



## U.S. COMMODITY FUTURES TRADING COMMISSION

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### Division of Swap Dealer and Intermediary Oversight

CFTC Letter No. 13-82  
No-Action  
December 23, 2013  
Division of Swap Dealer and Intermediary Oversight

### **Re: Staff No-Action Position Regarding Introducing Brokers' Compliance with Certain Financial Reporting and Capital Computation Requirements under Commodity Futures Trading Commission Regulations 1.10 and 1.17**

#### **Introduction**

The Commodity Exchange Act (the "Act")<sup>1</sup> and the regulations of the Commodity Futures Trading Commission (the "Commission") issued thereunder<sup>2</sup> impose various requirements on persons who are registered, or who are required to register, as introducing brokers ("IBs").<sup>3</sup> In this letter, and as more fully discussed below, the Division of Swap Dealer and Intermediary Oversight (the "Division") is providing no-action relief to certain IBs from compliance with specified financial reporting and capital computation requirements imposed by Regulations 1.10 and 1.17, respectively.

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<sup>1</sup> 7 U.S.C. § 1 *et seq.* The Act may be accessed through the Commodity Futures Trading Commission's Web site, [www.cftc.gov](http://www.cftc.gov).

<sup>2</sup> 17 CFR Part 1 *et seq.* The Commission's regulations similarly may be accessed through the Commission's Web site.

<sup>3</sup> An IB is defined under the Act as any person (except an individual who elects to and is registered as an associated person of a futures commission merchant ("FCM")) who is registered with the Commission as an IB, or any person who is engaged in soliciting or in accepting orders for the purchase or sale of: (1) any commodity for future delivery, security futures product, or swap; (2) any agreement, contract, or transaction described in section 2(c)(2)(C)(i) of the Act (*i.e.*, certain foreign currency transactions with counterparties that are not eligible contract participants) or section 2(c)(2)(D)(i) of the Act (*i.e.*, certain leveraged or margined commodity transactions with counterparties that are not eligible contract participants or eligible commercial entities); (3) any commodity option authorized under section 4c of the Act; or (4) any leverage transaction authorized under section 19 of the Act. 7 U.S.C. § 1a(31).

## Background

On July 21, 2010, President Obama signed the Dodd-Frank Act into law.<sup>4</sup> Title VII of the Dodd-Frank Act established a comprehensive new regulatory framework for swaps and security-based swaps. The new regulatory framework included revising the definition of the term “introducing broker” under the Act to include persons that engage in soliciting or accepting orders for the purchase or sale of swaps.<sup>5</sup>

Revising the IB definition to include the solicitation of, or the acceptance of orders for, swap transactions, and the subsequent listing of certain energy transactions that previously had been transacted in the over-the-counter markets as futures contracts by designated contract markets, has resulted in persons that historically have brokered swap or over-the-counter transactions outside of the Commission’s jurisdiction to be required to register with the Commission as IBs. These new IB registrants include persons domiciled in the United States (“U.S.”) and outside of the U.S.

The Division has received requests for no-action relief from several of these entities that have recently registered as IBs, or are in the process of registering as IBs.<sup>6</sup> Specifically, U.S. and non-U.S. domiciled IBs have requested relief from the Commission’s capital rule and financial reporting requirements. A discussion of the no-action requests is set forth below.

### Regulation 1.17 Capital Requirements for Introducing Brokers

Regulation 1.17(a)(1)(iii) provides that each person registered as an IB must maintain “adjusted net capital” equal to or in excess of the greatest of: (1) \$45,000; (2) the amount of adjusted net capital required by a registered futures association of which the IB is a member;<sup>7</sup> or, (3) for IBs that are also registered as brokers or dealers (“BDs”) with the Securities and Exchange Commission (“SEC”), the amount of net capital required by SEC Rule 15c3-1(a) (17 CFR 240.15c3-1(a)).<sup>8</sup> Regulation 1.17 is intended, as discussed below, to require an IB to hold a sufficient amount of highly liquid assets to cover its total balance sheet liabilities (excluding certain qualifying subordinated debt).

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<sup>4</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act also may be accessed through the Commission’s Web site.

<sup>5</sup> See section 721 of the Dodd-Frank Act.

<sup>6</sup> Entities that are registered as IBs and entities that are pending registration as IBs are referred to collectively as “IBs” in this letter.

