

# The Treasurers' Report

May 2012

We are pleased to present our financial reporting retrospective covering recent financial reporting cycles including this past March 31 cycle. As in previous editions, we endeavor to provide insight and observations into financial reporting issues impacting our clients. We believe that all of this information is worth sharing with you and welcome your comments and questions.

## ASU 2011-03

### Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements

The release of Accounting Standards Update 2011-03 ("ASU 2011-03") by the Financial Accounting Standards Board ("FASB") is intended to improve financial reporting of repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem the financial assets before their maturity.<sup>1</sup>

ASU 2011-03 changes the conditions necessary to determine whether a transfer of securities in a repurchase agreement is accounted for as a sale or a secured borrowing. A significant change in the determination of effective control is the elimination of the collateral maintenance provision that may be used to make the sale versus secured borrowing decision. Another key change is the elimination of the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed-upon terms, even in the event of default by the transferee; rather the transferor must now have only the contractual obligation to do the same.

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<sup>1</sup> FASB Accounting Standards Update 2011-03, page 1

All of the following conditions must be met in order to deem that the transferor has maintained effective control over the financial assets transferred (and thus must account for the transaction as a secured borrowing):

- The financial assets to be repurchased or redeemed are the same or substantially the same as those transferred.
- The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
- The agreement is entered into contemporaneously with, or in contemplation of, the transfer.

Mortgage dollar roll transactions involving TBA securities would continue to be treated as purchases and sales as ASU 2011-03 does not amend the previous guidance pertinent to those transactions. However, as a consequence of eliminating the collateral maintenance provision, ASU 2011-03 may now result in certain mortgage dollar roll transactions being characterized as secured borrowings. Fund Advisers will need to designate the purpose of all mortgage dollar roll transactions to facilitate the appropriate accounting treatment.

ASU 2011-03 is effective for the first interim or annual period beginning on or after December 15, 2011.

As of the date of this report, none of J.P. Morgan's clients have made any changes to their funds' accounting policies regarding transfers of securities under this new guidance.

## ASU 2011-04

### Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs

The intent of the FASB amendments included in Accounting Standards Update 2011-04 ("ASU 2011-04") is to ensure that fair value measurements and disclosures are the same under both U.S. GAAP and International Financial Reporting Standards ("IFRSs").

ASU 2011-04 requires disclosure of the amounts of any transfers between Level 1 and Level 2, and the reasons for the transfers.<sup>2</sup> Previous disclosure requirements were limited to only those transfers between Level 1 and Level 2 that were considered significant. At present, the majority of J.P. Morgan's clients are incorporating the new disclosure requirement by presenting the values of, and reasons for, the transfers between Levels 1 and 2 in the footnotes to the ASC 820 fair valuation table currently included in the shareholder report.

ASU 2011-04 also requires disclosure of quantitative information about the significant unobservable inputs used for Level 3 securities and states that a reporting entity is not required to create quantitative information to comply with the disclosure requirement if quantitative unobservable inputs are not developed by the reporting entity (for example, when the entity uses third-party pricing information without adjustment). The

FASB guidance suggests a tabular disclosure by class of financial instrument, indicating for each class: the fair value, the valuation technique, a general description of the types of inputs used, and a quantitative range for each type of input.<sup>3</sup>

Clients will need to provide J.P. Morgan with the data points for the quantitative disclosures required. An example of the required disclosure is shown in the table below.

Additionally, for Level 3 fair value measurements, ASU 2011-04:

- Requires a description of the valuation processes used by the reporting entity (including, for example, how an entity determines its valuation policies and procedures and analyzes changes in fair value measurements from period to period)<sup>4</sup>;
- Requires a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement. If there are interrelationships between those inputs and other unobservable inputs used in the fair value measurement, the entity must also provide a description of those interrelationships and of how they might magnify or mitigate the effect of changes in unobservable inputs on the fair value measurements<sup>5</sup>; and

	Fair value at 12/31/2011 (amounts in thousands)	Valuation Technique(s)	Unobservable Input(s)	Range
Residential mortgage-backed securities	\$10	Discounted cash flow	Constant prepayment Probability of default	3.5%- 5.5% 5%-50%
Common stocks	10	Market comparable companies	Loss severity EBITDA multiple Revenue multiple	40%-100% 6%-12% 5%-20%
Credit Contracts	10	Option model	Counter-party credit risk Own credit risk	0.5%-3.5% 0.3%-2%
<b>Total</b>	<b>\$30</b>			

<sup>3</sup> FASB Accounting Standards Update 2011-04, page 62

<sup>4</sup> FASB Accounting Standards Update 2011-04, page 63

<sup>5</sup> FASB Accounting Standards Update 2011-04, page 64

<sup>2</sup> FASB Accounting Standards Update 2011-04, page 61

- Does not require a Level 3 measurement uncertainty analysis providing ranges of alternative fair value measurements.

