Dataline

A look at current financial reporting issues

No. 2013-30
December 20, 2013

What's inside:

Overview 1
Background 1
Dodd-Frank reforms: central clearing rules........... 2
Regulation of uncleared OTC derivatives 3
Comparing OTC derivatives to centrally cleared derivatives........................... 3
Questions and interpretive responses .. 6
Questions........................... 10
Appendix—List of useful websites 11

Accounting for centrally cleared derivatives

Understanding the implications of Dodd-Frank Title VII

Overview

- The Dodd-Frank Wall Street Reform and Consumer Protection Act Title VII (Dodd-Frank) significantly changed the regulations for derivative instruments, such as mandating that certain derivatives be centrally cleared and transacted by certain counterparties provided an end-user does not meet an exception.

- A number of financial reporting implementation questions have arisen as companies consider the Dodd-Frank requirements. These include, but are not limited to, determining fair value of centrally cleared derivatives, accounting for collateral, assessing the impact on hedge accounting, and determining the appropriate presentation (gross versus net).

- This Dataline discusses the financial reporting implications of the new requirements, primarily focusing on end-users that trade in the affected derivatives and who do not qualify for the end-user exception.

- Constituents should also consider whether there are additional international regulations beyond those discussed in this paper that may be relevant depending on the nature of their trading activity and brokerage relationships.

Background

.1 Following the global financial crisis in 2008, the leaders of the Group of Twenty (G20) nations made a number of commitments to substantially reform over-the-counter (OTC) derivative market practices. In 2009, they committed that:

- All standardized OTC derivative contracts should be traded on exchanges or electronic platforms, where appropriate

- All standardized OTC derivatives contracts should be cleared through central counterparties

- OTC derivative contracts should be reported to trade repositories

.2 In 2011, the G20 noted that non-centrally cleared OTC derivative contracts should be subject to margin requirements in the future as well.

.3 The main objectives for these regulatory reforms are greater transparency and standardization of OTC derivatives and processes thereby limiting operational and systemic risk. It also provides a mechanism for enhanced transparency around the pricing of derivative contracts.

.4 To implement the G20 commitments, the United States adopted legislative and regulatory changes through the Dodd-Frank Act, which was signed into federal law on July 21, 2010. Title VII of Dodd-Frank addresses regulation of the OTC derivative markets and divides the regulatory jurisdiction for derivatives into two parts: (1) the Commodities Futures Trading Commission (CFTC) has responsibility to regulate swaps, swap dealers, and major swap participants and (2) the Securities and Exchange Commission (SEC) regulates security-based swaps, security-based swap dealers, and security-based major swap participants. While significant progress in the United States has been made, changes are still expected to stretch beyond 2013.

Dodd-Frank reforms: central clearing rules

.5 The reforms mandated by Title VII of Dodd-Frank have changed the way entities trade certain derivative instruments (such as interest rate and credit default swaps). The main objectives of the regulatory reforms are achieving greater transparency of certain derivative instruments, and reducing operational and credit risk by introducing central clearing for these instruments.

.6 The rules require that certain derivative instruments be traded through designated electronic trading platforms, and cleared through registered clearing houses. Additionally, both cleared and uncleared[1] OTC derivatives need to be reported to one of the registered swap data repositories. The timing of the requirements is staggered and aspects of the regulation are still unfolding.

.7 Entities that wish to trade derivative instruments (as discussed above) are now required to follow new requirements when transacting within the scope of the regulation (provided the entity does not qualify for an end-user exception[2]). In order to enter into certain derivative instrument transactions, an entity will now need to:

- transact either through a swap execution facility or directly with a registered swap dealer,
- have relationships with a registered swap dealer, and
- have a relationship with a registered swap clearing broker (also referred to as swap/futures commission merchants, or clearing member) who in turn interacts directly with the clearing house on the entity's behalf.

