Louis Rauchenberger

Managing Director & Corporate Controller

April 20, 2011

Sir David Tweedie Chairman International Accounting Standards Board 30 Cannon Street London, EC4M 6XH United Kingdom

Ms. Susan M. Cosper Technical Director Financial Accounting Standards Board 401 Merritt 7 Post Office Box 5116 Norwalk, Connecticut 06856-5116

Re: File Reference No. 2011-100, Proposed Accounting Standards Update – Balance sheet (Topic 210) - Offsetting

Dear Sir David and Ms. Cosper:

JPMorgan Chase & Co ("JPMorgan Chase" or "the Firm"), appreciates the opportunity to comment on *Proposed Accounting Standards Update – Balance Sheet – Offsetting* (the "Proposed ASU") issued by the Financial Accounting Standards Board ("FASB" or the "Board") and the International Accounting Standards Board ("IASB" or the "Board") (collectively, "the Boards").

We do not support the Proposed ASU because it does not represent an improvement to current US GAAP. Given the specialized legal agreements, collateral arrangements, and cash settlement procedures of the financial instruments that will be most impacted by the Proposed ASU, balance sheets prepared under the Proposed ASU would be *less* useful to understanding the businesses and risks of financial institutions than balance sheets prepared under current US GAAP. Therefore, while we generally support the efforts of the FASB and the IASB to achieve high quality global accounting standards, if the FASB and IASB cannot agree on a single global standard that maintains the usefulness of the balance sheet by recognizing the unique nature of derivatives, securities financing agreements, and unsettled securities transactions, we believe that the FASB and IASB should cease to seek convergence on this topic and instead focus on the appropriate disclosures for comparability.

We understand that the Proposed ASU is based in large part on the view that gross presentation of these transactions more accurately conveys the resources of an entity and the claims against it. Inherent in this view is the assumption that derivative receivables, aggregated using fair values calculated on a trade-by-trade basis, represent resources to creditors other than derivatives counterparties, and that derivative payables, calculated individually, represent claims against the entity. We believe that this assumption is simply not true in bankruptcy or on a going concern basis, because in both cases the gross cash flows are only available to derivative counterparties and only the *net* amounts are available to general creditors. We encourage the Boards to re-examine this assumption in detail during the redeliberation period. In Appendix A, we provide a more detailed discussion of this issue and other arguments that have been cited in support of gross presentation.

In addition, we note that consensus does not exist among any constituency, including users of financial statements, in favor of gross presentation that would imply a mandate for a change to US

GAAP. To the contrary, financial statement users, including banking and securities regulators, taxing authorities, and investors who rely on asset-based ratios (e.g., a leverage ratio) as part of their decisions or oversight would be forced to either recalibrate their analyses (if asset-based ratio analysis even continues to be relevant) or adjust the amounts reported on the balance sheet, since the gross amount of derivative receivables and liabilities fluctuate over time based on movements in market indices without any substantive effect on a firm's financial position.

For these reasons, we cannot support the Proposed ASU solely in the interest of convergence. We agree with the views expressed by the dissenting Board members that existing US GAAP principles are sound. In the comments that follow, we seek to supplement the information supporting the Alternative Views for the Boards' further consideration, and highlight the consequences of the Proposed ASU which we do not believe are justified by the perceived benefits.

- Appendix A outlines our detailed comments on the Proposed ASU.
- Appendix B and C explain the legal agreements and cash settlement operations for derivatives and securities financing agreements, respectively. We encourage the Boards to ensure that these agreements and operations are fully and clearly understood before reaching a conclusion.
- Appendix D discusses the legal enforceability of the ISDA Master Netting agreement, and addresses recent legal cases arising out of derivative counterparty default. We believe it is important for the Boards to have an accurate understanding that the Close Out Netting provisions have been enforceable in all circumstances to the best of our knowledge.

We appreciate the opportunity to submit our views and would be pleased to discuss our comments with you at your convenience. If you have any questions, please contact me at 212.270.3632, Bret Dooley at 212.648.0404 or Laurin Smith at 212-648-0909.

Sincerely yours,

Louis Rauchenberger

Appendix A

We believe that net presentation is a more representative and useful balance sheet presentation for derivatives and securities financings for a number of reasons. As described further below:

- Net presentation appropriately reflects the resources available to or claims against other creditors and investors (other than the counterparty), both upon default and on an ongoing basis.
- The net presentation of the fair values of multiple derivative confirmations under a single
 enforceable master netting agreement is the logical equivalent of recognizing a single asset or
 liability for a derivative instrument whose value comprises many estimated cash inflows and
 outflows.
- Net presentation is the best portrayal of the credit risk, liquidity risk, and solvency risk of derivative instruments.
- Balance sheet presentation should not be dependent on non-economic differences in settlement procedures (i.e. whether net settled, simultaneously settled, or settled on the same day subject to an intra-day credit agreement).

