or a liability is active or inactive and when a particular transaction is distressed.[57] The other project was intended to improve disclosures about fair value measurements.[58] The FASB stated that it anticipated

[50] *Id.* at 8.

[51] *Id.* at 204-05.

[52] *Id.* at 205-06.

[53] *Id.* at 206.

[54] *Id.* at 207.

[55] *Id.* at 207-08.

[56] *Id.* at 208.

[57] FASB, *Project Update: FAS 157 – 125Determining Whether a Market is Not Active and a Transaction is Not Distressed* (updated Apr. 3, 2009), *available at* http://www.fasb.org/project/fas157_active_inactive_distressed.shtml#objective.

[58] FASB, *Project Update: FAS 157 – Improving Disclosures about Fair*

completing the project on application guidance by the end of the second quarter of 2009 and the project on improving disclosure in time for year-end financial reporting.[59]

The FASB's action did not quell its critics. The ABA immediately objected to the failure to include OTTI in the projects and said that the FASB needed to move more quickly than the second quarter target.[60]

On March 9, 2009, a group of trade associations and others sent a letter to the chairman and ranking member of the House Financial Services Committee. While stating they "do not ask that Congress write accounting rules," the writers asserted that the scope of the changes under consideration by the SEC and the FASB was not adequate and the pace was not "consistent with the crisis conditions that exist." The letter also contended that appropriate changes in mark-to-market accounting should not wait until mid-year or year-end.[61]

On March 10, 2009, Federal Reserve Chairman Ben Bernanke weighed in on the controversy. In a speech to the Council on Foreign Relations, he appeared to provide some support to critics of mark-to-market accounting. Acknowledging the pending efforts to enhance existing standards, he also suggested that "further review of accounting standards governing valuation and loss provisioning would be useful, and might result in modifications to the accounting rules that reduce their pro-cyclical effects without compromising the goals of disclosure and transparency."[62]

On March 11, 2009, two senior Republican members of Congress sent a letter to Mary Schapiro, Chairman of the SEC, asserting that the SEC and the FASB "lack a sufficient sense of urgency in addressing the negative impact of mark-to-market accounting rules in the current economic environment." The congressmen asked the SEC "to take immediate action."[63] At a hearing the same day, Ms. Schapiro indicated that she was pushing the FASB to issue its new guidance in the second quarter. She emphasized that "it was not the SEC's intention to force banks to write down assets to fire-sale prices."[64] By contrast, in a speech given the same day, Senator Christopher Dodd, Chairman of the Senate Banking Committee, emphasized his opposition to "Congress getting into the business of accounting standards."[65]

The continuing controversy also prompted new legislative proposals. On March 4, 2009, members of Congress introduced a bill to establish a Federal Accounting Oversight Board ("FAOB"). The FAOB would be composed of the Chairman of the Federal Reserve, the Secretary of the Treasury, the Chairman of the SEC, the Chairman of the Federal Deposit Insurance Corporation and the Chairman of the PCAOB. Under this legislation, the FAOB would "approve and oversee accounting principles and standards for purposes of the Federal financial regulatory agencies and reporting requirements required by such agencies." The bill identifies various substantive factors that the FAOB would have to consider in deciding whether to approve a standard. The factors include, among others, "the balance between investors' need to know a value of a company or financial institution's balance sheet at any given time versus financial regulators' responsibility to examine a company or financial institution's capital and value on both a liquidation and going concern basis" and "the need for accounting principles and standards to take into account the need for financial institutions to maintain adequate reserves to cover expected losses from assets held by such institutions." The bill, if enacted, would divest the SEC of its power to oversee the FASB and transfer it to the FAOB.[66]

Finally, on March 12, 2009, the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Financial Services Committee convened a hearing on mark-to-market accounting. Among the witnesses at the hearing were James Kroeker, Acting

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Value Measurements (updated Mar. 10, 2009)*, available at* http://www.fasb.org/project/fas157_improving_ disclosures_about_fvm.shtml.

[59] News Release, Financial Accounting Standards Board, FASB Initiates Projects to Improve Measurement and Disclosure of Fair Value Estimates (Feb. 18, 2009), *available at* http://www.fasb.org/news/ nr021809.shtml.

