UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

DIVISION OF
TRADING AND MARKETS

January 4, 2018

Mary Kay Scucci, PhD, CPA
Managing Director
Securities Industry and Financial Markets Association
120 Broadway, 35th Floor
New York, NY 10271-0080

Re: Treatment of Revenue from Contracts with Customers under Rule 15c3-1

Dear Ms. Scucci:

In your letter dated October 23, 2017 on behalf of the Securities Industry and Financial Markets Association ("SIFMA"), you request assurance that the staff of the Division of Trading and Markets (the "Division") of the U.S. Securities and Exchange Commission (the "Commission") will not recommend enforcement action to the Commission under Rule 15c3-1 of the Securities Exchange Act of 1934 (the "Exchange Act")[1] if a broker-dealer offsets certain "incremental costs of obtaining a contract with a customer" as well as the "costs incurred in fulfilling a contract with a customer", as defined under the Financial Accounting Standards Board's ("FASB") *Accounting Standards Codification 340-40, Other Assets and Deferred Costs – Contracts with Customers ("ASC 340-40")*,[2] that are recognized as non-allowable assets, with the related deferred tax liability for purposes of computing its regulatory net capital.

Based on the representations in your letter, I understand the following to be pertinent to your request for relief. FASB adopted *Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers* ("Topic 606").[3] Topic 606 is a new revenue recognition standard that supersedes existing guidance. 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 entity expects to be paid for those goods or services. As part of the new standard, the guidance on the treatment of incremental costs of obtaining a contract with a customer as well as the costs incurred in fulfilling a contract with a customer were also updated

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1 See 17 CFR 240.15c3-1.

2 See FASB ASC No. 340-40, Other Assets and Deferred Costs – Contracts with Customers.

3 See FASB ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606).

in ASC 340-40. The incremental costs of obtaining a contract are defined in ASC 340-40-25-2 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."[4]

Implementation of Topic 606 requires entities, including broker-dealers, to apply the guidance within the standard to determine if these costs qualify for capitalization, and also requires broker-dealers to retroactively assess costs associated with open contracts at the adoption date and expensed in prior periods. If the Topic 606 requirements for capitalization are met, the broker-dealer would capitalize those previously expensed costs, which requires an adjustment to opening retained earnings. Therefore, in such cases, there will be an initial asset recognized upon adoption of Topic 606, and new assets recognized in the future as these costs are capitalized. The new asset may also have a related deferred tax liability initially recognized upon adoption, as well as in future periods. These capitalized costs are expensed when the associated revenue is recognized.

For the reasons set forth above, the new standard could have the effect of increasing a broker-dealer's assets (as certain incremental costs to obtain a contract and costs to fulfill a contract are required to be capitalized). Correspondingly, this would increase the broker-dealer's retained earnings, and thus the broker-dealer's equity capital computed in accordance with U.S. GAAP. This increase in a broker-dealer's equity capital may be partially offset by the creation of an associated deferred tax liability directly related to the new asset. While the effect of the new accounting standard would increase the broker-dealer's equity it would decrease the broker-dealer's regulatory net capital to the extent that the non-allowable asset could not be offset with its associated deferred tax liability.

Without the ability to offset the newly created non-allowable asset with its associated deferred tax liability, a broker-dealer's net capital would be impacted even though there has been no change in the firm's cash flows, income tax liability, or overall operating risk profile. The new accounting standard merely alters the timing under which incremental costs of obtaining a contract with a customer as well as the costs incurred in fulfilling a contract with a customer are recognized in net income as required by U.S. GAAP, and in doing so it would create a negative net capital consequence through the firm's balance sheet.

Based on the facts and representations set forth in your letter and discussions with the Staff as collectively set forth in this letter, the Division will not recommend enforcement action to the Commission under Rule 15c3-1 if a broker-dealer, when computing net capital, adds back

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4 For example, a sales commission that a broker-dealer is required to pay out when the firm enters into a customer contract may be an example of a cost that is "incremental to obtaining the contract".

to net worth the amount of the deferred tax liability to the extent that amount directly relates to the non-allowable asset consisting of a "incremental costs of obtaining a contract with a customer" as well as "costs incurred in fulfilling a contract with a customer", as defined in ASC 340-40.

