

BDC ROUNDTABLE

John J. Mahon, Sutherland

September 16, 2009

Fair Value: The Continuing Development of FAS 157

Attorneys Serving Clients Around the World

SUTHERLAND

ATLANTA AUSTIN HOUSTON NEW YORK WASHINGTON DC

www.sutherland.com

Overview of FAS 157

- FAS 157 requires that public companies' financial instruments generally be valued at their current market price (i.e., "mark to market")
- Three tier approach:
 - Level 1: market value is established using observable market prices
 - Level 2: market value is established using inputs based on observable prices
 - Level 3: assets have little observable market inputs and are typically characterized by an illiquid market

Interaction with 1940 Act

- FAS 157 – “Fair value is 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.”
- 1940 Act – “Fair value as determined in good faith by the board of directors.”
- ARS 113 and ARS 118 – Securities for which “market quotations are readily available” must be valued at current market value.

Where there is a thin market in the security and market quotations are not readily available, use fair value as determined in good faith by the board of directors.

Recent Controversies

- When has a market become “inactive?”
- When is a market transaction “disorderly” or “distressed?”
- Issues mostly came to the forefront as a result of recent severe economic downturn
 - Tightening of credit reduced secondary demand in syndicated and securitized debt markets
 - Adverse economic conditions forced increasing number of “fire-sale” situations in the same markets
 - Holders of those debt securities were faced with sometimes irrational mark-downs on debt securities where the borrower remained financially stable
- Congressional and public pressure to “fix” the problem

FASB Responds

- FASB initially adopted FAS 157-3 to provide guidance on valuing assets in an inactive market
 - Provided limited guidance on when a market had become “inactive”
 - Generally focused on using alternative scenarios to value securities in an inactive market
- In response to Congressional and public pressure, FASB then adopted FAS 157-e
 - Provided guidance on when a market was “inactive”
 - Generally presumed that transactions in an inactive market were “distressed”
- FASB then adopted a final version of the guidance set forth in FAS 157-e in FAS 157-4
 - Removed the presumption that inactive markets only had distressed transactions
 - Proscribed more concrete criteria for evaluating markets and transactions under FAS 157
 - Included an annual and quarterly disclosure requirement regarding valuation techniques and related inputs

Overview of FAS 157-4

- Two-step analysis:
 - Is a market “inactive?”
 - Is a transaction “disorderly” or “distressed?”
- If both apply, then Level 2 or Level 3 analysis may be applied
- FAS 157-4 also included proposed valuation scenarios where an issuer may be unable to determine if a transaction is “distressed,” such as when the volume within a market has materially decreased
- FAS 157-4 also implemented an annual and quarterly disclosure requirement reflecting:
 - The inputs and valuation techniques applied during the covered period to measure fair value, and
 - A discussion of changes in valuation techniques and related inputs from prior periods

When is a market “inactive?”

Factors to consider include:

- Whether there were only a few or less recent transactions;
- Whether price quotations are based on current information;
- Whether price quotations vary substantially either over time or among market makers;
- Whether indexes that previously were highly correlated with the fair values of assets are demonstrably uncorrelated with recent fair values;
- Whether implied liquidity risk premiums, yield or performance indicators are significantly higher for observed transactions or quoted prices when compared to reasonable estimates of credit and other non-performance risks;
- Whether the bid-ask spread is abnormally wide;
- Whether there has been a significant decline or absence of a market for new issuances of the asset or liability;
- Whether sparse public information is available; and
- Other information available to the issuer determining fair value

When is a transaction “distressed?”

Factors to consider include:

- Whether there was inadequate exposure to the market prior to the measurement date for usual and customary marketing activities;
- Whether the asset or liability was only marketed to a single market participant, even though the usual and customary marketing activities occurred;
- Whether the seller is in or near bankruptcy;
- Whether the seller was required to sell because of regulatory or legal requirements; and
- Whether the transaction price is an outlier compared to other recent transactions

If the weight of the evidence suggests:

- the transaction is distressed, the entity should use a valuation technique that places little significance on the observed market price and look at Level 2 or Level 3 inputs
- the transaction was orderly, the entity should utilize the observed market price in its valuation technique. The weight the entity gives to this observed market price in an inactive market, however, should be based on the facts and circumstances. Accordingly, entities should look at factors such as volume of the orderly transaction, the comparability of the asset or liability being measured at fair value to the orderly transaction's asset or liability and the proximity of the orderly transaction to the measurement date
- the entity does not have sufficient information to determine whether a transaction is orderly, the entity should consider the transaction price when determining fair value, or market risk premiums, but this transaction price should not be determinative of fair value

Impact of FAS 157-4

- In an inactive market, even a transaction price that is “orderly” must be evaluated and weighed in context
- Provided a basis to evaluate other inputs in addition to transaction price in certain scenarios, even where a market ostensibly exists
- Implementation of FAS 157-4 has led to some significant upticks in fair values in subsequent periods
- More reflective of 1940 Act valuation process and determination of whether “market quotations are readily available” for valuation purposes