For these reasons, in addition to the significant costs and consequences of implementing the Proposed ASU, we believe that the FASB has failed to demonstrate how the Proposed ASU represents any informational or conceptual improvement over existing US GAAP, which already requires disclosure of derivable receivables and payables on a gross basis, presented separately by type of derivative contract. We encourage the Boards to agree on a single global standard that maintains the usefulness of the balance sheet, but if such agreement cannot be reached, then the FASB and IASB should cease to seek convergence on this topic and instead focus on developing the appropriate disclosures to provide comparability.

Display of Resources and Claims

We agree with the Boards' focus on the usefulness of the information presented to users of financial statements on the face of the balance sheet, and believe that net presentation is far more useful than gross presentation for those seeking to understand the resources of an entity and the claims against it.

The gross presentation proposed by the Proposed ASU inherently assumes that derivative receivables, calculated on a trade-by-trade basis, represent resources to creditors other than derivatives counterparties, and that derivative payables, calculated individually, represent claims against the entity that are identical in nature to other liabilities. We believe that this assumption is simply not true on either a default/termination basis or a going concern basis, and that reporting derivative assets on a gross basis overstates the resources of the entity available to general creditors.

- Upon termination by the counterparty, derivative asset "resources" are unavailable to satisfy other claims, since net settlement of termination amounts (including collateral amounts) under the Close Out Netting provisions is not subject to stay under bankruptcy laws of most major jurisdictions, unlike other claims. Therefore, reporting derivative assets on a gross basis, rather than on a net basis (which properly considers the aggregate claim under a master netting agreement under bankruptcy law), would mislead users of financial statements by overstating the resources of the entity.
- On a going concern basis, gross presentation would also be an overstatement of the resources of an entity because of the nature of common collateral agreements and settlement processes that ensure that derivative cash settlements are returned the next day as collateral. If an entity receives cash to settle a derivative receivable that is currently eligible for netting against the related derivative payables and cash collateral amounts, that cash receipt is not freely available to the general creditors of an entity. Cash would be required to be returned to the counterparty within the next day in order to rebalance the credit exposure between the two counterparties that had changed as a result of the settlement of the derivative receivable. (See Appendix B for further discussion of derivatives collateral). Even for uncollateralized derivatives, derivative assets do not represent resources freely available to other creditors due

to the restrictions upon transfers of the derivative assets to other parties without the consent of the original counterparty. While such consent cannot be unreasonably withheld, the unfavorable change in credit risk that would occur due to the counterparty's payable and receivable no longer receiving the benefit of Close Out Netting upon an event of default would be sufficient cause to withhold consent.

Net Presentation of Net Cash Flows

Some have questioned why net presentation of derivative assets and liabilities under derivative agreements is appropriate, especially in circumstances in which the timing of cash flows is not expected to match, when such net presentation would not be permitted for other types of assets and liabilities. We believe that the answer is related to the unique nature of derivative assets and liabilities.

In derivative instruments, two-way cash flows are very common throughout the term of the agreement. This differs from most other assets and liabilities recognized on the balance sheet, as an asset generally represents solely a right to receive cash in the future, and a liability generally represents solely an obligation to pay cash in the future. The accounting for derivative instruments acknowledges this unique characteristic and requires that derivative instruments be presented at fair value on the balance sheet – a fair value that represents the <u>net present value</u> of expected cash inflows and outflows within the transaction. Net presentation of the fair values of multiple transactions under a single enforceable master netting agreement is simply a logical extension of this single presentation of the multiple expected cash inflows and outflows for a single derivative transaction.

Communication of Risks: Liquidity, Solvency, Market and Credit

We share the Boards' objective of providing information to users of financial statements that is most indicative of the risks of an entity, and believe that net presentation is the best portrayal of the liquidity, solvency, and credit risks of derivative instruments, while market risk cannot be effectively portrayed on the balance sheet and is therefore more appropriately addressed through disclosures.

• For derivatives, the nature of risk management practices, legal and collateral agreements, and cash settlement procedures result in a liquidity profile that is much more aligned with net presentation. Funding requirements for derivatives arise from the need to supply cash collateral as a result of market movements, and such collateral requirements are calculated on a net basis. Cash would only be required to be posted to a counterparty if, on a net basis, derivative payables exceeded derivative receivables on a particular day. This calculation under the Credit Support Annex ("CSA" or "collateral agreement") within the ISDA Master Netting Agreement is similar to the calculation under Close Out Netting. (See Appendix B for more information about the CSA and collateral.)

