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96-34

DIVISION OF
TRADING & MARKETS

April 11, 1996

Re: Treatment of Deposits in Taiwanese Banks

Dear :

Former Commissioner Bair referred to this office a copy of your letter dated April 5, 1994 to Michael A. Macchiaroli, Esq., Assistant Director, Division of Market Regulation (DMR) of the U.S. Securities and Exchange Commission (SEC). In that letter, you requested advice concerning the treatment under the SEC's net capital rule[1/] of deposits in branches or subsidiary banks located in Taiwan of international banking institutions made by contract market clearing member firms registered as futures commission merchants (FCMs) in Taiwan. This advice was requested on behalf of your client, "V", with the trade name "W",[2/] a firm that is registered under the Commodity Exchange Act (Act) as an FCM and is a clearing member of all principal futures exchanges as well as one of the few U.S.-based firms granted a license to operate in Taiwan under its Foreign Futures Trading Law (FFTL).[3/] You have supplemented your April 5 letter with a letter dated October 18, 1994 to the Division of Trading and

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1/ 17 C.F.R. § 240.15c3-1 (1995).

2/ When you submitted your letter, "W" was known as "Z". The name change became effective December 1, 1994.

3/ Your April 5, 1994 letter stated that five or six U.S.-based firms registered as FCMs under the Act have been granted licenses to operate in Taiwan under the FFTL. It is our understanding that Taiwan has taken this action as part of an effort to eradicate local boiler room operations. We further understand that U.S.-based securities broker-dealers have not been accorded similar access to operate in Taiwan.

Markets (Division) as well as telephone conversations with Division staff and other correspondence.[4/]

You have made the following representations. A non-Taiwanese FCM registered under the FFTL that is operating a retail business must, among other things, specifically allocate NT $200 million as operational capital in Taiwan (equivalent to approximately U.S. $8 million).[5/] Taiwanese law also provides that a foreign futures brokerage firm engaged in retail business must place a business guaranty bond (in the form of cash, government bonds or financial bonds) with a bank designated by TSEC in the amount NT $50 million (equivalent to approximately U.S. $2 million).[6/] You stated in your October 18, 1994 letter that "W's" business guaranty bond currently consists of an NT $50 million certificate of deposit at the Taiwan branch of "Y". You further represented in a telephone conversation with a Division of Trading and Markets staff member that the certificate of deposit functions in a manner similar to a demand deposit in the U.S. in that it can be drawn upon at any time without penalty and interest is earned until the time of withdrawal.

The FFTL defines a business guaranty bond, in Article 4, paragraph (8) thereof, as a guaranty bond deposited at a fixed percentage by a futures brokerage firm, as prescribed by TSEC, to cover future liability for damages.[7/] Such a bond could therefore be viewed as somewhat analogous to a clearing organization guarantee deposit that could be drawn upon in the event of a

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4/ As you know, we provided a draft of this response to the Taiwan Securities and Exchange Commission (TSEC). Under cover of a letter dated January 10, 1995, we provided you with a copy of TSEC's response dated January 5, 1995 to the draft, another copy of which is enclosed. You responded to TSEC's letter by letter dated January 18, 1995. You have also sent letters to the CFTC on this matter dated May 9 and November 8, 1995, and January 8, 1996.

5/ Article 19 of the Rules Governing the Establishment Criteria of Futures Brokerage Firms. All references herein to Taiwanese law are taken from the unofficial translations of the FFTL and rules thereunder which you enclosed with your April 5, 1994 letter.

6/ Article 13 of the Rules for Administration of Futures Brokerage Firms.

7/ Article 17 of FFTL provides in pertinent part that a "futures customer shall have the right of priority to receive damages from the business guaranty bond for all the rights arising from the futures trading consigned by the futures customer to the futures brokerage firm."

clearing member's default and which is treated as a current asset under the CFTC's adjusted net capital rule, Commission Rule 1.17.[8/]

You have represented that the effect of Article 19 of the Establishment Criteria rules and Article 13 of the Administration rules is that initially a foreign futures firm such as "W" must demonstrate to the Taiwanese authorities that NT $200 million is available for use by the Taiwanese branch, but that only the NT $50 million business guaranty bond is required to be placed with a bank designated by the TSEC. Therefore, the remainder of the NT $200 million amount, i.e., NT $150 million, may be spent on the business in Taiwan. You have further represented that in the event of the insolvency of "W", all of the NT $200 million specially allocated as operational capital pursuant to Article 19 cited above may be taken for all customers of "W", regardless of whether such customers are located in Taiwan. You also represent that there are no Taiwanese laws or regulations which might inhibit an insolvent U.S. FCM from transferring its funds out of its own accounts in Taiwan, although you noted that this would not apply to funds belonging to Taiwanese customers.[9/]

You noted in your April 5, 1994 letter that in your discussions with the DMR, concern was expressed "with respect to the . . . regulation of the commercial banking industry in [Taiwan]." You expressed your view that Taiwan appears to have a viable governmental supervising authority for the commercial banking system within its borders and in particular covering international commercial banks maintaining a branch or an affiliate there.

