

CFTC letter No. 03-37

October 20, 2003

No-Action

Division of Clearing and Intermediary Oversight

Mr. Dennis A. Dutterer
President and Chief Executive Officer
Board of Trade Clearing Corporation
141 West Jackson Blvd.
Suite 1460
Chicago, Illinois 60604

Re: No-action position concerning the treatment of Clearing Corporation stock for purposes of computing adjusted net capital under Rule 1.17.

Dear Mr. Dutterer:

This is in response to your letter dated October 14, 2003, submitted on behalf of the Board of Trade Clearing Corporation (the “Clearing Corporation”), in which you request that the Division of Clearing and Intermediary Oversight (“DCIO”), of the Commodity Futures Trading Commission (“Commission”), not recommend that the Commission commence an enforcement action with respect to a futures commission merchant (“FCM”) that includes as a current asset in computing its adjusted net capital under Commission Rule 1.17^[1] the book value, less an applicable haircut, of Clearing Corporation stock that has been pledged to and accepted by the Clearing Corporation’s guaranty fund. Your letter also requests that DCIO not recommend enforcement action, pursuant to Section 4f(b) of the Commodity Exchange Act (“Act”) ^[2] and Commission Rule 1.52, against self-regulatory organizations (“SROs”) that adopt the same interpretation for net capital purposes or in the conduct of their field audit programs.

Commission Rule 1.17(c)(2)(viii) permits an FCM to include the stock of a clearing corporation as a current asset in computing its adjusted net capital, to the extent of the margin value of such stock. The Clearing Corporation, however, does not accept Clearing Corporation stock as margin. Commission Rule 1.17(c)(2)(viii) also permits an FCM to include guarantee deposits with clearing organizations as a current asset. However, clearing organization rules generally restrict guarantee deposits to liquid assets that can be immediately liquidated to satisfy clearing member margin or other obligations. Clearing Corporation stock is not offered or sold on an organized securities market, and therefore is not considered “readily marketable” within the meaning of Commission Rule 1.17.

DCIO previously took a “no-action” position with respect to FCMs that included Clearing Corporation stock as a current asset in their net capital computations, after such Clearing Corporation stock was no longer accepted for margin by the Clearing Corporation.^[3] The previous no-action position was based,

in part, on the Clearing Corporation's representations concerning the liquidity of its stock in an emergency situation and DCIO's mandated condition that 85% of the assets of the Clearing Corporation remain in cash or specified highly liquid investments.

Your current request is made in anticipation of the effectiveness of the Clearing Corporation's overall realignment ("Realignment") of its corporate and capital structure, which is subject to a shareholder vote on October 23, 2003. You have represented that, if effected, the Realignment will result in the Clearing Corporation buying back a significant number of its shares from its current clearing members, no longer requiring stock ownership for clearing participation, and establishing a separate Clearing Corporation guaranty fund. You have further represented that, if effective, the Realignment will result in the lifting of all Clearing Corporation restrictions on the transferability of Clearing Corporation shares (such as the Clearing Corporation's right of first refusal and limitation of permissible purchasers to existing clearing members), subject to the continued applicability of all securities laws restrictions and other statutory requirements. In addition, you have stated that, after the Realignment, the Clearing Corporation no longer intends to make a practice of repurchasing its stock from shareholders, including clearing participants, but will accept Clearing Corporation stock for deposit in the Clearing Corporation guaranty fund, subject to an applicable haircut calculation and further subject to a schedule to phase-out such acceptance by February 2008.^[4]

Subject to and upon the effectiveness of the Realignment, you have requested that DCIO not recommend that the Commission commence an enforcement action with respect to an FCM that includes as a current asset in its calculations of adjusted net capital the book value, less an applicable haircut, of Clearing Corporation stock pledged to the Clearing Corporation's guaranty fund. You have further requested that DCIO not recommend enforcement action against an SRO that adopts the same interpretation under its net capital rule or in the conduct of its field audit program.

As noted, the "no-action" position contained in the 1995 Letter and continued in the 2002 Letter required the Clearing Corporation to maintain at least 85% of its assets in highly liquid instruments, and included the Clearing Corporation's representation that in an emergency situation a member's Clearing Corporation stock could be converted to cash in a few days from the Clearing Corporation's immediately available liquid assets, except for a reasonable amount held back to cover any unpaid amounts, which would consist primarily of clearing fees.