Based on this collateral calculation and transfer process, it is clear that net presentation does not conceal liquidity risk or hide future liquidity events, which has been a concern of the Boards. Consider a derivative asset due in 2 years and a derivative liability of an equal amount due tomorrow that are netted for balance sheet presentation purposes. Upon cash settlement of the liability, the credit exposure between the counterparties has changed, and the amount due under the collateral agreement must be recalculated. As discussed above, this recalculation of the credit exposure entails netting all of the remaining derivative receivables and payables between the two counterparties. As the derivative liability no longer exists to offset the credit risk of the derivative asset, cash collateral must be received to secure the asset. Therefore, the cash initially paid out to settle the derivative liability would be received back in the next day through the collateral call. As this example demonstrates, gross balance sheet presentation of the derivative receivable and payable would not provide valuable information regarding the company's liquidity profile, and in fact, could be misleading given the mechanics of collateral cash movements and the high percentage of derivatives typically subject to collateral agreements.

- Solvency risk measures the degree to which net asset values have to fall before a firm becomes insolvent. However, it is the risk of open market positions that drives volatility (and potential declines) in net asset values, not the size of gross derivative amounts. For example, in a perfectly matched derivative portfolio with no net open market risk, derivative receivables would grow equivalently with derivative payables based on movements in market indices, and therefore there is no effect on the solvency of the entity. Major derivative dealers typically dynamically hedge market risk and manage it on a net basis to a relatively low open risk position (as evidenced by low VaR relative to gross assets). Therefore gross balance sheet amounts are not particularly useful indicators of how much net derivative asset values have to decline before a firm becomes insolvent.
- Market risk cannot be adequately communicated through either gross or net presentation, since it represents the sensitivity of potential future changes in the underlying, which cannot be expressed as a point-in-time amount on the balance sheet. A portfolio of derivatives may be virtually immune to market risks, yet have a large amount of assets and liabilities on a gross basis; or a portfolio of derivatives may be significantly exposed to market risks, yet have virtually no current fair value on a gross or net basis. However, the inability to adequately communicate all risks through the balance sheet should not preclude the Boards from pursuing relevant presentation where possible.
- Finally, consistent with the views expressed in FIN 39 and the Proposed ASU's Alternative Views, net presentation better informs users of the credit risk when supported by a legally enforceable netting framework. When evaluating credit exposure at a specific point in time, market participants and regulators generally refer to net exposures as the most accurate and relevant information of the current credit exposure faced by a company. While a point in time measure of credit exposure does not reflect the volatility of the credit exposure, we believe volatility and other characteristics of an exposure are best addressed through disclosure, in a manner similar to other volatility disclosures.

We note the Boards' views that the balance sheet is not intended to reflect just one risk (credit) at the expense of other risks, and that the credit risk reduction achieved for instruments transacted under a master netting agreement does not, by itself, warrant a different balance sheet treatment. However, in other respects, the Boards seem to focus on credit risk as the determinative criterion for net presentation. In the simultaneous settlement criterion, the Boards do not allow net presentation unless credit risk is entirely eliminated by the settlement of gross cash flows at exactly the same moment; the presence of same day settlement combined with other credit risk mitigation features are not considered sufficient to warrant net presentation. We are confused by the inconsistent consideration of credit risk in the Proposed ASU, and support net presentation on the basis that it is the most effective portrayal of all risks, including credit, as described above.

Presentation based on Settlement Procedures

Significant differences in balance sheet presentation should not be dependent on non-economic differences in settlement procedures (whether net settled, simultaneously settled, or settled on the same day subject to an intra-day credit agreement). There are valid operational reasons for settlements to occur throughout the day rather than all at the same moment throughout the financial system, and minor differences in the timing of settlement should not be the sole driver of different balance sheet treatment. For example, for cleared derivatives, coupon (i.e. trade settlement amounts) and margin payments are settled either together or separately on a net basis (depending on the clearing house) but always separately by currency. Clearing houses and clearing members have established credit risk mitigants which may include initial margin requirements, intra-day credit arrangements, guarantee funds, and termination provisions, to result in cash flows that are economically akin to net settlement. Forcing all amounts to be settled via a single net payment each day (in order to appropriately reflect transactions on a net basis under the Proposed ASU) would, therefore, result in a significant and costly change to some clearing house systems and processes with no apparent economic benefit.

Furthermore, a shift towards simultaneous settlement of financial instruments is likely to create consequences unintended by the Boards. For example, requiring settlement at the exact same moment for repurchase agreements (and outright securities purchases and sales given that both are settled through the same securities transfer systems) could severely limit liquidity in the repo markets. Since many participants in such markets maintain low levels of inventory in the underlying securities and many securities transfer systems operate on a delivery versus payment basis, requiring net settlement would result in the need to specify the precise delivery time for each underlying security to ensure availability for onward delivery. This could have the effect of reducing liquidity in the repo market, as there would be fewer participants willing to settle a particular security transaction at a specified time than willing to settle at some time during that day. Furthermore, it would result in participant firms holding increased securities inventory on their balance sheet to ensure delivery obligations can be met, requiring the reallocation of free capital from other activities.