[60] News Release, American Bankers Association, ABA Welcomes FASB's Decision to Review Measurements for Fair Value Accounting; Expresses Concern that OTTI is Being Overlooked (Feb. 18, 2009), *available at* http://www.aba.com/Press+Room/ 021809FASBReviewMeasurmentFairValue.htm.

[61] Letter from American Bankers Association, et al. to Hon. Barney Frank and Hon. Spencer Bachus (Mar. 9, 2009), a*vailable at* http://www.icba.org/files/ICBASites/PDFs/ ltr030909.pdf.

[62] Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, Speech at the Council on Foreign Relations, *Financial Reform to Address Systemic Risk* (Mar. 10, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm#f9.

[63] Letter from Reps. Spencer Bachus and Roy Blunt to Mary Shapiro, Chairman, SEC (Mar. 11 2009), *available at* http://blunt.house.gov/ Media/PDFS/MarkToMarket.pdf.

[64] Rachelle Younglai, *Mark-to-Market Accounting Guidance Due in Q2 – SEC Chief,* Reuters, Mar. 11, 2009, http://www.reuters.com/article/ governmentFilingsNews/idUSN1129020920090311.

[65] Sen. Dodd, *Congress Should Not Set Accounting Rules,* Reuters, Mar. 11, 2009, http://www.reuters.com/article/newsOne/ idUSN1129607720090311?virtualBrandChannel=10112.

[66] H.R. 1349, 111th Cong. (1st sess. 2009).

Chief Accountant of the SEC, and Robert Herz, Chairman of the FASB. While many of the congressmen present disclaimed any intention to suspend fair value accounting or to set accounting rules, nonetheless, the Subcommittee pressed for immediate action to improve the application of fair value accounting. According to reports of the hearing, Representative Paul Kanjorski, Subcommittee Chairman, noted that three pieces of legislation (including the FAOB bill) were pending with respect to mark-to-market accounting or standard-setting generally, and that if the FASB did not act immediately, one of those bills "will become law before early April." In response, Mr. Herz committed to issuing final guidance within three weeks, *i.e.,* by April 2, 2009.[67]

NEW FASB STANDARDS

Following the March 12th hearing, on March 17, 2009, the FASB issued two proposals to address fair value accounting implementation and OTTI. At a meeting on April 2, 2009, following a two-week comment period, the FASB voted to adopt the proposals, as revised in certain respects. The FASB issued the text of the guidance on April 9, 2009. Both the fair value and OTTI guidance will be effective for the second quarter of 2009 for calendar-year companies. Companies are permitted to apply the guidance in the first quarter, but must adopt both of them simultaneously. The FASB rejected requests that companies be permitted to retroactively apply the standards to 2008 financial statements.

Fair Value. Responding to recommendations in the SEC report, the FASB adopted FASB Staff Position No. FAS 157-4 ("FSP 157-4"), to provide additional guidance for determining when markets have become less active and transactions may not be orderly.[68] In certain respects, the FASB reaffirmed SFAS 157. It noted that the standard had been adopted in 2006 after extensive input from various constituents and that many constituents indicated that the fair value measurement framework and related disclosures in SFAS 157 have improved the quality and transparency of financial information. In particular, the FASB emphasized that the "objective" of the fair value measurement remained the same – to ascertain "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions."[69]

At the same time, the FASB sought to address concerns expressed by many constituents that SFAS 157 did not adequately address the impact of inactive markets and often resulted in recent transaction prices or price quotes being used as a basis for estimating fair value, even if those transactions were not "orderly" and therefore not necessarily indicative of fair value. The FASB concluded that "a significant decrease in the volume and level of activity for the asset or liability is an indication that transactions or quoted prices may not be determinative of fair value because in such market conditions there may be increased instances of transactions that are not orderly." In those circumstances, the FASB stated, "further analysis of transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with [SFAS 157]."[70]

Accordingly, the FASB amplified the methodology for determining fair value of financial and other assets in various respects:

- FSP 157-4 identifies eight factors for the reporting entity to evaluate whether there has been a significant decrease in the volume and level of activity for the asset when compared with normal market activity for the asset.[71] The reporting entity is to evaluate the significance and relevance of the factors to determine whether, "based on the weight of the evidence," there has been a significant decrease in the volume and level for the asset. (Note that this is a comparative analysis, based on whether there has been a decrease from "normal market activity for an asset, not a determination whether a particular market is or is not "inactive.")
- If there has been a decrease in market activity as described above, then transactions or quoted prices

[67] Sarah N. Lynch, *FASB Pledges Mark-to-Market Guidance Soon,* WALL ST. J., Mar. 12, 2009, *available at* http://online.wsj.com/article/SB123687695524209423.html?mod=googlenews_wsj.

[68] FASB Staff Position No. FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (Apr. 9, 2009), *available at* http://www.fasb.org/pdf/fsp_fas157-4.pdf ("FSP 157-4").

[69] *Id.* at 1.

[70] *Id.*at 3-4.

[71] *Id.* at 4-5. The eight factors relevant to evaluating changes in activity of financial assets are summarized as: (a) few recent transactions; (b) price quotations are not based on current information; (c) price quotations vary substantially either over time or among market makers; (d) indexes that previously were highly correlated with fair values are "demonstrably uncorrelated" with recent indications of fair value; (e) significant increase in implied risk premiums, yields, or performance indicators for observed transactions compared with reporting entity's estimate of expected cash flows; (f) wide bid-ask spread or significant increase in the bid-ask spread; (g) significant decline or absence of market for new issuances of asset or similar assets; and (h) little information is released publicly.

may not be determinative of fair value. In that case, the revised standard requires "further analysis" of the transactions or quoted prices, and a significant adjustment to those prices may be necessary to estimate fair value. FSP 157-4 notes that SFAS 157 does not prescribe a methodology for these adjustments but SFAS 157 does note that the use of multiple valuation techniques may be appropriate.

- At the same time, FSP 157-4 emphasizes that even where there has been a decrease in market activity and regardless of the valuation methodology used, the objective of a fair value measurement to estimate a market price (as described above) remains the same. FSP 157-4 emphasizes that determining a price at which willing market participants would transact if there has been a decrease in market activity "depends on the facts and circumstances and requires the use of significant judgment."[72] However, a reporting entity's intention to hold the asset is not relevant in estimating fair value.

- Even if there has been a decrease in market activity, that does not mean all transactions are not orderly. The FASB identified a non-exclusive list of circumstances that may indicate that a transaction is not orderly. The reporting entity must evaluate the circumstances to determine whether the transaction is orderly "based on the weight of the evidence."[73] FSP 157-4 provides guidance about how to weigh the transaction price based on whether it was or was not orderly.[74]

- Finally, FSP 157-4 provides for additional disclosures regarding fair value determinations. The reporting entity will be required to disclose the inputs and valuation technique(s) used to measure fair value and any changes in them, and to break out the fair value disclosures by "major categories" of securities.[75]

OTTI. By a 3-2 vote, the FASB also adopted FASB Staff Position No. FAS 115-2 and FAS 124-2 ("FSP 115-2"),[76] which significantly modified the standards for recognition and measurement of OTTI for available-for-sale and held-to-maturity debt securities. The FASB indicated that it was responding to concerns that requirements for taking write-downs for investments in debt securities differed from those for loans, that financial statements do not provide users with sufficient information about expected cash flows from holding an asset, and that current market conditions had caused temporary declines in value greater than declines resulting solely from a reduction in expected future cash flows.

FSP 115-2 revises the 2008 Standards for OTTI in the following key respects:

- It changes the prior standard for avoiding recognition of an OTTI. Under the 2008 Standards, the entity had to affirmatively assert that it had both the "intent" and the "ability" to hold an impaired asset for a period of time sufficient to allow for an anticipated recovery in the asset's fair value to its amortized cost. The new standard changes two things: (1) "intent to hold" becomes "no intent to sell" and (2) "ability to hold" becomes "more likely than not will not have to sell." The first change appears to be principally one of emphasis. As for the second change, under the new standard, as long as the reporting entity can assert as little as a 51% probability that it will not have to sell the asset, it will not have to recognize an OTTI; the old requirement did not have a probability threshold and therefore may have required a higher level of certainty that the entity would be able to hold the asset. If the reporting entity has an intent to sell or it is more likely than not that it will have to sell the securities before recovery of its fair value, then the entire difference

[72] *Id.* at 6.

