



Accounting Treatment for UST Repo Transactions Cleared Through FICC

Background

On December 13, 2023, the Securities and Exchange Commission (“SEC”) approved Final Rules that will require central clearing of certain U.S. Treasury Security (“UST”) cash trades by the end of 2026 and certain UST repurchase agreement transactions (“repos”) by the end of June 2027. In response, the Fixed Income Clearing Corporation (“FICC”), a subsidiary of the Depository Trust & Clearing Corporation (“DTCC”), has proposed significant changes to its Government Securities Division (“GSD”) Rulebook (“Rulebook”), including the introduction of an Agent Clearing Service (“ACS”). The ACS provides market participants with indirect access to clearing on both a “Done-Away” basis, where an Agent Clearing Member (“ACM”) clears customer transactions executed by the customer with a pre-novation counterparty other than the ACM, and on a “Done-With” basis, where the trading desk of the ACM is the customer’s pre-novation counterparty. For a description of the ACS and its associated workflows, see the description beginning on page 16 of *Treasury Clearing Rules Accounting Considerations* published by DTCC (“DTCC Paper”). The FICC also made targeted changes to its existing Sponsored Service.

Executive Summary

This whitepaper documents the Securities Industry and Financial Markets Association (“SIFMA”) Accounting Committee’s UST Clearing Working Group’s (“Working Group”) conclusion on the ACM’s accounting for repo transactions that it clears through FICC on behalf of its customers. The primary question addressed is whether the ACM is acting as a principal or as an agent with respect to the *customer’s* repo transaction facing FICC post novation. This distinction is important because an ACM acting as principal is required under United States Generally Accepted Accounting Principles (“US GAAP”) to recognize the customer’s repo transaction on its balance sheet. An ACM acting as agent would not recognize the customer’s repo transaction on its balance sheet but would recognize or disclose any assets, liabilities, and/or contingent off-balance sheet exposures resulting from its role as agent (e.g., guarantees, margin receivables and payables). This analysis applies to both “Done-With” and “Done-Away” trades.

	“Done-With”	“Done-Away”
Dealer leg	Customer leg	Customer leg
Principal – on balance sheet	Agent – off-balance sheet	

The Working Group concluded that:

1. Submitting a customer repo transaction to FICC for clearing is not a *transfer* under ASC 860
2. Post-novation, FICC is legally principal to the customer’s repo transactions

3. The ACM, in its capacity providing clearing services to its customer, is legally considered an agent of the customer with respect to the customer's repo transaction based on the following factors:
 - a. A "would" level legal opinion issued by Cleary Gottlieb Steen & Hamilton LP ("Cleary Gottlieb") confirming that a court applying New York Law would conclude that novation of the trades extinguishes the payment and delivery obligations between the pre-novation counterparties and replaces them with new identical payment and delivery obligations between each party and FICC;
 - b. A "would" level legal opinion issued by Cleary Gottlieb confirming that a court applying New York law would conclude that in submitting, carrying, and clearing the customer's repo transaction, the ACM acts as agent for the customer;
4. The ACM does not have market risk to the customer's repo transaction;
5. The ACM only has "one-sided" credit risk with respect to the customer's repo transaction. The ACM does not guarantee FICC's performance on the repo transaction to its customer. Additionally, its credit risk arising from its clearing and margin obligations to FICC under the Rulebook is substantively mitigated based on the terms of the bilateral agreement between the ACM and the customer ("customer agreement"); and
6. The ACM's role is to submit the customer's repo transactions to FICC for clearing and provide clearing services during the life of the repo transaction.

Transaction Overview

The transaction overview is presented in the DTCC Paper, including the appendix *Responses to questions provided by SIFMA UST Central Clearing Task Force*.

The Working Group assumes that the following provisions will be included in the customer agreement:

1. Explicit acknowledgement from the customer that ACM's role is as agent to the customer's repo transaction when performing clearing services for the customer;
2. The customer is legally obligated to perform under all terms of the transaction and must deliver all cash and securities when due;
3. The ACM does not guarantee the value of the customer's repo transaction to the customer, rather the ACM is responsible for the performance of clearing services for the customer (i.e., performance of all of the outstanding cash and security delivery obligations to FICC on behalf of its customer);
4. The ACM does not guarantee FICC's performance to the customer;
5. The ACM cannot initiate, amend, or terminate a transaction without instruction from the customer (other than in event of customer default)¹;
6. The ACM's compensation for providing clearing services is limited to a pre-defined fee (though the ACM may be entitled to receive interest earned on margin posted by the customer); and
7. The ACM is permitted to call for sufficient margin such that its credit risk to the customer is substantively mitigated.