As noted above, the letter to which we are responding was addressed to Mr. Macchiaroli at the SEC. As a result, we have

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8/ See 17 C.F.R. § 1.17(c)(2)(viii) (1995). Although for several years the Chicago Board of Trade (CBT), the designated self-regulatory organization for "W", required its member FCMs to increase their minimum adjusted net capital by an amount equal to guarantee deposits with clearing organizations of other contract markets to the extent such deposits could not be used for margin purposes, CBT no longer has such a requirement.

9/ As you know, TSEC's January 5, 1995 letter appears to express some skepticism with respect to the representations referred to in this paragraph. The extent, if any, of the restrictions upon funds required to be maintained in Taiwan by foreign futures firms bears directly upon the conditions to the relief discussed herein and thus appropriate measures should be taken to resolve the issues raised on this subject.

consulted extensively with him and his staff concerning this issue.[10] In August 1992, the DMR staff set forth interpretive guidance regarding when certain money market instruments may be treated as allowable assets for the purposes of the SEC's net capital rule.[11] As indicated in that letter, the SEC's net capital rule has been interpreted to permit securities broker-dealers to include as liquid assets only those certificates of deposit, bank deposit notes, bankers acceptances, and bills of exchange that are negotiable, meet certain other criteria, and are deposited and payable in a major money market. The August 1992 letter specified twenty-three foreign countries plus the United States as major money markets and Taiwan was not included in that group. However, pursuant to a request by Taiwan's Ministry of Finance that Taiwan be recognized by the SEC as a major money market, DMR has reconsidered its position and has now indicated that Taiwan should be considered as a major money market.[12]

In these circumstances, subject to the requirements of Commission Rule 1.17 that do not permit assets subject to restriction to be counted as current assets, we do not believe that all deposits in branches or subsidiary banks of international banking institutions in Taiwan made by an FCM firm need be subject to a 100 percent haircut and thus effectively given no value under the CFTC's adjusted net capital rule, particularly where such deposits would constitute excess adjusted net capital above an FCM's minimum requirement.

However, such deposits would be otherwise subject to the capital rule. For example, the permissible forms of business guaranty bond in Taiwan include cash, government bonds or financial bonds. If a non-U.S. currency is used, appropriate haircuts

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10/ You noted in your April 5, 1994 letter that the CFTC will generally consult the SEC and DMR for guidance in a number of financial areas, in part because many firms are dually registered as securities broker-dealers with the SEC and as FCMs with the CFTC.

11/ Letter from Michael A. Macchiaroli, DMR, to Douglas Preston, Securities Industry Association, Inc., August 21, 1992, reprinted at 1992 SEC No-Act. LEXIS 899.

12/ Letter from Michael A. Macchiaroli, DMR, to Division Director Andrea M. Corcoran, March 6, 1996. This letter stated, among other things, that the nationally recognized statistical rating organizations have given generally high ratings to Taiwan's debt securities as well as to money market instruments backed by Taiwan banks.

would apply, such as twenty percent for an uncovered balance in Taiwanese currency.[13] As to government bonds, the CFTC's adjusted net capital rule cross-references the SEC's rules on securities haircuts and nonmarketable securities.[14] U.S. and Canadian government debt obligations are subject to haircuts of up to six percent based upon the time to maturity.[15] In the case of government bonds of other countries, if such bonds are marketable, the haircuts range from fifteen to forty percent.[16] Other financial bonds would also be subject to appropriate CFTC and SEC haircuts. Further, CFTC Rule 1.17 does not permit restricted assets to be considered current (see CFTC Rule 1.17(c)(2)(vi)). Therefore, it is of concern to us that the TSEC appears to interpret its requirements (see enclosed letter) to render capital located in Taiwan as restricted for business other than securing Taiwanese customer claims.