[73] *Id.* at 6-7. The identified circumstances for determining when a transaction is not orderly are summarized as follows: (a) there was not adequate exposure to the market before the measurement date to allow for usual and customary marketing activities for such assets; (b) there was a usual and customary marketing period, but the asset was marketed to a single market participant; (c) seller is in or near bankruptcy or receivership or required to sell to meet regulatory or capital requirements; (d) transaction price is an "outlier" compared to other recent transactions. Notably, the FASB rejected a proposal in its exposure draft that a transaction be presumed not to be orderly where markets were inactive. *See* FASB, *Proposed Staff Position: Determining Whether a Market Is Not Active and a Transaction is Not Distressed,* 4 (Mar. 17, 2009), *available at* http://www.fasb.org/fasb_staff_positions/ prop_fsp_fas157-e.pdf.

[74] Generally, the weight given to the transaction price is assessed as follows: 1) if the transaction is not orderly, then little, if any weight, shall be placed on the transaction compared with other indications of fair value; 2) if the transaction is orderly, then the transaction price will be considered but the amount of weight placed on it will depend on the facts and circumstances; and 3) if the reporting entity does not have sufficient information to determine whether the transaction was orderly or not orderly, it shall consider the transaction price but it may

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not be determinative. FSP 157-4 at 7. FSP 157-4 notes that any fair value measurement must contain "appropriate risk adjustments" to reflect the risk premium that market participants will demand because of uncertainty in cash flows. It also discusses the weight, or lack thereof, to be given to quoted prices provided by third parties, such as pricing services or brokers. *Id.* at 8.

[75] *Id.* at 9.

[76] FASB Staff Position No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (April 9, 2009), *available at* http://www.fasb.org/ pdf/fsp_fas115-2andfas124-2.pdf.

between fair value and amortized cost will be recognized in earnings. In this last respect, FSP 115-2 resembles the 2008 Standards.

- FSP 115-2 introduces new standards for recording write-downs to reflect "credit loss" with respect to a debt security. Even if the entity does not intend to sell the asset and it is not more likely than not it will have to sell the asset, if the present value of cash flows expected to be collected on the security is less than the amortized cost (*i.e.*, there is a "credit loss"), then an OTTI has occurred.[77] In this case, however, the accounting treatment is bifurcated. Only the amount of the credit loss will be recognized in earnings, not the total decline in fair value below cost. Any portion of the decline in fair value over and above the portion attributable to the credit loss will be recognized in OCI, not earnings. Consistent with the 2008 Standards, subsequent increases or decreases in fair value of available-for-sale securities will be included in OCI, unless an additional OTTI occurs. FSP 115-2 does modify the treatment of OCI for held-to-maturity debt securities. For these securities, the OCI component of OTTI will be accreted to amortized cost over the remaining life of the security.

- FSP 115-2 also imposes extensive additional interim and annual disclosure requirements regarding available-for-sale and held-to-maturity securities and the treatment of OTTI with respect to such securities. These disclosures include information about the types of available-for-sale and held-to-maturity securities held and information to enable users to understand the reasons a portion of OTTI was not recognized in earnings and the methodology and inputs used to calculate the portion of OTTI that was recognized.[78]

Two of the five members of the FASB dissented from the issuance of FSP 115-2. They identified two principal reasons for their dissent. First, they stated that to the extent there is an OTTI, it should be measured as the entire difference between the fair value and the carrying value of the impaired asset and that change should be fully reflected in net income. In their view, investors preferred this approach. They rejected the bifurcation of the loss into credit and non-credit components and stated that they did not believe that the approach of FSP 115-2 can in fact isolate the credit loss from other losses. Second, the dissenters objected to the change in the trigger for avoiding recognition of the full OTTI in net income. They noted that "a likely result of this change is a reduction in the amount of impairment losses recognized in net income."[79]