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[1] Non-cleared OTC derivatives are principally foreign currency swap contracts with size-based notional quantities that are transacted directly with banks or equivalent counterparties. These contracts were not made subject to the trading and clearance requirements of Title VII; however, these contracts will still be required to be reported to one of the registered swap data repositories by the counterparty bank or equivalent entity. Foreign currency swaps contracts that are below designated notional quantities (such as less than $1 million notional), are regulated by the CFTC and must be transacted through a registered foreign currency dealer, and are not subject to the Title VII reporting requirements.

[2] For more details on the end-user exception, see PwC's *10Minutes on derivatives reform for non-financial services companies*.

.8 These changes have significantly affected operations, technology, finance, and legal functions within organizations that transact in derivative instruments covered by the Dodd-Frank regulations.

.9 Central clearing rules were finalized and issued on December 13, 2012. The CFTC adopted a phase-in approach to clearing, with compliance dates staggered by counterparty type as follows:

- March 11, 2013: Swap dealers, major swap participants, and active funds
- June 10, 2013: Funds other than active funds, commodity pools, and those primarily engaged in the business of banking
- September 9, 2013: All other market participants for which the end-user exemption does not apply

.10 Once the rules were finalized, the CFTC issued a list of derivative types that included interest rate and credit default swaps (as of the date of this publication) that are required to be cleared in accordance with the relevant compliance dates above.

Regulation of uncleared OTC derivatives

.11 End-users subject to the general clearing requirements under Dodd-Frank may still trade certain other OTC derivatives that are not subject to central clearing after the effective dates for Title VII so long as they are not one of the derivative types required to be traded/cleared/margined through a central clearing party[3] or meet the end-user exception referenced in footnote two above.

.12 A significant milestone was reached in February 2013 to regulate OTC derivatives that do not require central clearing. The Basel Committee on Banking Supervision and the International Organization of Securities Commissions announced a final framework for requiring uncleared swaps to have collateral margining. The principles provide for a phase-in implementation from January 2015 through 2019.

.13 The requirements to post margin to the counterparty are only applicable to entities or affiliate groups with over $8 billion gross notional of uncleared OTC derivatives outstanding. There is a complete exemption for sovereigns, central banks, and certain international agencies. Furthermore, posting of initial margin is only required when it exceeds a given initial margin threshold between counterparties.

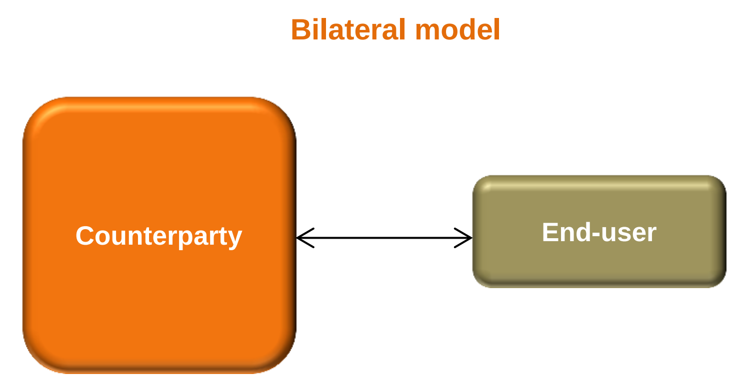
Comparing OTC derivatives to centrally cleared derivatives

.14 There are significant differences between OTC derivatives that are traded bilaterally and those that are traded using a clearing house under the new requirements. A few of the key differences include:

[3] As discussed in footnote 1, principally foreign currency swap contracts.

Bilateral execution (pre-Dodd Frank)	Centrally cleared (post-Dodd Frank)
• All aspects of an agreed trade — legal, credit, market, and operational risks — are dealt with directly between the two transacting parties. • Posting of collateral is not required unless each party agrees to it as a requirement for the trade. Therefore, collateral agreements are customized. • Non-performance risk of the trade resides with both parties to the extent the trade is uncollateralized.	• Trades are executed bilaterally through a swap execution facility/swap dealer and then "back to back" or novated to the clearing house. Multiple parties are involved including end-user, swap execution facility, swap dealer broker, clearing member, and clearing house. • Requirements for initial margin set by clearing house irrespective of the quality of the counterparty. • Variation margin is subject to daily movement. • Trades are executed on a trading platform (swap execution facility (SEF) or designated contracts market (DCM)). • Customer assets are legally segregated from clearing member assets.

