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SECURITIES INDUSTRY ASSOCIATION
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Audit Guideline

Commodities

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SECURITIES INDUSTRY ASSOCIATION
INTERNAL AUDITORS DIVISION
AUDIT GUIDELINES COMMITTEE

I. Background

Most security brokers and dealers who deal in commodities are engaged in one or a variety of commodity related activities. The company may act as a futures commission merchant, cash commission merchant or commodity merchandiser. Due to the highly specialized nature of the transactions, the commodity function usually operates as a separate independent unit with its own purchase and sales, accounting and margin departments. Because of the volatility involved, some broker-dealers have even created separate subsidiaries to conduct all of their commodities business. This has the effect of transferring the exposure inherent in the commodities business away from the broker-dealer.

Commodity transactions may involve any of the following types:

- "spot" trades which are sales of an actual commodity for current delivery, or
- "forward" transactions, whereby the seller agrees to deliver goods to a buyer at some future date at some fixed price, or
- option contracts which give the holder the right to buy (call) or sell (put) a futures contract at a specific price, within a specified period of time, or
- "futures" contracts which are contracts for delivery in a specified future month. The commodity is not necessarily in existence at the time of the trade.

Spot trades are made and settled directly between the traders and brokers in accordance with ordinary trading practices.

Trading of futures contracts is most often the type of commodity trade encountered in brokerage examinations.

Trades for futures contracts are generally cleared through a clearing house connected with a commodity exchange. Each transaction is treated as a separate purchase agreement and sale agreement with the clearing house, as though it were the other party to the transaction. Both buyer and seller are required to make a margin deposit with the clearing house and additionally they pay or receive amounts as a result of marking open contracts to current market prices.

Futures contracts require payment upon delivery of the commodity and not at the time the contract is entered into.

A "round-turn" in commodity transactions is a purchase or sale of a futures contract followed by an offsetting transaction, or by the actual delivery of the commodity upon maturity of the contract.

In the case of certain commodities regulated by the Commodities Exchange Act, customers' funds must be segregated. The amount to be segregated is the total of all customers' positive equities: that is, the total credit balances (including free credit balances) and related control differences on open contracts for all customers, eliminating the amounts for customers with negative (deficit) equities. The segregated funds must be used or invested only as deposits with the clearing house or other brokers, in permitted investments, or as deposits in a separate bank account.

This guide will overview some of the key areas which should be considered in developing an audit plan for the examination of a Commodity Department.

II. Audit Objectives

An audit of a Commodity Department should, at a minimum, determine that:

1. All customer accounts are opened and maintained in accordance with the rules and regulations of the Commodity Futures Trading Commission (CFTC), the various commodity exchanges, the New York Stock Exchange and the internal requirements of the firm, including the suitability of a commodity account for the customer and the monitoring of account activity.

2. Procedures and controls are adequate for the evaluation of potential and existing credit granted to commodities clients:
   - Adequate guidelines for trade levels, by commodity, are properly assigned and adhered to;
   - Customer trading limits are properly monitored, and
   - Review of customer financial status is performed and documented.

3. Transactions are promptly and accurately reflected on the books and records of the firm:
   - All daily settlements with the various exchanges are being made and recorded on a timely and accurate basis,
   - Open commodity positions and equity per the firm's internal records are reconciled to exchange clearing house reports on a daily basis, and

- Trade confirmations are accurate and prepared on a timely basis.

4. Margin rates on commodity trades are properly established:
   - Procedures are in effect over the maintenance of original and variation margins associated with the trading activities of firm and customer accounts,
   - Controls over the restriction or liquidation of under-margined accounts are adequate, propriety of transfers between a customer's regulated and non-regulated accounts is determined, and
   - Compliance with rules of regulatory authorities is achieved.

5. Adequate controls exist to ensure the accuracy and propriety of information contained in regulatory reports, such as the Commodity Futures Trading Commission Form 1-FR, and the FOCUS report.

III. Risks

- Accounts exceeding established trading levels place the firm in a position to incur potential losses due to over commitment on the part of the client.
- Failure to review the account status of a client on a timely basis may leave the firm in a potential loss position.
- Failure to make timely collection of margin calls.
- Failure to properly follow-up on unsecured debits.
- Untimely reconciliation of all trading activity.
- Inaccurate computation of margin calls.
- Inadequate controls over customer Treasury Bills in segregated accounts.
- Potential lawsuits if commodity trading is unsuitable for the customer or excessive trading is permitted, particularly where discretionary accounts are concerned.

