



U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Swap Dealer and Intermediary Oversight

CFTC Letter No. 18-21
No-Action
August 29, 2018
Division of Swap Dealer and Intermediary Oversight

Ms. Allison Lurton
Senior Vice President and General Counsel
Futures Industry Association
2001 Pennsylvania Avenue NW
Suite 600
Washington, DC 20006

Re: Commission Regulation 1.16 – Staff No-Action Position Regarding PCAOB Requirement to Communicate Critical Audit Matters in Unqualified Audit Opinions

Dear Ms. Lurton:

This is in response to your letter dated August 14, 2018, to the Division of Swap Dealer and Intermediary Oversight (“Division”) of the Commodity Futures Trading Commission (“Commission”). By your letter, you request on behalf of your members that the Division confirm by no-action letter that it will not recommend enforcement action to the Commission for a violation of Regulation 1.16(c)¹ should the accountant’s audit opinion included in the annual financial report of a futures commission merchant (“FCM”) not communicate “critical audit matters” (or the absence thereof) as otherwise required by standards adopted by the Public Company Accounting Oversight Board (“PCAOB”).

I. Background

As represented in your letter, we understand the relevant facts to be as follows.

A. PCAOB Audit Standard 3101

On June 1, 2017, the PCAOB adopted a new standard, *The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (“AS 3101”) that, among other things, requires an auditor registered with the PCAOB to communicate any “critical audit matters” (“CAMs”) in its audit report related to the financial statements of a

¹ Commission rules referred to in this letter are found at 17 C.F.R. Ch. 1 (2017). The Commission’s website, www.cftc.gov, provides links to the Regulations.

public company.² CAMs are defined, in general, as matters communicated or required to be communicated to the audit committee and that: (1) relate to the accounts or disclosures that are material to the financial statements; and (2) involved especially challenging, subjective, or complex auditor judgement.³ The provisions of AS 3101 related to CAMs are to take effect for audits of fiscal years ending on or after June 30, 2019 with respect to large accelerated filers and for fiscal years ending on or after December 15, 2020 for all other companies to which the requirements are applicable.

B. Exclusion from AS 3101 for Audits of Brokers and Dealers

The PCAOB explicitly excluded from the CAM provisions of AS 3101 the audits of Securities and Exchange Commission (“SEC”) registered brokers and dealers that report under Securities Exchange Act Rule 17a-5.⁴

In describing its rationale for excluding audits of brokers and dealers from the CAM requirements, the PCAOB noted, among other things, economic considerations (i.e., costs and benefits), and existing SEC rules and PCAOB standards. In particular, the PCAOB referenced its adoption in 2013 of standards related to brokers and dealers that enhanced auditors’ performance and reporting responsibilities for financial audits, as well as engagements on compliance and exemption reports of brokers and dealers.⁵

The PCAOB also stated that the nature of brokers and dealers’ business and structure limits the value of reporting CAMs. Specifically, the PCAOB noted that currently there are no brokers or dealers that are “issuers” and that, in many cases, there is much less separation in ownership and control in brokers and dealers than in issuers. Upon review of the ownership and reporting characteristics of brokers and dealers and the PCAOB’s standard-setting activities related to brokers and dealers, the PCAOB concluded that the reporting of CAMs with regard to audits of brokers and dealers would not provide meaningful information in the same way as for issuers.

C. Applicability of AS 3101 to Futures Commission Merchants

² PCAOB Release No. 2017-001 (June 1, 2017). Paragraphs .11 - .17 of AS 3101 sets forth PCAOB requirements with respect to CAMs. AS 3101 originally was proposed in August 2013 (See PCAOB Release No. 2013-005 (Aug. 13, 2013)) and was re-proposed in May 2016 (See PCAOB Release No. 2016-003 (May 11, 2016)).

³ AS 3101.11

⁴ The standard also excludes audits of the following entities from the CAM communication requirements: (1) Investment companies other than business development companies; (2) employee stock purchase, savings, and similar plans; and (3) emerging growth companies. AS 3101.05b. Although not required, the PCAOB noted that auditors of these entities may choose to include CAMs in the auditor’s report voluntarily.

⁵ See *Attestation Standards for Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards*, PCAOB Release No. 2013-007 (Oct. 10, 2013) and *Auditing Standard No. 17, Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards*, PCAOB Release No. 2013-008 (Oct. 10, 2013).