This staff position is based strictly on the facts and circumstances discussed in this letter, and any different facts and circumstances may require a different response. This response, furthermore, expresses the Division's position regarding enforcement action only and does not purport to express any legal conclusions on the question presented. The Staff expresses no view with respect to any other questions that the activities discussed above may raise, including the applicability of any other federal or state laws, or self-regulatory organization rules. This position is subject to modification or revocation as necessary or appropriate for the public interest or the protection of investors.

If you have any questions regarding this letter, please call me at (202) 551-5525, Randall Roy at (202) 551-5522, or Jessica Mark at (202) 551-3551.

Sincerely,

Michael A. Macchiaroli
Associate Director

Invested in America

October 23, 2017

Mr. Michael A. Macchiaroli, Esq.
Associate Director
Division of Trading and Markets
Securities and Exchange Commission
100 F Street NE
Washington, D. C. 20549

Re: Net Capital Implications resulting from the Financial Accounting Standards Board's *Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606)*

Dear Mr. Macchiaroli:

The Capital Steering Committee of the Securities Industry and Financial Markets Association (SIFMA)[1] respectfully requests that the staff of the Securities and Exchange Commission (the "Commission") issue an interpretation and no action relief to correct for the impact that the adoption of the Financial Accounting Standards Board's ("FASB") *Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606)* (the "ASU") would otherwise have on the net capital computations of broker-dealers. In particular, we are requesting relief for the capital impact of the creation of a deferred tax liability associated with "cost to obtain or fulfill" contracts as defined under the new ASU.

<u>Accounting Overview</u>

Topic 606 is a comprehensive new revenue recognition standard that supersedes existing guidance. 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 entity expects to be paid for those goods or services.[2]

[1] SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $18.5 trillion in assets and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

[2] A brief explanation of the process leading up to the adoption of the ASU can be found at the following website: http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176163728398

As part of the new standard, the guidance on the treatment of incremental costs of obtaining a contract with a customer was also updated in ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*. The incremental costs of obtaining a contract are defined in ASC 340-40-25-2 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 that a broker-dealer is required to be pay out when the firm enters into a customer contract is an example of a cost that is incremental to the obtaining of the contract."[3] Suppose that a broker-dealer was required to pay out a $1,000 commission with respect to a services contract where it expected to earn revenue over a five-year period. Historically, the broker-dealer would have expensed the $1,000 immediately, though that expense would be partially offset by a reduction in its income taxes. Under the new guidance, the broker-dealer would amortize the $1,000 expense over the five-year period (which means that a diminishing share of the $1,000 would continue to be an asset on the broker-dealer's balance sheet), with that asset partially offset by a deferred tax liability, which would be recognized as the associated expense was amortized.

SIFMA member firms are undertaking an analysis of their sales costs for the purpose of identifying those costs that should be expensed immediately and those that should be amortized over several years. Implementation of Topic 606 requires these sales costs be capitalized going forward, but also requires that a broker-dealer assess costs associated with open contracts at the adoption date and expensed in prior periods. Providing that the ASC 606 requirements for capitalization are met, the broker dealer would capitalize those previously expensed costs, which requires an adjustment to opening retained earnings. Therefore, there will be an initial asset recognized upon adoption of Topic 606 and new assets recognized in the future as these costs continue to be capitalized. This new asset will also have a related deferred tax liability initially recognized upon adoption and new deferred tax liabilities recognized in future periods as the costs continue to be capitalized.

"Cost to Obtain or Fulfill" Contracts and Net Capital Calculations

In short, the new standard will have the effect of increasing broker-dealer's assets (as the cost of gaining a customer contract is amortized over time rather than immediately expensed), which will increase a firm's retained earnings, and thus the broker-dealer's equity computed in accordance with US GAAP. This increase in a broker-dealer's

[3] Conversely, ASC 340-40-25-3 states "costs to obtain a contract that would have been incurred regardless of whether the contract was obtained shall be recognized as an expense when incurred." Example 36 in Topic 606 refers to ASC 340-40-55-2 through 55-4 for an illustration of accounting for costs of obtaining a contract. In Example 1 of ASC 340-40-55, the entity is a provider of consulting services and wins a bid to provide consulting services to a new customer. The entity incurs external legal fees, travel costs and commission expenses to employees as costs to obtain the contract. As explained in the example, the legal and travel costs would be expensed as incurred as they would have been incurred regardless if the entity won the bid. The commission expenses would be capitalized as an asset as the costs are incremental and the entity expects to recover the costs through fees received from the consulting services. The example also notes bonuses paid based on sales, entity profitability and employee performance would not be capitalized as these costs are discretionary and based on other factors and thus are not directly attributable to identifiable contracts.