¹ Note: the existing SIFMA form of agreement does not include an express prohibition on the ACM taking these actions. That is because, as a legal matter, an ACM would not have these rights absent contractual authorization to do so. The Working Group assumes that the ACM is not contractually authorized to take these actions.

This document focuses on the ACS because the existing Sponsored Service is well understood. With respect to the Sponsored Service, Cleary Gottlieb has issued a “would” level opinion to FICC confirming that, post novation, the existing transaction is terminated and replaced with a new transaction between the Sponsored Member and FICC. It necessarily follows that, assuming no one has appointed it as agent or trustee or some other capacity, that the Sponsored Member is the principal to FICC. Under the Sponsored Service, Sponsored Members are limited members of FICC under the Rulebook. The Sponsoring Member provides FICC with a written guarantee of its Sponsored Member’s performance. In contrast, under the ACS, customers are not direct or limited members of FICC. However, they are bound to the Rulebook through their agent, the ACM. In other words, the customer is counterparty to the repo with FICC while the ACM, acting solely as agent on the customer’s repo transaction, is fully responsible to FICC for the performance of all outstanding obligations to FICC on behalf of its customer.

Overview of Relevant Accounting Literature

The authoritative guidance the Working Group considered includes:

- Accounting Standard Codification (“ASC”) 860, Transfers and Servicing
- ASC 606, Revenue from Contracts with Customers (by analogy)
- ASC 470-50, Debt – Modifications and Extinguishments (by analogy)
- ASC 460, Guarantees

Accounting Question

Under the ACS, is the ACM principal or agent to the customer’s repo transaction?

Working Group’s Interpretation

Novation

The ASC Master Glossary definition of a *transfer* excludes originations and settlements of receivables. Cleary Gottlieb has issued a “would” level novation opinion for the Agent Clearing Service that confirms that novation of the trades extinguishes the payment and delivery obligations between the pre-novation counterparties and replaces them with new identical payment and delivery obligations between each party and FICC. Therefore, because the novation process results in a legal extinguishment (settlement) of the pre-novation trade and creation of a new trade (origination), the novation to FICC does not meet the ASC Master Glossary definition of a *transfer* and is outside the scope of ASC 860.

The novation opinion also supports the Working Group’s conclusion that FICC is legally principal to the transactions. Further, through loss mutualization, FICC allocates to its members, on a pro rata basis, losses from a customer default not otherwise mitigated through margining (or through the guarantee or other financial resources of the customer’s clearing member). This loss mutualization process supports the Working Group’s conclusion that FICC is substantively principal to the transactions.

Principal vs. Agent Analysis

Legal Opinion

Cleary Gottlieb has issued a “would” level opinion on the role of the Agent Clearing Member as agent. The opinion confirms that a court applying New York law would conclude that in submitting, carrying, and clearing repo transactions for customers, the ACM acts as agent for the customer.” This opinion further supports the conclusion that post novation, the customer’s repo transaction is outside the scope of ASC 860 and should not be reflected on the balance sheet of the ACM.

This opinion is not requested for the Sponsored Service because Sponsored Members are limited members of FICC under the Rulebook.

ACM’s Risks and Rewards

The Working Group next considered the ACM’s rights and obligations in the event of default by each of the parties:

Scenario	Who bears the risk?	Analysis
1. Customer default	ACM	Post novation, the ACM is responsible to the FICC for the customer’s performance as if it was a counterparty to the transaction; therefore, the ACM has credit risk to the customer. This credit risk is substantively mitigated through the collateral and margining requirements under the customer agreement. The customer agreement will govern the form of margin (e.g., cash or securities), the timing of when margin must be posted by the customer, which party bears the risk of non-performance of non-cash collateral, and which party is entitled to receive interest earned on margin. Consistent with other clearing arrangements, the form, timing, and amount of margin could be different from the ACM’s obligations under the Rulebook. Cleary Gottlieb has confirmed that the fact that the ACM and FICC may seek to margin their respective exposures differently does not affect the legal analysis of the ACM as an agent of its customers.
2. FICC default	Customer	The customer agreement will specify that the ACM does not guarantee FICC’s performance to the customer.
3. ACM default	FICC	FICC anticipates proposing rule changes that would permit it to do one of the following after declaring that FICC ceases to act for an ACM: <ol style="list-style-type: none">1. Settle – continue to settle the transaction with the ACM’s customer2. Close-out – close out the ACM’s customer’s transactions3. Port – port the customer’s positions to another ACM

