CFA INSTITUTE
Centre for Financial Market Integrity

12 September 2008

Mr. Fernando Restoy
The Committee of European Securities Regulators (CESR)
11-13 avenue de Friedland
75008 Paris, France

Re: ***CESR Consultation Paper: Fair Value measurement and related disclosures of financial instruments in illiquid markets Ref: CESR/08-437***

Dear Mr. Restoy,

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),[1] in consultation with its Corporate Disclosure Policy Council (CDPC)[2], appreciates the opportunity to comment on the consultation on the fair value measurement and disclosure of financial instruments in illiquid markets.

The CFA Institute Centre represents the views of its investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics and Standards of Professional Conduct.*

GENERAL COMMENTS

The CESR consultation paper provides operational principles related to three key factors affecting the fair value accounting of sub-prime assets. These include:

- Principles of distinction between an active and inactive market;

[1] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The Council is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the Council provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

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- Inputs used in valuation of illiquid instruments; and
- Required disclosure levels on these instruments.

There is a consensus, amongst the preparer, regulatory and user communities that these three factors identified in the consultation paper have presented the most difficulties in the implementation of the fair value measurement of structured financial products during the ongoing credit crisis. The consultation paper has substantively elaborated on a number of the areas.

Overall we agree with the recommendations on valuation inputs contained in the document. However, although the paper spells out key principles on assessing an inactive market, the question of how to determine an inactive market is largely unresolved. We also have concerns about period to period inconsistencies and reduced comparability across firms that could arise from a principles based disclosure approach.

Two recently published reports[3] by Price Waterhouse Coopers and Fitch Ratings highlight the variation in the implementation across selected financial institutions of IFRS 7, the recently enacted financial instrument risk disclosure standard. Both reports find that there has been some improvement, albeit insufficient, in the risk disclosure and there is clearly an issue of poor comparability between firms. The inconsistency seems to be due to the IFRS 7 requirement of disclosure 'through the eyes of management'. While it is early days in the adoption of IFRS 7 and there could be an assumption that corporate managers will ratchet up the disclosure levels in the future, there are lessons to be learnt from previous voluntary disclosure requirements and how this often simply results in the provision of boiler plate, meaningless information. It will also be helpful if there was more illustration of best practices dealing with aggregation and sensitivity analysis.

Before providing our detailed response to the CESR views on the three key areas, we have some general observations

GOAL OF CONSULTATION

In the introduction section, one of the stated goals of the document is to provide input that will assist preparers and auditors in developing and opining on disclosure of financial information in the current market. However, the IASB conceptual framework identifies capital providers as the primary users of external financial reports. In addition, CESRs stated mission includes enforcement of standards of financial information to protect investors and promote market confidence by contribution to the transparency of information relevant to investors' decision making process. We note that anticipated user considerations have in part shaped the proposals on disclosure practices. **But one of the explicit goals of the consultative process ought to be achieving both measurement and disclosure best practices from the point of view of investors. This should be explicitly articulated in the document introduction and objective sections.**

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[3] 1) Accounting for change: transparency in the midst of turmoil- A survey of banks' 2007 annual reports August 2008- Price Waterhouse Coopers 2) Fair value disclosures: A reality check, June 26th 2008, Fitch Ratings

Given that the raison d'être of IFRIC and IASB is to provide interpretative guidance it raises the question whether the CESR can provide sufficient incremental insights on implementation related issues. There also seem to be overlaps of this consultation with the work currently conducted by the IASB valuation expert advisory group and it is unclear whether and how the outputs from this initiative will be integrated with IASB work-streams. Nevertheless, the regulatory bodies clearly have a role in encouraging and enforcing best practice financial reporting and, therefore, this consultation is both welcome and timely. In that spirit, the regulatory intervention should also go beyond refining the extant interpretation of promulgated standards from the point of view of issuers of financial statements and should also seek ways of encouraging best practice disclosure through different economic cycles.

Another concern is that the scope of the document seems limited in several respects. The scope is limited because it has a retrospective focus and ignores possible regulatory intervention on disclosure incentives. It also excludes the question of consolidation of special purpose entities.

RETROSPECTIVE FOCUS AND SEEKING CONSISTENCY THROUGH ECONOMIC CYCLES

While it is understandable the consultation focuses on illiquid instrument measurement and disclosure implementation issues, a key shortcoming of the paper is that it does not attempt to address the systemic factors that contribute to sub-optimal disclosure practices around financial instruments. The approach adopted in this paper seems to retrospectively construct 'measurement and disclosure' best practices. Yet from an investor viewpoint, more would be expected on how the regulator can encourage best practice disclosure through different economic cycles. **Best practice disclosure should be consistently applied through crisis, normal and exuberant phases.**