CONCLUSION

While there were calls in late 2008 to "suspend" SFAS 157, as of July 2009, that occurrence seems unlikely. Still, the FASB and SEC came under strong pressure to act expeditiously to provide additional guidance to address how fair value accounting should be applied in the current distressed marketplace. Pressure for additional change may continue.[80] So far, the mark-to-market controversy has not resulted in legislative prescriptions of accounting rules or direct legislative intervention in the standard-setting process. But it has forced a departure from the FASB's established methods of deliberation and due process in formulating accounting standards and guidance. While this may be understandable in the exigent circumstances posed by the economic crisis, it is nonetheless disconcerting where the process appears to be driven, procedurally if not substantively, by the political process. ■

[77] FSP 115-2 provides extensive guidance on how to estimate the present value of cash flows to be collected from the debt security. FSP 115-2 at 8-10. Among other things, FSP 115-2 refers to the standards for determining credit impairments of whole loans. FSP 115-2 ¶ 23, citing FASB, Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (May 1993), *available at* http://www.fasb.org/pdf/aop_FAS114.pdf.

[78] The FASB also adopted another standard requiring disclosures about fair value instruments in interim, as well as annual, financial statements prepared by public companies. See FASB Staff Position No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* (April 9, 2009), *available at* http://www.fasb.org /pdf/fsp_fas107-1andapb28-1.pdf.

[79] FSP 115-2 at 17-18.

[80] On May 13, 2009, the ABA and other organizations sent another letter to the Chair and Ranking Member of the House Financial Services Committee. They contended that the FASB's recent changes had "only scratched the surface" and "do not focus on the heart of the problem: mark-to-market does not provide the most relevant measurement basis for many types of transactions." Letter from American Bankers Association, et al. to Hon. Barney Frank and Hon. Spencer Bacchus (May 13, 2009), *available at* http://www.aba.com/aba/ documents/press/FairValueJointTradesLetter051309.pdf.

CFTC'S SUPERVISION RULE EXPANDED?

In two settlements involving the industry's largest FCMs, the CFTC found liability not for employee wrongdoing, but for failure to detect wrongdoing by customers or customer agents. The cases suggest an expansion of the CFTC's supervision rule to create liability for negligence or errors in judgment in handling customer accounts, even by senior officials and regardless of an appropriate system of internal supervision.

By Daniel R. Waldman and Ahmad M. Hajj *

Rule 166.3 of the Commodity Futures Trading Commission ("CFTC") requires futures professionals to diligently supervise persons under their direction and control. Rule 166.3 states that a registrant must "diligently supervise the handling by its partners, officers, employees, and agents (or persons occupying a similar status or performing a similar function) of all commodity interest accounts carried, operated, advised, or introduced by the registrant and all other activities of its partners, officers, employees, and agents . . . relating to its business as a Commission registrant." Pursuant to Rule 166.3, the Commission has held that futures professionals must: i) maintain an adequate program of supervision to detect wrongdoing by its officers, employees, or agents; and ii) ensure that the program of supervision is properly implemented and followed.[1] Thus, in order to prove a violation of Commission Rule 166.3, it must be demonstrated that either: (1) the registrant's supervisory system was generally inadequate; or (2) the registrant failed to perform its supervisory duties diligently.[2]

Rule 166.3 itself does not provide standards for what constitutes an adequate system of supervision and the CFTC has provided little guidance through interpretative statements or administrative case law. In addition, since CFTC registrants rarely litigate with the Commission over supervisory liability, there is little judge-made law defining diligent supervision.