Scenario	Who bears the risk?	Analysis
		<p>With respect to margin posted by the customer to the ACM, as noted on page 26 of the DTCC Paper in the section titled “Insolvency Claim of Executing Firm Customer as SIPA Customer of Defaulted Agent Clearing Member,” Cleary Gottlieb has issued a “would” level opinion confirming that customer margin would not form part of the general estate of the ACM upon its bankruptcy, regardless of whether the customer posts margin on a segregated basis². Rather, the customer would have:</p> <ul style="list-style-type: none"> – If the ACM is a broker-dealer, a SIPA “customer” “net equity” claim, or - If the ACM is a bank, the rights of an “entitlement holder” under the New York Uniform Commercial Code.

ACM’s Control of the Repo Transaction

The ACM provides clearing services to its customer and earns a fee, which is in scope of ASC 606. Specifically, the agreement is a services contract related to clearing activities and is not a financial instrument. The legal opinion described above provides strong evidence that the ACM acts as agent to the customer’s repo transaction from an accounting perspective. To complement the legal analysis, the Working Group also performed a principal-versus-agent analysis using the indicators in ASC 606-10-55-39 and ASC 470-50-55-7, by analogy, on the accounting question of whether the ACM should be viewed as principal or agent to the customer’s repo transaction. This analysis is significant because an ACM acting as principal to the customer’s repo transaction would be required to recognize the customer’s repo transaction on its balance sheet. An ACM acting as an agent on behalf of its customer would not recognize the customer’s repo transaction on its balance sheet but would report any assets, liabilities, and/or contingent off-balance sheet exposures resulting from its role as agent (e.g., guarantees, margin receivables and payables).

ASC 606-10-55-39 indicator	Analysis
(a) Primarily responsible for providing the “good/service”, which is the customer’s repo transaction	As noted above, based on the novation opinion from Cleary Gottlieb, post novation, the customer is the primary obligor and legal counterparty to the FICC. The Rulebook states that each transaction must be subject to a customer agreement authorizing the ACM to act as agent. Under the customer agreement, the ACM is not contractually authorized to change any terms to the underlying repo transaction during or after the clearing process.

² Note that if the customer posts unsegregated margin and grants the clearing member full reuse rights such that the Clearing Member reuses the margin for its own benefit, then that may not satisfy the assumptions of the opinion.

ASC 606-10-55-39 indicator	Analysis
	The customer agreement will state that the customer appoints and authorizes the ACM to act as its agent and that the customer is bound to the transaction and must deliver all cash and securities when due. Therefore, the customer and FICC are primarily responsible under the repo transaction.
(b) Inventory risk	<p>Inventory risk for a repo transaction is exposure to the underlying collateral, the repo rate, and credit risk to the repo counterparty. The customer agreement will specify that the ACM does not guarantee to the customer the performance of the repo transaction or FICC's performance to the customer. Therefore, the ACM is not exposed to inventory risk other than if the customer defaults, a risk that is substantively mitigated through margining.</p> <p>The Rulebook does not require that customer margin posted to the ACM be segregated or non-segregated. If the customer posts margin on a non-segregated basis to a broker-dealer ACM, that margin is subject to lock-up under broker-dealer customer protection rules (not a function of the Rulebook).</p>
(c) Discretion in establishing the price	The ACM (solely in its capacity as agent and not executing broker) is not contractually authorized to establish the price or economic terms of the repo transaction. The ACM merely submits the customer's trade to FICC for clearing.

470-50-55-7 indicator	Analysis
(a) Intermediary does not put its own funds at risk	See inventory risk above.
(b) Placement is done under a best-efforts agreement	n/a
(c) Intermediary cannot independently initiate an exchange or modification of the instrument	The ACM is not contractually authorized to initiate amend, or terminate a transaction without instruction from the customer (other than in the event of the customer's default). Additionally, as noted above, the Rulebook does not allow the ACM to change any terms to the underlying repo transaction during or after the clearing process.

(d) Compensation derived by an intermediary is limited to a preestablished fee	The ACM's compensation is limited to a pre-defined fee and, if agreed to with the customer, interest on margin.
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Guarantee

Under the Sponsored Service, the Sponsoring Member provides FICC with a written guarantee of its Sponsored Member's performance. Under the ACS, the ACM does not provide FICC with a written guarantee. Rather, while the ACM is agent to the customer's repo transaction, it is responsible for the performance of all outstanding obligations to FICC on behalf of its customer, which the Working Group has concluded is a guarantee for accounting purposes. In either case, the ACM or Sponsoring Member will account for this guarantee under ASC 460.