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 is positive as to a firm's equity determined in accordance with U.S. GAAP, it would actually be negative as to a broker-dealer's regulatory capital. This is because, under the SEC's net capital rule, the amortizing asset (the capitalized sales cost incurred in gaining the customer contract) would be a non-allowable asset and the broker-dealer would be required to deduct the related deferred tax liability from its equity.

For example, for each $1,000 of newly capitalizable costs of obtaining a customer contract, equity capital would be typically increased by $600 (the $1,000 deferred expense reduced by the $400 deferred tax liability for the timing difference between tax and book expense).[4] That same $1,000 will be included at 100% as a nonallowable asset in calculating net capital, creating a $400 net reduction in net capital for regulatory purposes.

This negative impact would occur even though there has been no change in the firm's cash flows, income tax liability or overall operating risk profile, even though the firm's US GAAP equity has actually increased. The new accounting standard merely alters the timing under which costs to obtain or fulfill a contract are recognized in book net income, and in doing so creates an unintended negative net capital consequence through the firm's balance sheet.

Request

We do not believe that the adoption of *Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606),* which is intended to bring about comparable accounting practices across all industries, should negatively impact net capital for broker-dealers under Rule 15c3-1.[5] The Capital Steering Committee therefore respectfully requests that the staff of the Commission issue a "no-action" position allowing broker-dealers to net certain costs to obtain or fulfill a contract, as defined in the ASU, against the related deferred tax liability for purposes of computing its regulatory capital. This position would leave the broker-dealer's net capital calculation unchanged by the ASU, which we also believe results in net capital being a more accurate representation of the broker-dealer's "regulatory capital," as opposed to its accounting equity.

We note that the SEC staff has previously given essentially identical relief as to prior changes in US GAAP relating to prepaid advertising expenses,[6] development costs of internal-use software,[7] intangible assets representing the value of a retail distribution network,[8] and pre-paid commissions.[9] Similarly, the SEC staff also provided relief as

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[4] Our analysis assumes a 40% tax rate, but a similar result would be observed for any non-zero tax rate.

[5] For the same reasons that FASB's accounting update should not change broker-dealers' calculation of net capital, it also should not affect firm's calculation of their leverage ratios under FINRA 10-44 *New Alert – Reporting Criterion for Leverage in FOCUS Report* or under the Commission's anticipated rulemaking related to leverage ratios.

[6] See Advanced Clearing, Inc. (SEC No-Act, March 23, 1999).

[7] See The Charles Schwab Corporation (SEC No-Act, Dec. 8, 1998).

[8] See John Hancock Funds, LLC (SEC No-Act, Dec. 12, 2006).

to the potential net capital impact of changes to the US GAAP accounting rules relating to leases that would have put effectively offsetting amounts of lease assets and lease liabilities on a broker-dealer's balance sheet, resulting in no change to equity but unintended reductions to regulatory capital.[10]

We also request that the SEC staff note that the same relief will apply to its capital rules that will eventually apply to security-based swap dealers. Finally, just as the ASU should not change broker-dealers' calculation of net capital, it also should not affect a firm's calculation of its leverage ratios.

We appreciate your consideration of this request. Please also be aware that we will be making an identical request to the staff of the Commodity Futures Trading Commission with respect to the calculation of regulatory capital pursuant to CFTC Rule 1.17 and capital requirements applicable to Futures Commission Merchants.

Thank you for this opportunity to provide you with the concerns regarding the consequences of the new revenue recognition ASU. We would be pleased to discuss our views or provide any addition information. Please contact me at 212-313-1331 if you have any questions.

Regards,

Mary Kay Scucci, PhD, CPA
Managing Director
Securities Industry and Financial Markets Association

Cc: Gary Barnett, Deputy Director, SEC Trading and Markets
Tom McGowan, Associate Director, SEC Trading and Markets
Tom Smith, Deputy Director, Capital, Margin and Segregation, CFTC Division of Swap Dealer and Intermediary Oversight

[9] Id.
[10] See Securities Industry and Financial Markets Association (SEC No-Act, Nov. 8, 2016).