Rule 166.3 was first promulgated as part of a broader set of early customer protection proposals. The initial proposed rule contained specific requirements for supervision by Futures Commission Merchants ("FCMs"). An FCM was required to maintain written procedures for the approval by supervisors of the opening of all commodity accounts, of the delegation of discretionary authority to the broker, and for the review of all correspondence sent by the broker concerning the solicitation, acceptance, or execution of commodity orders. The proposed rule also required supervisory approval of all discretionary trades, frequent review of all commodity accounts to detect and prevent any violations of the Commodity Exchange Act or Commission or exchange rules, and the prompt review of all customer complaints. The proposed rule also had provisions requiring that a FCM designate an officer or partner to supervise the designated supervisors.

Not surprisingly, the Commission decided not to adopt the more specific requirements and instead opted for the flexibility provided by the broad language requiring "diligent supervision." The Commission stated that the more specific requirements (with certain minor exceptions) were a "useful guideline as to the types of measures FCM's should adopt in order to supervise their employees properly."[3]

Although the Commission's Rule 166.3 duty of supervision is broad, it is a logical extension of the common law obligation of employers to supervise their employees to ensure that they do not commit torts or other misconduct. Most prior cases can be understood in this context.[4] However, two 2007 settlements involving two of

[1] *In re GNP Commodities, Inc.*, [1990-92 transfer binder] Comm. Fut. L. Rep. (CCH)125,360 at 39,219 (CFTC Aug. 11, 1992). 1992 WL 201158 (CFTC).

[2] *In re Walsh Trading, Inc.* CFTC Docket No. 09-09 (March 11, 2009) quoting *In re Murlas Commodities,* [1994-1996 Transfer Binder] Comm. Put. L Rep. (CCH) ¶26,485 at 43,161 (CFTC Sept. 1, 1995).

[3] 43 Fed. Reg. 31886 (1978).

[4] However, the CFTC has made clear that an "underlying violation" is not needed for there to be a violation of Rule 166.3. *In re Collins*, [1996-98 transfer binder] Comm. Fut. L. Rep (CCH) par. 27,194 at 45,744 (CFTC Dec. 10, 1997). 1997 WL

** DANIEL R. WALDMAN is a partner in Arnold & Porter's Washington, D.C. office and is a former general counsel to the CFTC., He is the head of Arnold & Porter's derivatives practice group and a member of the securities enforcement and litigation and antitrust groups. AHMAD M. HAJJ is an associate in Arnold & Porter's Washington, D.C. office with a practice focusing on derivatives, bank regulatory, and hedge fund work. Their e-mail addresses are, respectively, Dan.Waldman@aporter.com and Ahmad.Hajj@aporter.com.*

the industry's largest FCMs, Interactive Brokers LLC and MF Global Inc., highlight an evolving, more expansive use of Rule 166.3.

In the Matter of Interactive Brokers, Inc.[5] was a case involving a customer of Interactive Brokers who operated an unregistered commodity pool that defrauded investors of over $8 million. While the customer represented that his account was a personal account and that he had a limited net worth, there were numerous third-party deposits to the account totaling approximately $7.7 million. The account also suffered extensive trading losses. The compliance staff of Interactive Brokers contacted the customer three times but accepted the customer's explanations for the third-party deposits and withdrawals as reasonable. As a result, the broker took no additional steps to verify the source of the funds, why monies in excess of the customer's net worth were being deposited, or why there were frequent withdrawals from the account. The CFTC concluded that Interactive Brokers' compliance officer and staff failed to respond adequately to the warning signs of possible pool activity and that its compliance procedures should have detected the possibility that the customer was pooling funds of third parties. Accordingly, the CFTC found that Interactive Brokers violated Rule 166.3.

In the Matter of MF Global Inc.[6] also involved customer fraud by a third-party advisor. MF Global had opened an account for a large off-shore fund. The account was managed by a Commodity Trading Advisor ("CTA"). During the course of the CTA's trading for the fund, the account incurred massive losses, which the CTA tried to conceal from the fund and its administrator. The CFTC found that MF Global and the senior vice president in charge of the account failed to respond to various red flags indicating potential wrongdoing by the advisor. These red flags included the backdating of the execution dates of certain EFPs to improve performance, the establishment of a subaccount with electronic access limited to the CTA, the frequent transfers of losing positions from one subaccount to another, and rapid and substantial trading losses, resulting in very large margin calls. Various MF Global personnel with differing areas of responsibility were aware of, and involved in, much of the activity complained of by the Commission, but apparently were unable to detect the CTA's fraud. However, based on MF Global's failure to investigate adequately and respond to the indicators of possible wrongdoing, the Commission concluded that the broker had an inadequate system of supervision and found a violation of Rule 166.3.

