Invested in America

April 28, 2011

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Technical Director
File Reference No. 2011-100
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: Proposed Accounting Standards Update: ***Balance Sheet (Topic 210) Offsetting***

Dear Ms Cosper:

The Dealer Accounting Committee of the Securities Industry and Financial Markets Association[1] appreciates the opportunity to provide comments on the Financial Accounting Standards Board's ("FASB" or the "Board") exposure draft regarding offsetting of financial assets and financial liabilities (the "Exposure Draft"). Given the material differences between the FASB and the International Accounting Standards Board ("IASB") models on offsetting, particularly in respect of derivatives and repurchase agreements, we applaud your decision to seek convergence in this important area. We believe, however, that the Board has chosen the wrong model for convergence. For the reasons noted below, we do not believe that the proposed Exposure Draft will result in an improvement to U.S. generally accepted accounting principles ("GAAP") and, therefore, do not support the Exposure Draft as a basis for convergence.

Key Messages

- Our views are consistent with the Alternative Views expressed in paragraphs BC81-BC84 of the Exposure Draft.
- Net presentation provides more relevant balance sheet information about a reporting entity's credit risk and liquidity profile than gross presentation for derivative receivables and payables subject to an enforceable master netting agreement or equivalent. Neither

[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

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gross nor net presentation of derivative receivables and payables provide relevant market risk information.

- The standard-form International Swaps and Derivatives Association ("ISDA") Master Agreement effectively (and legally) consolidates individual derivatives, executed as confirmations to the master agreement, into a single agreement between the parties, which should provide the basis for net balance sheet presentation of derivative receivables and payables, including related receivables for the right to reclaim associated cash collateral and payables for the obligation to return associated cash collateral.
- Variation margin for exchange-traded derivatives constitutes settlement and should be recognized accordingly. Variation margin posted for centrally cleared derivatives represents advance payment for settlement of the position, which should provide the basis for net balance sheet presentation.
- Repurchase and reverse repurchase agreements with the same counterparty maturing on the same day should be presented net if subject to a settlement mechanism that results in the functional equivalent of net settlement.
- A broker-dealer's receivables and payables from unsettled regular-way securities transactions should be presented net in the balance sheet given that the amounts are fully collateralized on trade date, the time between trade date and settlement date is very short, and the amounts generally settle through clearing organizations.
- The proposed disclosure requirements duplicate other U.S. GAAP disclosure requirements, attempt to provide information that is not relevant to the offsetting of assets and liabilities and, in certain circumstances, will be costly and burdensome to produce.

We agree with the Board's objective, as stated in paragraph 5 of the Exposure Draft, that eligible assets and eligible liabilities should "be presented in the financial statements in a manner that provides information that is useful for assessing: a) the entity's ability to generate cash in the future (the prospects for future net cash flows), b) the nature and amounts of the entity's economic resources and claims against the entity, and c) the entity's liquidity and solvency." We do not believe that the Board's proposed guidance, as specified in the Exposure Draft, meets the above noted objectives for certain assets and liabilities. Application of this guidance will require gross presentation of most derivative receivables and payables, most repurchase and reverse repurchase agreements and all receivables and payables from unsettled regular-way trades, which for member firms will obscure true credit risk positions and liquidity profiles, and provide misleading views of future cash flows given the way in which derivatives settle. This distorted view could impact a reporting entity's capital ratios, funding options, and tax liabilities.

We believe current U.S. GAAP offsetting principles, as set out in ASC 210, ASC 815 and ASC 940-320-45-3, augmented by enhanced disclosures, provide more relevant information about the reporting entity's credit risk and liquidity profile for qualifying derivative receivables and payables, repurchase and reverse repurchase agreements and receivables and payables from unsettled regular-way trades.

It is interesting to note that when issuing FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (now codified in ASC 210), the Board quoted similar principles to those put forth in the Exposure Draft as their basis for allowing offsetting of derivative receivables and payables with the same counterparty,[2] yet the Board is now using virtually the same objective to forbid offsetting. We see developments in derivatives markets (since 1992, when FIN 39 was originally issued) reinforcing the relevance of net reporting, that is, increased use of collateral, central clearing, and legislative changes to make netting more enforceable.

Derivatives

Section II, C of the FASB *Rules and Procedures* (Amended and Restated through February 28, 2011) states that to accomplish the Board's mission, the FASB acts to "improve the usefulness of financial reporting by focusing on the relevance and faithful representation of financial information." We do not believe that requiring gross presentation of derivative receivables and payables, when executed with the same counterparty under an enforceable master netting agreement, provides relevant information. These proposed principles will not provide faithful and relevant information about cash flows, liquidity risk and credit risk, and will not improve the quality of information provided in balance sheets of member firms.

In the following sections, we describe the three principal categories of derivatives, determined by reference to their contractual and settlement characteristics, and provide an overview of their typical terms and settlement processes. For each, we evaluate the proposals in the Exposure Draft as applied thereto.

Derivative Categories

A derivative is a risk transfer agreement, the value of which is derived from changes in the price of a specified asset or a rate. The underlying asset could be a physical commodity, a company's equity shares, an equity index, a currency, or the underlying could be a rate (e.g., LIBOR) or virtually any other observable variable upon which parties can agree. Derivatives are required to be recognized at fair value, which is the net present value of a derivative contract's estimated future cash flows.

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[2] Paragraph 20 of FIN 39: "FASB Concepts Statement No. 1, Objectives of Financial Reporting by Business Enterprises, paragraph 37 , states that ". . . financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise" (footnote reference omitted). The amount of credit risk exposure—the amount of accounting loss the entity would incur if the counterparties to forward, interest rate swap, currency swap, option, or other conditional or exchange contracts failed to perform in accordance with the terms of those contracts—is one indicator of the uncertainty of future cash flows from those instruments."