While the PCAOB excluded audits of brokers and dealers from the CAM requirements in AS 3101, the PCAOB does not have regulatory authority with respect to Commission registrants and, therefore, did not consider or address the applicability of CAM requirements to the audits of FCMs. Absent a statement from the Commission or its staff the PCAOB's CAM requirements would impact FCMs, however, as Commission regulations generally require accountants engaged in audits of FCMs to register with the PCAOB and to conduct FCM audits in accordance with PCAOB standards.⁶

II. Requested Relief and Analysis

You state that for reasons similar to those provided by the PCAOB with respect to its exclusion of audits of brokers and dealers from the CAM requirements, audits of FCMs also should not be subject to CAM communication obligations. You contend that the application of the CAM requirements in the case of FCM audits would provide little, if any, additional meaningful information than is already provided under Commission regulations and that any potential benefit of requiring compliance with the rules is outweighed by the added expense of such compliance. Accordingly, you request that the Division provide no-action relief so that FCMs are treated similarly to registered broker-dealers with respect to the application of the AS 3101 CAM requirements.

Many FCMs are entities registered dually as broker-dealers with the SEC. As noted, audits of brokers and dealers are explicitly excluded from the PCAOB's CAM regulations. Like brokers and dealers, FCMs are not issuers. Rather, they are entities typically more centrally controlled and owned. As a result, owners of the FCM are typically managers of the entity that would have direct access to the auditor and would not necessarily benefit from written communication in the audit report.

With regard to the FCM audit on which the annual report is prepared, Commission regulations specify the audit scope. The scope of the audit must be sufficient to provide reasonable assurance that any material inadequacies in (i) the accounting system, (ii) the internal accounting controls, and (iii) the procedures for safeguarding customer and firm assets (including customer fund segregation requirements) that exist at the date of the examination will be discovered.⁷ An FCM must file concurrently with its annual report a supplemental report by the accountant describing any material inadequacies found to exist or found to have existed since the date of the previous audit.⁸

In addition, Commission regulations require each FCM to designate a chief compliance officer whose duties include, among others, preparing and providing to the Commission an annual report covering an assessment of certain policies and procedures and other operational aspects of the firm.⁹ This report must be provided to the firm's board of directors or senior officer for review prior to furnishing it to the Commission.¹⁰

⁶ Regulations 1.16(b)(1) and (c).

⁷ Regulation 1.16(d).

⁸ Regulation 1.16(c)(5).

⁹ The Commission recently adopted rule amendments clarifying and simplifying its regulations governing, among other things, chief compliance officer annual reporting requirements for FCMs. The amended regulations are effective September 26, 2018. *Chief Compliance Officer Duties and Annual Report*

Further, similar to the regulations of brokers and dealers, Commission customer protection regulations already require FCMs to provide significant disclosures to customers as well as relevant information about an FCM's financial condition, operations and audits. In November, 2013, the Commission adopted new and amended regulations aimed at enhancing its FCM customer protection regulations.¹¹ A central part of this rulemaking was the adoption of additional disclosures that FCMs are required to provide to existing and prospective customers. Under these rules each FCM is required to disclose to existing and prospective customers all information that would be material to the customers' decision to entrust funds to, or otherwise do business with, the FCM, including its business, operations, risk profile, and affiliates.¹² Each FCM also is required to disclose on its website certain current and historical information regarding its holding of customer funds as well as its certified annual report.¹³

Requirements for Futures Commission Merchants, Swap Dealers, and Major Swap Participants, 83 Fed. Reg. 43510 (Aug. 27, 2018).

Regulation 3.3(e), as amended, requires that the chief compliance officer annual report, at a minimum, contain a description of:

- (1) The written policies and procedures of the FCM, including the code of ethics and conflicts of interest policies;
- (2) The FCM's assessment of the effectiveness of its policies and procedures relating to its business as an FCM;
- (3) Areas for improvement, and recommended potential or prospective changes or improvements to its compliance program and resources devoted to compliance;
- (4) The financial, managerial, operational, and staffing resources set aside for compliance with respect to the Commodity Exchange Act and Commission regulations relating to its business as an FCM, including any material deficiencies in such resources;
- (5) Any material noncompliance issues identified and the corresponding action taken; and
- (6) Any material changes to compliance policies and procedures during the coverage period for the report.

¹⁰ Regulation 3.3(f).

¹¹ See *Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivative Clearing Organizations* 78 Fed. Reg. 68506 (Nov. 13, 2013).

¹² See Regulations 1.55(i)-(k).

