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

CFTC letter No. 05-09
May 20, 2005
No-Action
Division of Clearing and Intermediary Oversight

Re: "No-Action" Position for Alternative Capital Deductions Approved by Securities and Exchange Commission Order dated "Y"

Dear :

This is in response to your letter dated May 10, 2005, to the Division of Clearing and Intermediary Oversight ("the Division") of the Commodity Futures Trading Commission ("the Commission"). By your letter, you have advised that by written order dated "Y", the U.S. Securities and Exchange Commission ("SEC") has approved an application that was submitted by "X" or "the Firm") in accordance with Appendix E of SEC Rule 15c3-1(§240.15c3-1e).[1] The terms of the SEC order authorize the Firm to calculate its net capital "using the market risk standards of Appendix E to compute a deduction for market risk on some or all of its positions, instead of the provisions of paragraphs (c)(2)(vi) and (c)(2)(vii) of Rule 15c3-1, and using the credit risk standards of Appendix E to compute a deduction for credit risk on certain credit exposures arising from transactions in derivatives instruments, instead of the provision of paragraph (c)(2)(iv) of Rule 15c3-1."[2] The order was issued pursuant to §240.15c3-1(a)(7), by which the SEC may authorize brokers or dealers who meet specified requirements to compute alternative capital deductions that incorporate measurements from value-at-risk ("VaR") and other mathematical models that are used internally by the broker or dealer.[3]

"X" is also a registered futures commission merchant ("FCM"). On behalf of the Firm, you have requested confirmation that if "X" uses its SEC-approved alternative market risk and credit risk capital deductions for purposes of determining the Firm's adjusted net capital under Commission Rule 1.17, including when preparing and filing with the

[1] The SEC regulations referenced herein may be found at Title 17 C.F.R. Ch. II (2004).

[2] A copy of the "Y" order is available for public viewing on the SEC's website, at "Z".

[3] The deduction for market risk under §240.15c3-1e is an amount equal to the sum of several components, including specified multiples of the VaR of those positions for which VaR models have been approved by the SEC. The required computations for the deductions for market risk and credit risk under Appendix E are specified in full at §240.15c3-1e(b) and (c).

Commission its required capital computations under Commission Rule 1.10, the Division will not recommend that the Commission commence an enforcement action against "X" for failure to comply with applicable Commission regulations.[4]

A. Applicable regulations

Commission Rule 1.17(a) requires each FCM to maintain a minimum amount of adjusted net capital, which is defined as the FCM's net capital less deductions (or "haircuts") specified in Rule 1.17(c)(5) and (8). For purposes of these deductions, the Commission has incorporated by reference specific percentage haircuts that are set forth in SEC regulations §§240.15c3-1(c)(2)(vi) and (vii).[5] Also, Commission Rule 1.17(c)(2)(ii), which is similar to §240.15c3-1(c)(2)(iv), requires unsecured receivables arising from an FCM's transactions in OTC derivatives to be excluded from assets for purposes of determining the firm's regulatory capital. Neither of these Commission rules references the alternative capital deductions in §240.15c3-1e, which the SEC added through rule amendments that were adopted last year.[6]

Pursuant to Commission Rule 1.10, each FCM must file with the Commission monthly financial statements on Form 1-FR-FCM, which includes a computation of the FCM's adjusted net capital as determined in accordance with Rule 1.17(c). Those FCMs that are also registered with the SEC as securities brokers or dealers are permitted by Commission Rule 1.10(h) to file their Financial and Operational Combined Uniform Single Report ("FOCUS Report") in lieu of the Form 1-FR-FCM, provided that the FOCUS report includes all information which is required to be furnished on and submitted with a Form 1–FR-FCM.

B. Request for relief

A broker or dealer receiving approval under §240.15c3-1(a)(7) to compute the alternative market risk and derivatives-related credit risk capital deductions must satisfy certain conditions specified in the SEC's regulations, including enhanced reporting, notification, and minimum capital requirements. In this regard, §240.15c3-1(a)(7) requires the broker or dealer to: (1) maintain tentative net capital of no less than $1 billion;[7] (2) provide same day notice to the SEC if its tentative net capital is less than $5 billion; and (3) maintain net capital of no less than $500 million. Also, the broker or dealer's VaR models must meet the qualitative and quantitative requirements specified in §240.15c3-1e, and the

[4] The Commission regulations referenced herein may be found at Title 17 C.F.R. Ch. 1 (2004).

