

**From: ISDA Accounting Committee**  
**To: SEC**  
**Date: October 20<sup>th</sup>, 2016**  
**Reference: Follow up on Whitepaper ‘Accounting Impact of CCPs’ Rulebook Changes to Financial Institutions and Corporates May 2016’**

## **Overview**

The purpose of this additional paper is to respond to the follow up queries raised in relation to the original paper submitted by ISDA Accounting Policy Committee ‘Accounting Impact of CCP’s Rulebook Changes to Financial Institutions and Corporates May 2016’. Specifically, this paper addresses the accounting analysis for concluding that the rulebook changes result in a change in the presentation of variation margin amounts as settlement of the derivative exposure<sup>1</sup>, and not collateral against it.

Given a critical element of the accounting analysis is the legal characterisation and that the specifics of the rulebooks and related legal opinions differ by CCP, responses to specific questions have been addressed by counsel to each of LCH and CME separately. These responses are provided in full as Appendix I (for LCH) and Appendix II (for CME).

For the responses and opinions provided by A&O in respect of LCH and by Skadden in respect of CME, these are provided to the SEC for the purposes of information only, and in each case on the basis that A&O and Skadden assume no duty of care or other responsibility whatsoever to any recipient or other person or any liability whatsoever as a result, or otherwise.

### **1. What are the key elements of the legal opinion that will be necessary to inform the accounting conclusion that the derivative, variation margin and PAA are one unit-of-account?**

In considering the appropriate reflection of STM transactions on balance sheet, firms have given consideration to whether the payment of variation margin<sup>2</sup> and PAA amounts give rise to separate debtor-creditor relationships between the CCP and clearing member<sup>3</sup> in addition to the derivative positions on which those amounts are paid (as applies for a CTM contract), or are settlement of those derivative exposures without giving rise to a separate debtor-creditor relationship. We consider the legal determination of the nature of variation

---

<sup>1</sup> Throughout this paper, the term ‘derivative exposure’ is intended to mean the derivative NPV as calculated by the CCP.

<sup>2</sup> The term ‘variation margin’ is commonly used in the CTM context, but refers generically to amounts paid or exchanged between the counterparties. Within the STM context, market participations may refer to variation margin simply as payments. For simplicity, this paper uses the term variation margin to describe these payments made, regardless of whether in CTM or STM, without intending any specific meaning to the term margin.

<sup>3</sup> Throughout this paper, references to ‘clearing member’ could equally apply to the end clients of clearing members, who have entered into cleared swap transactions via the clearing member.

margin amounts to be the key component of the accounting analysis and obtaining legal opinions has therefore been a critical step in the accounting analysis.

In considering the legal characterisation, we have given consideration to whether payment or receipt of variation margin is legally settlement of the derivative exposure and whether the payer of variation margin could have any right to reobtain that variation margin amount or whether the receiver of the variation margin could have any obligation to return it. As outlined in the specific responses provided by A&O for the LCH STM model at section 3.6(d) and 4.6(a)(iv), the legal analysis has considered this point and concluded that there is no express or implied obligation for the recipient of a variation margin payment under the STM model to return it.

In contrast, for a CTM contract, the payment or receipt of collateral gives rise to a receivable or payable between the CCP and clearing member for the aggregate balance of collateral paid or received. The amounts are legally distinct from the derivative NPV and do not settle or extinguish it. As such, firms have presented collateral amounts as separate payables and receivables to which offsetting criteria are then applied where appropriate, offsetting the collateral payable/receivable against related derivative asset/liability. This accounting representation is in line with the legal framework where payments of variation margin are collateral against exposure, and not settlement of it.

Even though netting is generally applicable to derivative NPVs and related cash collateral posted or received as variation margin for derivatives cleared at CCPs such that the net balance sheet exposure for a CTM contract after application of offsetting is akin to the balance sheet where variation margin is settlement, the offsetting disclosures for CTM derivatives will appropriately reflect the gross balances, acknowledging that there are multiple components and exposures, which are then subject to offset. This appropriately reflects the different legal nature of the arrangements.

To the extent that the legal framework supports that payments of variation margin do not give rise to additional payables and receivables between the CCP and clearing members, and are instead settlement of it, it would not be appropriate to reflect these variation margin amounts as separate units of account (payables/receivables). To do so would inappropriately indicate that there are multiple debtor and creditor balances in relation to a single derivative trade and related variation margin amount. Additionally, inclusion of these amounts within the offsetting disclosures would inappropriately indicate the reduced balance sheet exposure is achieved through the application of offsetting. The right to offset collateral against the derivative exposure is not relevant given the legal opinions support that the payment of variation margin has already been applied as settlement of the exposure. STM contracts do not fit within the model for offsetting of cash collateral balances against derivative exposures.

Given we consider the legal analysis to be a determinative factor, we would not expect a different conclusion to be reached under US GAAP or IFRS. Under both GAAPs, we believe the considerations outlined above to be applicable. As previously discussed in calls to date, a number of IFRS firms have already elected to utilise STM contracts at LCH, reflecting these positions as settled for accounting purposes in their issued financial statements.

2. **How did the legal rights/obligations to variation margin under CTM change when compared to STM? Consider explaining, for example, how a derivative counterparty had a legal right to variation margin paid under CTM (and how those rights could be exercised throughout the derivative's term), and how those legal rights will be eliminated under STM when the payment of variation margin is considered a settlement of the derivative's MTM.**

See Appendices for CCP specific responses.

3. **Upon the 2015 Rulebook changes at the CME, what were the pressure points that precluded a satisfactory legal opinion from being obtained and what changes (or clarifications) are taking place to the CME Rulebook in order to obtain a legal opinion supporting "settlement."**

See Appendix II for specific response. The 'Redline Showing CME Rule Edits' document previously provided (referred to as '(Attached)' in the Skadden response) highlights the specific clarifying amendments or additions to the rule.

4. **Why did clearing members deem it necessary to obtain a legal opinion that the derivative's MTM was settled under STM, but not determine that a legal opinion was necessary to treat variation margin/PAI as a separate unit-of-account from the derivative under CTM?**

Firms consider that the historic reflection of variation margin amounts as separate payables or receivables to which the offsetting criteria are then applied is in line with the legal characterisation of these amounts as collateral for CTM contracts. The exact nature of legal opinions obtained by different firms for different CCPs has varied. For example, certain opinions obtained focused on the enforceability of netting the variation margin collateral against the unsettled derivatives exposure. However, as a general point, firms have obtained the requisite opinions to support their characterisation of these amounts and application of offset where appropriate.

Generally, firms do not obtain opinions for unit of account analysis as this is not required by accounting rules, and firms would generally only seek to obtain an opinion if they considered that the unit of account may be something other than the individual contract.

5. **Do you have any insight into when the CME's legal opinion will be finalized? The staff would like to see the final legal opinion**

See Appendix II.

Note:

Appendix I: A&O responses to the SEC questions

Appendix II: Skadden responses to SEC questions (Not available)