U.S. COMMODITY FUTURES TRADING COMMISSION
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Division of Swap Dealer and
Intermediary Oversight

CFTC Letter No. 18-01
No-Action
January 4, 2018
Division of Swap Dealer and Intermediary Oversight

Ms. Mary Kay Scucci
Managing Director
Securities Industry and Financial Markets Association
120 Broadway
New York, NY 10271

Re: Commission Regulation 1.17 – Staff No-Action Position Regarding the Treatment of a Deferred Tax Liability Caused by a Change in Accounting Principles

Dear Ms. Scucci,

This responds to your letter dated October 23, 2017 to the Division of Swap Dealer and Intermediary Oversight ("DSIO" or "Division") of the Commodity Futures Trading Commission ("Commission"). By your letter, you request, on behalf of The Capital Steering Committee of the Securities Industry and Financial Markets Association ("SIFMA"), confirmation that DSIO staff will not recommend an enforcement action to the Commission if a futures commission merchant ("FCM"), in computing its net capital under Regulation 1.17, excludes deferred tax liabilities directly related to certain "costs to obtain or fulfill" contracts as defined under the Financial Accounting Standards Board's ("FASB") *Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers* ("Topic 606").[1]

Based upon the representations in your letter, we understand the pertinent facts to be as follows. Topic 606 is a new FASB revenue recognition standard that supersedes existing guidance, and is applicable to FCMs. The objective of Topic 606 is for a firm to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the firm expects to be paid for those goods or services. As part of the

[1] Commission regulations are found at 17 CFR Ch. 1.

new standard, the guidance on the treatment of incremental costs of obtaining a contract with a customer was also updated in Accounting Standards Codification ("ASC") 340-40, Other Assets and Deferred Costs – Contracts with Customers. The definition of "costs to obtain or fulfill" contracts in Topic 606 refers to ASC 340-40-25-2, which defines incremental costs of obtaining a contract as those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).

You state that the implementation of Topic 606 and ASC 340-40 will alter current accounting treatment by requiring FCMs to capitalize portions of sales and commission expenses associated with the acquisition of customer accounts, which FCMs have historically immediately expensed. Implementation of Topic 606 and ASC 340-40 requires these costs to be capitalized going forward, but also requires that an FCM assess costs associated with open contracts at the adoption date and expensed in prior periods. If the ASC 340-40 requirements for capitalization are met, the FCM would capitalize those previously expensed costs, which requires an adjustment that increases opening retained earnings. Therefore, there will be an initial asset recognized upon adoption of Topic 606 and ASC 340-40, and new assets recognized in the future as these costs continue to be capitalized. You state that the implementation of Topic 606 and ASC 340-40 will create a difference between book accounting under U.S. generally accepted accounting principles ("GAAP") (which will require customer acquisition costs to be capitalized and amortized) and tax accounting under the Internal Revenue Code (which allows customer acquisition costs to be deducted for tax purposes when paid). This difference in book and tax accounting creates a new deferred tax liability directly related to the new asset. This new deferred tax liability will be initially recognized upon adoption, which requires an adjustment that decreases opening retained earnings. New deferred tax liabilities will continue to be recognized in future periods as the costs continue to be capitalized.

For the reasons set forth above, the new standard would have the effect of increasing an FCM's assets (as the cost of gaining a customer contract is amortized over time rather than immediately expensed). This would increase the FCM's retained earnings, and thus the FCM's equity computed in accordance with GAAP. This increase in an FCM's capital will be partially offset by the creation of a new deferred tax liability directly related to the new asset. While the effect of the new accounting standard would increase the FCM's equity determined in accordance with GAAP, it would decrease the FCM's regulatory capital. This is because, when determining net capital under Regulation 1.17(c)(2), the FCM would need to exclude the amortizing asset as a non-allowable asset, and the FCM would be required to deduct the related deferred tax liability from net capital under Regulation 1.17(c)(4).

To address the negative impacts on FCM net capital, you have requested a no-action position to allow an FCM to exclude a deferred tax liability that is directly related to the capitalized costs of acquiring customer accounts under Topic 606 and ASC 340-40 from the FCM's net capital computation under Regulation 1.17. In support of your request, you state that the negative impact occurs even though there has been no change to the FCM's cash flows, income tax liability, or overall operating risk profile, and that the accounting change merely alters the timing under which customer acquisition costs are recognized in book net income. You further state that the new accounting standard results in an inappropriate double charge to the FCM's net capital as the capitalized costs are non-allowable assets under Regulation 1.17(c)(2) and the related deferred tax liability reduces the FCM's capital under Regulation 1.17(c)(4). In addition, in support of your request, you state that SIFMA has made an identical request to the staff of the Securities and Exchange Commission ("SEC") with respect to the calculation of broker-dealer regulatory capital pursuant to SEC Rule 15c3-1.[2]

In addition to the request for a no-action position with respect to capitalized costs of acquiring customer accounts, you further note that SEC staff has previously provided essentially identical relief from Rule 15c3-1 to allow broker-dealers to add back to net worth deferred tax liabilities that were directly related to non-allowable assets resulting from the recognition of prepaid advertising expenses,[3] development costs of internal-use software,[4] intangible assets representing the value of a retail distribution network,[5] and pre-paid commissions.[6] In each of these situations, a broker-dealer was required to record a deferred tax liability due to a timing difference in the recognition of expenses for book purposes under GAAP accounting and for tax purposes under the rules the Internal Revenue Code. You request confirmation that the Division would not recommend an enforcement action if an FCM, including a dual-registered broker-dealer/FCM, excluded deferred tax liabilities as set forth in the above SEC staff letters in computing its net capital under Regulation 1.17.

Based on the foregoing, the Division will not recommend that the Commission commence an enforcement action if, when computing net capital in accordance with Regulation 1.17, an FCM excludes deferred tax liabilities that are directly related to the capitalized costs of acquiring and fulfilling customer accounts under Topic 606 and ASC 340-40 and such capitalized costs are excluded from current assets under Regulation 1.17. The Division also confirms that it will not recommend that the Commission commence an enforcement action against an FCM that in computing its adjusted net capital under Regulation 1.17 excludes deferred tax liabilities that are directly related to non-allowable assets resulting from the recognition of prepaid advertising expenses, development costs of internal-use software, intangible assets representing the value of a retail distribution network, and pre-paid commissions as set forth in the SEC staff letters.[7]

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[2] 17 CFR 240.15c3-1.
[3] *See* Advanced Clearing, Inc. (SEC No-Act, March 23, 1999).
[4] *See* The Charles Schwab Corporation (SEC No-Act, Dec. 8, 1998).
[5] *See* John Hancock Funds, LLC (SEC No-Act, Dec. 12, 2006).
[6] *Id.*
[7] The Division also would not recommend that the Commission commence an enforcement action against an introducing broker that, in computing its net capital under Regulation 1.17, excludes deferred tax liabilities under the same terms and conditions as discussed in this letter.

This letter, and the position taken herein, are based upon the representations made to us and are subject to compliance with the conditions stated above. Any different, changed or omitted material facts or circumstances might require DSIO to reach a different conclusion and render this letter void. You must notify DSIO immediately in the event there is any change to the facts presented to the Division. This letter does not provide no-action relief from any provision of Regulation 1.17 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. 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 Jennifer Bauer, Special Counsel at 202-418-5472, or Josh Beale, Special Counsel at 202-418-5446.

Sincerely,

Thomas Smith
Deputy Director