NFA Financial Information on Forms PQR and PR

NATIONAL FUTURES ASSOCIATION®

Today’s Agenda

- Background and development
- Required ratios
- Ratio reporting
- Calculating required ratios
- Key takeaways
- Questions

Regulatory Objective

- NFA has taken a number of emergency disciplinary actions in recent years against CPO and CTA Members that caused serious harm to customers due to the operation of firms with insufficient assets
- Objective is to evaluate trends related to a CPO's or CTA's financial situation
- Used in conjunction with other information NFA already receives from your firm

Background

- CPOs and CTAs do not currently provide any information to NFA on the financial condition of the firm
- January 2014 request for comments on the concept of a CPO/CTA capital requirement and other possible customer protection measures
- Commenters proposed the idea of collecting data on a firm's financial condition, similar to SEC requirements for Investment Advisers

Background

- Over the last two years, NFA worked extensively with the CPO/CTA Advisory Committee and various trade associations to determine the best approach to meet NFA's regulatory objective
- Reviewed and approved by NFA's Executive Committee and Board of Directors
- Submitted to and approved by the CFTC in September 2016
- Effective June 30, 2017

Development

Interpretive Notice entitled *NFA Compliance Rule 2-46: Reporting Financial Information on NFA Forms PQR and PR* issued December 2016

- Requires CPOs and CTAs to report two financial ratios regarding a CPO's or CTA's financial condition on the quarterly Forms PQR and PR
  - Current Assets/Current Liabilities (CA/CL) Ratio
  - Total Revenue/Total Expenses (TR/TE) Ratio

Before Calculating a Firm's Ratios

- Determine if reporting at firm level, or at parent level if structured as such

Holding Company/Subsidiary Reporting

Firms that are part of a holding company/subsidiary structure may elect to report the below ratio information at the parent level.

A001

Are you a subsidiary in a holding company structure? ◉ Yes ○ No

At which level are you reporting?

A002

○ Parent/Holding Company Level ○ Subsidiary Member Firm Level

Before Calculating a Firm's Ratios

- Determine reporting quarter
  - Firms with a fiscal year end not aligned with current quarter ends can report for the firm's most recently ended fiscal quarter

Reporting Period

A firm that has a fiscal year end that does not align with the reporting quarters may report the ratios as of the firm's most recently ended fiscal quarter.

Are you reporting ratios for a period with the same end date as the end date of this PQR filing (i.e. PQR reporting date is 6/30/2017, Total Assets/Total Liability Ratio as of 6/30/2017)?

A005

○ Yes ◉ No

A006

Please indicate the period end date for the reported ratios.

Current Assets and Current Liabilities

- **Current Assets**: Cash or any asset that can be readily converted to cash within one year. Current assets for a CPO or CTA may include, but are not limited to, cash, marketable securities, short-term investments, accounts receivable, and a general partner's investment in its pool.
- **Current Liabilities**: Obligations that are reasonably expected to be paid within one year. Current liabilities include, but are not limited to, accounts payable, accrued expenses, payroll liabilities, income tax liabilities, and interest payable. A firm's long-term financial obligations that are not due within the present accounting year are considered a noncurrent liability and should not be included in this ratio.

Current Assets/Current Liabilities (CA/CL) Ratio

- Designed to measure a firm's liquidity
- Should be based on a firm's current assets and current liabilities at the reporting quarter end

Current Assets/Current Liabilities (CA/CL) Ratio

This ratio is based on a firm's current asset and current liability balance at the reporting quarter end.

Current Assets/Current Liabilities (CA/CL) Ratio	A003

Total Revenue and Total Expenses

- **Total Revenue**: Gross income earned by a firm from its normal business activities before any expenses have been deducted. Income may be received as cash or a cash equivalent and is typically generated by a CPO or CTA through management and/or incentive fees.
- **Total Expenses**: Costs incurred in a firm's efforts to generate revenue, representing the cost of doing business. Expenses may include, but are not limited to, wages and salaries, rent, utilities, depreciation, and bad debts.

Total Revenue/Total Expenses (TR/TE) Ratio

- Designed to measure a firm's operating margin
- Firm will be required to report this ratio each quarter, but it should reflect the total revenue earned and expenses incurred during the prior 12 months
- For the first three quarterly reports, only have to provide the information for the time period that the rule was in effect
  - NFA expects to receive information on prior 12 months, if available

Total Revenue/Total Expenses (TR/TE) Ratio

This ratio must reflect the total revenue earned and total expenses incurred during the prior 12 months.