Derivatives fall into the following three categories[3]:

1. Over-the-counter (OTC) derivatives, which are customized, bilateral agreements that transfer risk from one party to the other. OTC derivatives are negotiated privately between the two parties and then booked directly with each other.
2. Exchange-traded derivatives, which are known generically as listed options and futures. In contrast with OTC derivatives, listed derivatives are standardized derivatives that are executed over a centralized trading venue (an exchange) and then booked with a central counterparty (CCP) otherwise known as a clearing house.
3. Centrally cleared derivatives, which like OTC derivatives are negotiated bilaterally, but like exchange-traded derivatives are novated to a CCP such that the original parties to the contract face the CCP directly or through clearing member agents of the CCP (the CCP stands in between every transaction becoming buyer to every seller and seller to every buyer).

OTC Derivatives

OTC derivatives are commonly executed as confirmations subject to a standard-form ISDA Master Agreement, otherwise known as a master netting agreement (MNA). The MNA is a document agreed between two parties with standard terms that apply to all the derivative confirmations entered into between those parties. Each time that a derivative confirmation is executed, the terms of the MNA do not need to be re-negotiated as they apply automatically. When a new trade (confirmation) is executed, it modifies the entire agreement between the parties rather than forming a separate, divisible transaction. Individual confirmations conducted under the MNA, in aggregate, form a single contract. This is evidenced by the standard-form MNA, which states that: "All Transactions are entered into in reliance on the fact that this Master Agreement and all Confirmations form a single agreement between the parties (collectively referred to as this "Agreement"), and the parties would not otherwise enter into any Transactions."[4]

This single agreement concept is integral to the structure and forms part of the netting-based protection offered by the MNA. The fact that all transactions are executed as part of one contract reinforces the ability to close out those transactions upon a termination event and arrive at a single net amount payable.

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[3] Much of this letter's description of derivatives and differences in derivative types is summarized from product descriptions provided by ISDA at (http://www.isda.org/educat/faqs.html).

[4] Section 1(c) of the 2002 MNA.

Credit Support Annex

The Credit Support Annex (CSA) to the MNA is optional but is widely used in most MNAs for OTC derivative transactions. The CSA is added if the parties agree that collateral is to be provided by a party if the exposure of one party to the other exceeds an agreed amount. The CSA contains provisions concerning the posting and return of collateral, the types of collateral that may be used, and the treatment of collateral by the secured party.

Termination and Close-out Netting[5]

Close-out netting is a process consisting of three parts. The first is early termination of transactions with the defaulting counterparty. The second is valuation of defaulted transactions under a contract. The third is calculation of the close-out amount as the sum of offsetting positive and negative replacement costs. If the defaulting party owes the close-out amount, the non-defaulting party can apply collateral posted by the defaulting party to satisfy all or a portion of its claim. If the non-defaulting party owes the close-out amount, it can set off the close-out amount against amounts owed by the defaulting party. The non-defaulting party then must pay any remaining amount to the insolvency administrator.

Many insolvency regimes around the globe permit termination and close-out netting, notwithstanding the imposition of a stay order or the appointment of a trustee or receiver.[6] In support of close-out netting, the U.S. Bankruptcy Code exempts participants in OTC derivative transactions covered by a MNA from the automatic stay provisions of the Bankruptcy Code and permits them to setoff obligations owed between the creditor and the bankrupt party even during the pendency of a bankruptcy stay order. These Bankruptcy Code safe-harbor protections are described in more detail below.

Given the above overview, we do not agree with the conclusion in BC45 of the Exposure Draft that in the context of offsetting, the unit of account is the individual transaction (individual confirmation) undertaken under the MNA. It is true that in the context of hedge accounting, the unit of account is the individual confirmation because derivatives can be accounted for in several ways, depending on an entity's commercial objectives and whether a hedge accounting

[5] Provided for in Sections 5 and 6 of the MNA. Events which can lead to termination of transactions before their intended maturity are events of default, which are summarized as events for which a party is at fault, such as a failure to perform under a transaction, breach of a representation or undertaking, and insolvency. Termination events may also include other events that, although no-one is at fault, warrant the early termination of the transactions, such as a change in tax law resulting in taxes being imposed on transactions, illegality, and a merger of a party resulting in a deterioration in its credit quality.

[6] ISDA has received legal opinions on the enforceability of netting in bankruptcy from 57 jurisdictions.

relationship is established and, if so, the type of relationship. Since establishing a hedge accounting relationship is fundamentally a risk and pricing analysis that considers an entity's commercial objectives, it is entirely appropriate to conclude that the unit of account for hedge accounting is the individual confirmation.

However, in the context of balance sheet presentation of derivatives receivables and payables, including related receivables for the right to reclaim associated cash collateral and payables for the obligation to return associated cash collateral, the unit of account analysis should naturally focus on legal structure and enforceability. Offsetting of derivatives receivables and payables should rely more on the structure and legal framework of the arrangement in question. Fundamentally, offsetting is about rights and obligations of the parties involved and therefore should follow the legal framework. Since these transactions are legally viewed as one contract and may be settled net upon close-out, they should be presented net in the balance sheet if the right of offset upon a termination event is enforceable.

In arriving at its decision to disregard the legal framework of the MNA and instead view individual confirmations subject to an MNA as separate assets and liabilities for balance sheet presentation, BC44 states the Board

> concluded that: a) each trade or transaction is exposed to risks that may differ from the risk to which the other trades or transactions are exposed, b) the pricing of the individual transactions is independent, c) each transaction is typically negotiated as a separate trade with a different commercial objective, d) each of the individual transactions represents a transaction with its own terms and conditions and is not meant to be performed concurrently or consecutively with other transactions, [and] e) an entity has separate performance obligations and rights for each of such transactions and each may be transferred or settled separately.