<sup>7</sup> The National Futures Association (“NFA”) is currently the only registered futures association.

<sup>8</sup> An IB that is not also registered with the SEC as a BD is exempt from the capital and financial reporting requirements if it elects to operate pursuant to a “guarantee agreement” with an FCM. See Regulations 1.17(a)(2)(ii), 1.10(b)(2), and 1.10(j).

The term “adjusted net capital” is defined in Regulation 1.17(c)(5) and generally means the IB’s net equity or net worth, as computed under U.S. generally accepted accounting principles (“GAAP”), less illiquid assets (such as property, plant, and equipment), and further reduced by capital charges to cover the potential market risks of the highly liquid assets.<sup>9</sup> Regulation 1.17(c)(2)(ii) also generally provides that an IB, in computing its adjusted net capital, must exclude unsecured receivables, advances and loans. The Regulation, however, allows an IB to include unsecured commission receivables due from other brokers or dealers that are outstanding for no longer than 30 days from their due dates.<sup>10</sup> This provision has allowed IBs that have operated in the futures markets to recognize commission receivables as part of their adjusted net capital as the IBs historically have been paid their commissions within 30 days of the due dates.

Several IBs have requested relief from Regulation 1.17. These IBs state that they earn commission income from brokering transactions for customers that are traditional swap market participants that are now engaging in both futures transactions and swap transactions. The IBs also state that the commission payment structure for these customers is significantly different from the traditional commission structure for the futures markets. The IBs state that they typically directly bill customers for commissions earned on both swap and futures transactions, and that generally they receive payment several months after the commissions are earned and due. Accordingly, these IBs are required to exclude unsecured commission receivables as current assets in computing their adjusted net capital.

The IBs also further represent that in many cases part of the commissions that are due from their customers are required to be passed on to their employees that brokered the transactions under the terms of the employees’ compensation agreements. Some IBs further represent that they maintain agreements with their employees that provide that the IBs’ obligation to compensate the employees is contingent upon the receipt of the commissions from the customers.

The IBs, however, are required to record the liability to their employees under GAAP and Regulation 1.17(c)(4) when the swap or futures transactions are brokered and the obligation is due to the IBs’ employees. Therefore, Regulation 1.17 requires the IBs to exclude commission receivables as a current asset while also requiring the IBs to recognize a liability to its employees for the portion of such commissions that the employees are entitled to as part of their compensation agreements. The IBs request that the Division provide no-action relief such that the IBs, in computing their adjusted net capital under Regulation 1.17, may reduce their accounts payable to the extent that the accounts payable to employees derives from commission receivables from customers which are excluded from current assets, when the IB’s obligation to

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<sup>9</sup> For example, IBs are required to take capital charges against proprietary securities that are included in the firms’ computation of adjusted net capital to cover potential market risks with the securities. *See* 17 CFR 1.17(c)(5)(v).

<sup>10</sup> 17 CFR 1.17(c)(2)(ii)(B).

pay the liability to employees is contingent upon the receipt of the commissions from the customers.

The Division has considered the IBs' request and has determined that it will not recommend that the Commission initiate an enforcement action if an IB does not include as a liability, in computing its adjusted net capital under Regulation 1.17, certain employee compensation that is associated with commissions due from the IB's customers for swaps and futures transactions. The Division's position is subject to the following conditions for an IB in computing its adjusted net capital:

- (1) The full amount of any unsecured commission receivable that is outstanding more than 30 days after the due date of the commission receivable must be excluded from the IB's current assets in accordance with Regulation 1.17(c)(2)(ii)(B);
- (2) To exclude a payable to an employee from its liabilities under Regulation 1.17(c)(4), the related commission receivable must be excluded from the IB's current assets and the IB must have executed a written agreement with the employee to which commissions are payable stipulating that the employee waives the payment of any commissions from the IB until the IB receives the related commissions from its customers; and
- (3) The IB's liability for the commission payable to an employee is limited solely to the proceeds from the related commission receivable.

