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Division of Clearing and
Intermediary Oversight

CFTC letter No. 06-05
January 18, 2006
Interpretation
Division of Clearing and Intermediary Oversight

Subject: Satisfactory subordination agreement as equity capital under Rule 1.17(d)

Dear :

This letter responds to your recent inquiry to staff of the Division of Clearing and Intermediary Oversight ("Division") of the Commodity Futures Trading Commission ("Commission"). You have contacted the Division to obtain guidance concerning Commission Rule 1.17(d), by which the funds advanced under certain satisfactory subordination agreements of futures commission merchants ("FCMs") may be included in their equity capital.[1] Your inquiry is made on behalf of "A", which is the designated self-regulatory organization ("DSRO") for "Z", a registered FCM.

"Z" has recently contacted "A" to obtain approval of the terms of a proposed subordination agreement with "W".[2] "W" owns 100 percent of the shares of "X", which owns 100 percent of the shares of "Y", which owns 100 percent of the shares of "Z".[3] "A" has asked for guidance on whether the term "stockholder" in Rule 1.17(d)(1) may be construed to include certain indirect stockholders, as "A" is satisfied that the proposed subordination agreement complies in all other respects with the Commission's requirements for equity capital, as summarized below.

For each FCM and IB, Commission Rule 1.17(d) requires that the firm's "debt-equity total", which is the FCM's or IB's satisfactory subordination agreements added to its equity

[1] Commission rules referred to herein may be found at 17 C.F.R. Ch. 1 (2005).

[2] Ordinarily, loans to FCMs and introducing brokers ("IBs") are treated as liabilities, and will therefore decrease the capital of an FCM or IB under Commission Rule 1.17(c). However, Commission Rule 1.17(c)(4)(i) allows FCMs and IBs, in computing their regulatory capital, to exclude as liabilities any funds borrowed under subordination agreements that are "satisfactory" under Rule 1.17(h). Prior approval of the terms of the agreement by the firm's DSRO is one of the requirements in Rule 1.17(h).

[3] "W" and its wholly owned subsidiary are operating companies. As part of pending reorganization plans, "Z" would be owned by a new entity, "Y".

capital, consist of no less than a minimum percentage (30 percent) of equity capital. The definition of equity capital within Rule 1.17(d)(1) also includes satisfactory subordination agreements that meet certain additional requirements. Specifically, these satisfactory subordination agreements must:

- have been entered into with a lender that is a partner or stockholder of the FCM or IB;
- have an initial term of 3 years, and a remaining term of not less than 12 months;
- generally preclude accelerated maturity of the debt;
- contain no "special prepayment" [4] provisions; and
- be subject to the capital withdrawal restrictions in Rule 1.17(e).

When proposing the requirements set forth in Rules 1.17(d) and (h), the Commission explained that it was concerned that prior Commission regulations allowed FCMs and IBs to finance their businesses solely through the use of subordinated debt.[5] The additional requirements for satisfactory subordination agreements to be included as equity are consistent with the Commission's objective of helping to enhance the stability and relative permanence of any subordinated debt that serves as capital.[6] These same requirements were also adopted by the Securities and Exchange Commission ("SEC"), prior to the Commission's adoption of Rule 1.17(d), in order to permit certain subordination agreements of broker-dealers to serve as equity capital.[7] For purposes of compliance with the SEC's equity capital requirements, the National Association of Securities Dealers ("NASD") has provided written guidance concerning the interpretation of the term stockholder as used in the SEC's equivalent regulation. Among other things, the NASD has advised its broker-dealer members that equity capital includes agreements where the lender owns all of the stock of a company that owns 100 percent of the broker-dealer.[8]

Rather than making arrangements for funds to be advanced to "Z" through intervening subsidiaries, "W" would prefer to provide equity capital to the FCM directly, by entering into a qualifying subordination agreement in which "W" is the lender. Division staff believes that it would be appropriate in this instance to harmonize the interpretation of Rule 1.17(d)(1) with the NASD guidance. "W" has an indirect ownership interest in 100 percent of the shares of the FCM, because the sole stockholder of "Z" is wholly owned by an entity that is wholly owned by "W". In light of this ownership interest, treating the funds advanced under the proposed agreement as equity capital would be consistent with the regulatory objective of

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[4] Satisfactory subordination agreements that are not treated as equity may include "special prepayment" provisions that allow prepayments within less than one year. *See* Rule 1.17(h)(2)(vii)(B).

[5] 42 F.R. 27166 (May 26, 1977).

[6] 47 FR 12353, 12355 (March 23, 1982).

[7] *See* SEC Release 10525, 1973 SEC LEXIS 2309 (November 29, 1973).

[8] The NASD advisory may be accessed electronically on its website at: http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_012551

requiring investment by lenders whose interests in the FCM are not limited to their subordination agreements, but who instead also have ownership interests in the FCM.

The position taken in this letter is based upon the representations made to the Division, and any different, changed, or omitted facts or conditions might render this position void. Moreover, this letter represents the position of the Division only, and does not necessarily reflect the views of the Commission or any other office or division of the Commission. If you have any questions concerning this correspondence, please feel free to contact me or Thelma Diaz, Special Counsel, at (202) 418-5137.

Very truly yours,

Thomas Smith,
Deputy Director and Chief Accountant