



## U.S. COMMODITY FUTURES TRADING COMMISSION

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### Division of Swap Dealer and Intermediary Oversight

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CFTC Letter No. 15-02  
No-Action  
January 23, 2015  
Division of Swap Dealer and Intermediary Oversight

### **Re: Request for No-Action Relief for Introducing Brokers' Compliance with Certain Financial Reporting and Capital Computation Requirements under Regulations 1.10 and 1.17**

#### **Introduction**

The Division of Swap Dealer and Intermediary Oversight (“DSIO” or “Division”) of the Commodity Futures Trading Commission (“CFTC” or “Commission”) is issuing this no-action relief in response to requests from several entities registered, or pending registration as, introducing brokers (“IBs”). These entities have requested relief from certain of the Commission’s financial reporting requirements and capital requirements applicable to IBs under Commission Regulations 1.10 and 1.17, respectively.<sup>1</sup> The Division has considered the requests and is issuing this no-action letter subject to the conditions discussed below.

#### **Background**

Prior to the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”),<sup>2</sup> the term “introducing broker” was defined under the Commodity Exchange Act (“Act”) to mean:

[A]ny person...engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market or derivatives transaction execution facility who does not accept any money, securities, or

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<sup>1</sup> Commission regulations may be found at 17 CFR Ch. I, and may be accessed via the Commission’s web site, [www.cftc.gov](http://www.cftc.gov).

<sup>2</sup> See Dodd-Frank 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.

property (or extend credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.<sup>3</sup>

The Dodd-Frank Act established a new comprehensive regulatory framework for swaps and security-based swaps. As part of the swaps framework, the Dodd-Frank Act revised the definition of the term “introducing broker” to reflect the Commission’s expanded jurisdiction over swap transactions. Specifically, the Dodd-Frank Act amended the Act by revising the definition of the term “introducing broker” to include persons that engage in soliciting or accepting orders for the purchase or sale of any swap.<sup>4</sup>

Furthermore, subsequent to the passage of the Dodd-Frank Act, the Commission revised the definition of the term “introducing broker” in Regulation 1.3(mm) to include any person who, for compensation or profit, whether direct or indirect, is engaged in soliciting or in accepting orders (other than in a clerical capacity) for the purchase or sale of any commodity for future delivery, security futures product, or swap. The revisions of the statutory and regulatory definitions of the term “introducing broker” to include persons that engage in soliciting or accepting orders for swaps has resulted in an increase in the number of entities registering, or applying for registration, as IBs. These new IB registrants further include a significant number of foreign-domiciled entities that previously participated in the swaps market.

### **Introducing Broker Financial Reporting and Capital Requirements**

Persons registered as IBs, and applicants registering as IBs, are subject to Commission financial reporting and capital requirements. In this regard, Regulation 1.10 requires each person applying for registration as an IB to file audited or unaudited financial statements, as applicable, as part of its registration application.<sup>5</sup> In addition, each person registered as an IB is required to file unaudited financial statements semiannually as of the middle and close of the IB’s fiscal year.<sup>6</sup> A person registered as an IB also is required to file financial statements as of the close of its fiscal year end that are certified by an independent public accountant.<sup>7</sup>

The audited and unaudited financial statements generally are required to be prepared on CFTC Form 1-FR-IB, and presented in accordance with generally accepted accounting principles as adopted in the United States (“US GAAP”).<sup>8</sup> DSIO, however, previously issued a no-action letter in December 2013 providing that the Division would not recommend an enforcement action if foreign-domiciled IBs file audited and unaudited financial statements prepared in accordance with the International Financial Reporting Standards (“IFRS”) as adopted by the

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<sup>3</sup> Section 1a(23) of the Act, 7 U.S.C § 1a(23) (2006).

<sup>4</sup> See Section 721 of the Dodd-Frank Act and Section 1a(31) of the Act.

<sup>5</sup> Regulation 1.10(a).

<sup>6</sup> Regulation 1.10(b)(2)(i).

<sup>7</sup> Regulation 1.10(b)(2)(ii)(A).

<sup>8</sup> Regulation 1.10(a)(1).