IV. Control Points

1. With reference to the granting of customer credit lines a thorough analysis of the customer's overall financial position is performed prior to trading authorization.

2. The daily Point Balance reconciliation provides the primary measure of control over open positions, accounts payable or receivable and margin with the clearing organizations.
3. Confirmations of each transaction are sent to customers indicating the quantity, delivery month, and contract price to ensure the integrity of transactions.
4. Original margin deposits in cash or acceptable securities to guarantee performance of contracts are determined in accordance with the rules of the firm, exchange and clearing house.
5. The normal control over the failure to effect a timely collection of margin calls is a policy and procedure for liquidating the customer's account to the extent necessary to meet the margin calls and eliminate the exposure.
6. Most margining is done by data processing and manually reviewed. Since the source of prices and margin deposits is input for margin purposes from other independent areas the exposure as a result of inaccurate computation is minimized.
7. The propriety of opening commodity accounts for given customers, and monitoring of daily trading activity is usually achieved by a comprehensive new account approval system and Compliance Department reviews.

V. Audit Procedures

The rules and regulations of the CFTC should be read and comprehended prior to developing a detailed audit program for a commodity department.

New Accounts

- Review for completeness all documentation received relating to new customer accounts. Determine that all documents are in a form acceptable to the regulatory environment, and that the question of suitability is resolved prior to granting trading authorizations.
- Verify as to the type of document follow-up and additional imposition of account restriction where such requested follow-ups remain unanswered.

Credit Department

- Review the firm's credit policies and procedures (more details may be obtained from the "Credit Department Audit Guidelines," dated October, 2001).
- Review firm trading and position limits.
- Examine new account documentation for adequacy and proper authorization on a timely basis.

Trade Processing

- Verify that transactions are properly recorded.
- Verify that confirmations properly reflect executed transactions, comply with regulatory standards and are prepared on a timely basis.
- Verify that firm and exchange guidelines requiring the prompt resolution of differences and the retention of all reconciling documentation are being adhered to.
- Examine the timeliness and accuracy of Point Balance reconciliations and review timely resolution of reconciling items.
- Verify the accuracy of gains/losses and commission charged to respective customers.
- Analyze internal controls over the maintenance of warehouse receipts. Count warehouse receipts and compare to firm records.

Commodity Margin

- Verify details of Daily Equity Runs and examine margin calculations.
- Ascertain that margin calls are issued on a timely basis.
- Ascertain compliance with margin trading limits assigned by the Credit Department.
- Ascertain that the accounts are liquidated on a timely basis if margin calls are not met within the required time period.

Regulatory Reporting

- Review supporting documentation on unsecured or partly secured debit balances to assure proper FOCUS and Form 1-FR classification.
- Examine under-margined accounts and accounts liquidating to a deficit for purposes of 15c3-1 inclusion.
- Examine call lists and aging schedules to determine propriety of above for inclusion in capital computation.
- Determine the regulatory status of physical inventory, fixed price commitments and forward contracts for purposes of assigning "hair-cut" percentages in accordance with Rule 15c3-1, Appendix A (i .e., as to covered, uncovered, or registered as deliverable).
- Review classification of general ledger accounts for regulatory financial statement purposes.
- Review compliance with reporting requirements for customer accounts.
- Verify all other components of capital computation and charges thereto, such as "spot penalties" and haircuts on securities positions.
- Review Schedule of Segregation Requirements and Funds in Segregation.

Other

- Review adequacy of customer collateral put up as margin deposits.
- Review propriety of authorizations for transfers between regulated and unregulated accounts.
- Examine the daily review, subsequent follow-up, and collection procedures for unsecured debits.
- Examine procedures to record customers' purchases and sales of precious metals.
- Examine procedures for shipment of precious metals to customers.
- Ascertain the adequacy of the firm's surveillance system for monitoring trading activity.

Reference Material

1. Brokers and Dealers in Securities – AICPA Audit and Accounting Guide

2. Processing Securities Transactions - H. V. Petrillo, C. L. Bullock - The Ronald Press Co.

3. Commodity Exchange Act – U. S. Code, Title 7 (www.access.gpo.gov/uscode/title7)

4. Commodities Futures Modernization Act of 2000 – H.R. 5660 (www.cftc.gov/files/ogc/ogchr5660)