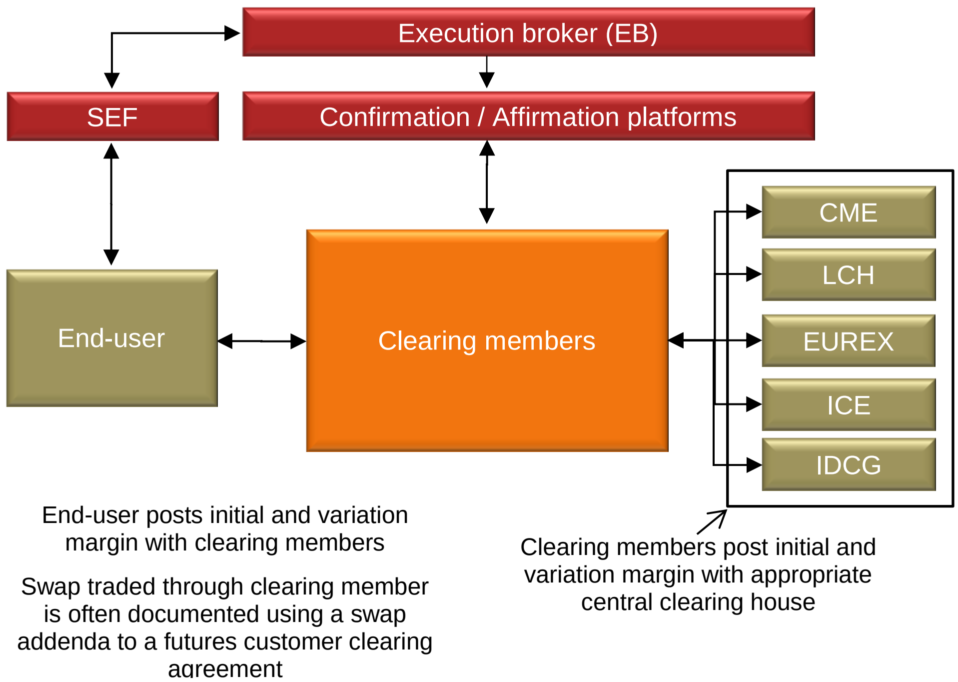
.15 The following diagrams illustrate examples of certain differences between the two models:



- Contract governed by ISDA
- Collateral requirements are outlined by CSA (as applicable)

- Collateral is exchanged in accordance with CSA
- ISDA – International Swap and Derivatives Association
- CSA – Credit support annex which is an addendum to ISDA

Centrally cleared



- SEF – Swap Execution Facility used as a platform for the trading or processing of swaps
- Margin methodology and collateral eligibility determined by central clearing house

.16 As noted above, to the extent an end-user is not directly a clearing member it needs to engage an entity who is registered as a swap/futures commission merchant (FCM) with the CFTC and who is a clearing member of a clearing house. The clearing member acts as an intermediary to clear the derivative contract since the clearing house does not have a direct relationship with the end-user.

Collateral requirements

.17 End-users provide cash or securities[4] to their clearing members for initial margin (amount required to be deposited in order to open a position). Subsequent to the trade date, variation margin is exchanged in either direction based upon price movements of the contracts that are currently open. This periodic movement of variation margin mitigates default risk. The clearing member then pays initial margin and, if negative, variation margin to the clearing house. If the variation margin is positive, the clearing member receives the amount from the clearing house.

.18 The type of collateral accepted varies by clearing house. The collateral that is accepted typically includes very liquid and highly rated securities. However, clearing houses and clearing members continue to add new qualifying financial assets to the list of eligible collateral. Since this process is now more standardized, the form of the collateral may differ compared to what had been negotiated into bilateral trades through an

[4] Collateral may take several forms, including examples such as US Treasury issues or corporate debt. End-user entities should validate with the clearing broker what form of collateral will be accepted.

existing credit support annex (CSA) to an International Swap and Derivatives Association (ISDA) master agreement. End-users now need to manage these types of instruments and cash to meet existing and future margin calls.