We address each of the Board's conclusions below in the context of offsetting:

(a) "each trade or transaction is exposed to risks that may differ from the risk to which the other trades or transactions are exposed" (BC44(a))

It is true that each individual derivative confirmation under a MNA may have different market risk exposures. However, each share counterparty credit risk, a significant input in the valuation of any individual derivative confirmation, which is informed by legal structure and is calculated in the aggregate for all confirmations subject to an enforceable MNA.

(b) "the pricing of the individual transactions is independent" (BC44(b))

The value and pricing of individual derivative confirmations subject to a single MNA is based, in part, on counterparty credit risk which is wholly dependent on the entire MNA contract. That is, the pricing of CVA[7] is based upon the net uncollateralized position of all derivative confirmations subject to a single MNA. Derivative transactions that are not subject to a MNA are valued differently than if the transaction were part of an enforceable MNA, since a MNA is a form of credit mitigation.

Additionally, if the MNA has a CSA, the value of any individual derivative subject to the MNA is determined inclusive of the related collateral posted pursuant to the CSA. For example, to value a LIBOR-based interest rate swap subject to an enforceable MNA with a CSA, the counterparties will identify the expected cash flows that they have agreed to pay to (or receive from) each other over the life of the swap and discount these cash flows at the rate at which each party will fund them. If the CSA, in this example, stipulated that interest on posted collateral is paid based on the daily fed funds rate (the holder of cash collateral must pay the other party a return on that collateral based upon the daily fed funds rate), then the fed funds rate would be the appropriate discount rate because a dealer with a derivative receivable funds the asset via the collateral payable. Said another way, the pricing of collateralized trades is inextricably linked to the return on the underlying collateral.

(c) "each transaction is typically negotiated as a separate trade with a different commercial objective" (BC44(c))

Users of derivatives often have a unique commercial objective for each derivative confirmation hence the reason hedge accounting has looked to the confirmation as the unit of account. However, individual derivative confirmations are also frequently executed to offset one or more existing derivatives subject to the same MNA thus effectively closing-out the original positions. Executing an offsetting derivative is typically a quicker and less expensive means of closing out open risk than terminating the original derivative confirmations. This approach to closing out open contracts is also prevalent with centrally cleared derivatives, which are discussed below.

(d) "each of the individual transactions represents a transaction with its own terms and conditions and is not meant to be performed concurrently or consecutively with other transactions" (BC44(d))

As described above, each individual derivative confirmation is executed subject to the terms and conditions of the governing MNA. That is, when a new derivative confirmation is executed, it modifies the entire agreement between the parties rather than forming a separate, divisible transaction. This is also true for exchange-traded and centrally cleared derivatives which are described below.

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[7] Credit value adjustment (CVA) is the difference between the credit risk-free portfolio value and the portfolio value that considers possibility of a counterparty's default, legal structure, enforceability, collateral and other credit risk mitigants. In other words, CVA is the market adjustment for counterparty credit risk.

When subject to a CSA, individual derivative confirmations under a MNA are "performed concurrently or consecutively with other transactions" subject to the same MNA. This is because periodic collateral payments are determined based upon the uncollateralized net fair value of all derivatives confirmations subject to a MNA.[8] So a party's obligation to perform under any individual derivative confirmation is linked to their obligation to perform under all derivatives subject to the same MNA.

> *(e) "an entity has separate performance obligations and rights for each of such transactions and each may be transferred or settled separately" (BC44(e))*

We described above how an entity does not have separate performance obligations, but rather how the MNA governs an entity's performance obligations for all derivative confirmations subject to the MNA. Parties to an MNA do not have the ability to transfer or settle an individual derivative confirmation separate and apart from other confirmations subject to the same MNA. Any such transfer requires the consent of the other party to the MNA.

The transfer of rights and obligations of a derivative confirmation is known as a "novation". In a novation, with the consent of all parties, one contract is entered into in substitution for and supersession of another contract. Consent of all parties is a key ingredient for novation, and accordingly under Section 7 of the MNA, neither a MNA nor any interest or obligation in or under that agreement (for example, a confirmation) may be transferred by either party without the prior written consent of the other party, subject to certain limited exceptions.[9] This is important since the MNA is a form of credit mitigation. One party to a MNA that contains multiple derivative confirmations will normally not consent to the novation of an individual derivative payable (payable to the party seeking to 'sell' their derivative asset) separate from the derivative receivables, since their derivative payable mitigates their credit risk on the derivative receivables.

Lastly, in deliberating FIN 39, the Board acknowledged the 'single agreement concept' of a MNA and looked to this legal view and resulting credit mitigation as one reason why offsetting should be permitted for contracts executed with the same counterparty under a legally enforceable MNA. Paragraph 21 of FIN 39 notes that the "board decided to permit offsetting of the fair value recognized for forward, interest rate swap, currency swap, option, and other conditional or exchange contracts if they are executed with the same counterparty under a master netting arrangement. That arrangement effectively consolidates individual contracts into a single agreement between the parties. The failure to make one payment under the master netting arrangement would entitle the other party to terminate the entire arrangement and to demand

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[8] Collateralized derivatives are discussed in more detail, below, under the section: Usefulness of information provided.
[9] From the "User's Guide to the 2004 ISDA Novation Derivatives"

the net settlement of all contracts. The Board believes that an exception to the requirement of paragraph 5(c) of this Interpretation, which states that

> the reporting party intends to set off" is justified when a master netting arrangement exists because the net presentation discloses the amount of credit risk exposure under that arrangement. The Board decided that, given a master netting arrangement, presentation of the aggregate fair values of the individual contracts executed under that arrangement would not provide more information about the uncertainty of future cash flows from those contracts than net amounts would.

