July 17, 2014

Submitted via e-mail (to rrgolden@fasp.org) and mail

Mr. Russell Golden
Chairman
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Offsetting Certain Payables and Receivables Associated with Securities Lending Transactions Cleared by a Regulated Central Counterparty

Dear Mr. Golden:

As Chairman and Chief Executive Officer of Quadriserv, Inc., I am writing on behalf of our wholly owned subsidiary, Automated Equity Finance Markets, Inc., a registered broker-dealer that operates an alternative trading system (“ATS”), known as AQS. AQS effects stock loan transactions among its participants by matching stock lenders and borrowers. Stock loan transactions effected through AQS are submitted to The Options Clearing Corporation (“OCC”) for clearance. OCC, the world’s largest derivatives clearing organization, is the central counterparty (“CCP”) to each stock loan transaction effected through AQS when settled at the Depository Trust Company (“DTC”).

The purpose of this letter is to highlight an important financial statement presentation issue that we believe should be considered by the Financial Accounting Standards Board (“FASB” or the “Board”). This letter may seem familiar to you, as it should. In a letter dated October 21, 2009, our firm requested FASB consider a similar request. At that time, when our request was being considered, FASB and International Accounting Standards Board (“IASB”) were in the midst of working towards global convergence of accounting standards. After careful consideration by Board staff during that volatile time, it was decided that the agenda item would be deferred to a point in the future.

Since then, CCP-based activity has become one of the standard modes of transacting stock loans among industry participants and the loan volume from this centrally cleared activity has grown steadily, a trend indicating the profound relevance of this particular issue to securities financing activity under the evolving capital regime. There is a deep understanding of this issue among Board directors and staff, and the basis of our original request was the result of an exhaustive, broad-based effort among industry experts. Given these and other facts, presented in greater depth herein, we would respectfully ask the Board to now reconsider our request that securities lending and borrowing arrangements executed under a CCP platform be granted an exception from meeting the condition of “intent to set off” similarly to derivative and other financial instruments that are executed with the same counterparty under a master netting arrangement.

Developments in the processes for centrally cleared stock loan transactions provide an opportunity for FASB to consider whether, for financial reporting purposes, a participant should be permitted to offset

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1 Automated Equity Finance Markets, Inc. is a FINRA member broker-dealer that operates an ATS in accordance with Regulation ATS under the Securities Exchange Act of 1934.
payables and receivables for positions associated with stock loan transactions with a CCP, which are adjusted daily to market value and subject to a master netting agreement, under FASB Accounting Standards Codification ("ASC") section 815-10-45, Derivatives and Hedging, Balance Sheet Netting (formerly paragraph 10 of FASB Interpretation No. 39, as amended by FSP FIN 39-1). Derivative instruments, repurchase and reverse repurchase agreements, and securities lending transactions may be offset in balance sheet presentation in accordance with either section 210-20-45 or section 815-10-45 of ASC. We are of the view that the rationale for net presentation should be extended to securities lending transactions that are cleared by a participant through a CCP that has adopted a master netting agreement. Our view is strongly supported by the current practice of derivative instruments offset in the clearing accounts at a CCP. Unless the current accounting guidance is extended, participants may report payables and receivables attributable to stock loan and borrow positions differently from payables and receivables associated with derivative instruments, even though the payables and receivables arising from both transactions are carried in the same clearing accounts at the same CCP and could be (or are) treated by the CCP as offsets against one another for purposes of determining margin requirements.

In the following paragraphs, we have provided a brief description of the securities lending market followed by a description of the AQS stock loan marketplace. We describe the role of OCC and the evolution of their stock loan programs to become the CCP for stock lending and borrowing transactions effected through AQS, as well as the role of DTC. We then analyze the requirements of the FASB’s current literature, as applied to derivative instruments, and explain how the FASB’s rationale for that literature should apply equally to centrally cleared stock lending and borrowing transactions.

In our view, providing balance sheet offsets for payables and receivables associated with stock loan transactions effected through an electronic market operated by a regulated entity and cleared by a regulated CCP would most importantly promote better financial reporting for financial statement users. In addition, offsetting the payables and receivables would provide an incentive for participants to clear more of their transactions through CCPs, contributing to the important goal of facilitating transparency via a CCP, reducing systemic risk in the securities lending market, and enhancing the liquidity and integrity of our national securities markets.