Use of contracts

.19 A bilateral trade generally only requires one contract (for example, an ISDA agreement supplemented by a CSA that has historically governed the rules for collateralization between the two parties). After Dodd-Frank, transacting and clearing derivative instruments requires multiple legal contracts between the end-user, swap execution facility, swap dealer, and clearing member. The clearing members, in turn, will need to have contracts with the clearing house. The common agreement that the end-user firm needs to sign with the clearing member is a futures account agreement (FCM agreement) together with an "OTC addendum," which is now needed to accommodate these derivative instrument transactions.

PwC observation:

The legal form of the contractual relationship has several accounting implications. Companies should use caution when drawing comparisons to other types of derivative arrangements since these trades involve new relationships defined under different contracts. Companies should consider consulting with legal counsel regarding their rights with respect to centrally cleared derivatives.

Questions and interpretive responses

Question 1

How should an end-user utilize swap values provided by clearing houses in determining the fair value of a swap in accordance with ASC 820, *Fair Value Measurement*?

Interpretive response

There are several clearing houses actively involved in the clearing of credit default swaps and interest rate swaps. Each clearing house may have a different approach to calculating variation margin each day. More specifically, the clearing house provides a "value mark" used to determine the amount of variation margin required to be moved. The value mark is not a price. It is not a value at which an entity could open or close the trade at that particular point in time. As a result, this value mark is not considered an "exit price" or a "level 1" fair value input (as defined in ASC 820). However, the value mark at the end of the day is one data point that an end-user may consider in determining fair value.

Companies will need to evaluate their specific facts and circumstances related to their portfolios, and assess clearing house values in a similar manner as a vendor or counterparty price. As further explained in the response to question two, the value provided by the clearing house and clearing member may not be solely attributed to changes in the valuation of the derivative[5]. Companies should keep this in mind when determining fair value of their derivatives in accordance with ASC 820.

[5] The clearing broker may have internal standards, known as "house margin," which are increments above the clearing house initial and variation margin amounts. These "house margin" requirements are not readily transparent to end-users and may be subject to negotiation between the end-user and the swap clearing broker.

Question 2

What does the periodic movement of variation margin represent, and should an end-user view it as payments of collateral, or a legal settlement of an open position?

Interpretive response

First, it is helpful to establish precisely what is meant by variation margin. Variation margin is an amount that is required to be paid or received periodically as dictated by the clearing member and/or clearing house. The clearing house will determine a "value" used to calculate the amount of variation margin owed or due to be received. In addition to the pure change in "value" of the derivative, the clearing house may or may not decide to incorporate an additional amount be posted to mitigate any non-payment risk or for other reasons. Moreover, in some cases the clearing member may request an amount in addition to what is dictated by the clearing house for the same reasons. This means that the variation margin may not be a pure representation of the change in the derivative's value.

From an end-user's perspective as it relates to its financial statement presentation, there appear to be two possible characterizations for the variation margin (subject to a legal determination of the facts and circumstances for each end-user and legal framework). One is that the cash payment amounts are considered collateral associated with open positions. In this scenario, the derivative and the accumulated collateral need to be assessed for both the balance sheet presentation under ASC 210, *Balance Sheet,* and ASC 815, *Derivatives and Hedging,* as well as footnote disclosures required by ASC 210.

A second view is that the cash movements are considered legal settlements of an open contract. This determination is not an accounting election, but rather requires a legal assessment of the specific terms of each trade and the legal relationship with the clearing member and clearing house. In this scenario, the position is legally partially settled or extinguished each day cash is moved, so a position only remains open to the extent cash has not settled.

Question 3

Does an entity need to consider different accounting treatments depending on whether cash or securities are provided as margin?

Interpretive response

The clearing house requires margin be posted to insulate itself from any losses as a result of adverse price movements and a default of the clearing member or end-user. Margin can consist of cash, securities, or other collateral. The financial reporting presentation of the margin depends on the legal arrangements with the clearing member and clearing house.