A rear mirror view of best practice disclosures is certainly most helpful and there is plenty of useful information to be gleaned that will enrich current practice. However, a possible unintended consequence of regulatory intervention that mainly identifies best practices on a retrospective basis and during market crashes is that it could leave regulators playing catch up. **Financial innovation is a necessary and ongoing characteristic of sophisticated capital markets. Hence regulatory efforts should primarily be anticipatory rather than retrospective.**

Another problem of restricting the scope of analysis to the market crisis period is that it could engender the mindset amongst corporate financial statement preparers that high quality disclosure is a 'temporary aberration' that is mainly required during market crisis periods. The notion of additional disclosures being required in market crisis situations is expressed in paragraph 44. The concern of period to period inconsistency especially arises under a principles based accounting regime that necessitates the disclosure 'through the eyes of management'. It could result in period to period inconsistencies if managers, due to reasons of materiality, as stated in paragraph 52 become less transparent during phases of market exuberance.

Understanding disclosure incentives can contribute to the design of anticipatory regulatory efforts that aim to encourage best practice disclosure. Disclosure incentives can include capital market incentives, proprietary information concerns, and a conservative bias by auditors. The question of incentives is important given the backdrop of entities sometimes ignoring the principles of International Financial

Reporting Standard No. 7, *Financial Instruments: Disclosures* (IFRS 7). As noted in paragraph 49 of the document, IFRS 7 encourages disclosures of assumptions relating to prepayment rates, rates of estimated credit losses, and interest rates or discount rates. Yet there was evidence of boiler plate, generic disclosure by companies as they ignored the requirements of IFRS 7.

OFF BALANCE SHEET REPORTING

The consultation paper does not address the consolidation of special purpose entities. From an investor transparency point of view fair value measurement, accompanying disclosures and the recognition of all risk exposures are inextricably interlinked as financial reporting users' process risk exposure information on a seamless basis. We are aware that the IASB has undertaken a review of Standing Interpretation Committee Statement no.12 (SIC 12), *Consolidations- Special Purpose Entities* and International Accounting Standard Statement no.27 (IAS 27), *Consolidated Financial Statements* as a separate project. Nevertheless, a compartmentalised review of these areas by regulatory authorities would miss an opportunity to cross pollinate insights from the review of each of these inter-related areas.

SPECIFIC COMMENTS

Q1: Distinguishing between Active and Inactive Markets

The distinction between active and inactive market is important as IAS 39, *Financial Instruments: Recognition and Measurement* does not require the use of exit or exchange prices when dealing with a forced transaction, involuntary liquidation or distressed sale. The consultation paper touches on a number of principles also outlined in IAS 39 that could be used to determine active or inactive markets for financial instruments. These include having a hierarchy of sources of market price information and the paper covers different considerations used in determining the frequency of transactions (e.g. bid-ask spreads and regularity of transactions). Despite analysing different principles, the paper is inconclusive on how issuers can actually determine an inactive market.

We concur with the view that there are difficulties in establishing suitable, consistent and implementable bright lines to enable the distinction between active or inactive markets across the universe of financial instruments. For this reason, we concur with the perspective that management judgement is appropriate in determining whether a market is active or inactive. From an investor perspective, what is necessary is to ensure that there is consistent definition and application of such judgement in the valuation policy. And there should be sufficient accompanying disclosure to investors on the valuation policy in place.

Q2: Valuation inputs

We generally agree with the principles articulated on valuation inputs. We agree with it being necessary to factor in liquidity and correlation risk factors in the valuation of financial instruments. We concur with the approach of testing and calibrating valuation techniques against observable data, on an ongoing basis. In addition, we would emphasize the importance of disclosure about the following:

- Adjustments made to observable inputs
- The differences between valuation effects of observable and unobservable inputs on profit and loss
- Movements and reconciliation of movements across all the three levels of valuation
- Sources of unobservable inputs
- Hedge effectiveness and Asset/Liability management effectiveness of matched items residing in different valuation hierarchies

Q3: Disclosure

Comprehensive Business Reporting Model (CBRM) principle 12 enumerates on the principle and key elements of disclosure, as follows:

> *Disclosures must provide the additional information investors require to understand the items recognised in the financial statements, their measurement properties, and their risk exposures. The*

role of disclosure is to provide a comprehensive explanation of events and transactions that have been recognised, including:

- *the models, estimates, assumptions, and principles that were applied to measure the effects*
- *and the sensitivity of the reported information to changes in those principles and assumption*

Membership surveys we have conducted over the last decade consistently show that our members believe there are significant quality gaps[4] in the disclosures of risk management activities and risk exposure. The 2007 and 2003 corporate disclosure surveys showed quality gaps of -1.1 and -1.3 for risk management activities, respectively. The same surveys showed quality gaps in risk exposures of -1.0 and -1.3. These findings are part of a recurrent experience of poor quality disclosures, from the perspective of users.

On the question of disclosure, the paper covers a number of important dimensions. These include the aggregation level, where the IFRS requires and CESR concurs that it ought to be based on management judgement. Other important aspects included are the observed inadequate disclosures on valuation methodologies and the shortcomings of current sensitivity analysis reporting.