Rather than using a bright-line net settlement or simultaneous settlement test, we suggest that the Boards incorporate a concept of a "functional equivalent of net settlement" in its final standard. For securities financing transactions, we believe that the principles currently found in U.S. GAAP in ASC 210-20-45-11 (FIN 41) for repurchase agreements are practical and well tested over many years. In the basis for conclusions of FIN 41, the FASB previously concluded that the clearing and settlement mechanisms described therein constituted the "functional equivalent" of net settlement where daylight overdraft or other intraday credit privileges exist, noting that the constraints of settlement that require 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 such privileges are present. We believe that this conclusion remains equally valid today and that such an approach would remain consistent with the concept of net settlement, while providing appropriate practical accommodations for common daily settlement practices.

For derivatives transactions, the principles found in ASC 815-10-45 (FIN 39) have been equally well tested. These principles reflect the unique nature of derivative transactions as equivalent cash flows under a single contract, and logically extend the unique accounting for single derivative instruments as the net present value of offsetting cash flows on different dates to the multiple derivative instruments that exist under a single master netting agreement contract. The presentation is most consistent with the information needed to understand the impact of derivatives on the liquidity and solvency of an entity, and with the credit exposure to the derivative counterparty.

Financial Statement Ratios

One of the significant effects of the Proposed ASU is its effect on many commonly used ratios based on total assets or total liabilities, including ratios such as the leverage ratio used by regulatory agencies. While we understand the Board's view that regulators are theoretically free to revise their calculations as a consequence of a change to US GAAP, we believe that the FASB should consider the practical constraints that may exist on their ability to do so. In addition, the assets of a reporting entity may fluctuate more significantly over time based on movements in market indices that affect the value of derivative receivables, thereby decreasing the usefulness of these asset based ratios as comparative measures over time.

Brokerage Receivables and Pavables

We disagree with the proposed elimination of the industry guidance allowing net presentation of brokerage receivables and payables related to unsettled regular way securities transactions. The AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* describes the rationale for why net presentation is appropriate:

• The risk of nonperformance of regular-way settling trades is minimal given the following: (a) they are fully collateralized on the trade date; (b) the period of time between trade date and settlement date is reasonably short; and (c) most equity, U.S. government, and mortgage-backed agency securities are affirmed by both parties to the trade and settle net through a

clearing entity. Accordingly, FASB ASC 940-20-45-3 states that payables and receivables arising from these unsettled regular-way transactions may be recorded net in an account titled net receivable (or payable) for unsettled regular-way trades.

We do not believe that a compelling case could be made that grossing up these amounts would be useful to users of financial statements. Regular way security trades generally settle without difficulty. If there is a settlement failure, the receivables and payables are appropriately presented gross on the balance sheet on settlement date. The existing guidance has been systemically incorporated into how securities transactions are processed and accounted for and would require significant cost, resources and time to unwind from the securities systems globally for no apparent financial reporting benefit.

Other Concerns

Collateral and Variation Margin

We recommend that the Boards focus on creating principles that require entities to apply consistently the criteria for net presentation to all eligible assets and eligible liabilities, including the financial assets and financial liabilities related to variation margin and collateral as we do not believe there is a conceptually sound reason to treat them differently.

Under the ISDA Master Netting Agreement, there is no legal distinction between a coupon cash flow and a collateral cash flow; they are each a cash flow under a single contract. The amount of cash collateral arises from and is calculated based on the unrealized gains or losses of the related derivative. It cannot exist apart from the unrealized gains and losses, and it should be afforded the same presentation. Further, as the collateralization process is intrinsic to understanding the resources of the entity that would be available to creditors other than the derivative counterparty, net presentation of these amounts better informs financial statement readers than gross presentation.

In addition, we note that variation margin posted under the rules of several exchange-traded products, including many futures contracts, is legally a form of settlement. Amounts that are legally settled are derecognized, not netted. For the avoidance of confusion on this point, we recommend the deletion of all references to "futures contracts."

Enforceability of right of setoff

We understand that concerns have been expressed that litigation arising out of the financial crisis may call into question the enforceability of the Close Out Netting provisions in the ISDA Master Netting Agreement. Our experience has been that the Close Out Netting provisions have been enforceable in every default event in a jurisdiction in which ISDA has obtained a legal opinion supporting its enforceability. While certain counterparty defaults have resulted in litigation, none of the cases involved issues about the enforceability of the Close Out Netting provisions of the ISDA Master Netting Agreement. Rather, the legal cases have involved issues about the operation of the mutual suspense provision of the ISDA Master Agreement, issues involving the setoff provision (particularly affiliate setoff), the use of certain subordination mechanisms in structured finance transactions, or whether the calculation of individual transaction values was appropriate and in accordance with the restrictions in the agreement. Please see Appendix D for a discussion of the legal provisions that have been the subject of litigation.