We believe that, despite the market crisis of 2008, nothing has changed to alter this conclusion. In fact, since FIN 39 was adopted, jurisdictions around the globe have passed legislation to further enhance the rights of parties to derivatives contracts to close-out and net their positions under a MNA.[10]

Exchange-traded Derivatives

The key differences between OTC derivatives and exchange-traded derivatives are:

- The terms of an exchange-traded derivative – including delivery places and dates, volume, technical specifications, and trading and credit procedures – are standardized for each type of contract. For OTC derivatives, the same characteristics are subject to negotiation by the parties to the contracts.
- Exchange-traded derivatives are always traded on an exchange, while OTC derivatives are traded on a bilateral basis.
- Those who engage in exchange-traded derivative transactions assume exposure to default by the exchange's CCP; for OTC derivatives, the exposure is to default by the counterparty to the extent not collateralized.
- Credit risk mitigation measures, such as daily mark-to-market and variation margin posting, are automatically required for exchange-traded derivatives but currently optional for OTC derivatives.
- Exchange-traded derivatives are generally subject to a single regulatory regime in one jurisdiction, while OTC derivatives – although usually transacted by regulated firms – are transacted across jurisdictional boundaries and are primarily governed by the contractual relations between the parties.
- By their design, exchange-traded derivatives may be sold ("closed-out") at any time prior to their expiration, as compared with OTC derivatives, for which a close-out must be negotiated by the counterparties.

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[10] This includes the 2005 amendments to the US Bankruptcy Code, and the recent enactment in multiple states of netting protections for insurers.

A futures contract is one example of an exchange-traded derivative. Under a futures clearing arrangement, the variation margin or maintenance margin is not collateral, rather it is settlement (a daily payment of profits and losses). Futures are marked-to-market daily by the CCP with the current price compared to the previous day's price to determine the daily settlement price. The CCP then computes a single net amount due from or payable to each member based on the settlement price applied to the member's aggregated and netted end-of-day position.[11] This variation margin may be paid/received instantaneously through the use of Protected Payment System ("PPS") accounts, or on a T+1 basis via wire. Certain other exchange-traded derivatives, such as listed options, settle in the same way.

Variation margin with exchange-traded derivatives permits the counterparties to fully realize any daily mark to market profit or loss on their open risk positions. Upon payment of the variation margin, a party is generally deemed to be long or short the net position of its various contracts at the settlement price at the close of the trading day.[12] In other words, variation margin settles all contractual amounts due or receivable at their current market value, and re-establishes any open position of the trading partner as if such position were acquired at the opening of the following day's trading. Logically, for exchange-traded derivatives, this practice facilitates the ability of the trading parties to close out (i.e., sell) derivatives at any time prior to their expiration date without the need for subsequent settlement payments (other than the difference in the trading price from the time the prior variation margin was calculated).

Under U.S. GAAP and international financial reporting standards ("IFRS"), the above payments are recognized as settlement; not "collateral". "Collateral" is a term that may have numerous technical meanings under the laws or regulations of various jurisdictions. However, it is generally considered to be property pledged by a borrower to protect the interests of a lender.[13] The conveyance of un-restricted cash is, however, not a "pledge" of collateral. With exchange-traded derivatives, neither party has a right or obligation to refund amounts paid as variation margin. Any subsequent payments amongst the parties are based on subsequent fluctuation in the market price of the subject derivative.

Given that variation margin for futures and other similar exchange-traded derivatives is legally settlement, we are bothered by the proposed guidance in C14 which views margin for all derivatives as collateral. Specifically, C14 of the Exposure Draft states:

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[11] The CME refers to its daily closing price as the "settlement price" (Rule 813) and requires its members to pay a "settlement variation" per Rule 814, as follows: "When a clearing member is long or short any amount of any futures contract at the end of the trading day, as indicated by its clearing memoranda, settlement shall be made with the Clearing House to the settlement price for that day, and such member shall be liable to pay to, or entitled to collect from, the Clearing House any loss or profit, as the case may be, represented by the difference between the price at which the commodity was bought or sold and the settlement price of the commodity at the end of the trading day."

[12] Certain central counterparties require intra-day margin or operate on a 24 hour basis. However, variation margin arrangements function in much the same way as described above.

[13] Merriam-Webster Dictionary

> Many financial instruments, such as interest rate swap contracts, *futures contracts, and exchange-traded written options*, require margin accounts. Margin accounts are a form of collateral for the counterparty or clearing house and may take the form of cash, securities or other specified assets, typically liquid assets. Margin accounts are assets or liabilities that are accounted for separately. [Emphasis added]

We are concerned that in drafting C14, the Board may not have anticipated the complexities and nuances of the settlement processes of exchange-traded derivatives and the consequential effects thereof. We therefore request the Board to delete paragraph C14 of the Exposure Draft.

Centrally Cleared Derivatives

The key differences between OTC derivatives and centrally cleared derivatives are:

- As mentioned above, OTC derivatives are booked bilaterally between the counterparties while centrally cleared derivatives are booked with a CCP. OTC derivatives counterparties therefore assume counterparty credit risk to each other while cleared derivatives counterparties are exposed to credit risk of the CCP.
- Cleared derivatives always involve the posting of variation margin to the CCP by the parties to a trade, while margining by OTC derivatives counterparties is subject to negotiation by the parties.
- The terms of OTC derivatives can be customized to fit the needs of the contracting parties. The terms of cleared derivatives, in contrast, involve a high degree of standardization. The reason for standardization of cleared derivatives is to facilitate the computation of required variation margin.