Subject to and upon the effectiveness of the Realignment, the condition and representation described above would no longer be satisfied. Accordingly, the no-action position contained in the 1995 Letter and continued in the 2002 Letter would be superceded and no longer in effect. The Clearing Corporation has represented that its acceptance of Clearing Corporation stock as a guaranty fund deposit provides approximately the same assurance of liquidity as the previously made representation by the Clearing Corporation in the 1995 and 2002 Letters that, in an emergency situation, liquidity for the Clearing Corporation stock would be derived from the Clearing Corporation's own liquid assets. Further, the Clearing Corporation has represented that the haircut calculation described herein adequately ensures that value will not be attributed to the Clearing Corporation stock for net capital purposes in excess of

the underlying net liquid assets of the Clearing Corporation.

Therefore, based upon the facts and representations set forth in your letter and in subsequent discussions held with DCIO staff, DCIO has determined that, subject to and upon the effectiveness of the Realignment, it will not recommend that the Commission commence an enforcement action with respect to any FCM that, in computing its adjusted net capital pursuant to Rule 1.17, includes as a current asset Clearing Corporation stock, subject to the following conditions:

- Only stock of the Clearing Corporation that has been pledged to and accepted by the Clearing Corporation as guaranty fund contributions may be recognized by an FCM for regulatory capital purposes;
- Clearing Corporation stock will be valued at its book value, which will be determined by dividing total assets less total liabilities, by the number of shares of Clearing Corporation stock issued and outstanding. The Clearing Corporation's assets and liabilities shall be determined in accordance with generally accepted accounting principles applied on a consistent basis;
- The book value per share of Clearing Corporation stock will be subject to a haircut equal to the greater of: (i) 15 percent of the book value per share; or (ii) 100 percent minus the ratio, expressed as a percentage of the Clearing Corporation's liquid assets (less any margin haircuts that the Clearing Corporation would impose on liquid assets held by the Clearing Corporation if such liquid assets had been deposited to satisfy original margin requirements) to the Clearing Corporation's total assets;
- The Clearing Corporation will make available to FCMs that have pledged Clearing Corporation stock to the guaranty fund, in a timeframe and manner consistent with Commission rules and the conditions of this no-action letter, information necessary for the FCMs to determine the value of the Clearing Corporation stock for computing their adjusted net capital in accordance with Rule 1.17; and
- The Clearing Corporation will routinely provide DCIO copies of its quarterly and annual financial statements, which will detail the composition of its assets and clearly set forth the calculation of the book value per share and haircuts described herein.

DCIO has further determined that it will not recommend enforcement action, pursuant to Section 4f(b) of the Act and Commission Rule 1.52, against an SRO that adopts the same interpretation for net capital purposes or in the conduct of its field audit program.

Should the Realignment not become effective, the 1995 and 2002 Letters will continue in effect so long as the underlying representations contained therein remain valid and the conditions contained therein continue to be satisfied. These include the Clearing Corporation's representation concerning the liquidity of its stock in the event of an emergency situation. ^[5]

This letter is based upon the representations you have made to DCIO and is subject to compliance with the conditions set forth above. Any different, changed or omitted facts or circumstances might render the positions taken herein void. Further, this letter represents the views of DCIO only and does not

necessarily represent the views of the Commission or of any other office or division of the Commission. If you have any questions regarding this letter, please contact me or Thomas Smith, Associate Director and Chief Accountant, at (202) 418-5495.

Very truly yours,

Jane Kang Thorpe
Director

cc: Michael Macchiaroli, SEC
Anne Glass, Chairman, Joint Audit Committee

^[1] Commission rules referred to herein are found at 17 C.F.R. Ch. 1 *et seq.* (2003).

^[2] 7 U.S.C. §6f(b) (2000).

^[3] See unpublished Letter from Andrea M. Corcoran, Director, Division of Trading and Markets, Commodity Futures Trading Commission, to Dennis Dutterer, Executive Vice-President and General Counsel, Board of Trade Clearing Corporation dated July 17, 1995 (the “1995 Letter”) and CFTC Letter No. 02-94, [2002-2003 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶29,136 (August 8, 2002) (no-action position concerning the treatment of Clearing Corporation stock for purposes of computing adjusted net capital under Rule 1.17) (the “2002 Letter”).

^[4] Although the phase-out period may be extended by the Clearing Corporation, pursuant to the current schedule, a clearing participant will not be permitted to contribute to the guaranty fund (i) more than two-thirds of its total holdings of Clearing Corporation stock after February 2006, (ii) more than one-third of its total holdings of Clearing Corporation stock after February 2007, and (iii) any Clearing Corporation stock after February 2008.

^[5] Specifically, the 1995 Letter states that “...in the ordinary course of business, possibly as much as 60 days could be required in order to ensure that the firm had met all obligations to [the Clearing Corporation] prior to the repurchase of the firm’s shares, but that in an emergency situation the carrying value would be converted to cash in a few days from the [Clearing Corporation’s] immediately available liquid assets, except for a reasonable amount held back to cover any unpaid amounts, which would consist primarily of clearing fees.”