International Accounting Standards Board (“IASB”) in lieu of US GAAP.<sup>9</sup> In addition, the Division’s no-action letter further provided that the Division would not recommend enforcement action if foreign-domiciled IBs used local accounting standards for the year ending December 31, 2013 if IFRS or US GAAP was not adopted in the IBs’ respective local jurisdiction.<sup>10</sup>

Commission Regulation 1.17 requires each person applying for registration as an IB, and each IB registrant, to maintain adjusted net capital of \$45,000.<sup>11</sup> 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 US GAAP, less illiquid assets (such as property, plant, and equipment), and further reduced by capital charges to cover the potential market risks or credit risk of the highly liquid assets.<sup>12</sup>

### **Relief Requested**

DSIO has received requests for relief from certain aspects of the financial reporting requirements of Regulation 1.10 and the capital requirements of Regulation 1.17 from Introducing Broker A (“IB-A”) and Introducing Broker B (“IB-B”).<sup>13</sup> Both IB-A and IB-B submitted their requests for relief on behalf of their foreign affiliates. IB-A has affiliates domiciled in the Republic of Korea (“Korea”) and Singapore that are currently registered as IBs (“IB-A’s Affiliates”). IB-B has affiliates domiciled in Mexico, Columbia, and Chile that have submitted applications to NFA for IB registration (“IB-B’s Affiliates”).

NFA staff also has discussed with Division staff several other foreign-domiciled entities that are registered as IBs, or have applications for IB registration pending, that have similar issues to the issues raised by IB-A and IB-B. Many, if not all, of these foreign-domiciled entities registered, or are registering, as a result of the Dodd-Frank revisions to the IB definition to include swap transactions.

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<sup>9</sup> See CFTC No-Action Letter No. 13-82 (December 23, 2013).

<sup>10</sup> *Id.*

<sup>11</sup> 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 [the National Futures Association (“NFA”)]; 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)). However, the IBs subject to this letter are not expected to be SEC registrants and the NFA capital requirement is not expected to be greater than \$45,000. If an IB is registered with the SEC and is subject to a capital requirement in excess of \$45,000, or if the NFA capital requirement is greater than \$45,000, the IB would be subject to such higher capital requirement.

<sup>12</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 Regulation 1.17(c)(5)(v). Furthermore, 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).

<sup>13</sup> See Letter dated July 31, 2014 from IB-A and Letter dated August 20, 2014 from IB-B.

With respect to the financial reporting requirements of Regulation 1.10, IB-A requests relief to permit the IB-A's Affiliates to use either IFRS as adopted in the local jurisdictions or other local accounting principles if the jurisdiction has not adopted IFRS as established by the IASB. IB-A further requests that it be permitted to prepare the financial statements in local currency as opposed to the U.S. dollar.

In support of its position, IB-A states that Korea has not adopted IFRS and that local law requires Korean entities to use accounting principles established in Korea in preparing financial reports for use in Korea. IB-A also states that any differences between local accounting principles and US GAAP/IFRS are not material and should not impede the Commission's ability to evaluate the IB-A's Affiliates' respective financial position and compliance with the \$45,000 capital requirement. In addition, IB-A states that absent any regulatory relief, it would have to prepare two sets of financial statements to comply with the requirements of two different jurisdictions, which will significantly increase costs without substantially increasing the regulatory benefits.

IB-A and IB-B also request relief on behalf of the IB-A's Affiliates and IB-B's Affiliates, respectively, from certain provisions of the Commission's capital rule, Regulation 1.17. Specifically, Regulation 1.17 requires an IB to take a capital charge of up to 20 percent on any uncovered "inventory" in foreign currencies.<sup>14</sup> In addition, Division staff has previously issued guidance providing that any cash or other property deposited by an IB in a foreign jurisdiction that is not a "major money market" as defined in the guidance was subject to a 100 percent capital charge in computing its regulatory capital under Regulation 1.17.<sup>15</sup>

IB-A and IB-B state that their respective Affiliates are foreign-domiciled<sup>16</sup> entities that use the applicable local currencies as their functional currencies. IB-A and IB-B further state that foreign currency capital charges set forth in Regulation 1.17 and the staff guidance are not appropriate when applied to foreign-domiciled IBs that use a local currency as its functional currency. IB-A and IB-B state that the foreign currency charges are more appropriate when the IB is holding funds outside of its home jurisdiction and, therefore, is subject to market risk associated with fluctuating exchange rates.

For example, IB-A notes that under the staff guidance and Regulation 1.17, its Korean affiliate would have to exclude all of its assets held with a Korean depository in computing its

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<sup>14</sup> Regulation 1.17(c)(5)(ii).