ASU 2011-04 is effective for the first interim or annual period beginning on or after December 15, 2011. J.P. Morgan is assisting our clients with adoption of this guidance, commencing with Form N-Q as of March 31, 2012.

### Commodity Futures Trading Commission - Commodity Pool Operators Rules.

On February 24, 2012, the Commodity Futures Trading Commission ("CFTC") adopted amendments to Rule 4.5 (the "Final Rule") which impose compliance, registration and disclosure requirements on commodity pool operators ("CPO") and commodity trading advisors ("CTA"). These amendments greatly narrow the exclusion from registration as a CPO for operators of registered investment companies. Advisers to investment companies will now be required to register with the CFTC as a CPO unless notice is filed explaining that the investment company does not meet the definition of a CPO, or an exemption can be claimed.

In order to rely on the amended Rule 4.5 and not be deemed a commodity pool, a registered investment company must meet the requirements of a two-part test: a Trading Test and a Marketing Test. The Trading Test includes two alternatives for proving the exemption: (1) A CPO may not trade commodity futures, options and swaps in an amount such that initial margin payments exceed 5% of the registered investment company's liquidation value; or (2) A CPO may limit use of commodity futures, options and swaps to meet a "net notional test" whereby the aggregate net notional value of the entity's derivative positions does not exceed the liquidation value of the

fund. Additionally, under the Marketing Test, a registered investment company must not market itself as a commodity pool or "as a vehicle for trading in the commodity futures, commodity options or swaps markets." Entities able to rely on the Rule 4.5 exclusion must re-affirm their eligibility at the end of each calendar year.

Entities that cannot claim the above exclusion or fall within an exemption from registration as a CPO will be subject to both new requirements as prescribed by the amendments and pre-existing requirements imposed under the current CPO regime, as follows. CPOs will now be required to register with the CFTC by filing Form CPO-PQR (CTAs must complete Form CTA-PR), as well as amend disclosure documents. Further, registered CPOs will also be required to become members of the National Futures Association ("NFA"), a self-regulatory organization, which will subject them to additional compliance and reporting obligations.

Additionally, on February 24, 2012, the CFTC issued Proposed Harmonization Rules affecting registered investment companies, which attempt to reduce duplicative, inconsistent, and possible conflicting disclosure and reporting requirements imposed by the Final Rule that may arise from being dually registered with the CFTC and the SEC.

The Investment Company Institute ("ICI") and the U.S. Chamber of Commerce ("U.S. Chamber") filed a complaint on April 17, 2012 in U.S. Federal District Court for the District of Columbia challenging these amendments. The ICI and U.S. Chamber focused their challenge on the cost-benefit analysis conducted by the CFTC in developing the final rules, arguing that the cost-benefit analysis failed to reasonably assess the true costs and benefits of the rules; an argument the Court has previously embraced. The ICI and the U.S. Chamber are requesting a

stay on the effectiveness and enforcement of the final rules and that the rules be vacated. As of the date of this publication the Court had not yet ruled on the stay of effectiveness and enforcement.

An analysis of the data requirements for CFTC reporting on funds that are deemed commodity pools under the Final Rule is being conducted by J.P. Morgan. We are also engaged in a review of the harmonization proposal to identify any disclosure changes that would be required under the Final Rule.

### Retirement of the DOS-based Form N-SAR system

In November 2011, the U.S. Securities and Exchange Commission ("SEC") had announced the retirement of the DOS-based Form N-SAR application and the launch of an on-line Form N-SAR protocol, available on the EDGAR Filing website. The EDGAR system was originally scheduled to be upgraded to support this functionality and to accept only XML-formatted Form N-SAR answer files beginning on April 9, 2012. In response to industry concerns, the SEC deferred the effective date of the change to July 9, 2012. All N-SAR answer files submitted on or after July 9, 2012 will be required to use the XML format.<sup>6</sup>

The SEC will not be accepting test Form N-SAR answer files in the new format until the effective date. J.P. Morgan has received assurance from its N-SAR filing software vendor that their system will be updated by the effective date. J.P. Morgan will coordinate testing with clients once software updates are available.

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<sup>6</sup> SEC Release 33-903