Through the eyes of management

As implied in paragraphs 40 and 52, business model heterogeneity is the most frequently cited justification for having disclosure made through the eyes of management. It is hard to argue with the contention that corporate managers do indeed have a superior grasp of the idiosyncrasies of their specific entities. Yet the notion that 'through the eyes of management' disclosure suffices to provide optimal investor requirements overlooks several realities of the investment process. Specifically the reality that investors allocate capital on the basis of a cross sectional view across industries and across firms within an industry. Investment analysis is based on comparative attributes and therefore the importance of comparability of information cannot be overstated. Providing comparable information that contributes to an investor's appreciation of relative risk return prospects is more relevant than perfect entity specific information. A 2007 CFA Institute study showed that 77% prefer a standardised presentation of information.

As was evident from the study conducted by Price Waterhouse Coopers and Fitch Ratings, 'Through the eyes of management' disclosure can result in significant variation across firms and across reporting time periods. Rather than relying on a wholesale through the eyes of management approach the standard setters and regulators should define and mandate a threshold level of meaningful comparable accompanying note information. Management should then have the discretion of exceeding this threshold when they want to convey greater insights of their entity specific circumstances. The ongoing acceptance and application of the three level valuation hierarchy is a good example of the type of minimal disclosure threshold that is meaningful to investors yet it does not constrain managers from conveying additional specificities of their business models.

[4] Quality gaps are differences in the rating of quality and importance (a five-point scale was used, with 5 as very important and high quality). A wide, negative gap is a quality deficit indicating that the information quality is deficient relative to its importance.

In defining the threshold of minimal disclosure, the standard setters and regulators should continue to seek user views on the type of information that is useful and we would encourage the development of a user oriented overall disclosure framework.

Additional areas of consideration

Aggregation
Beyond stating that aggregation should occur based on issuer judgement the paper does not provide any detailed principles on the aggregation approach that would be informative for users. This is an area where finding the right balance between 'too summarised' and 'too granular' is important. Aggregation can occur by risk type and by instrument. The point of reference in determining useful information should be user feedback and clearly more work needs to be done.

Sensitivity Analysis
Sensitivity analysis is crucial to conveying the range of outcomes possible as acknowledged in the consultation paper. The appropriate sensitivity analysis is under-developed in this consultation. Similar to aggregation, more guidance is required on the sensitivity analysis that is relevant to users. The earlier mentioned Fitch Ratings and Price Waterhouse studies of a cross section of disclosures highlighted the variability and shortcomings in the quality of some of the sensitivity analyses currently available under IFRS 7 reporting. Some useful considerations to improving sensitivity analysis include:

- It is necessary to segment between forward looking and retrospective sensitivity analysis
- Symmetrical risk analysis is necessary. Investors are interested in knowing the upside and downside potential of the assets and liabilities held.
- Multifactor risk analysis is more informative than a single factor sensitivity analysis. This is especially the case due to the correlation of key risk factors e.g. liquidity risk and counterparty credit risk. Hence a sensitivity analysis that captures the interaction of key risk factors is informative to investors.
- As highlighted in the Fitch Report, there is a need to balance the level of aggregation in sensitivity analyses. Too much aggregation could offset countervailing risk factor effects, yet highly disaggregated sensitivity could provide information overload to investors.

Valuation Methodologies
We believe that disclosure of valuation methodologies is important because it informs investors about the uncertainty and fragility of inputs to and outputs from valuation models. Valuation methodology disclosure should include information about:

- Model limitation disclosures
- Valuation forecast error (i.e. differences between the internal model valuation and the exchange value realised)
- Effect of credit risk deterioration and the credit value adjustments

Tabular Format
We agree with the proposal to have a tabular format of presentation made in paragraph 60. The tabular presentation helps to make the information accessible and comprehensible to investors.

Q4: Do you agree that the benefits of the presentation of disclosures regarding financial instruments in illiquid markets outweigh the costs of preparing this information?

We agree. The credit crisis has reinforced the importance of adequate disclosure and highlighted the perils of capital misallocation due to opacity on risks undertaken by financial institutions. The benefits of transparency for capital markets far outweigh the incremental information processing costs.

CLOSING REMARKS

If you, other board members or your staff have questions or seek further elaboration of our views, please contact either Vincent T. Papa, CFA, by phone at +44.207.531.0763, or by e-mail at vincent.papa@cfainstitute.org, or Patrick Finnegan, CFA, by phone at +1.212.754.8350, or by e-mail at patrick.finnegan@cfainstitute.org.

Sincerely,

/s/

Charles Cronin, CFA
Head of EMEA Centre
Council

/s/ Gerald I. White

Gerald I. White, CFA
Chair, Corporate Disclosure Policy

cc: Corporate Disclosure Policy Council