

Commodity Futures Trading Commission

§ 1.17

such application a guarantee agreement, provided such introducing broker or applicant therefor is not also a securities broker or dealer.

(Approved by the Office of Management and Budget under control numbers 3038-0007, 3038-0024)

[43 FR 39970, Sept. 8, 1978, as amended at 46 FR 54516, Nov. 3, 1981; 46 FR 63035, Dec. 30, 1981; 48 FR 35284, Aug. 3, 1983; 49 FR 39526, Oct. 9, 1984; 52 FR 28995, Aug. 5, 1987; 53 FR 4612, Feb. 17, 1988; 69 FR 41426, July 9, 2004; 69 FR 49798, Aug. 12, 2004; 71 FR 5593, Feb. 2, 2006]

§ 1.17 Minimum financial requirements for futures commission merchants and introducing brokers.

(a)(1)(i) Except as provided in paragraph (a)(2)(i) of this section, each person registered as a futures commission merchant must maintain adjusted net capital equal to or in excess of the greatest of:

(A) \$1,000,000;

(B) The futures commission merchant's risk-based capital requirement, computed as eight percent of the total risk margin requirement for positions carried by the futures commission merchant in customer accounts and non-customer accounts.

(C) The amount of adjusted net capital required by a registered futures association of which it is a member; or

(D) For securities brokers and dealers, the amount of net capital required by Rule 15c3-1(a) of the Securities and Exchange Commission (17 CFR 240.15c3-1(a)).

(ii) Each person registered as a futures commission merchant engaged in soliciting or accepting orders and customer funds related thereto for the purchase or sale of any commodity for future delivery or any commodity option on or subject to the rules of a registered derivatives transaction execution facility from any customer who does not qualify as an "institutional customer" as defined in § 1.3(g) must:

(A) Be a clearing member of a derivatives clearing organization and maintain net capital in the amount of the greater of \$20,000,000 or the amounts otherwise specified in paragraph (a)(1)(i) of this section; or

(B) Receive orders on behalf of the customer from a commodity trading

advisor acting in accordance with § 4.32 of this chapter.

(iii) Except as provided in paragraph (a)(2) of this section, each person registered as an introducing broker must maintain adjusted net capital equal to or in excess of the greatest of:

(A) \$45,000;

(B) The amount of adjusted net capital required by a registered futures association of which it is a member; or

(C) For securities brokers and dealers, the amount of net capital required by Rule 15c3-1(a) of the Securities and Exchange Commission (17 CFR 240.15c3-1(a)).

(2)(i) The requirements of paragraph (a)(1) of this section shall not be applicable if the registrant is a member of a designated self-regulatory organization and conforms to minimum financial standards and related reporting requirements set by such designated self-regulatory organization in its bylaws, rules, regulations or resolutions approved by the Commission pursuant to section 4f(b) of the Act and § 1.52.

(ii) The minimum requirements of paragraph (a)(1)(iii) of this section shall not be applicable to an introducing broker which elects to meet the alternative adjusted net capital requirement for introducing brokers by operation pursuant to a guarantee agreement which meets the requirements set forth in § 1.10(j). Such an introducing broker shall be deemed to meet the adjusted net capital requirement under this section so long as such agreement is binding and in full force and effect, and, if the introducing broker is also a securities broker or dealer, it maintains the amount of net capital required by Rule 15c3-1(a) of the Securities and Exchange Commission (17 CFR 240.15c3-1(a)).

(3) No person applying for registration as a futures commission merchant or as an introducing broker shall be so registered unless such person affirmatively demonstrates to the satisfaction of the National Futures Association that it complies with the financial requirements of this section. Each registrant must be in compliance with this section at all times and must be able to demonstrate such compliance to the satisfaction of the Commission

§ 1.17

17 CFR Ch. I (4-1-11 Edition)

or the designated self-regulatory organization.