### **Accounting Principles Used in Preparing IB Financial Reports**

Commission regulations require each IB to file with the NFA: (1) an unaudited financial Form 1-FR-IB semiannually as of the middle and the close of the IB's fiscal year;<sup>11</sup> and (2) an audited financial Form 1-FR-IB (*i.e.*, certified annual financial report) as of the close of the IB's fiscal year.<sup>12</sup> Each unaudited Form 1-FR-IB and certified annual financial report must be completed in accordance with the instructions to the form and contain: (1) a statement of financial condition; (2) a statement of income (loss); (3) a statement of changes in ownership equity; (4) a statement of changes in liabilities subordinated to the claims of general creditors; and (5) a statement of the computation of minimum capital requirements pursuant to Regulation 1.17.<sup>13</sup> The certified annual financial report must further include a statement of cash flows; appropriate footnote disclosures; and, a reconciliation of the material differences between the

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<sup>11</sup> Regulation 1.10(b)(2)(i). Regulation 1.10(b)(2)(i) further provides that each Form 1-FR-IB must be filed no later than 17 business days after the date for which the report is made.

<sup>12</sup> Regulation 1.10(b)(2)(ii)(A). Regulation 1.10(b)(2)(ii)(A) further provides that each certified annual financial report must be filed within 90 days of the IB's fiscal year end, with the exception of IBs that are also registered with the SEC as BDs, who must file such reports within 60 days of their fiscal year end.

<sup>13</sup> See Regulation 1.10(d)(1).

year-end unaudited and audited statements of minimum capital requirements.<sup>14</sup> Furthermore, the instructions to the Form 1-FR-IB provide that the unaudited and audited financial statements must be prepared in accordance with GAAP.<sup>15</sup>

The Division has received a number of inquiries from IBs which have their principal place of business outside of the U.S. (“Foreign IBs”). Specifically, these Foreign IBs have requested relief from filing their financial statements under GAAP. Many of these Foreign IBs have indicated that they currently prepare their financial statements in accordance with accounting standards prescribed by their home jurisdiction, of which several are either identical or nearly identical to the International Financial Reporting Standards (“IFRS”) issued by the International Accounting Standards Board (“IASB”). Several of these Foreign IBs further state that they are subject to financial reporting requirements by their home country regulators that require that the financial information be prepared using home country accounting principles.

As a consequence of registering as an IB with the Commission, without relief these Foreign IBs will incur additional, and in some circumstances substantial, costs associated with either: (i) preparing an additional set of financial statements in accordance with GAAP, or (ii) otherwise reconciling their financial statements prepared under local accounting principles to financial statements prepared under GAAP. Further, several of these Foreign IBs have filed with NFA unaudited financial statements prepared in accordance with local accounting principles that indicate that the firms are in compliance with the Commission’s minimum capital requirement of \$45,000, as computed under Regulation 1.17.<sup>16</sup>

The Division notes that the financial reports required in Form 1-FR-IB serve an important purpose of allowing the Commission and NFA to appropriately evaluate the financial condition of an IB. For example, the Commission has traditionally regarded certified financial statements as an important part of its minimum financial and related reporting requirements and the financial surveillance program.<sup>17</sup> Indeed, the Division believes that an accurate reporting of the financial position of an IB will allow NFA to monitor the IB and highlight areas of financial concern. In addition, the audited financial statements of an IB provide for an independent assessment of whether an IB’s financial reporting is consistent with generally accepted accounting principles and whether an IB meets the Commission’s minimum adjusted net capital requirement of \$45,000.

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<sup>14</sup> See Regulation 1.10(d)(2).

<sup>15</sup> See Form 1-FR-IB Instruction Manual. See also, National Futures Association, Independent IB Financial Requirements, available at <https://www.nfa.futures.org/NFA-compliance/NFA-introducing-brokers/iib-financial-requirements.HTML>.

<sup>16</sup> A preliminary review of these Foreign IBs indicates that the capital computations provided demonstrate a sufficient amount of highly liquid assets to meet their total balance sheet obligations.

<sup>17</sup> See *Financial Reporting by Introducing Brokers; Valuation of Investment of Customer Funds by Futures Commission Merchants*, 58 FR 10,949 (Feb. 23, 1993).

The Division is mindful, however, of the substantial expense that may be incurred by Foreign IBs as a result of multiple filings (or reconciliations) of financial statements that are required to be prepared using different accounting standards. The Division further recognizes that while IBs are market intermediaries, they are prohibited from holding customer funds and from engaging in proprietary trading, which materially minimizes the risks that IBs may present to the safety of customer funds.<sup>18</sup> In addition, IBs pose minimal risk to the clearing system as they engage in no proprietary trading and do not guarantee their customers' financial performance to a derivatives clearing organization.