Securities Lending and Benefits of Clearance by a Central Counterparty

Overview of Securities Lending

Securities lending and borrowing is essential to liquidity in the securities marketplace. Broker/dealers borrow securities in order to make delivery on short sales and to cover fails-to-deliver. Institutional investors and broker/dealers lend securities against receipt of collateral in order to effectively manage assets and generate a reliable source of short-term, inexpensive financing. Custodian banks are significant players on the lending side as they typically hold a large inventory of securities on behalf of their custodial clients – ERISA and non-ERISA pension plans, insurance companies, central banks, foundations, endowments, and mutual funds.

Broker/dealers also act as a conduit between borrowers and lenders of securities, thereby facilitating transactions between the ultimate lenders and borrowers. Broker/dealers typically act as principals (trading for their own accounts) on either side of the transactions, and trade on a spread basis.

When initiating a securities lending contract, the securities lender delivers the requested security and the borrower delivers the agreed-upon form of collateral, which in the AQS market is required to be in the form of cash. The delivery of securities and collateral is settled on a same-day basis in the U.S. domestic lending market.
Generally, the collateral delivered is at least 102 percent of the market value of the security being loaned. The securities lender is entitled, within the boundaries of the master lending agreement with the borrower, to use the collateral throughout the life of the loan as it sees fit by investing the cash. The securities lender is contractually obligated to return the collateral to the borrower upon return of the loaned security. In addition to the exchange of the loaned security and collateral, the transaction ordinarily also includes payment of a rebate or fee. A securities lender invests cash collateral and agrees to pay a rebate to the borrower on the value of cash being held. The spread between the investment rate earned by the securities lender and rebate rate agreed with the borrower represents the lender’s revenue on the loan. The accrued rebate or fee is calculated daily and paid periodically over the life of the loan.

The following diagram illustrates a typical securities lending arrangement between a borrower and a lender:

![Securities Lending Arrangement Diagram]

The rebate rate or fee is negotiated in advance between the borrower and the securities lender and is typically dependent upon the availability of the security being borrowed or the need for cash. The greater the demand for the security in relation to the available supply, the lower the negotiated rebate rate is likely to be. In some cases, the rebate rate can be negative in which case the securities lender retains all cash collateral investment income and collects an additional fee from the borrower. Rebate rates can be adjusted during the life of the loan.
Loans can be negotiated as “term,” and remain open for a fixed period, or on an open-ended basis where either the securities lender or borrower can “unwind” the loan at any time. In a standard securities lending arrangement, a lender can unwind the transaction by issuing a loan recall to the borrower, at which point the borrower is obligated to return the loaned security in exchange for collateral. Also, a borrower can choose to unwind the loan by returning the securities to the lender.

The securities borrower and lender are required to make mark-to-market payments between themselves each business day in order to “true-up” the amount of collateral held by the lender, generally equal to at least 102 percent of the current market value of the loaned securities. Since corporate actions are credited to the security holder, the borrower is obligated, under the terms of the applicable lending agreement, to pass the equivalent benefit to the lender.

Benefits and Mechanics of a CCP Market Structure

The securities lending market has traditionally been an over-the-counter (“OTC”) market, and transactions in that market – while ordinarily documented on boilerplate documentation with standardized terms – usually have remained bilateral transactions between the original counterparties. Today, however, a growing portion of securities lending transactions that are negotiated and settled in the OTC market then submitted for clearance through OCC under its Stock Loan/Hedge Program with OCC as the guarantor of principal, or are alternatively effected through AQS and submitted to OCC as the CCP under its Market Loan Program.

In 1993, OCC introduced the Stock Loan Program (formerly known as “Hedge Program”, together “Stock Loan/Hedge Program”) which allowed Clearing Members of OCC (“CMs”) to use borrowed and loaned securities to reduce OCC margin requirements by reflecting the real risks of their intermarket hedged positions. Under the OCC Stock Loan/Hedge Program, securities lending transactions are negotiated and settled bilaterally under Master Securities Lending Agreements (“MSLAs”) between CMs at DTC: the lender delivers shares directly to the borrower’s account, while the borrower delivers cash directly to the lender’s account. Following settlement at DTC, the transaction is submitted to OCC for approval. Once approved, OCC novates itself as the principal counterparty to the borrowing and lending CMs for the principal value of the transaction. The remaining terms of the stock loan transaction continue to be governed under the bilateral MSLA between the CMs. OCC guarantees the return of the securities and collateral to the lending and borrowing CMs, respectively, and effects daily mark-to-market payments through OCC’s cash settlement system. However, recalls, buy-ins, corporate actions, dividends and the settlement of rebate payments remain between the counterparties and outside of OCC’s program.