In instances where an entity posts a financial asset other than cash, it will be required to evaluate ASC 860, *Transfers and Servicing*, to determine whether it has relinquished effective control and it is appropriate to derecognize the financial asset.

In situations where cash is provided as margin, an entity will typically record a receivable "due from the clearing member" equal to the cash posted.

Under both scenarios, end-users should consider any margin posted for both the balance sheet presentation under ASC 210 and ASC 815, as well as footnote disclosures required by ASC 210. These are discussed in more detail in question 5.

Question 4

What is the impact of using central clearing and novating a position to a clearing house when hedge accounting is applied in accordance with ASC 815?

Interpretive response

In 2012, ISDA asked the SEC if the novation of a bilateral OTC derivative contract to a central counterparty "on the same financial terms" would require the designation of a new hedging relationship. The SEC staff responded that it does not object to a conclusion that, for accounting purposes, the original derivative contract is not considered terminated and replaced with a new derivative contract, nor would it object to the continuation of the existing hedging relationship, provided that other terms of the contract have not been changed, in any of the following circumstances:

- For an OTC derivative transaction entered into prior to the application of mandatory clearing requirements, an entity voluntarily clears the underlying OTC derivative contract through a central counterparty, even though the counterparties had not agreed in advance (i.e., at the time of entering into the transaction) that the contract would be novated to effect central clearing.

- For a derivative instrument transaction entered into subsequent to the application of mandatory clearing requirements, the counterparties to the underlying contract are required to clear through a central counterparty in accordance with standard market terms and conventions, and the hedging documentation describes the counterparties' expectations that the contract will be novated to the central counterparty.

We understand that the SEC staff generally believes that the counterparty is a critical term of a derivative contract. As a result, following novation of a derivative contract designated in a hedging relationship, such contract would generally be considered a new derivative contract, requiring de-designation of the original hedging relationship. However, the SEC staff recognizes that Dodd-Frank will have a far-reaching impact on many institutions and change how central counterparties become involved with transactions.

Thus, the SEC staff does not object to certain novations not being viewed as creating new derivative instruments. The SEC staff's view should not be interpreted as permitting any novation of an OTC derivative contract to be viewed as a continuation of an existing derivative contract. Careful consideration should be given to the effect of modifications other than the change in counterparty, which could trigger a termination of the hedge relationship under US GAAP. For more information, refer to Dataline 2012-16, *Implications to hedge accounting of changes to derivative counterparties or hedging relationships*.

Question 5

How should an end-user assess its ability to present derivative contracts on a net basis (appreciation, depreciation, and any associated collateral in accordance with guidance below) on the statement of financial position?

Interpretive response

Generally, under ASC 210 a right of setoff exists when all of the following conditions are met:

a) There are two parties

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

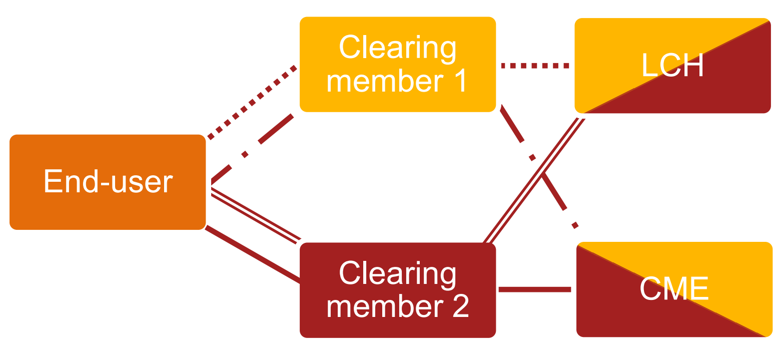
An entity can net assets and liabilities associated with derivative contracts and any related collateral without regard to criteria “c” so long as certain criteria are met in accordance with ASC 815-10-45. One such requirement is that the entity must have an enforceable master netting arrangement in place with the counterparty. Additionally, if an entity elects to net under the provisions in ASC 210 and ASC 815 it must be done in a consistent fashion across all derivatives subject to similar netting arrangements as an established accounting policy.