Payment Netting

The Proposed ASU's application to Payment Netting is unclear. If certain of the cash flows under the eligible assets and eligible liabilities have the same settlement date while others do not, we are unable to determine whether the Proposed ASU allows netting based on the entire fair value of the assets and liabilities, or whether there would be a requirement to look through the unit of account for each transaction and only net those cash payments that are expected to occur on the same date. We believe peeking through the unit of account to net individual cash flows is not an accurate reflection of the net exposure, and would be overly burdensome from an operational perspective.

Disclosures

We believe the sole purpose of disclosures in this project should be to provide transparency as to amounts that have been netted for presentation purposes. Accordingly, the disclosure requirements should include the gross asset or liability amount related to amounts presented net, transaction amounts presented net, collateral amounts presented net, the carrying value on the balance sheet, and any collateral amounts not nettable for presentation purposes, but considered in the evaluation of credit risk exposure.

Credit risk disclosures, to the extent that they are not within the scope of recent improvements in credit quality disclosures ("ASU 2010-20"), should be addressed in a separate project that considers all credit risk management activities, rather than just rights of set off and related collateral arrangements. While rights of set off and related arrangements may be the primary means of credit risk management for derivatives and securities financing arrangements, such is not the case for all eligible assets and liabilities. At a minimum, loan receivables in the scope of ASU 2010-20 should be excluded from the scope of any new credit risk disclosure requirements.

Paragraphs 12 and C16 of the Proposed ASU require disclosures by class of eligible asset and liability. Since the provisions of netting agreements material to an understanding of credit risk apply by counterparty to broad categories of instruments, we believe that differentiation by class similar to that found in disclosures prepared in accordance with ASU 2010-20 would not be useful, nor in be some cases, be operational. We believe that any reference to class should clarify that it is intended to refer to a broad category of eligible assets and liabilities such as "derivative assets" or "repurchase agreement liabilities", and not to sub-categories of those instruments.

Certain other disclosures would not be operational:

- Paragraph 12c and 12d of the Proposed ASU require separate disclosure of the amounts related to Payment Netting and Close Out Netting. These requirements are not operational in our view, because the separate disclosures relate to the same amounts. Payment Netting and Close Out Netting are provisions within the same contract. Payment Netting exists during the life of the transactions, but ceases to exist upon termination of the transactions. Upon termination, Close Out Netting applies.
- Paragraph 12c, in requiring disclosure of instances in which a preparer has a right of set off
 but does not intend to exercise it, seems to require that preparers search for instances of
 incidental rather than intentional offset. We believe it would be extremely difficult to search
 for such incidental offset.

Effective date and transition

As discussed above, we strongly disagree with the offsetting criteria proposed by the Boards, and believe that criteria consistent with those under current US GAAP have the strongest conceptual basis. However, if the Boards were to issue a final standard containing netting criteria that would be new to preparers, the required effort to analyze the multitude of agreements and settlement procedures across all of the business activities of a global firm would be very significant. In particular, the elective nature of the netting criteria under ASC 815-10-45 and ASC 210-20-45 (FIN 39 and FIN 41) allowed preparers sufficient time to complete comprehensive investigations into these agreements and systems. By requiring mandatory net presentation when the revised criteria are met, the Proposed ASU would significantly increase the effort that would be required to properly account for affected transactions. In addition, in our comments addressing the Discussion Paper - Effective Dates and Transition Methods, we proposed that the accounting proposals in the scope of that Discussion Paper, including balance sheet offsetting, should be implemented through a single date approach. If the Proposed ASU is issued final with a separate effective date, we believe that a minimum of two years between the issuance date and the effective date of the final standard would be necessary due to the efforts required to analyze legal agreements and settlement procedures throughout the world given the change to a mandatory presentation requirement.

Appendix B

Derivatives: Agreements and Settlement

As the Proposed ASU would have a disproportionate impact on the presentation of derivative transactions and securities financing transactions, we provide background relevant to understanding the contractual and operational nature of derivatives (Appendix B) and securities financings (Appendix C), and therefore the usefulness of the different balance sheet presentations and the applicability of the conceptual framework model to those transactions.