In 2009, OCC introduced the Market Loan Program in conjunction with AQS, as the next step to provide a true centrally cleared stock loan transaction where CMs remain anonymous and only know OCC as counterparty. All aspects of Market Loan Program transactions are covered by OCC rules and By-Laws. Bilateral MSLAs or credit agreements are not required between CMs, but rather between OCC and each CM. Unlike stock loan transactions under the Stock Loan/Hedge Program, all operational facets of the stock loan transactions under the Market Loan Program are governed by OCC as OCC novates itself as the CCP to the stock loan transaction. CMs do not have the ability to negotiate or transact bilaterally with CMs on the other side of the transaction. In addition, there is not any ambiguity on which agreement governs

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2 The OCC Stock Loan/Hedge Program was introduced in July 1993 and allows CMs to use the current DTC stock delivery process to create hedge stock loan/borrow positions, thereby reducing their OCC margin requirements. (See http://www.optionsclearing.com/clearing/clearing-services/stock-loan.jsp#stockloan)
3 See http://www.optionsclearing.com/clearing/clearing-services/stock-loan.jsp#mktloan
4 See http://www.optionsclearing.com/clearing/clearing-services/stock-loan.jsp#stockloan
specific aspects of a stock loan transaction. OCC rules and By-Laws, and CM’s agreement with OCC govern all aspects of stock loan transactions under the Market Loan Program.

In the Market Loan Program, the loaned securities are delivered against the cash collateral through DTC’s delivery versus payment (“DVP”) system (i.e., delivery to the DTC member that is or represents the borrower will not occur unless the borrower receives the cash collateral and vice versa when the loan is consummated/terminated). These DVP transactions are effected at DTC through the intermediation of an account of OCC at DTC so that the lender and borrower remain anonymous to each other. Again, in the Market Loan Program, unlike the Stock Loan/Hedge Program, OCC is the counterparty to each and every transaction from the point of trade acceptance by a loan market (i.e. AQS)⁶. Accordingly, OCC guarantees not only the return of the securities and cash collateral and mark-to-market adjustments, but also guarantees other associated cash flows, such as the payment of dividend equivalent payments and rebates, for which it collects margin from the CMs.

In order to collateralize each CM’s obligations to it, OCC maintains a risk management system that calculates a margin requirement on all of the positions in each account of each CM. Stock loan and borrow positions in CM accounts are margined on the same basis as are positions in equity options and security futures contracts, and a stock loan or borrow position may offset, for margin purposes, a long or short position in a put or call option on the same or a related underlying security. Thus, CMs that choose to clear stock loan and borrow transactions through AQS, and thus OCC, receive not only the benefit of an AA-rated counterparty, but also reduced margin requirements on their positions in options and other derivatives to the extent that their stock loan and borrow positions provide risk offsets against those other derivative positions.

**Master Netting under the CCP Platform**


The rule change was intended to prevent a trustee, upon a default or insolvency of OCC, from being able to “cherry pick” by assuming the benefit of certain contracts with CMs representing an asset of OCC without offset for contracts representing a liability of OCC to the same counterparty. The rule was expected, among other things, to permit CMs to treat exposure to OCC with respect to options and other derivatives on a net basis under FASB ASC section 815-10-45 to the extent of the netting permitted under the rule.

Section 27 of Article VI provides each CM the right to net the rights and obligations in each of its accounts with OCC in the event of the default or insolvency of OCC.⁷ (Under Chapter XI of OCC’s Rules, OCC is afforded the same right to net the rights and obligations in each of its accounts with CMs in the event of the default or insolvency of a CM.) Section 27(b) states the following:

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⁶ Currently, AQS is the sole loan market providing the CCP-based securities lending market platform under OCC’s Market Loan Program. See [http://www.optionsclearing.com/clearing/clearing-services/stock-loan.jsp#mktloan](http://www.optionsclearing.com/clearing/clearing-services/stock-loan.jsp#mktloan)