Determining the appropriate presentation requires a legal analysis of the facts and circumstances and the contractual rights that are in place with the clearing member. Companies should be careful to review trades individually since they may have open derivatives that are traded through different clearing members and clearing houses. An entity should be cognizant of the fact that there are not likely to be cross-netting provisions across different clearing members. Therefore, an entity will need to evaluate its ability to net in accordance with ASC 210 and ASC 815 accordingly.

Each company will need to assess its facts and circumstances in relation to its trades and netting rights. However, as a practical matter, as of the date of this publication we are not aware of companies or legal counsel supporting an ability to present on a net basis unless a trade flows through both the same clearing member and clearing house. Companies should review their arrangements with legal counsel to understand their particular legal rights. Companies should also consider whether their agreements would be considered “master netting agreements” as that term is referenced in ASC 815-10-45-5:

> A master netting arrangement exists if the reporting entity has multiple contracts, whether for the same type of derivative instrument or for different types of derivative instruments, with a single counterparty that are subject to a contractual agreement that provides for the net settlement of all contracts through a single payment in a single currency in the event of default on or termination of any one contract.

The graphic below illustrates the fact that an end-user may have relationships with different clearing members. Certain trades may clear through one or more clearing houses as well. As noted above, as of the date of this publication, we are not aware of legal counsel supporting netting transactions that are separately traded through different clearing members (clearing member 1 and 2 in the below example), even if the trades ultimately clear at the same clearing house.



Note: Each different line formatting represents a particular group of trades through the same clearing member and clearing house.

LCH = London Clearing House
CME = Chicago Mercantile Exchange

Question 6

How should an entity that qualifies as an investment company under ASC 946, *Financial Services—Investment Companies*, account for the transaction fees associated with trading centrally cleared swaps?

Interpretive response

Investment companies apply specific industry guidance that results in different financial statement presentation as compared to other registrants. For example, an investment company discloses unrealized gains and losses separately from realized gains and losses. When an entity purchases a security, and incurs transactions costs in connection with the investment, ASC 946-320-40 states that such transaction costs are recorded in the cost basis of the security. In effect, this results in a day one unrealized loss rather than expensing such costs as part of "operating activities." We believe that an investment company could apply this guidance to these derivative transactions by analogy, but it should establish a consistent accounting policy in doing so[6].

Entities should carefully examine the terms of their agreements when concluding that the fees referenced above relate to transaction-based activity and are not a maintenance fee, financing fee, or other expenditure not directly associated with the transaction. Fees other than transaction costs should not be accounted for by analogy to the guidance in ASC 946-320.

Questions

.14 PwC clients who have questions about this Dataline should contact their engagement partner. Engagement teams that have questions should contact the Financial Instruments team in the National Professional Services Group (1-973-236-4803).

[6] If the investment company is registered with the CFTC and is a commodity pool, it would need to evaluate CFTC rules to determine if such costs need to be presented on a unique line item or if they can be grouped with other commissions and fees.

Appendix — List of useful websites

PwC	www.pwcregulatory.com
Futures Industry Association	www.futuresindustry.org
US Commodity Futures Trading Commission (CFTC)	www.cftc.gov
US Securities and Exchange Commission (SEC)	www.sec.gov
US Financial Stability Board	www.financialstabilityboard.org
Dodd Frank Act	www.sec.gov/spotlight/dodd-frank.shtml
European Market Infrastructure Regulation (EMIR)	ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm
International Swaps and Derivatives Association, Inc.	www.isda.org
LCH.Clearnet	www.lchclearnet.com
Legal Entity Identifier	www.leiroc.org
CME Group	www.cmegroup.com/clearing/
CME Clearing Europe	www.cmeclearingeurope.com
ICE Trust	www.theice.com/clear_overview.jhtml
ICE Clearing Europe	www.theice.com/clear_europe.jhtml
NASDAQ OMX	www.nasdaqomx.com
SGX Derivatives Clearing	www.sgx.com
Eurex Clearing AG	www.eurexclearing.com
AIMA	www.aima.org

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