Based on the foregoing, the Division of Trading and Markets will not recommend that the CFTC take any enforcement action against "W" under CFTC Rule 1.17 based upon "W's" failure to take a 100 percent charge against its net capital with respect to deposits made for purposes of compliance with the requirements of the FFTL and rules promulgated thereunder in branches or subsidiary banks located in Taiwan provided that: (1) the subsidiaries or branches in Taiwan are part of an international banking institution which is organized under the law, and whose headquarters is located in and subject to the regulatory authority, of a sovereign national government where a major money market as defined by the SEC is located;[17] (2) the commercial paper or long term debt of the international banking organization referred to above is rated in one of the two highest rating categories by Standard and Poor's Corporation or Moody's Investors Services, Inc.; (3) "W" takes a 100 percent charge against any deposit in Taiwan to the extent of NT $50 million or such deposit is segregated or otherwise restricted for the benefit of Taiwanese customers or otherwise, whichever amount is greater; (4) "W" takes appropriate haircuts under CFTC Rule 1.17 with respect to

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13/ See 17 C.F.R. § 1.17(c)(5)(ii) (1995); CFTC Interpretative Letter 93-95, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,861 (Aug. 31, 1993).

14/ See 17 C.F.R. § 1.17(c)(5)(v) (1995); 17 C.F.R. § 240.15c3-1(c)(2)(vi) and (vii) (1995).

15/ 17 C.F.R. § 240.15c3-1(c)(2)(vi)(A) and (C) (1995).

16/ 17 C.F.R. § 240.15c3-1(c)(2)(vi)(J), (K) and (L) (1995).

17/ See nn. 11-12, supra.

non-U.S. currency, government bonds or other financial instruments deposited in Taiwan; and (5) "W's" adjusted net capital would exceed the minimum required under Commission Rule 1.17 even if the deposits in Taiwan were subject to a 100 percent haircut, i.e., such deposits constitute excess adjusted net capital.[18] Per the request set forth in your January 8, 1996 letter, "W" can make its adjusted net capital computation in accordance with the relief provided herein beginning as of December 31, 1995.

We note that this letter relates solely to compliance with CFTC Rule 1.17 with respect to "W" deposits in Taiwan and other "W" funds related to its business in Taiwan as limited in the preceding paragraph, and does not excuse "W" from compliance with any other applicable requirements contained in the Act or rules promulgated thereunder. The treatment of any customer funds related to trading on or subject to the rules of U.S. contract markets will be governed by Section 4d(2) of the Commodity Exchange Act,[19] Rules 1.20-1.30, 1.32 and 1.36 promulgated thereunder[20] and Division Financial and Segregation Inter-

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18/ These conditions are particularly relevant in light of the views expressed in TSEC's January 5, 1995 letter referred to in footnote 9, supra. The portion of the NT $200 million in excess of the NT $50 million required to be deposited in Taiwan may be considered as excess adjusted net capital under CFTC Rule 1.17 by "W", subject to the other conditions set forth herein, only to the extent that such funds are not so segregated or restricted.

Therefore, if "W" has a minimum adjusted net capital requirement of U.S. $15 million and it maintains U.S. $15 million in adjusted net capital and has deposits in Taiwan of Taiwanese currency in the amount of NT $200 million, of which NT $75 million is segregated or restricted for Taiwanese customers, "W's" total adjusted net capital would be approximately U.S. $19 million based on the 100 percent haircut applied to the NT $75 million segregated or restricted for Taiwanese customers and the 20 percent haircut applied to the remaining uncovered balance in Taiwanese currency (NT $125 million x 80% = NT $100 million) and the conversion of NT $100 million to U.S. currency, which would be approximately equivalent to U.S. $4 million. Under such a scenario, "W's" adjusted net capital would fall below the "early warning level" set forth in 17 C.F.R. § 1.12(b) (1995).

19/ 7 U.S.C. §6d(2) (1994).

20/ 17 C.F.R. §§1.20-1.30, 1.32 and 1.36 (1995).

pretation No. 12.[21/] The treatment of U.S. customer funds related to trading in foreign futures and option transactions will be governed by Commission Rule 30.7.[22/]

The position taken herein is based upon the representations set forth in your April 5, 1994 letter to Mr. Macchiaroli and the documents enclosed with that letter, as well as representations in your October 18, 1994, January 18, 1995, May 9, 1995 and January 8, 1996 letters and telephone conversations with Division staff, and is subject to the conditions set forth above. Any different, change or omitted facts or circumstances might require us to reach a different conclusion. Therefore, we request that you notify us immediately in the event that the operations or activities of "W" change in any way from those represented in your letters and conversations or if the relevant provisions of Taiwanese law change in any way from those set forth in the documents accompanying the April 5, 1994 letter.

This letter represents the position of the Division of Trading and Markets only and does not necessarily reflect the position of the Commission or any other office or division of the Commission. If you have any questions concerning this correspondence, please contact me or Associate Chief Counsel Lawrence B. Patent at (202) 418-5450.

Very truly yours,

Susan C. Ervin
Chief Counsel

21/ 53 Fed. Reg. 46911 (Nov. 21, 1988), reprinted in 1 Comm. Fut. L. Rep. (CCH) ¶7122.

22/ 17 C.F.R. §30.7 (1995).