The Division has considered the IBs' requests and has determined that it will not recommend that the Commission commence an enforcement action against a Foreign IB that files unaudited Forms 1-FR-IB and certified annual financial reports that are not prepared in accordance with GAAP subject to the following conditions:

- (1) The Foreign IB is not a resident of the U.S.;
- (2) The Foreign IB is not a corporation, partnership, limited liability company, business or other trust, association, or any form of enterprise that is organized or incorporated under the laws of a state or other jurisdiction in the U.S. or having its principal place of business in the U.S.;
- (3) The Foreign IB does not otherwise prepare unaudited or audited financial statements in accordance with GAAP; and
- (4) The Foreign IB files with NFA Forms 1-FR-IB and a certified annual financial report prepared in accordance with IFRS as issued by the IASB containing the financial statements and other information required by, and in accordance with the timeframes established in, Regulation 1.10.

In addition, the Division will not recommend that the Commission commence an enforcement action against a Foreign IB if the Foreign IB files an unaudited Form 1-FR-IB for the six-month period ending December 31, 2013, or a certified annual financial report for the year ending December 31, 2013, in accordance with local accounting principles. This relief is limited solely to the financial statements that are due as of December 31, 2013. Any unaudited Forms 1-FR-IB or certified annual financial reports that are required to be filed by a Foreign IB with a reporting date after December 31, 2013, must be prepared in accordance with GAAP or IFRS as issued by the IASB.

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<sup>18</sup> See Regulation 1.57 which provides, in relevant part, that an IB may not carry proprietary accounts, and may not accept any money, securities, or property (or extend credit in lieu thereof) to margin, guarantee, or secure trades of customers.

### **Relief from Filing a Certified Annual Financial Report for the Year Ending December 31, 2013**

The Division has received requests from several IBs with a fiscal year end date of December 31, 2013, that had their IB registration applications approved by NFA during the last several months of calendar year 2013. These IBs request relief from the certified annual financial report requirements of Regulation 1.10(b)(2)(ii)(A). These IBs generally state that, prior to registering as IBs, they were not obligated to prepare certified annual financial reports. The IBs further cite the costs involved in obtaining an initial audit and note that they have been registered for only a part of calendar year 2013.

The Division has considered these requests and has determined that it will not recommend that the Commission commence an enforcement action against an IB that does not file a certified annual financial report for fiscal year ending December 31, 2013, subject to the following conditions:

- (1) The IB's registration must have been approved by NFA during the period October 1, 2013 through December 31, 2013. Any IB whose registration was approved prior to October 1, 2013, must file a certified annual financial report for the fiscal year ending December 31, 2013;<sup>19</sup>
- (2) The IB must file an unaudited financial report for the six-month period ending December 31, 2013, within 17 business days of December 31, 2013, as currently required by Regulation 1.10(b)(2)(i); and
- (3) The IB's first certified financial report must cover the full period from the effective date of the IB's registration through December 31, 2014.

An IB, however, that is otherwise eligible for this no-action relief and prepares a certified annual financial report for the year ending December 31, 2013, must file such certified annual financial report with the NFA as required by Regulation 1.10(b)(2)(ii)(A). Such certified annual financial report may be prepared using GAAP, IFRS, or local accounting principles, as applicable, provided that if the IB has a certified annual financial report that was prepared using GAAP, the IB must file such report with the NFA.

### **Conclusion**

This letter, and the positions taken herein, represent the view of DSIO only, and do not necessarily represent the position or view of the Commission or of any other office or division of the Commission. The relief issued by this letter does not excuse persons relying on it from compliance with any other applicable requirements contained in the Act or in the regulations

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<sup>19</sup> This no-action letter does not apply to IBs that also are registered with the SEC as BDs, as such IBs are required to file with the SEC a certified annual financial report for the year ending December 31, 2013.

December 23, 2013

Page 8

issued thereunder. Further, this letter, and the relief contained herein, is based upon the facts represented to the Division. Any different, changed, or omitted material facts or circumstances might render this no-action relief void.

Should you have any questions, please do not hesitate to contact Francis Kuo, Attorney-Advisor, at 202-418-5695, or Joshua Beale, Attorney-Advisor, 202-418-5446.

Very truly yours,

Gary Barnett