Similar to concerns identified with exchange-traded derivatives above, we also have concerns regarding the Board's proposed margin guidance in C14 of the Exposure Draft as it relates to centrally cleared derivatives. Many entities currently offset the market values of centrally cleared derivatives with posted cash variation margin on the basis that the cash variation margin represents a payment for settlement of the cash flows arising on the centrally cleared derivatives. As noted above, C14 of the Exposure Draft specifically requires that "margin" advanced against derivative contracts be presented separately, regardless of the arrangement.

We do not agree with the proposed prescriptive requirement for the recognition of variation margin paid/received on centrally cleared derivatives. We believe that in many circumstances variation margin for cleared derivatives is in-substance settlement of the net position. We encourage the Board to consider the economic substance of the underlying operational settlement practices which have been designed to ensure that all credit and liquidity risk is closed out between counterparties and that profit and loss is realized on a daily basis. In most instances, these mechanisms constitute an economic and functional equivalent to settlement (i.e., the entities have, in effect, a single net financial asset or liability as with exchange-traded derivatives).

We understand that the Board may be concerned about creating an implied in-substance-defeasance model within the offsetting guidance. Historically, the in-substance-defeasance accounting concept generally contemplated property placed in an escrow fund (i.e., the creditor has a security interest in the property, but is not in control of unrestricted cash). Where the settlement mechanism is constructed such that the counterparty has received unrestricted cash in the full amount of any obligation outstanding with no present obligation to refund such amount, we believe that the creditor's claim has been de facto settled. We do not believe that such an arrangement should be analogized to in-substance-defeasance.

Repurchase and reverse repurchase agreements

Repurchase agreements (repos) refer to a type of financing transaction in which a borrower acquires funds by selling securities or other financial instruments (e.g., loans) and simultaneously agreeing to repurchase the same or similar instrument after a certain time at a given price (plus interest at an agreed-upon rate). When viewed from the perspective of the borrower of the funds the transaction is referred to as a repurchase agreement and, if viewed from the lender, a reverse repurchase agreement (reverse repo).

While classic repos are generally credit-risk mitigated instruments, there are residual credit risks. Though it is essentially a collateralized transaction, the seller may fail to repurchase the securities sold at the maturity date (the repo seller defaults on his obligation). Consequently, the buyer may keep the security, and liquidate the security in order to recover the cash lent. The security, however, may have lost value since the outset of the transaction as the security is subject to market movements. To mitigate this risk, repos often are over-collateralized as well as being subject to daily mark-to-market margining. Conversely, if the value of the security rises there is credit risk for the borrower in that the creditor may not sell the securities back. If this is expected to happen then the borrower may negotiate a repo which is under-collateralized. Credit risk associated with a repo is subject to many factors: term of repo, liquidity of security, the strength of the counterparties involved, etc.

Many securities transfer systems are structured so that the record of ownership is transferred and the associated cash payment is made based on the gross amount of each transaction on a delivery-versus-payment basis. Currently, most systems are equipped to settle transactions in different securities separately; that is, only on an individual basis at gross amounts. Offsetting securities transactions cannot be settled simultaneously. However, major clearing systems maintain features to mitigate intra day credit and liquidity risk (e.g., via daylight overdraft credit provided by a clearing bank).

In arriving at the current U.S. GAAP guidelines for offsetting repos and reverse repos, the Board considered the functioning of securities settlement systems and associated risk mitigants and concluded that if certain risk mitigants (including the existence of a master netting agreement) and other conditions are met, "then settlement, while on a gross basis, may be considered for accounting purposes as the functional equivalent of net settlement from the perspective of the parties to repurchase and reverse repurchase agreements that have the same settlement date. The Board noted that the constraints of settlement that require a same-day transfer of the gross amounts may not have a gross economic effect on the parties, since only net amounts are required to be available if daylight overdraft or other intraday credit privileges are present."[14]

The "simultaneous settlement" requirement, as drafted in the Exposure Draft, is expected to change the application of both U.S. GAAP and IFRS to repos and reverse repos. We believe that the Board should keep its existing guidance for offsetting repos and reverse repos or develop a principled approach for "simultaneous settlement" based around substantial mitigation of credit and liquidity risk (the basis to the netting criteria currently provided in U.S. GAAP). The Exposure Draft's definition relies on instantaneous or point-in-time settlement that is not practical in even the most sophisticated clearing systems.

Specifically, paragraph 6(b) of the Exposure Draft specifies that a reporting entity must intend to either "settle the eligible asset or eligible liability on a net basis" or "realize the eligible asset and settle the eligible liability simultaneously" in order to meet the second criteria to apply offsetting. Paragraph 10 further stipulates that simultaneous is considered to be "executed at the same moment." We are concerned that this narrow interpretation of simultaneous settlement is overly restrictive and mixed in practice due to operational constraints of CCPs and clearing agents. Repos and reverse repos are typically executed between two counterparties but cleared through a CCP or central settlement system. Many widely used CCPs, such as the Fixed Income Clearing Corporation (FICC), settle repos and reverse repos with the same maturity date on a DVP[15] and RVP[16] basis in batches throughout the day due to the significant levels of transactions. The CCP typically calls for only one net payment per day from the clearing member for all settlements occurring on that day, utilizing a daylight overdraft feature or other intraday credit facility to fund the settlements. A reporting entity cannot track specific transactions cleared in each batch. As a result, it is not feasible to identify which transactions are in the same batch and are therefore settled at the same moment. However, all transactions are cleared on the same day and the economic effect is, in substance, the same as settlement at the same moment.

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[14] Paragraph 9 of the Basis to Conclusions of FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements.

[15] Delivery versus payment means that the buyer's payment for securities is due at the time of delivery. Security delivery and payment are simultaneous.

[16] Receive versus payment – the inverse of DVP.