(4) A futures commission merchant who is not in compliance with this section, or is unable to demonstrate such compliance as required by paragraph (a)(3) of this section, must transfer all customer accounts and immediately cease doing business as a futures commission merchant until such time as the firm is able to demonstrate such compliance: *Provided, however,* The registrant may trade for liquidation purposes only unless otherwise directed by the Commission and/or the designated self-regulatory organization: *And, Provided further,* That if such registrant immediately demonstrates to the satisfaction of the Commission or the designated self-regulatory organization the ability to achieve compliance, the Commission or the designated self-regulatory organization may in its discretion allow such registrant up to a maximum of 10 business days in which to achieve compliance without having to transfer accounts and cease doing business as required above. Nothing in this paragraph (a)(4) shall be construed as preventing the Commission or the designated self-regulatory organization from taking action against a registrant for non-compliance with any of the provisions of this section.

(5) An introducing broker who is not in compliance with this section, or is unable to demonstrate such compliance as required by paragraph (a)(3) of this section, must immediately cease doing business as an introducing broker until such time as the registrant is able to demonstrate such compliance: *Provided, however,* That if such registrant immediately demonstrates to the satisfaction of the Commission or the designated self-regulatory organization the ability to achieve compliance, the Commission or the designated self-regulatory organization may in its discretion allow such registrant up to a maximum of 10 business days in which to achieve compliance without having to cease doing business as required above. If the introducing broker is required to cease doing business in accordance with this paragraph (a)(5), the introducing broker must immediately notify each of its customers and the futures com-

mission merchants carrying the account of each customer that it has ceased doing business. Nothing in this paragraph (a)(5) shall be construed as preventing the Commission or the designated self-regulatory organization from taking action against a registrant for non-compliance with any of the provisions of this section.

(b) For the purposes of this section:

(1) Where the applicant or registrant has an asset or liability which is defined in Securities Exchange Act Rule 15c3-1 (§240.15c3-1 of this title) the inclusion or exclusion of all or part of such asset or liability for the computation of adjusted net capital shall be in accordance with §240.15c3-1 of this title, unless specifically stated otherwise in this section.

(2) *Customer* means customer (as defined in §1.3(k)), option customer (as defined in §1.3(jj) and in §32.1(c) of this chapter), cleared over the counter customer (as defined in §1.17(b)(10)), and includes a foreign futures, foreign options customer (as defined in §30.1(c) of this chapter).

(3) *Proprietary account* means an account in which commodity futures, options or cleared over the counter derivative positions are carried on the books of the applicant or registrant for the applicant or registrant itself, or for general partners in the applicant or registrant.

(4) *Noncustomer account* means an account in which commodity futures, options or cleared over the counter derivative positions are carried on the books of the applicant or registrant which is either:

(i) An account that is not included in the definition of customer (as defined in §1.17(b)(2)) or proprietary account (as defined in §1.17(b)(3)), or

(ii) An account for a foreign-domiciled person trading futures or options on a foreign board of trade, and such account is a proprietary account as defined in §1.3(y) of this title, but is not a proprietary account as defined in §1.17(b)(3).

(5) *Clearing organization* means clearing organization (as defined in §1.3(d)) and includes a clearing organization of any board of trade.

(6) *Business day* means any day other than a Sunday, Saturday, or holiday.

Commodity Futures Trading Commission

§ 1.17

(7) *Customer account* means an account in which commodity futures, options or cleared over the counter derivative positions are carried on the books of the applicant or registrant which is either:

(i) An account that is included in the definition of customer (as defined in § 1.17(b)(2)), or

(ii) An account for a foreign-domiciled person trading on a foreign board of trade, where such account for the foreign-domiciled person is not a proprietary account (as defined in § 1.17(b)(3)) or a noncustomer account (as defined in § 1.17(b)(4)(ii)).

(8) *Risk margin* for an account means the level of maintenance margin or performance bond required for the customer or noncustomer positions by the applicable exchanges or clearing organizations, and, where margin or performance bond is required only for accounts at the clearing organization, for purposes of the FCM's risk-based capital calculations applying the same margin or performance bond requirements to customer and noncustomer positions in accounts carried by the FCM, subject to the following.