⁷ Article VI, Section 27 contains certain limitations on netting. For example, positions in the customers’ account of a CM that liquidate to an asset cannot be offset against losses in the CM’s firm account, and certain long option positions in the CM’s customers’ account are required to be “segregated” and cannot be used to offset losses in any account. These limitations on netting are necessary to comply with SEC Rule 15c3-3 and other customer protection rules.
(b) Notice of Termination. Upon the occurrence of any event described in clause (i) through (iii) of paragraph (a), a Clearing Member that is neither suspended nor in default with respect to any obligation owing to the Corporation may notify the Corporation in writing of its intention to terminate all cleared contracts and stock loan and borrow positions in all accounts of such Clearing Member; provided that a notice based on the Corporation’s failure to comply with an obligation described in clause (i) may only be made by the Clearing Member to whom such obligation is owed. [...] As of the close of business on the third business day following the Corporation’s receipt of such notice or such other termination time as may be established by the United States Bankruptcy Code in the case of a proceeding governed by such Code (the “Termination Time”), the Corporation shall accept no more confirmed trades for clearing, and all pending transactions, positions in cleared contracts and stock loan and borrow positions remaining in all accounts of all Clearing Members at the Termination Time shall be valued as of the Termination Time and liquidated in accordance with this Section. Such liquidated positions shall be netted to the maximum extent permitted by law and the By-Laws and Rules, and settlement of the net amounts shall be effected in the manner provided by this Section in satisfaction of all obligations owing between the Corporation and Clearing Members in respect of such positions.

The netting provisions of Section 27 apply to stock loan and borrow positions just as they do to positions in options, futures, and other derivative contracts. Stock loan and borrow positions would be included in the same close-out netting process as other contracts without distinction.

Analysis of Relevant Accounting Literature and Proposal to Permit the Offsetting of Payables and Receivables Associated with Securities Lending Arrangements Cleared by a CCP

Existing Accounting Guidance Applicable to Stock Loan/Borrow Transactions

If the criteria for sale accounting under FASB ASC Topic 860, Transfers and Servicing (formerly Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities), are met, securities received by the borrower are accounted for under U.S. GAAP as a purchase of the “borrowed” securities in exchange for the “collateral” and a forward resale commitment. Under sale accounting treatment, the lender accounts for the lending as a sale of the “loaned” securities for proceeds consisting of the cash “collateral” and a forward repurchase commitment. As a consequence, gross receivables and payables arising from the movement of cash collateral are not recognized, and offsetting considerations for financial reporting purposes are largely moot.

However, in almost all cases, a securities lending agreement entitles the securities lender to repurchase the transferred security on demand – contractual provisions that allow the securities lender (transferor) to maintain effective control over the securities loaned. Similarly, borrowers ordinarily have the right to return the loaned securities against return of the collateral at any time. As a result, securities lending transactions are accounted for by both the lender and the borrower as a secured borrowing in which cash received as collateral is considered the amount borrowed by the securities lender, the securities “loaned” are considered pledged as collateral and reclassified as such in accordance with FASB ASC Topic 860, and any rebate is accounted for as “interest” on the cash the securities lender is “borrowing.”

Offsetting under FASB ASC Topic 210, Balance Sheet

Securities lending arrangements are subject to the general conditions for offsetting amounts related to
certain contracts set forth under FASB ASC Topic 210 (Topic 210). Topic 210 reiterates the principle set forth in APB Opinion No. 10, Omnibus Opinion, paragraph 7, which states that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of set off exists." FASB ASC Paragraph 210-20-45-1 (formerly paragraph 5 of FIN 39) prescribes four conditions that must be met for a right of set off to exist:

a) Each of two parties owes the other determinable amounts.
b) The reporting party has the right to set off the amount owed by the other party.
c) The reporting party intends to set off.
d) The right of set off is enforceable at law.

There is a general consensus that most securities lending arrangements meet conditions (a), (b), and (d) of FASB ASC paragraph 210-20-45-1; however, because most securities lending contracts do not have an explicit settlement date, it is difficult for a reporting entity to demonstrate its "intent to set off" a receivable and payable arising from two contracts with the same counterparty.

**Exception to Intent to Set Off for Derivative Instruments**

The same problem in demonstrating an "intent to set off" exists with respect to "derivative instruments" as defined by FASB ASC Topic 815, Derivatives and Hedging, paragraphs 815-10-15-83 through 15-139. However, in the case of derivative instruments, FASB ASC paragraph 815-10-45-5 provides an exception to the requirement of the "intent to set off". Paragraph 815-10-45-5 permits a reporting entity to offset fair value amounts recognized for derivative instruments executed with the same counterparty under a master netting arrangement without applying the condition in FASB ASC paragraph 210-20-45-1(c) that a reporting entity intends to set off.

As discussed further in the following section, we believe that the same exception can be extended and accorded to stock loan and borrow contracts cleared through a CCP. Considering the interaction among the value of the underlying borrowed security, cash collateral, customary margin requirements, the role of the CCP and master netting agreement discussed above, a securities lending transaction having the attributes cited in this letter should qualify for the exception.