Additionally, we understand that application of the Exposure Draft will be a significant change for IFRS preparers. At present, IAS 32.48 indicates that "simultaneous settlement of two or more financial instruments may occur through, for instance, the operation of a clearing house…in these circumstances the cash flows are, in effect, equivalent to a single net amount and there is no exposure to credit or liquidity risk. In other circumstances…realization of a financial asset and settlement of a financial liability are treated as simultaneous only when the transactions occur at the same moment." Many IFRS preparers have read this to mean that the operation of a clearing house for repos and reverse repos is deemed to constitute simultaneous settlement and it is only "in other circumstances" that the settlement has to occur "at the same moment" for the offset requirements to be met. In practice, these IFRS preparers have looked to the repo and reverse repo offsetting requirements in U.S. GAAP to identify whether the clearing house arrangements qualify for offsetting under IAS 32.48. As such, we recommend that the Board revisit the proposed guidance and interpretation of simultaneous settlement and amend it accordingly. The final guidance could either adopt current U.S. GAAP repo netting guidance or explicitly accommodate the operational functioning of the clearing houses in the interpretation of simultaneous settlement.

Unsettled regular-way trades

ASC 940-320-45-3 currently provides for net presentation of receivables and payables resulting from a broker dealer's unsettled regular-way trades. The Exposure Draft eliminated this guidance without public deliberation by the Board and with no reason articulated. We see no compelling reason why this industry-specific guidance has been altered as its application and usefulness have not been controversial. Additionally, we do not believe this change provides any relevant financial information given the majority of these trades settle in the ordinary course of business through DVP exchanges (with any failed settlement already subject to being grossed up). Given the information lacks relevance, but would be operationally complex to provide, we do not believe its requirement is justified on a cost-benefit basis.

Additionally, the Board proposes to delete 940-320-45-2 of the Codification. We question the need and reason for this proposed change, as this guidance is not related to offsetting. Rather, the paragraph provides balance sheet classification guidance for proprietary securities positions by stating that: "proprietary securities transactions entered into by a broker-dealer for trading or investment purposes shall be included in securities owned and securities sold, not yet repurchased." The paragraph merely says that a broker-dealer's long securities positions should be classified as 'securities owned' while its short securities positions should be classified as 'securities sold, not yet repurchased.' Possibly, the Board meant to amend 940-320-25-2, which by way of example provides offsetting guidance for unsettled regular-way trades.

Safe-harbor provisions for financial contracts

All of the contracts or transactions discussed above (OTC derivatives subject to an enforceable MNA, exchange-traded derivatives, centrally cleared derivatives, repos and reverse repos, and receivables and payables resulting from a broker-dealer's unsettled regular-way trades) share a common characteristic in that these contracts or transactions qualify for protection under Title 11 of the United States Code (the "Bankruptcy Code"). Section 362 of the Bankruptcy Code imposes an automatic stay, as of the commencement of a case, of virtually all acts and proceedings against the debtor or property of the bankruptcy estate, including exercise of setoff rights. However, in order to mitigate or eliminate market disruptions resulting from a debtor's bankruptcy and to ensure stability of the capital markets, Congress has provided for safe-harbor protections for these contracts and transactions within the Bankruptcy Code. The relevant safe-harbor provisions essentially: (a) immunize non-debtor parties from the automatic stay as it applies to the termination of contracts; (b) permit non-debtor parties to enforce *ipso facto*[17] termination provisions; (c) immunize non-debtor parties from avoidance actions; and (d) immunize non-debtor parties from the automatic stay as it applies to the set-off of mutual debts.[18]

Usefulness of information provided

The Board believes that application of their proposed principles for offsetting assets and liabilities, which will require gross presentation in most circumstances, will "provide information that is useful for assessing…the entity's ability to generate cash in the future (the prospects for future net cash flows)." (BC10(a)) The carrying value of derivative receivables and payables is not at all indicative of future cash flow movements. The carrying value (fair value) simply represents the net present value of the contract's estimated future cash inflows and outflows (shown as one net amount). This estimate of net future cash flows changes from day-to-day based on relevant market and other factors. Neither gross nor net presentation of derivative receivables and payables provides predictive information of future cash flows.

Elsewhere, the Board states that:

- "generally, presenting assets and liabilities net limits the ability of users of financial statements to assess the future economic benefits available to, and obligations of, the entity and their ability to assess the entity's financial strengths and weaknesses. Offsetting obscures the existence of some assets and liabilities and thereby reduces users' ability either to assess the entity's liquidity and solvency and its needs for additional financing or to predict how future cash flows will be distributed among those with a claim against the entity." (BC15)

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[17] Master agreements typically contain bankruptcy termination or "ipso facto" clauses. Thus, when a party terminates a master agreement, all transactions under that agreement terminate.
[18] Source: *Bankruptcy Code Safe-Harbor Provisions for Financial Contracts*, Michael L. Cook, Schulte Roth & Zabel LLP, March 2009.

- "gross amounts of derivative assets and liabilities are more relevant to users of financial statements than net amounts for assessing the liquidity or solvency of an entity. A derivative can generally be settled or sold at any time for an amount equal to its fair value. Thus, the Boards believe that gross amounts generally provide better information about the entity's derivatives portfolio and its exposure to risk." (BC21)

We disagree with these statements. The carrying value (fair value) of an individual derivative contract generally does not provide relevant information about its liquidity profile, because payments often occur at different amounts, at different times, and in different directions. All of a contract's future payments (cash inflows and outflows) are then condensed into a single fair value measurement. This lack of insight into the contract's liquidity profile gets compounded when multiple contracts, say in an asset position, are combined with other similarly classified contracts on the balance sheet.