Interestingly, the focus of the Interactive Brokers and MF Global cases appears not to have been the failure of the FCMs to develop systems and procedures to detect wrongdoing by *their* employees, but rather on the failure of the brokers to detect wrongdoing by their customers or their customers' agents. It could be that the Commission concluded that misconduct by the customers or their agents could not have occurred without the inattention or inaction of an employee or employees at the FCM and that the employees' negligence in turn could not have occurred without inadequate supervision by the broker. However, in both cases, the misconduct at the broker was not the action of a low-level employee who was unsupervised, but of more senior officials who failed to act to detect the customer's or trading advisor's misconduct. The gravamen of the offense appears to have been a lack of care by the broker in supervising the account and not a failure to supervise its own employees.

What these recent cases suggest is that Rule 166.3 may extend beyond requiring a system of supervision that is properly followed. Rule 166.3 may be used by the Commission not simply to capture a broker's duty to supervise its employees and agents, but essentially to codify the broker's common law duty of care to its customer. Under this theory, if the broker acts negligently in handling a customer account, Rule 166.3 liability will attach regardless of whether the negligence or errors in judgment were made by senior officials and notwithstanding an appropriate system of internal supervision.

This expansion of Rule 166.3 is not surprising or unexpected. The Commodity Exchange Act and Commission regulations provide strict liability for violations of a limited number of specific legal requirements applicable to FCMs, such as capital, recordkeeping, and segregation. Virtually all other potential violations must fit within the general prohibition against fraud or, in some circumstances, breach of fiduciary duty. Rule 166.3, however, provides a negligence standard that must be virtually irresistible to the Division of Enforcement when it seeks to pursue a registrant who fails to exercise due care in dealing with its customers. The rule provides a means for the Commission to punish registrants whose conduct falls below the standard that the Commission expects from its registrants in cases where the misconduct is neither intentional nor fraudulent. An argument can be made that it is good public policy for the Commission to have that authority in order to properly police the commodity markets, but some additional transparency from the Commission on what it is doing is probably in order. ■

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761927 (CFTC). An inadequate system of supervision alone is sufficient.

[5] CFTC No. 07-07 (July 17, 2007) 2007 WL 2088728.

[6] CFTC Docket 08-02 (December 26, 2007) 2007 WL 4564104.

CLE QUESTIONS on White & Monroe, *The Mark-to-Market Accounting Controversy* (August 19, 2009). Please circle the correct answer to each of the questions below. If at least four questions are answered correctly, there is one credit for New York lawyers (nontransitional) for this article. Complete the affirmation and evaluation and return it by fax to RSCR-CLE, 212-876-3441, or by e-mail attachment to rscrpub@att.net.

1. There are provisions relating to mark-to-market accounting in the Emergency Economic Stabilization Act of 2009. **True** **False**

2. Under 2008 standards, unrealized changes in value of available-for-sale debt securities were required to be reflected in earnings. **True** **False**

3. An SEC report, issued on December 30, 2008, recommended a suspension of FASB's Statement of Financial Standards No. 157 in light of the financial crisis. **True** **False**

4. FASB's Staff Position No. FAS 157-4, issued on April 9, 2009, identified eight factors for a reporting entity to consider in evaluating whether there had been a significant decrease in the volume and level of activity for an asset. **True** **False**

5. FSB 115-2 introduced new standards for recording write-downs to reflect credit loss with respect to a debt security. **True** **False**

A F F I R M A T I O N

_____, Esq., an attorney at law, affirms pursuant to CPLR
[Please Print]
2106 and under penalty of perjury that I have read the above article and have answered the above questions without the assistance of any person.

Dated: _____

_____
[Signature]

_____
[Name of Firm] [Address]

E V A L U A T I O N

This article was (circle one): Excellent Good Fair Poor

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