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

CFTC letter No. 05-10
February 23, 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 February 11, 2005, to the Division of Clearing and Intermediary Oversight ("the Division" or "DCIO") of the Commodity Futures Trading Commission ("the Commission"). By your letter, you have advised, on behalf of ("X" or "the Firm"), a registered futures commission merchant ("FCM"), that the U.S. Securities and Exchange Commission ("SEC") has issued a written order dated "Y", permitting the Firm, in computing its minimum capital requirement under SEC Rule 15c3-1, to compute certain capital charges on proprietary positions in securities and over the counter ("OTC") transactions in derivatives in accordance with Appendix E of SEC Rule 15c3-1 (§240.15c3-1e).[1] On behalf of "X", you have requested confirmation that if the Firm uses the SEC-approved "market risk" alternative capital charges for purposes of determining the Firm's adjusted net capital under Commission Rule 1.17, including when preparing and filing with the Commission its required capital computations under Commission Rule 1.10, DCIO will not recommend that the Commission commence an enforcement action against "X" for failure to comply with applicable Commission regulations.[2]

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). Among the required deductions are haircuts on the value of the FCM's positions in securities, and, for purposes of these deductions, the Commission has incorporated by reference specific percentage haircuts set forth in SEC

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

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

regulations §§240.15c3-1(c)(2)(vi) and (vii).[3] These SEC rules apply stated percentage deductions that differ by the classes of securities identified in the rule. Also, Commission Rule 1.17(c)(2)(ii) generally requires unsecured receivables to be excluded from current assets for purposes of an FCM's capital computation. 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.

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). An FCM also registered with the SEC as a securities broker or dealer is permitted by Commission Rule 1.10(h) to file the SEC's 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

"X"s request for relief is prompted by the SEC's recent adoption of §240.15c3-1(a)(7), which provides that the SEC "may approve, in whole or in part," an application from a qualifying broker or dealer to compute, in accordance with the requirements of §240.15c3-1e, "market risk" deductions on its proprietary positions in securities. When calculating its net capital, the broker or dealer would use the market risk deductions computed under §240.15c3-1e in lieu of the deductions required by §§240.15c3–1(c)(2)(vi) and (c)(2)(vii). Such market risk capital deductions will incorporate measurements from value-at-risk ("VaR") models used internally by the Firm and approved by SEC order.[4] Additionally, the amended rule establishes requirements for permitting qualifying broker-dealers to compute "credit risk" deductions for the credit exposures arising from transactions in derivatives instruments, but only if the broker-dealer has first computed market risk deductions on these instruments that comply with the amended §240.15c3-1e. These credit risk deduction computations would be in lieu of the computations for deductions required by §240.15c3–1(c)(2)(iv).

A broker or dealer receiving approval to compute the alternative market risk and derivatives-related credit risk capital deductions must satisfy certain conditions specified in the SEC's amended regulations, including enhanced reporting, notification and minimum capital requirements. In this regard, §240.15c3-1(a)(7) requires such broker or dealer to: (1)

[3] 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))."

[4] The approved 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 approved deduction for market risk calculation is specified in full at §240.15c3-1e(b).

maintain tentative net capital of no less than $1 billion;[5] (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 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.[6] The ultimate holding company and its affiliate group will therefore be deemed a "consolidated supervised entity", or "CSE", under the SEC rules.

By order dated "Y", the SEC has approved an application filed by "X" to compute alternative market risk and credit risk capital deductions in accordance with §240.15c3-1e.[7] For purposes of calculating its capital in accordance with Rule 1.17, the Firm requests no-action relief that would be applicable only to the alternative market risk deductions approved under the SEC's order. The requested relief is limited to its approved market risk deductions as "X" has advised in writing that its capital calculations with regard to its OTC derivative exposures will not be made in accordance with the alternative credit risk deductions set forth in §240.15c3-1e.

Staff from the Division and from the Office of the Chief Economist of the Commission, accompanied by staff of the SEC and the New York Stock Exchange, visited "X" to review portions of the application information that the Firm filed with the SEC as required under §240.15c3-1e. Division staff expects to continue coordinating its efforts with those of the SEC in reviewing appropriate information, such as that filed with the SEC in accordance with §240.15c3-1e, so as to avoid unnecessary or duplicative burdens on the Firm.

In support of its request, the Firm has represented as follows:

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 Firm requests from the SEC the approval of an amendment to its application to compute capital deductions under §240.15c3-1e;

(b) the Firm obtains from the SEC the approval of an amendment to its application to compute capital deductions under §240.15c3-1e;

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

[6] 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.

[7] The "Y" order has been published [at "Z"].

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

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

(e) 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; and

(f) the Firm notifies the SEC that its tentative net capital falls below $5 billion.[8]

2. The Firm will provide, upon the Division's request, copies of its monthly and quarterly filings with the SEC under §240.17a-5(a)(5).

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" capital deductions approved under the SEC's order to the Firm dated "Y", the Division will not 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 DCIO 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,

[8] The Firm will also provide copies of any of the written requests and notices that the Firm has filed with the SEC, or those that the Firm has received from the SEC, as described in 1(a) through (f) above.

or Thelma Diaz or Jennifer C.P. Bauer, attorneys on my staff, at (202) 418-5430.

Very truly yours,

James L. Carley
Director