Net presentation of derivative receivables and payables provides more insightful information regarding an entity's liquidity profile, for the following reasons:

- Credit rating contingent provisions, which may call for the reporting entity to post additional collateral on derivatives subject to a MNA or clearing arrangement, are generally based on the reporting entity's net derivative liability position not their gross derivative liability position.
- The vast majority of derivatives in the marketplace are collateralized. When subject to a CSA, periodic collateral payments (usually daily) are determined based upon the uncollateralized net fair value of all derivatives confirmations subject to a MNA. So when the reporting entity's net derivative liability position increases, they will be required to pay additional collateral on that net uncollateralized position. Collateral outflows for cleared derivatives and derivatives subject to a MNA and CSA are not based a reporting entity's gross derivative liabilities. Gross balance sheet presentation of derivative receivables and payables would vastly overstate the reporting entity's liquidity risk or profile.

Regarding the Board's stated belief that gross presentation of derivative receivables and payables will provide information "to predict how future cash flows will be distributed among those with a claim against the entity," we note the following:

- From the perspective of the defaulting party, gross derivative receivables subject to an enforceable MNA will normally not be available to general creditors of the entity upon a termination event (including bankruptcy), because counterparties to the MNA will typically elect to terminate, close-out and set-off contracts subject to the MNA. In which case, gross derivative assets will not be available to the general creditors of the defaulting party. They will only have a claim to the net derivative receivable or have no claim at all if a net derivative payable.

- From the perspective of the nondefaulting party, the individual derivative receivables do not represent resources to which general creditors of the entity have rights and individual derivative payables do not represent claims that rank equally to the claims of the entity's general creditors. Upon the nondefaulting party's termination of contracts subject to a MNA, gross derivative asset "resources" are not available to satisfy other claims.

These points are equally true for exchange-traded and centrally cleared derivatives.

Paragraph BC22 of the Exposure Draft states that:

> Gross presentation of derivative assets and liabilities also depicts a market assessment of the present value of the net future cash flows directly or indirectly embodied in those assets and liabilities, discounted to reflect both current interest rates and the market's assessment of the risk that the cash flows will not occur. Periodic information about the gross fair value of an entity's derivative portfolio (under current conditions and expectations), for example, should help users both in making their own predictions and in confirming or correcting their earlier expectations.

The Board is suggesting that gross presentation of derivative receivables and payables somehow displays information that is useful for understanding the reporting entity's market risk exposure. Presenting derivative receivables and payables on a gross or net basis bears no relationship to the reporting entity's market risk exposures. The balance sheet does not provide market risk information. Any market risk analysis is first and foremost based on an entity's net exposures from all recognized and unrecognized assets and liabilities (i.e., net positions from assets, liabilities, unrecognized firm commitments, etc., regardless of whether the exposure comes from derivatives, cash instruments, physical assets, etc.). Member firms disclose value-at-risk, stress tests, and other risk measures to inform financial statement users about market risk exposure.

Disclosure requirements

Rather than converge on gross presentation for derivative receivables and payables, repurchase and reverse repurchase agreements and receivables and payables from unsettled regular-way trades, as per the Exposure Draft, and thus provide less relevant information in the statement of financial position, we believe the better approach is to keep the current U.S. GAAP offsetting principles and provide enhanced and consistent disclosure to readily identify any difference with IFRS.

Current U.S. GAAP disclosure requirements already call for disclosure of derivatives assets and liabilities before the impact of counterparty netting, so any derivative netting benefit can be easily obtained. However, current U.S. GAAP disclosures currently do not provide for disclosure of the netting impact of repurchase and reverse repurchase agreements. While not all member firms have historically provided these disclosures because of the limited need for this information, if convergence were not achieved with respect to offsetting, we support disclosure of these amounts.

Cost-Benefit Analysis

Section II, D of the FASB *Rules and Procedures* (Amended and Restated through February 28, 2011) lists as a guiding principle in standard setting, that the FASB "issue(s) standards only when the expected benefits exceed the perceived costs. While reliable quantitative cost-benefit calculations are seldom possible, the FASB strives to determine that a proposed standard will fill a significant need and that the perceived costs it imposes, compared with possible alternatives, are justified in relation to the overall expected benefits." It was clear from the Board's outreach activities that there was no consensus on whether gross information or net information was more useful in the statement of financial position. As a result, we do not believe the Board has met its guiding principle nor do we see sufficient justification to substantially change the U.S. GAAP model that has proven robust though the years and more recent economic crises.

Additionally, we see no justification or cost-benefit analysis articulated in the Exposure Draft, leaving the impression that the Board has not analyzed the costs to preparers. We believe that any standard should properly explain the basis for concluding cost-benefit requirements have been met including assessment of the operational costs to be incurred, potential regulatory costs or changes required, potential resulting state and local tax liabilities and the basis for the need for changes to U.S. GAAP from the Board's outreach activities.

While we understand that financial reporting and regulatory governance do not share the same objective, and that certain regulatory regimes do not rely on financial accounting balance sheet measures, current regulatory requirements under Basel I, both in respect of leverage ratios and capital requirements, are sensitive to changes in gross assets and liabilities in the financial accounting balance sheet. We do not underestimate the time required for U.S. regulators to evaluate the need to modify the financial metrics currently derived from U.S. GAAP financial reports, particularly with respect to derivative contracts, in light of changes which will result if the offsetting proposals are adopted. Further, where accounting standards and regulatory rules differ, preparers will need to evaluate the differences and develop systems to calculate regulatory asset and liability balances separately from financial accounting records, as well as create processes to systematically reconcile these differences. These changes will not be without significant cost, particularly for U.S. preparers and, therefore, we believe such costs must be justified.

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If the Board were to adopt the Exposure Draft, we set out specific concerns we have on the provisions of the Exposure Draft in Appendix A to this letter.