In the background below, we explain the legal agreements and cash settlement operations between bilateral counterparties and between clearing members and derivatives clearing houses. We believe that an understanding of the totality of these arrangements makes it clear that net presentation of derivatives, whether cleared or settled bilaterally, is preferable for an understanding of the resources of an entity involved in derivatives markets and the claims against it. All paragraph and section references below to the refer to the latest generally accepted market standard of the ISDA Master Netting Agreement and its component parts (the 2002 ISDA Master Netting Agreement, the 1994 Credit Support Annex and the 2003 Amendment to the Credit Support Annex).

Bilateral Derivatives

For over the counter derivatives transactions that are not cleared through a clearinghouse, the legal agreement between the counterparties is typically an ISDA Master Netting Agreement. Confirmations documenting individual transactions conducted under the ISDA Master Netting agreement, along with any other applicable provisions or documents such as the Credit Support Annex, Close Out Netting provisions, Payment Netting and other provisions, all form a single contract. The confirmation documenting the terms of the trade is not itself a separate divisible contract. Therefore, each separate derivative is not a "contract" but rather is only a "transaction" underneath the umbrella of the larger contract. When the two counterparties enter into an additional new derivative transaction, the new transaction modifies the entire ISDA Master Netting Agreement contract between the parties.

Payment Netting

Section 2(c) of the ISDA Master Netting Agreement provides that same-day, same-currency obligations within the same transaction are considered satisfied by settling the net amount. Section 2 (c) further provides that, if elected by the parties in any schedule or confirmation, this netting provision may be extended beyond an individual transaction, permitting the parties to net settle same-day, same-currency payments across multiple transactions. The contract provides that this election may be made separately for different groups of transactions and will apply separately to each pairing of offices through which the parties make and receive payments or deliveries. If elected, this form of net cash settlement across transactions (referred to as "Payment Netting") is typically performed within related product types, such as netting all interest rate swaps between two counterparty offices, or all equity derivatives. This reflects that different product types typically have different settlement systems and operations teams, and therefore, netting across systems and operational platforms is more difficult than netting within them. Thus the limitations of Payment Netting within product types reflect operational limitations, not market risk management concerns. Derivative dealers typically seek to maximize net settlement wherever it is operationally feasible for both the dealer and the counterparty.

Collateral

The Credit Support Annex ("CSA") to the ISDA Master Netting Agreement is a collateral arrangement within the contract that "forms part of, and is subject to," the ISDA Master Netting Agreement. In Paragraph 2 of the CSA, each party pledges security for its obligations to the other party and grants to the other a "first priority continuing security interest in, lien on and right of set-off against all posted collateral". The CSA further grants to the secured party upon default by the pledgor of collateral "the right to set-off any amounts payable by the pledgor of collateral … against

any posted collateral or the cash equivalent of any posted collateral held by the secured party." It also grants to the secured party the right to liquidate collateral and to apply the proceeds to an amount payable by the pledgor of collateral.

The collateral amounts required to be transferred under the CSA to secure each party's exposure are calculated under Paragraph 3 as the difference between the secured party's exposure and the amount of collateral already held to secure the exposure. The secured party's exposure is defined in Paragraph 12's definitions as the net amount that would be calculated as if all of the transactions were to be terminated as per the Close Out Netting provisions at the time of the collateral call calculation (please see below for a discussion of the Close Out Netting provisions). In other words, all of the derivative fair values under the ISDA Master Netting Agreement are netted by currency, positive against negative, to arrive at one net amount which is the basis for the collateral call. The terms of the CSA may include minimum thresholds for settlement so that the burden of transferring trivial amounts is avoided.

Under Paragraph 4(b) of the CSA, transfers of collateral are required to be made the next business day for all demands for collateral made before the required notification time (1:00 pm New York time, unless otherwise specified). If the demand for collateral is made after the required notification time, the transfer is required to be posted not later than the close of business on the second business day.

Paragraph 6(c) provides that collateral received under the CSA may be sold, pledged, rehypothecated, assigned, invested, used, commingled or otherwise disposed of, or otherwise used in the secured party's business, free from any claim or right of any nature whatsoever.

Close Out Netting

The Close Out Netting provisions in Sections 5 and 6 of the ISDA Master Netting Agreement provide that upon a default and subsequent termination of the Agreement by the Non Defaulting Party, (i) all transactions are terminated ("with no ability on the part of the Non Defaulting Party to selectively terminate or "cherry pick" transactions"), (ii) all transactions are valued and the positive value or "in the money" transactions are netted against the negative value or "out of the money" transactions and (iii) the only remaining payment obligation of the parties following termination is to pay the netted termination amount (the "Net Termination Amount").

The right to settle terminated transactions on a net basis has been tested real time in multiple events of default in multiple jurisdictions, and has been enforceable in all circumstances in our experience and to the extent of our knowledge of the experience of other market participants in any of the over 50 jurisdictions for which ISDA has obtained a "would" level opinion from outside counsel supporting its enforceability.