<sup>15</sup> The term "major money market" is taken from guidance found in the 1-FR-FCM Instruction Manual and several No-Action Letters issued by the staff of the SEC with respect to acceptable locations of deposits held by broker-dealers under the SEC capital rule. Following a harmonized approach, Commission staff has long recognized these interpretations with respect to all 1-FR filings, both those applicable to IBs and FCMs, when applying the Commission's adjusted net capital rule.

<sup>16</sup> For purposes of this letter and the relief expressed herein only, a foreign-domiciled IB is a person that: (1) is not a resident of the U.S.; and (2) 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.

adjusted net capital even though the firm's assets and liabilities are denominated in South Korean won. IB-B states that the foreign currency capital charges are more appropriate when the IBs are taking positions in currencies outside of the local currency. Accordingly, IB-A and IB-B request relief from the foreign currency capital charges imposed under the staff guidance and Regulation 1.17 when the "foreign" currencies are the local or functional currency of the foreign-domiciled IB.

### **Staff Position**

The Division has considered IB-A's and IB-B's requests for relief submitted on behalf of the IB-A's Affiliates and the IB-B's Affiliates, respectively. Based upon its consideration, and subject to the conditions set forth below, the Division will not recommend that the Commission initiate an enforcement action against a foreign-domiciled entity that is a registered IB, or direct NFA to reject an application of any foreign-domiciled person registering as an IB, that:

- (1) Files audited or unaudited financial Forms 1-FR-IB that are prepared using accounting principles adopted and in effect in the jurisdiction where the IB is domiciled in lieu of US GAAP or IFRS as adopted by the IASB;
- (2) Reports the account balances in the local currency of the jurisdiction where the IB is domiciled on the audited or unaudited Forms 1-FR-IB instead of U.S. dollars; or
- (3) In computing its adjusted net capital under Regulation 1.17, the IB does not apply the foreign currency capital charges required under Regulation 1.17 and staff guidance when the foreign currency is the local currency of the jurisdiction where the IB is domiciled.

The Division's no-action position is subject to the following conditions:

- (1) All Forms 1-FR-IB and certified financial reports filed with NFA by a foreign-domiciled IB or a foreign-domiciled IB applicant must be prepared in the English language;
- (2) Each Form 1-FR-IB, whether audited or unaudited, must include a Statement of the Computation of the Minimum Capital Requirements prepared in accordance with Commission Regulation 1.17 and staff guidance to the extent that relief is not provided by this letter;
- (3) Each Form 1-FR-IB, whether audited or unaudited, must include a second Statement of the Computation of the Minimum Capital Requirements with balances converted from the local currency to U.S. dollars as of the reporting date to demonstrate that the IB is in compliance with the Commission's capital requirements; and
- (4) Each IB is required to comply with the foreign currency capital charges set forth in Regulation 1.17 and staff guidance, with the exception that it may exclude from such capital charges the local currency of, and deposited in, the jurisdiction where such foreign IB is domiciled (for example, an IB domiciled in Korea may include all South Korean

won deposits maintained by depositories located in Korea in computing its adjusted net capital, but must take a 100 percent deduction from capital for any South Korean won or other currency deposits maintained outside of Korea with depositories located in non-major money center countries).

### **Additional Staff Position**

Separate from the relief discussed above pertaining to foreign-domiciled IBs, both IB-A and IB-B have also requested relief with regard to the net capital treatment of commission receivable balances held from persons other than a broker-dealer under Regulation 1.17. IB-A and IB-B both state that they arrange for customers the execution of over-the-counter swap transactions and charge such customers a commission for providing this service. IB-A states that it typically bills for these commissions on a monthly basis and those amounts are due within 30 days thereafter. IB-B states that unlike the traditional FCM model where a 30-day aged cycle is adequate for treatment as current assets, the collection of swap commission receivables typically averages between 60 and 90 days.

The Division has considered these requests in light of the new regulatory framework for the swaps market following the enactment of the Dodd-Frank Act. As such, the Division will continue to evaluate and consider recommending possible further Commission actions, including rulemaking or comprehensive guidance, with regard to IBs. In the interim, the Division will not recommend to the Commission that it initiate an enforcement action against an IB which recognizes as a current asset in computing its adjusted net capital under Regulation 1.17 a commissions receivable balance for an outstanding commission payment from an over-the-counter swap customer that has been billed during the calendar month of its origination and is aged not more than thirty (30) days from when it was billed.

This letter, and the positions taken herein, represent the view of the Division 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 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 me or Joshua Beale, Attorney-Advisor, 202-418-5446.

Very truly yours,

Thomas J. Smith  
Acting Director