CFTC Letter No. 04-07
January 28, 2004
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 inquiry to the Division of Clearing and Intermediary Oversight ("Division") of the Commodity Futures Trading Commission ("Commission"). By your inquiry, ["X"] has requested confirmation that a futures commission merchant ("FCM") may include in its equity capital proceeds from a subordinated loan agreement that satisfies all of the terms and conditions for equity capital set forth in Rule 1.17(d), and also provides for the possibility of several advancements of principal, or drawdowns, during the term of the loan agreement.[1]

It is our understanding that "X" has made this inquiry after receiving a request from ["Y" or "the firm"], a registered FCM, for approval of such an agreement.[2] The draft subordinated loan agreement submitted by "X", a copy of which has been reviewed by Division staff, provides for a maximum amount of credit that may be borrowed in incremental advances as the need arises during the term of the agreement.[3] The agreement has been drafted to have each advance satisfy the requirements for equity capital under Regulation 1.17(d)(1).[4]

For example, the agreement specifies that no advance shall be made within three years of the maturity date (June 30, 2013) of the agreement. As a result, not only the agreement, but also each advance, would have an initial term that is no less than three years. The agreement also does not include provisions that would permit "special prepayments", and expressly prohibits accelerated maturity of the payment obligations under the note.[5]

Although all prior agreements approved by "X" as equity capital have contained provisions that lend the entire principal amount of the note at the inception of the agreement, "X" is prepared to approve the firm's request to have each advance under the agreement, if and when made, included in the firm's equity capital. "X" seeks to confirm that Division staff has no objection to the proposed approval. This letter confirms that it is the opinion of Division staff that Rule 1.17(d) does not preclude including such advances in the firm's equity capital, so long as each such advance separately satisfies the requirements for equity capital under Rule 1.17(d).

This opinion is based upon the representations that have been made to the Division, and any different, changed or omitted facts or circumstances might render this opinion void. In this connection, we request that you provide copies of the approved agreement to DCIO staff in the Washington office and New

York Regional Office. Further, this letter represents the views of this Division 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 concerning this correspondence, please contact me or Thelma Diaz, Special Counsel, at (202) 418-5137.

Very truly yours,

James L. Carley
Director

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[1] Commission rules referred to herein may be found at 17 C.F.R. Ch. 1 (2003).

[2] "X" is the designated self-regulatory organization ("DSRO") for "Y". Commission Rule 1.17(h) requires prior review of an FCM's subordinated loan agreements by its DSRO.

[3] Although the draft is termed a "revolving" agreement, no advance would be scheduled to mature prior to the maturity date for all advances under the agreement (June 30, 2013). Representatives of the firm have stated that the availability of such advances would avoid the additional internal paperwork and time required if the same sums of money were borrowed and documented under separate subordinated loan agreements that meet the requirements for equity capital under Rule 1.17(d).

[4] Rule 1.17(d)(1) defines equity capital to include subordination agreements that (1) are "satisfactory subordination agreements" under Rule 1.17(h) that are entered into by a partner or a stockholder; (2) have an initial term of 3 years and a remaining term of not less than 12 months; (3) generally exclude "accelerated maturity" provisions; (4) are maintained subject to restrictions on withdrawal of capital, pursuant to Rule 1.17(e); and, (5) exclude "special prepayment" provisions that would otherwise be permitted under Rule 1.17(h)(2)(vii)(B).

[5] In general, "special prepayment" provisions are those that permit prepayments to be made at any time, and which therefore conflict with the Commission's general prohibition on prepayments within one year of the effective date of the governing subordination agreement. See Rule 1.17(h)(2)(vii).