¹³ Regulation 1.55(o) requires each FCM to make the following financial information publicly available on its website:

- (1) The daily Statement of Segregation Requirements and Funds in Segregation for Customers Trading on U.S. Exchanges, the daily Statement of Secured Amounts and Funds Held in Separate Accounts for 30.7 Customers, and the daily Statement of Cleared Swaps Customer Segregation Requirements and Funds in Cleared Swaps Customer Accounts Under Section 4d(f) of the Commodity Exchange Act, all for the most current 12-month period;
- (2) A summary schedule of the FCM's adjusted net capital, net capital, and excess net capital, all computed in accordance with Regulation 1.17 and reflecting balances as of the month-end for the 12 most recent months;
- (3) The Statement of Financial Condition, the Statement of Segregation Requirements and Funds in Segregation for Customers Trading on U.S. Exchanges, the Statement of Secured Amounts and Funds Held in Separate Accounts for 30.7 Customers Pursuant to Commission Regulation 30.7, the Statement of Cleared Swaps Customer Segregation Requirements and Funds in Cleared Swaps Customer Accounts Under Section 4d(f) of the Commodity Exchange Act, and all related footnotes to these that are part of the FCM's most current certified annual report; and

Other relevant Commission customer protection regulations include, for example, a daily reporting of the total amount of futures customer funds required, and on deposit in, segregated accounts, as well as the FCM's residual interest in such customer funds all computed as of the close of the prior business day.¹⁴

You contend that in light of FCMs' organizational structure and this backdrop of regulatory protections, failure to exclude audits of FCMs from the PCAOB's CAM requirements would add an unnecessary layer of costs to an FCM's audit that ultimately would be passed on to the FCM's customers. You note that AS 3101 requires not only an assessment by the auditor of which audit issues are (or are not) "critical", but also requires that the auditor document such assessment. Specifically, the PCAOB standard requires for each matter arising from an audit that was (1) communicated to the audit committee, and (2) relates to accounts or disclosures that are material to the financial statements, that the auditor document whether the matter was deemed to be a CAM and the basis for the determination.¹⁵ You further state that auditor concerns about the potential for increased liability exposure due to changes to the audit report required under the PCAOB requirements would result in additional work and costs to ensure minimization of these added risks.¹⁶

In light of the foregoing, the Division agrees that any benefit of applying the PCAOB's CAM requirements to FCM audits would be minimal while the added cost of compliance with such requirements could be significant. Accordingly, the Division believes that granting the requested no-action relief is appropriate.

III. Relief Granted

Based on the foregoing, the Division confirms that it will not recommend that the Commission take enforcement action against an FCM for a violation of Regulation 1.16(c) should an accountant's audit opinion included in the annual financial report of an FCM not communicate "critical audit matters" (or the absence thereof) as required in AS 3101 adopted by the PCAOB.

This letter and the position taken herein are based upon the representations made to us. Any different, changed or omitted material facts or circumstances might require the Division to reach a different conclusion and render this letter void. You must notify the Division immediately in the event there is any change to the facts presented to the Division.

(4) The Statement of Segregation Requirements and Funds in Segregation for Customers Trading on U.S. Exchanges, the Statement of Secured Amounts and Funds Held in Separate Accounts for 30.7 Customers Pursuant to Commission Regulation 30.7, and the Statement of Cleared Swaps Customer Accounts Under Section 4d(f) of the Commodity Exchange Act that are part of the FCM's unaudited Form 1-FR-FCM or Financial and Operational Combined Uniform Single Report under the Securities Exchange Act of 1934 ("FOCUS Report") for the most current 12-month period.

¹⁴ Regulation 1.32.

¹⁵ AS 3101.17

¹⁶ In its release adopting AS 3101, as well as in its proposal and re-proposal of the standard, the PCAOB acknowledged that including critical audit matters in the audit report would change the report in ways that could affect auditors' potential liability. See PCAOB Release No. 2017-001 at 40-44.

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This letter does not provide no-action relief from any provision of Regulation 1.16 except as specifically noted above, or from any other applicable requirements in the Commodity Exchange Act or in the Regulations issued thereunder. Further, this letter represents the position of the Division only and does not necessarily represent the views of the Commission or of any other division or office of the Commission. As with all no-action letters, the Division retains the authority to, in its discretion, further condition, modify, suspend, terminate or otherwise restrict the terms of the no-action relief provided in this letter. Finally, this letter does not create or confer any rights for or obligations on any person or persons subject to compliance with the Commodity Exchange Act that bind the Commission or any of its other offices or divisions.

If you have any questions concerning this correspondence, please feel free to contact me at 202-418-5213, Tom Smith, Deputy Director, at 202-418-5495 or Lawrence Eckert, Special Counsel, at 646-746-9704.

Sincerely,

Matthew Kulkin
Director