



UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHIEF ACCOUNTANT

May 11, 2012

Mr. Dan Palomaki, Chairman
Accounting Policy Committee
International Swaps and Derivatives Association
360 Madison Avenue, 16th Floor
New York, NY 10017

Dear Mr. Palomaki:

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Act) establishes a new framework for regulatory and supervisory oversight of the over-the-counter (OTC) derivatives market. Title VII mandates a number of reforms to the OTC derivatives market, including the mandatory clearing of certain derivatives transactions. This could result in the novation of the contracts underlying such transactions, which would effect a change in the counterparties to the contract (hereinafter referred to as a “novation”).

Under Title VII of the Act, certain derivatives that are currently executed in the OTC market may be required to be cleared through derivatives clearing organizations or clearing agencies (each a “central counterparty”). This could result in the novation of an OTC derivative contract between two parties, such that the central counterparty becomes the new counterparty via two new contracts with each of the original parties to the original derivative contract, rather than those original parties remaining counterparties to each other via the one original contract. While the final rule implementing the mandatory clearing requirements of Title VII of the Act would not require the clearing of derivatives transactions entered into prior to the application of the clearing requirement, provided that such transactions are reported to registered data repositories, you have indicated that certain counterparties to existing derivative transactions, either currently in effect or executed prior to the application of the clearing requirement, may choose to voluntarily clear such transactions through a central counterparty.

In addition, we understand that pursuant to Section 716 of the Act, in order to maintain “federal assistance” certain FDIC-insured institutions and other entities that have access to “federal assistance” such as Federal Reserve credit facilities, including banks, thrifts, and U.S. branches of foreign banks, will have to cease engaging in certain types of derivative transactions. This could result in such institutions conducting certain types of derivative transactions in affiliates that are not insured by the FDIC and that do not have access to Federal Reserve credit facilities. This prohibition would only apply to certain types of derivatives transactions entered into after the transition period described in Section 716(f) of the Act. You have indicated that it may be

operationally challenging to manage a derivatives portfolio in two separate entities. Therefore, you have indicated that some institutions may elect to move their existing derivatives positions from one legal entity to a separate legal entity within a consolidated group of companies.

OCA Staff Views

You have requested the Office of the Chief Accountant's (OCA) view regarding the accounting impact under U.S. GAAP, if any, of a novation of a bilateral OTC derivative contract to a central counterparty "on the same financial terms." Specifically you have asked about whether the novation of a derivative contract (that has been designated as an accounting hedge) to a central counterparty would result in the termination of the original derivative contract and associated hedge relationship, such that the use of hedge accounting subsequent to novation would require the designation of a new hedging relationship.

The Staff of OCA would not object to a conclusion for accounting purposes that the original derivative contract has not been terminated and replaced with a new derivative contract, nor would the Staff object to the continuation of existing hedging relationships when there is a novation of a derivative contract to effect a change in counterparties to the underlying contract, provided that other terms¹ 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 the 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 an OTC derivative transaction entered into subsequent to the application of the mandatory clearing requirements, the counterparties to the underlying contract agree in advance that the contract will be cleared 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.
- A counterparty to an OTC derivative transaction who is prohibited by Section 716 of the Act (or expected to be so prohibited) from engaging in certain types of derivative transactions novates the underlying contract to a consolidated affiliate that is not insured by the FDIC and does not have access to Federal Reserve credit facilities.

¹ Changes to the terms of the OTC derivative contract that are a direct result of the novation of the contract to the central counterparty would not preclude the continuation of hedge accounting. For example, contractual collateral requirements of the original contract may change as a direct result of the novation, because the original counterparties must now comply with the contractual collateral requirements of the central counterparty.

We have requested that the FASB consider the accounting for a change in counterparties when a derivative contract is designated as a hedging instrument in a hedge relationship as a part of their existing project on financial instruments.

Further questions about these matters should be directed to Paul Beswick, Deputy Chief Accountant (202-551-5300) or Rachel Mincin, Associate Chief Accountant (202-551-5300).

Sincerely,

A handwritten signature in black ink, appearing to read "Jim Kroeker". The signature is fluid and cursive, with a large initial "J" and "K".

James Kroeker
Chief Accountant

cc: James R. Doty, Chairman, Public Company Accounting Oversight Board
Michael Gallagher, Chairman Professional Practice Executive Committee, The Center for Audit Quality
Leslie F. Seidman, Chairman, Financial Accounting Standards Board