[5] Commission Rule 1.17(c)(5)(v) provides that the haircuts for an FCM's proprietary securities are "the percentages specified in Rule 240.15c3–1(c)(2)(vi) of the Securities and Exchange Commission (17 CFR 240.15c3–1(c)(2)(vi)) ("securities haircuts") and 100 percent of the value of "nonmarketable securities" as specified in Rule 240.15c3–1(c)(2)(vii) of the Securities and Exchange Commission (17 CFR 240.15c3–1(c)(2)(vii))."

[6] The SEC adopted rule amendments implementing the alternative market risk and credit risk capital deductions in June of 2004, with an effective date of August 20, 2004. See 69 FR 34428 (June 21, 2004).

[7] The term tentative net capital is defined at §240.15c3-1(c)(15).

broker or dealer also must maintain an internal risk management control system that satisfies the requirements set forth in §240.15c3-4. In addition, the broker-dealer's ultimate holding company must, as a necessary prerequisite for SEC approval of the firm's alternative capital deductions, provide a written undertaking to the SEC to comply with reporting, notice and other requirements set forth in SEC rules.[8] The ultimate holding company and its affiliate group will therefore be deemed a consolidated supervised entity ("CSE") under the SEC rules.

Staff from the Division and from the Office of the Chief Economist visited "X" to review portions of the application information that the Firm filed with the SEC as required under §240.15c3-1e. In support of its request for no-action relief, the Firm has represented the following in its letter to the Division:

1. The Firm will provide immediate written notice, addressed by fax to the Division Director, upon the occurrence of any of the following in respect of the Firm:

(a) the SEC notifies the Firm that the SEC has approved the Firm's request, if any, to amend its application to compute capital deductions under §240.15c3-1e;

(b) the SEC notifies the Firm that it is revoking, in whole or in part, its approval of the Firm's capital deductions under §240.15c3-1e;

(c) the Firm notifies the SEC that it intends to cease, after 45 days from such notice, to compute deductions for market risk and credit risk under §240.15c3-1e;

(d) the Firm is notified by the SEC that it has changed the effective date of the above described notice, so that the 45 day period is made either shorter or longer; or

(e) the Firm notifies the SEC that its tentative net capital falls below $5 billion.

2. At the same time that they are filed with the SEC, the Firm will provide copies to the Division Director of its monthly, quarterly, and annual filings with the SEC under §240.17a-5(a)(5) and (k).

3. At the time the Firm provides to the SEC any formal notification concerning planned withdrawals of excess net capital from the Firm, copies of such documents will also be provided to the Division.

Based upon these representations, the Division has determined that granting the requested relief would not be contrary to the public interest. If the Firm files financial reports that include computations of adjusted net capital using the market risk and credit risk capital deductions approved under the SEC's order to the Firm dated "Y", the Division will not

[8] SEC regulation §240.15c3-1e incorporates by reference another rule, §240.15c3-1g, that the SEC adopted at the same time. The purpose of §240.15c3-1g is to set forth the requirements applicable to the ultimate holding company for a broker or dealer that calculates its haircuts in accordance with §240.15c3-1e.

recommend that the Commission commence an enforcement action against "X" for failure to comply with applicable provisions, as outlined above, of Rules 1.10 and 1.17.

The "no-action" position taken herein is based upon the representations that have been made to the Division. Any different, changed, or omitted facts or conditions might require the Division to reach a different conclusion. You must notify the Division immediately in the event that there is any change from the facts as presented to us. To the extent that any subsequent amendments to Rule 1.17 authorize FCMs to use mathematical models to compute market risk and credit risk capital charges in lieu of the standard charges set forth in Rules 1.17(c), this letter will be deemed withdrawn on the effective date of such amendments, and "X" will be required to comply with the provisions of the amended Commission rules.

This letter represents the position of the Division only and does not necessarily represent the views of the Commission or any other division or office of the Commission. If you have any questions concerning this correspondence, please contact Thomas Smith, Chief Accountant, or Thelma Diaz or Jennifer C.P. Bauer, attorneys on my staff, at (202) 418-5430.

Very truly yours,

James L. Carley
Director

cc: [redacted]