**Definition of a "Derivative Instrument"**

FASB ASC paragraph 815-10-15-83 defines a derivative instrument as a financial instrument or other contract with all of the following characteristics:

a) Underlying, notional amount, payment provision. The contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required:
   1. one or more underlyings.
   2. one or more notional amounts or payment provisions or both.

b) Initial net investment. The contract requires no initial investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

c) Net settlement: The contract can be settled net by any of the following means:
   1. Its terms implicitly or explicitly require or permit net settlement.
   2. It can readily be settled net by a means outside the contract.
   3. It provides for delivery of an asset that puts the recipient in a position not substantially
different from net settlement.

**Underlying, Notional Amount and Payment Provision**

An underlying is defined under FASB ASC paragraph 815-10-15-88 as any variable (e.g., interest rate, security price, commodity price, foreign exchange rate, or index of prices or rates), along with either a notional amount or a payment provision, which would determine the settlement of the contract. Notional amount is defined in FASB ASC paragraph 815-15-92 as a number of units specified in the contract (e.g., currency units, shares, bushels, or pounds). The interaction of both the underlying and the notional amount determine the settlement amount of the derivative contract. As specified in FASB ASC paragraph 815-10-15-93, payment provision is a provision that “specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner. For example, a derivative instrument might require a specified payment if a referenced interest rate increases by 300 basis points.”

A stock loan contract may be viewed as having both an underlying and a notional amount. The underlying is the price of the loaned security, which is used to mark the stock loan contract to market and to determine the settlement value when the stock loan is terminated. The notional amount is the number of securities or units being lent.

**Terms Require or Permit Net Settlement**

As noted earlier, securities lending transactions cleared by OCC allow a non-defaulting counterparty (i.e., the OCC CM) the ability to terminate positions with OCC on a net basis in the event of a default by OCC. Indeed, the very same netting provisions applicable to derivative instruments cleared by OCC are also applicable to stock loan and borrow transactions cleared by OCC.

In addition, although each stock loan contract settles gross upon termination, the underlying security typically can be readily acquired or sold in the marketplace. Accordingly, notwithstanding the mechanics of gross settlement, both the securities lender/borrower and the CCP will find themselves, upon unwind, in a position not materially different than they would have been in had consummation of the contract (return of the loaned security to the lender and receipt of cash by the borrower) been effected through net settlement (that is, had the borrower sold the loaned security at the unwind date and exchanged solely the differential between the sales proceeds and the carrying amount of the financing receivable/payable).

**Initial Net Investment**

A stock loan contract, including those cleared by OCC, typically requires the deposit by the borrower of collateral at least equal to the value of the loaned securities. If this deposit of collateral is equated to an initial "investment" and if this "investment" is regarded as the "net investment" despite the fact that the lender transfers, and the borrower receives, marketable securities that are equal or nearly equal in value to the collateral deposit, then a stock loan contract does not meet the characteristic of "little or no initial net investment" of a derivative instrument under FASB ASC paragraph 815-10-15-83(b).

If, on the other hand, the transaction economics are considered as a whole, the net investment is either zero or negative (in the case of the stock lender) or 2 percent (in the case of the stock borrower). In many cases, the borrower is a short seller who puts up at least 102 percent cash, sells the securities and receives 100 percent of their market value and has both the right and the obligation under the stock borrow agreement to mark the borrow position to market daily. The borrower has thereby gained economic exposure to the price movements affecting the entire "notional amount" of the stock "underlying" the stock borrow position by putting up only 2 percent of the value (plus CCP risk margin), net of the proceeds of the securities sold.
For the reasons discussed in the following section, we believe that the rationale behind the FASB ASC paragraph 815-10-45-5 that permits netting of derivative instruments subject to a master netting agreement, irrespective of any intent on the part of the reporting party to settle net, supports the netting of stock loan and borrow transactions that are cleared through a CCP subject to a master netting agreement.

**Proposed Accounting Interpretation under US GAAP**

We believe that an exception to meeting the condition of “intent to set off” under FASB ASC paragraph 210-20-45-1(c) is warranted for stock loan transactions executed with the same CCP as counterparty under a master netting arrangement. The rationale for this view is not new, having been articulated by the FASB in section 815-10-45 in connection with establishing the accounting groundwork for offsetting assets and liabilities for derivative instruments. We contend that, with respect to settlement, netting, mark-to-market procedures and protocols, a securities lending market cleared by a CCP, having all cash flows margined for via a recognized risk management system, and guaranteed by a CCP, similarly warrant the reporting framework articulated in section 815-10-45 with respect to offsetting related receivables and payables in the statement of financial position.

