

Unwise Political Tampering With the Markets – The Hue and Cry About Marking to Market

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The financial news this week is dominated by the Bail Out Plan that is currently in legislative purgatory. As I write, the Senate has passed a sweetened version of the package, and all eyes are on the House. Meanwhile, the markets, which reacted to the rejection of the first Bail Out Plan by the House with the largest single-day market decline in its history, have reacted to news of its resuscitation with a further decline. Unemployment is up, and factory orders are down. The markets clearly think that a bail out will not prevent a prolonged recession.

It is only natural when things are going bad to fix blame on someone. The scapegoat in the current crisis has been the SEC and most especially its current chairman, Christopher Cox. Last week, we wrote that the SEC emergency short selling orders were in response to political pressure. Why else, at this critical time, do we react to a crisis in the debt markets with rules that only affect the equity markets? While the credit markets have descended into chaos, the National Market System in equities continues to function quite well. Trading is orderly and rational. Price discovery goes on unabated. The political call for action seeks to fix things that aren't broken. It is hard to imagine a better way to make things worse.

The political hounds baying for the SEC's blood are now after the mark to market rules.

Fundamentally, the value of any equity security is a function of two variables: The current net worth of an issuer, and the net worth of the issuer in the future. Net worth is simply the assets of an issuer, less its liabilities.

The future is, of course, inherently unpredictable. As a result, investors will disagree about the likelihood of future events and their effect on an issuer's net worth. The inherent unpredictability of future events is what markets are all about. Investors will disagree about the future, so that at any particular price, there will be buyers and sellers.

There is much less disagreement about current values. Current net worth is what financial statement disclosure for public investors is all about.

Before the mark to market rules, accountants generally valued assets on the balance sheet at their acquisition prices, with a discount for depreciation. This approach would generally be an appropriate way to value machinery used in a company's business. The machine would be expected to produce stuff for a certain period of time and eventually retired when obsolete. This approach to valuing assets was known as "historical cost."

However, the historical cost method of valuing assets was not a particularly useful way to value land, securities and other financial assets that can be expected to appreciate in value over time. However, it is also true that the value of financial assets involve a prediction about future events.

The mark to market rules therefore reflect something of a compromise. It is clear that historical cost does not provide the information investors need to know to assign a current value to an issuer. However, it wouldn't be useful if an issuer could simply make something up. So, the rules essentially state that, where there is a market for the asset, or something very similar to the asset, an issuer must value the asset at its value in the market.

In the current credit crunch, the market has severely marked down debt instruments. The reason for this is that there were a lot of defaults. The value of debt is a function of the likelihood that it will be repaid and current interest rates. Buyers in the market for debt will reduce their offering prices as the probability of default increases. This is a rational response to increasing default risk.

Now, however, it is argued that the market has irrationally exaggerated the probability of default. If buyers are wrong – there will actually be fewer defaults than predicted – then debt instruments are undervalued. But, that's a big if.

There is no question that the market doesn't do a very good job of predicting the future. There is no inherent reason why any stock should be ten percent more valuable today than it was last week. All that tells us is that it is hard to predict the future. But the market is something like democracy, the worst of all governments, except for all the others. The market at least reflects a consensus view about the future, which is a better predictor of future events than any other source available to mortal humans.

In response to political pressure, the SEC this week produced a "clarification" that essentially invites issuers to ignore market prices when transactions are "disorderly." The idea is that if people are being forced to sell under "fire sale" conditions, the market might not be functioning properly.

Certainly, if we were talking about a situation where someone had to sell an asset immediately that very few people wanted, the buyer might take advantage of the

seller by offering a price that did not reflect the buyer's future expectations. But, I submit that this is not what is occurring in the debt markets at this time. Instead, people rationally are expecting that there will be lots of defaults in the future, so the value of debt instruments is low. I am certain that whatever price is being offered is probably wrong. What else is new? Every price is wrong because the future is unpredictable.

As the SEC says in its clarification: "Determining whether a particular transaction is forced or disorderly requires judgment." But, whose judgment? The issuer with every incentive to lean on the balance sheet, or the impersonal market guided by greed and fear? Every issuer I have represented has at one time or another expressed the belief that the market was wrong, that factors other than the investor expectations were causing the market to undervalue their stock. Every trader that has bet wrong on a stock thinks the market got it wrong and can cite a hundred reasons for its disorderliness. However, the market rewards those who get it right more often than not, and punishes severely those who get it wrong. Unlike the issuer, the incentives on market participants to get it right are enormous.

The fact is that disorderly conditions have a way of disappearing rather rapidly as rational actors see opportunities for profits. To quote the SEC again: "In general, the greater the decline in value, the greater the period of time until anticipated recovery, and the longer the period of time that a decline has existed, the greater the level of evidence necessary to reach a conclusion that an other-than-temporary decline has not occurred." The debt markets have been in decline for a while. If recent unemployment statistics are any guide, there are good reasons why debt is so difficult to sell at less than "fire sale" prices.

The credit markets are also cursed with another problem. Some credit markets have completely broken down. There are no buyers. The reason for this is that buyers are concerned that seller will try to offload debt instruments they know to be bad. This introduces an element of risk to the market resulting from a lack of disclosure. If buyers were sure they knew the facts known to sellers, they would offer higher prices. Not as high as sellers would like, but prices based on buyers' beliefs about the future. At present, a buyer's offering price has to take into account the risk of non-disclosure; as that risk increases, the gulf between buyers and sellers widens. The market dries up so that all prices resemble fire sales.

The abandonment of mark to market principles amounts will cause a clouding up of financial disclosure so that investors will not be sure as to the current market value of an issuer's assets. Equity market prices will then reflect a lack of good disclosure, which will tend to make them dysfunctional too, just like the credit markets.

This is a really dumb idea.

I received an email last week from a General Electric employee who took strong exception to last week's column. He wrote: "You do not understand the mechanics of the market, do not understand the past, present, and apparently future laws as they pertain to a short sale, and worst of all, you fail to recognize that there is no black and white in a system full of greed."

I expect this week's column will be equally well received in some quarters. Thankfully, our firm still has some clients who feel differently. That's the nature of the market in legal services.

I am always delighted to hear from readers, if for no other reason than to know there are some. And, I was astonished to learn that anyone outside the trading industry reads this column. Please keep those cards and letters coming.

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