Cleared Derivatives

Over-the-counter derivative transactions to be cleared through a clearinghouse are initially transacted with a bilateral counterparty. The counterparties then submit the terms of the transaction to the clearinghouse. Upon matching by the clearinghouse, the bilateral trade is novated, at which time each bilateral counterparty becomes party to a derivative transaction facing the clearinghouse as its respective counterparty. The contract between each clearing member and the clearinghouse is codified in the clearinghouse rules.

Clearing house rules provide for Close Out Netting in the event of default of either the clearing member or the clearing house. Upon default, positive and negative payment obligations related to derivative transactions and margin amounts are calculated and settled net by currency. Close Out Netting is understood to be enforceable under bankruptcy law in major respective jurisdictions and certain clearing houses have sought and obtained opinions supporting enforceability in major jurisdictions.

Clearing house rules also provide for net settlement of certain cash flows due in the normal course. There are typically three types of cash settlements for cleared derivatives. Coupons, which include interim coupon, unwinds, and maturing trades, are settled once daily on a net basis; all positive and negative coupon amounts are calculated and the net amount is paid or received. Initial Margin and Variation Margin include amounts due at the initiation of a derivative transaction and throughout its life, based on potential and actual changes in fair value of the derivative transaction, respectively. Positive and negative amounts related to Initial Margin and Variation Margin are settled on a net basis at least once daily. Interest on Variation Margin is paid once a month and is typically netted within the Initial Margin and Variation Margin settlement amount. For all types of cash settlements, amounts are not netted across currencies; each currency's respective net amounts are settled separately. However, some clearing houses do net different types of cash settlements; for example, LCH and CME net settle Coupons, Initial and Variation Margin, and Interest on Variation Margin in a single cash flow. Given that IOSCO principles require legal enforceability of clearing house rules, such Payment Netting is considered enforceable, although market participants may not have sought formal written opinions to that effect from external counsel.

Therefore, when studying bilateral and cleared over the counter derivatives, it becomes apparent that it is generally not true that cash flows are netted only conditionally. There is significant netting of cash flows that occurs in the normal course of business, which is driven by the desire of market participants to reduce counterparty credit risk. However, the net settlements by clearing houses and bilateral counterparties may rarely meet the criteria of the Proposed ASU, as maturity dates and interim coupon dates do not align for all transactions and because (except for LCH and CME) Coupon and Margin cash settlements do not occur at the exact same moment during the day.

Appendix C

Securities Financing Transactions: Agreements and Settlement

Securities financing transactions such as repurchase and resale agreements fall broadly into two categories (i) bilateral transactions and (ii) transactions novated to a central counterparty ("CCP") such as the London Clearing House or the Fixed Income Clearing Corporation – Government Securities Division. Both categories of transactions are settled through the particular securities transfer system applicable to the type of underlying securities collateral; however a CCP typically nets certain amounts prior to transactions being submitted to the securities transfer system for settlement.

The settlement processes described below are designed to achieve the functional equivalent of net settlement. This is achieved through intra-day overdraft facilities provided by custodian banks, which are secured by collateral that is unrelated to the transaction being cleared. Therefore, while settlements of securities and cash occur throughout the day by the custodian bank, only one net cash flow is due to be received or paid between each securities financing counterparty and its custodian bank.

Bilateral securities financings

Legal agreements

Bilateral repurchase agreements are generally documented under either a Master Repurchase Agreement (MRA) (used primarily but not exclusively for US Dollar denominated securities) or a Global Master Repurchase Agreement (GMRA) (used primarily but not exclusively for non-US Dollar denominated securities). These two master contracts do have different terms, but are broadly similar in nature and effect with respect to net settlement:

- The MRA provides for the right to net settle in the normal course of business all amounts due under the contract, including securities, margin, interest and other amounts.
- The GMRA provides for the right to net settle in the normal course of business (a) all cash amounts due in the same currency and, separately, (b) securities of the same issue, denomination, currency and series, each due under the contract
- In an event of default, both contracts provide for termination and Close Out Netting that results in the payment or receipt of a single net amount by currency representing the satisfaction of all rights and obligations under the agreement.

While both the GMRA and the MRA provide the counterparties with rights of set off in the ordinary course of business, the transactions are not generally settled in accordance with these rights, since the established securities transfer system processes do not lend themselves to net settlement or to the additional operational complexity net settlement would entail.

As with the ISDA Master Netting Agreement, legal opinions exist to support the enforceability of these agreements in the event of bankruptcy or other default in the major jurisdictions, and the exercise of these rights has been upheld in actual defaults.