**Background**

In March 1992, the FASB released FIN 39. Notwithstanding the condition set forth in paragraph 5(c) related to “intent to set off,” this interpretation allowed reporting entities holding certain conditional or exchange contracts (e.g., forwards, interest rate swaps, currency swaps, and options) to offset fair value amounts recognized under those contracts executed with the same counterparty under a master netting arrangement. The Board believed the exception to be justified when a master netting arrangement exists because the net presentation of such contracts discloses the amount of credit risk exposure under such arrangements. That is, the net presentation provides the relevant information to help investors and creditors assess the uncertainty of prospective net cash inflows of the reporting entity – an objective of financial reporting as stipulated in FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*. The Board decided that presentation on an aggregate basis would not provide more information about the uncertainty of future cash flows from those contracts than would net amounts.

The Board referred to these types of instruments as *conditional contracts* because the eventual cash flow consequences were often not discernible from the amounts reported in the statement of financial position. That is, the fair value of the amounts arising from such contracts, which could be reflected at any point in time on the statement of financial position, often do not represent the eventual cash flow consequences that would occur upon settlement of the contract. This can depend upon several factors including future interest rates, future exchange rates, future prices, or unstated maturities.

The Board acknowledged that these conditional amounts recognized for such contracts are subject to the same general principle as unconditional amounts recognized for contracts – that the offsetting of such assets and liabilities is improper except where a right of set off exists. However, despite the fact that the condition of “intent to set off” was not met, the Board allowed such offsetting if a master netting arrangement was present. This exception was presented under paragraph 10 of the interpretation as described above.

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8 Background section reflects guidance prior to the release of FASB Accounting Standards Codification, on July 1, 2009.
In 2007, the Board issued FASB Staff Position FIN 39-1: Amendment of FASB Interpretation No. 39 ("FSP FIN 39-1"), which amended the interpretation to replace the terms **conditional contracts** and **exchange contracts** with the term **derivative instruments** as defined in FAS 133.

**Analysis of the Factors for Granting Exemption to Securities Lending Arrangements under a CCP Platform**

**Master Netting Arrangement**

A master netting arrangement is a contractual agreement that provides for the net settlement of all contracts between two counterparties through a single payment in the event of default or on termination of any one contract by either party.

For example, derivative contracts that are cleared through a CCP may, as in the case of contracts cleared by OCC, be subject to the provisions of a master netting arrangement providing for the net settlement of contracts between the CCP and the CM through a single payment in the event of default on or termination of any one contract.

Similarly, stock loan transactions cleared by OCC under the Market Loan Program, are governed entirely under OCC rules which protect CMs on both sides of the transactions in the event of default by allowing the non-defaulting CM the ability to terminate all positions with OCC in connection with the transactions of the defaulting CM, and settle all positions (including accrued cash flows) on a net basis (as discussed above).

Moreover, where a master netting arrangement exists (whether for derivative instruments or securities lending arrangements), as the Board concluded, the presentation of such positions **either gross or net** would provide the same relevant information regarding credit risk exposure to investors and creditors of the reporting entity.

**Same Counterparty**

As noted earlier, once a trade is executed under the Market Loan Program by a CM on the CCP platform, OCC novates the agreements; thus, for all transactions executed through the CCP platform, OCC is the counterparty to the CMs. While the Stock Loan/Hedge Program begins with a bilateral agreement negotiated and traded between two CMs that is then designated for OCC to act as guarantor of the principal, collateral, and marks, certain aspects of the transaction would continue to be covered by the bilateral agreement between the two CMs. By contrast, all transactions in the Market Loan Program are anonymously matched and traded under the governance of the OCC rules and regulations from inception, and OCC is the sole counterparty to every transaction.

**Daily Cash Settlement Versus Mark-to-Market Payments**

Derivative instruments cleared by a CCP typically require a daily net settlement of any net option premiums and mark-to-market payments due from CMs to the CCP, and amounts due from the CCP are also credited to the CMs’ accounts.

Similar to derivative instruments traded on a CCP platform, securities lending arrangements through AQS cleared by OCC as the CCP also require a daily collateral adjustment payment for the difference between the fair value of the security being lent and the collateral on hand securing the loan. For all contracts outstanding, a CM is required to make a net payment for any amount due the CCP. Likewise,
any credit due a CM would be paid daily by the CCP. Also, additional associated cash flows, such as rebates/fees, dividends and corporate actions, are margined, guaranteed, and settled through OCC as the CCP.