We hope you find our comments helpful. Should you have any questions or require further information concerning any of the matters discussed in this letter, please do not hesitate to contact the undersigned (212-357-8437; matthew.schroeder@gs.com) or Sam Lynn (212-357-5531; samuel.lynn@gs.com).

Very truly yours,

Matthew L. Schroeder
Chair
SIFMA Dealer Accounting Committee

Appendix A

Detailed comments and application concerns

If the Board adopts the Exposure Draft, we set out below specific concerns we have on certain provisions of the Exposure Draft if not otherwise described in the body of our letter:

Enforceability requirements & removable rights of set off

We believe that the proposed guidelines regarding the enforceability of rights of set-off may have the unintended consequence of preventing net presentation in situations in which the Boards believe net presentation is appropriate. Requiring rights of set-off to be enforceable "in all circumstances" is a much higher hurdle to meet than currently enforceable and enforceable in bankruptcy/insolvency of just one of the parties. We do not believe it necessary to consider the bankruptcy of the reporting entity, as this would be inconsistent with the going concern concept of financial reporting.

Similarly, prohibiting a right of set-off that may be removed by a future event (even if the probability of that event is remote) from meeting the unconditional right of set off criterion may have the same unintended consequence. For example, legal agreements typically seek to provide for equitable treatment of the parties in the event of a force majeure, and in the case of CCPs, also seek to ensure the smooth and continuing functioning of the derivatives and securities markets. Therefore, CCPs often times may include provisions regarding force majeure events that require clearing members to obey the directions of the CCP upon the notification of a force majeure event. While the agreements do not specify that CCPs may require gross settlement in that event, it may be theoretically possible. We believe that the criteria should be written to be based on current enforceability of the provision at issue, not enforceability in all circumstances.

Payment netting application

The application of the Exposure Draft to payment netting under a MNA is confusing. The guidance in paragraphs C2 to C9 implies that payment netting under a MNA may meet the netting requirements of the Exposure Draft. However, paragraphs BC52 and BC53 suggest that the Board intends for the criteria to be applied at the unit of account level, and therefore, in order for an entity to demonstrate its intent to settle net, a derivative asset and liability would be offset only if they have the same maturity date and same payment dates (i.e., close out trades). We are unsure if this was the Board's intent as this would, for example, prohibit the netting of many centrally cleared derivatives and represent a significant change to current practice.

The application of payment netting to OTC derivatives under a MNA is also unclear. Based on the guidance discussed above in paragraphs C2 and C9, the netting criteria could seemingly be met for some payments (as opposed to every contractual payment) related to a financial asset and financial liability. If this is the intent, we believe the Board should provide guidance on how this would be applied in order to address the diversity that may arise in practice if payment netting were required in such circumstances.

Elective use of offsetting

The Exposure Draft requires offsetting when conditions are met, eliminating a preparer's election to offset assets and liabilities meeting the conditions. While disagreeing with the Exposure Draft's proposed offsetting principles, we agree that, when the conditions are met, offsetting assets and liabilities should not be elective. Retaining the option limits comparability.

Disclosure Requirements

The scope of the proposed disclosure requirements is potentially too expansive and duplicative. For example, one of the requirements of the Exposure Draft is the disclosure of CVA and DVA by each class of financial instrument. We are not sure of the relevance of a fair value measurements disclosure embedded in a footnote regarding the financial assets and financial liabilities that are presented net. Aside from being in part duplicative of current fair value measurements disclosures, we question the relevance and usefulness of including CVA and DVA in the netting disclosure requirements. Additionally, we question whether all eligible financial assets and financial liabilities should be included in the footnote disclosure as some classes of financial instruments, while they may potentially provide for netting in certain remote conditions, will likely be presented gross in all cases under the proposed guidance (i.e., loans at amortized cost).

Paragraphs 12(c) and 12(d) of the Exposure Draft require separate disclosure of the amount of eligible assets and liabilities that the entity has an unconditional and legally enforceable right to set off but that the entity does not intend to settle net or settle simultaneously and disclosure of amounts that may be netted on a conditional basis. Paragraph 12(c) refers to payment netting and Paragraph 12(d) refers to close-out netting. Payment netting only occurs in the ordinary course of business. Once a default event occurs and termination is triggered, all payments in the ordinary course cease. Close-out netting then applies, and the obligations of all transactions under the MNA are settled net. Since payment netting and close-out netting therefore relate to the same transactions, we do not believe it is possible to separate the disclosure of amounts as proposed by paragraphs 12(c) and 12(d). We believe these separate requirements should be removed from the final standard.

In addition, paragraph 12(c), in requiring disclosure of the amount of eligible assets and liabilities that the entity has an unconditional and legally enforceable right to set off but that the entity does not intend to settle net or settle simultaneously, seems to scope in rights of set off in transactions that may not be related. We do not believe that the Board should impose the burden of requiring preparers to search for instances of offset in unrelated transactions across multiple geographies where such offset may not be contemplated at the initiation of one of the transactions.

Effective date

We understand that retrospective application is required but are concerned with the system constraints and operational complexity of generating certain elements of the netting requirements, including computation of the trade date adjustment gross up and potentially payment netting adjustments. As such, we do not support retrospective application and instead suggest prospective application as of the beginning of the reporting period in the first period of adoption. We believe prospective application is acceptable given the complexity to comply versus the perceived limited usefulness in providing comparative information for standards that only impact an entity’s statement of financial position.

Regarding the timing of adoption, sufficient time will be required to make the necessary system and operational changes needed to capture the data necessary to adopt the Exposure Draft requirements. Sufficient time is also needed to provide regulators and tax rule makers with the ability to assess the impacts on their rule sets and make necessary amendments to those rule sets where appropriate. As a result, we recommend an effective date no earlier than periods beginning on or after December 15, 2014.