A004

Total Revenue/Total Expenses (TR/TE) Ratio 0.00

Calculating Ratios

- Ratios must be computed using the accrual method of accounting and in accordance with generally accepted accounting principles or another internationally recognized accounting standard, consistently applied
- Accrual method allows for a consistent method of accounting used across all Members
- Firms using cash basis of accounting will need to reconcile their records to calculate these ratios

Accrual vs. Cash Method of Accounting

- Accrual method recognizes revenues and expenses in the accounting period in which they are earned or recognized as opposed to when they are received or paid
- Cash method recognizes revenue when it is actually received and expenses when they are actually incurred

Accrual Method

- Accrued revenue is income that has been earned but not yet received
  - Must be recognized in the accounting period in which it arises rather than in the subsequent period in which it will be received
- Accrued expense is an expense which has been incurred but not yet paid
  - Expenses must be recorded in the accounting period in which they are incurred, rather than in the subsequent period in which it will be paid

Accrual Method

- Incentive or management fees are examples of typical accrued revenue
  - Monthly management fee of $5,000 earned in June and received in July
  - Report as revenue for June
- Utilities or equipment fees are examples of typical accrued expenses
  - Monthly Internet charge of $7,000 for services used in June will be paid in July
  - Report as an expense for June

Adjusting from Cash Basis to Accrual Basis

Balance per Bank as of June 30th		$ 50,000
Accrued Receivables:		
June Management Fee	$ 5,000	
April-June Quarterly Incentive Fee	20,000	
Total Accrued Receivables		25,000
Total Adjusted Current Assets		**$ 75,000**
Accrued Liabilities:		
Unpaid Invoices	7,000	
Salaries earned but not yet paid	8,000	
Total Accrued Liabilities		**$ 15,000**
Current Assets/Current Liabilities		**5.00**

Revenue Received this quarter:		
April Management Fee	$ 5,000	
May Management Fee	5,000	
1st Quarter Incentive Fee	8,000	
Total Revenue -- Cash Basis		$ 18,000
Adjustments to Revenue:		
Reverse 1st Quarter Incentive Fee	$ (8,000)	
June Management Fee	5,000	
2nd Quarter Incentive Fee	20,000	
Accrued Revenue		$ 17,000
Total Adjusted Revenue		**$ 35,000**
Expenses Paid during the quarter - cash		$ 19,000
Accrued Expenses:		
Unpaid Invoices	$ 7,000	
Salaries earned but not yet paid	8,000	
Total Accrued Expenses		$ 15,000
Total Adjusted Expenses		**$ 34,000**
Total Revenue/Total Expense		**1.03**

Calculating Ratios and Financial Records

- When calculating the ratios, take the absolute value of the respective balance. Ratio should not be reported as negative number
- When calculating the ratios, if you have a "0" in the denominator, you should enter "0"
- Members must be able to demonstrate to NFA how they calculated the ratios reported on Form PQR or PR
- Members must maintain financial records supporting the calculation of these ratios in accordance with NFA Compliance Rule 2-10
- Each CPO and CTA Member will be required to make these financial records available to NFA during an examination or upon request

Key Takeaways

- There is no mandated minimum ratio that a CPO or CTA Member must meet
- The two ratios will be used as a tool to better understand your firm and its operations
- The ratios will be reviewed in conjunction with all other data collected relating to the firm and its operations
- NFA will review the ratio for trends over time and may call for clarification to better understand your firm's reported ratios

What to expect from NFA

- Effective with June 30, 2017 quarterly filings
- Updated schema published first week of June
  - For CPOs, the fields will be included in the XML schema
  - XML is not available for CTAs currently
- Filings available first week of July
- Firms registered as both a CPO and a CTA can report on either form

Resources

- NFA Compliance Rule 2-46
- Interpretive Notice: *NFA Compliance Rule 2-46: Reporting Financial Information on NFA Forms PQR and PR*
- Notice to Members I-16-31: Effective Date of Interpretive Notice to NFA Compliance Rule 2-46: Reporting Financial Information on NFA Forms PQR and PR

Contact Us

If you have questions or would like more information, please contact NFA.

Tracey Hunt
312-781-1284
thunt@nfa.futures.org

Mary McHenry
312-781-1420
mmchenry@nfa.futures.org