By contrast, under the Stock Loan/Hedge Program, mark-to-market adjustments and settlement are guaranteed by OCC as the principal counterparty, while rebates/fees, dividends, and corporate actions remain bilateral obligations outside the scope of OCC.

**Conditional Contracts**

A financial instrument fails to demonstrate the condition of “intent to set off” under FIN 39 if such instrument has the characteristic of conditionality, i.e., the fact that the eventual cash flow consequences of these kinds of contracts often are not discernible from the amounts reported in the statement of financial position because of various factors, including price and maturity. In other words, a net position on the statement of financial position of two contracts executed between the same counterparties can never be completely accurate because a reporting entity cannot be certain, for example, how prices related to certain contracts will change or on what day certain contracts will actually settle.

Similarly, securities lending arrangements also fail to demonstrate the “intent to set off” under FASB ASC paragraph 210-20-45-1. As each party to a securities lending agreement typically can unwind the arrangement at any time, a reporting entity cannot be certain on what day the contract will actually settle. Upon the contract’s unwind (return of the securities by borrower), the movement of cash collateral takes place on a gross basis. However, as noted earlier, underlying securities are marked-to-market daily and any difference in the value of the securities lent and collateral is settled on a daily basis; as such, the amount and direction of subsequent cash movements is conditionally dependent on such mark-to-market price changes. As also previously observed, these settlement amounts are calculated on a net basis if more than one contract is outstanding between OCC and the CM.

**Credit Risk Exposure**

For securities lending arrangements under a CCP platform, the net position of a party to the transaction represents the net credit risk exposure of the contract itself and, to the extent that the provisions or rules of a CCP establish a daily settlement of such exposure, the uncertainty of the prospective net cash inflows due to the party holding the net credit position is minimized. Under the Market Loan Program, the credit risk exposure is further minimized: recognizing the nominal cash flow exposure of uncovered rebates/fees, dividends and corporate actions of the Stock Loan/Hedge Program, such associated cash flows from securities lending arrangements are margined and covered by OCC as the CCP in the Market Loan Program.

**Views of Financial Statement Preparers and Users**

In preparation of the initial agenda item request in 2009, we have discussed the proposed accounting treatment with both potential participants (banks, broker/dealers, etc.) of AQS and analysts in the securities lending industry. We reproduce some of their comments below:

- Participants noted that net presentation captures the true economics of trading via a CCP system in a more accurate manner.
- Participants also agreed that the net presentation is a true reflection of the actual exposure/risk.
- Participants noted that there is no difference between securities lending transactions
via a CCP and the derivative/repo transactions as it relates to “intent to set off.” They also noted that the introduction of a CCP in the middle (novating both sides of the transaction) with a master netting agreement in place effectively covers the “intent to set off” condition.

- Analysts noted that the gross presentation does not provide any more information than the net presentation.
- Analysts noted that the ultimate readers of the financial statements will be able to make better decisions knowing the true exposure on the face of the financial statements while seeing the transaction details in the footnotes.
- Analysts noted that net presentation of CCP credit risk exposure was likely preferable, particularly during times of credit stress, than gross presentation of OTC credit risk for the purpose of evaluating financing activity.

Conclusion

We believe that securities lending arrangements executed under a CCP platform warrants an exception from meeting the condition of “intent to set off” similarly to derivative instruments and other financial instruments that are executed with the same counterparty under a master netting arrangement. While securities lending arrangements with a CCP cannot support a definitive argument in favor of “intent to set off” due to the conditional nature of the contracts, we believe the relevance of intent is lessened where the “right” and “ability” to offset has been clearly demonstrated under a master netting arrangement.

We also believe that the ability to offset payables and receivables associated with securities lending arrangements with a CCP and report them as a net amount in the statement of financial position does not diminish the objectives of financial reporting, but accurately reflects the economics of an improved centralized market for trading. Securities lending arrangements transacted through AQS’s CCP-based market, governed by OCC’s Market Loan Program, provides a good example. Continued gross presentation of aggregate fair values of individual contracts between a CM and OCC does not provide more information about the uncertainty of future cash flows from those contracts, because failure of OCC to make one payment under the master netting arrangement would entitle the CM to terminate the entire agreement and demand net settlement of all outstanding contracts in accordance with OCC’s By-Laws.