Settlement

Securities financings settle on the same securities transfer systems as outright purchases and sales of securities. While there are various securities transfer systems throughout the world with a variety of settlement procedures, their operation can be broadly summarized as follows:

• In some securities transfers systems, counterparties will seek to 'pair off' or 'net' securities transfer transactions, including transactions not subject to the MRA or GMRA, related to the same CUSIP with the same counterparty with the same currency and settlement date. Thus, for example, an outright purchase transaction may be paired off with one leg of a repurchase transaction with the same security. For paired off transactions, a net amount of securities is transferred and, separately, a net amount of cash is transferred to satisfy the obligations for all of the transactions, including transactions not subject to the MRA or GMRA, in that CUSIP.

- Transactions that are not paired off are settled when settlement instructions from both counterparties to the transaction are matched, which involves a debit or credit to the account of the transacting counterparty at the custodian bank, with a corresponding credit or debit to the relevant securities account at the custodian bank. For some securities transfer systems, the settlements are matched through a combination of one or more batch processes and 'real time' intra-day matching. Each counterparty is then required to settle the balance at the custodian bank on a daily basis or else utilize an overnight credit facility depending on credit capacity and availability.
- Securities financings also require margin to be paid or received as the value of the securities underlying a specific contract changes. Margin calls are generally made through a separate process to the settlement process, depending on securities transfer system in question.

Securities Financings with Central Counterparties

Legal agreements

Transactions executed through a central counterparty (a "CCP") are governed by the rules of the relevant CCP that is the novated counterparty to the transaction. Typically the netting provisions are reflective of the actual settlement processes that take place in the underlying securities transfer systems. Absent an event of default, CCPs generally require net settlement of transactions in the same underlying securities on the same day, such that a net amount of securities is transferred and, separately, a net amount of cash is transferred in respect of those transactions. As with the MRA and GMRA, we understand that the CCP rules provide for termination and Close Out Netting upon an event of default and a single net amount to be paid/received by currency.

Settlement

For securities financing transactions that are executed through a CCP, the rules of the CCP generally require that transactions are novated to the CCP on a gross basis, at which point the CCP will apply a rules-based pair off process prior to the submission by their members of the transactions to the underlying securities transfer system for settlement. Typically, a CCP will pair off all transactions within a single CUSIP that have the same counterparty, the same currency (where relevant) and same value date. Once the pairing has been applied under the CCP rules, the resulting (netted) settlement instructions are then submitted into the settlement process at the underlying securities transfer system as described above for bilateral transactions.

Appendix D

Legal Enforceability of the ISDA Master Netting Agreement

As discussed previously, the right to settle terminated transactions on a net basis has been tested real time in multiple events of default in multiple jurisdictions, and has been enforceable in all circumstances in our experience and to the extent of our knowledge of the experience of other market participants. Although we are aware of the concern that specific recent litigation matters may call into question the enforceability of the Close Out Netting Provisions of the ISDA Master Netting Agreement, a review of these litigation matters demonstrates that the matters do not involve issues about the enforceability of the Close Out Netting Provisions. It is important to note that the ISDA Master Agreement includes important provisions that parties may use upon a default *in addition* to the Close Out Netting Provisions. Two provisions in particular are worth mentioning in this context:

- Section 2(a)(iii), also called the "Mutual Suspense" provision, allows a Non Defaulting Party to suspend its performance, such as making payments, for so long as an event of default is continuing and termination of the contract has not been elected. This provision is intended to provide a means of alleviating transaction issues between the derivative counterparties through a means other than Close Out, allowing the parties to remedy the situation without increasing the non-defaulting counterparty's credit exposure. The Mutual Suspense provision is fundamentally (and legally) different from Close Out Netting, which provides for the calculation and payment of a single net Termination Amount in the event that termination is elected after default.
- An ISDA Master Agreement also typically contains a "Setoff Provision", which entitles a Non Defaulting Party to set off non-derivative obligations due from the Defaulting Party against the derivative-related single net Close Out Termination Amount owed to the Defaulting Party. For example a Non-Defaulting Party would, under this provision, not pay the net Close Out Termination Amount obligation, but instead use its net obligation to set off against its loans or debt obligation assets issued by the Defaulting Party. However, it is important to note that Set Off is a different provision from Close Out Netting, and is considered after the Close Out Net Termination Amount is determined.

The cases involving Lehman (and others) have *not* involved issues about the enforceability of the Close Out Netting Provisions of the ISDA Master Netting Agreement. Rather, they have involved issues about (i) the operation of the Mutual Suspense provision, (ii) issues involving the Setoff Provision, particularly affiliate setoff, (iii) the use of certain subordination mechanisms in structured finance transactions or (iv) whether the calculation of individual transaction values was appropriate and in accordance with the restrictions in the Agreement. A detailed discussion of recent cases has been provided to the FASB and IASB staff. We would be happy to discuss these cases in further detail if there remain questions as to how these litigation issues differ from the issue of the enforceability of the Close Out Netting provisions.