CMs benefit greatly from a significant reduction in counterparty credit risk by transacting only with OCC. Strict collateral requirements and an improved settlement model in the centralized market provide added protection for both lenders and borrowers. Therefore, we believe that where improvements have been made and continue to be made in the market, the accounting should accurately reflect these improvements to ensure that users of financial statements are not making uninformed decisions about their investments because the accounting model presents a different picture with respect to the preparer's financial condition and exposure to risk. Given that, under OCC’s By-Laws, stock loan and borrow positions are subject to precisely the same close-out netting rules that apply to derivative contracts in the case of an OCC insolvency, it is very difficult to see how transparency is served by presenting a CM’s exposure to one type of contract on a net basis while the other is presented on a gross basis. Such disparate treatment would appear to be misleading in that it implies a difference that does not exist.

For the reasons articulated above, we believe that receivables and payables arising from securities lending arrangements under a CCP platform accompanied by a master netting agreement warrant the same reporting treatment (with respect to offsetting such amounts) currently accorded to participants that trade in the derivative markets under a master netting arrangement. We ask that you consider the merits of this position and reconsider the circumstances for allowing the offset of payables and
receivables arising from securities lending arrangements executed with a CCP trading platform. More specifically, we are requesting that the FASB give serious consideration to amending the current guidance in paragraph 210-20-45-1 to the effect that assets and liabilities arising from securities lending transactions that are centrally cleared through a well-regulated CCP subject to a master netting agreement may be reported on a net basis, as is the case presently with respect to receivables and payables attributable to derivative instruments.

We would be pleased to discuss our comments with you.

Sincerely,

Pasquale Cestaro, III
Chairman & Chief Executive Officer
Quadriserv, Inc.

Enclosures:
Appendix A: Journal entries and Balance Sheet presentation under the present accounting and under proposed exception as applicable to CCP-based securities lending transactions.
Agenda Item Request

Appendix A: Journal entries and Balance Sheet presentation under the present accounting and under proposed exception as applicable to CCP-based securities lending transactions.

<table>
<thead>
<tr>
<th>Summary of Securities Lending Transaction</th>
<th>Journal Entries for the CM:</th>
<th>Balance Sheet Presentation:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>M holds cash of $2,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M has stockholders’ equity of $2,000 with no liabilities</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Assets | Liabilities
---|---
Cash: | $ 2,000 |
Equity: | |
Total: | $ 2,000 |

- CM borrows Security A from the OCC and lends it to NCM1.
- CM borrows Security B from NCM1 and lends it to the OCC.
- Security A has a carrying value/fair value of $1,000.
- Security B has a carrying value/fair value of $8.00.
- Borrowers must deliver 102% of the fair value of each security as collateral to the lender.

Assume all securities lending arrangements do not meet the conditions for sale accounting under FASB ASC Topic 860.

| To record the borrowing of Security A from the OCC: | Cash: $1,020 |
| Receivable from OCC (Collateral): $1,020 |

| To record the lending of Security A to NCM1: | Cash: $1,020 |
| Payable to NCM1 (Collateral): $1,020 |

| To record the borrowing of Security B from NCM1: | Cash: $816 |
| Receivable from NCM1 (Collateral): $816 |

| To record the lending of Security B to the OCC: | Cash: $816 |
| Payable to OCC (Collateral): $816 |

### Present Accounting

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash:</td>
<td>$ 2,000</td>
</tr>
<tr>
<td>Receivable from OCC</td>
<td>$ 1,020</td>
</tr>
<tr>
<td>Payable to OCC</td>
<td>$ 1,020</td>
</tr>
<tr>
<td>Receivable from NCM1</td>
<td>$ 816</td>
</tr>
<tr>
<td>Payable to NCM1</td>
<td>$ 816</td>
</tr>
<tr>
<td>Common Stock</td>
<td>$ 2,000</td>
</tr>
<tr>
<td>Total</td>
<td>$ 3,836</td>
</tr>
</tbody>
</table>

### Proposed Exception for offsetting with the OCC

FASB ASC Topic 815 Exemption - Similar to Derivatives - Master Netting Agreement

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash:</td>
<td>$ 2,000</td>
</tr>
<tr>
<td>Receivable from OCC</td>
<td>$ 816</td>
</tr>
<tr>
<td>Payable to OCC</td>
<td>$ 816</td>
</tr>
<tr>
<td>Receivable from NCM1</td>
<td>$ 204</td>
</tr>
<tr>
<td>Payable to NCM1</td>
<td>$ 204</td>
</tr>
<tr>
<td>Common Stock</td>
<td>$ 2,000</td>
</tr>
<tr>
<td>Net receivable from OCC</td>
<td>$ 3,020</td>
</tr>
<tr>
<td>Total</td>
<td>$ 3,020</td>
</tr>
</tbody>
</table>

Note: Rebate not considered in these examples.