(i) Risk margin does not include the equity component of short or long option positions maintained in an account;

(ii) The maintenance margin or performance bond requirement associated with a long option position may be excluded from risk margin to the extent that the value of such long option position does not reduce the total risk maintenance or performance bond requirement of the account that holds the long option position;

(iii) The risk margin for an account carried by a futures commission merchant which is not a member of the exchange or the clearing organization that requires collection of such margin should be calculated as if the futures commission merchant were such a member; and

(iv) If a futures commission merchant does not possess sufficient information to determine what portion of an account's total margin requirement represents risk margin, all of the margin required by the exchange or the clearing organization that requires col-

lection of such margin for that account, shall be treated as risk margin.

(9) *Cleared over the counter derivative positions* means "over the counter derivative instrument" (as defined in 12 U.S.C. 4421) positions of any person in accounts carried on the books of the futures commission merchant and cleared by any organization permitted to clear such instruments under the laws of the relevant jurisdiction.

(10) *Cleared over the counter customer* means any person that is not a proprietary person as defined in § 1.3(y) and for whom the futures commission merchant carries on its books one or more accounts for the over the counter-cleared derivative positions of such person.

(c) Definitions: For the purposes of this section:

(1) *Net capital* means the amount by which current assets exceed liabilities. In determining "net capital":

(i) Unrealized profits shall be added and unrealized losses shall be deducted in the accounts of the applicant or registrant, including unrealized profits and losses on fixed price commitments and forward contracts;

(ii) All long and all short positions in commodity options which are traded on a contract market and listed security options shall be marked to their market value and all long and all short securities and commodities positions shall be marked to their market value;

(iii) The value attributed to any commodity option which is not traded on a contract market shall be the difference between the option's strike price and the market value for the physical or futures contract which is the subject of the option. In the case of a call commodity option which is not traded on a contract market, if the market value for the physical or futures contract which is the subject of the option is less than the strike price of the option, it shall be given no value. In the case of a put commodity option which is not traded on a contract market, if the market value for the physical or futures contract which is the subject of the option is more than the strike price of the option, it shall be given no value; and

§ 1.17

17 CFR Ch. I (4-1-11 Edition)

(iv) The value attributed to any unlisted security option shall be the difference between the option's exercise value or striking value and the market value of the underlying security. In the case of an unlisted call, if the market value of the underlying security is less than the exercise value or striking value of such call, it shall be given no value; and, in the case of an unlisted put, if the market value of the underlying security is more than the exercise value or striking value of the unlisted put, it shall be given no value.

(2) The term *current assets* means cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold during the next 12 months. "Current assets" shall:

(i) Exclude any unsecured commodity futures or option account containing a ledger balance and open trades, the combination of which liquidates to a deficit or containing a debit ledger balance only: *Provided, however*, Deficits or debit ledger balances in unsecured customers', non-customers', and proprietary accounts, which are the subject of calls for margin or other required deposits may be included in current assets until the close of business on the business day following the date on which such deficit or debit ledger balance originated providing that the account had timely satisfied, through the deposit of new funds, the previous day's debit or deficits, if any, in its entirety.

(ii) Exclude all unsecured receivables, advances and loans except for:

(A) Receivables resulting from the marketing of inventories commonly associated with the business activities of the applicant or registrant and advances on fixed price purchases commitments: *Provided*, Such receivables or advances are outstanding no longer than 3 calendar months from the date that they are accrued;

(B) Interest receivable, floor brokerage receivable, commissions receivable from other brokers or dealers (other than syndicate profits), mutual fund concessions receivable and management fees receivable from registered investment companies and commodity pools: *Provided*, Such receivables are outstanding no longer than thirty (30)

days from the date they are due; and dividends receivable outstanding no longer than thirty (30) days from the payable date;

(C) Receivables from clearing organizations and securities clearing organizations;

(D) Receivables from registered futures commission merchants or brokers, resulting from commodity futures or option transactions, except those specifically excluded under paragraph (c)(2)(i) of this section;

(E) Insurance claims which arise from a reportable segment of the applicant's or registrant's overall business activities, as defined in generally accepted accounting principles, other than in the commodity futures, commodity option, security and security option segments of the applicant's or registrant's business activities which are not outstanding more than 3 calendar months after the date they are recorded as a receivable;

(F) All other insurance claims not subject to paragraph (c)(2)(ii)(E) of this section, which are not older than seven (7) business days from the date the loss giving rise to the claim is discovered; insurance claims which are not older than twenty (20) business days from the date the loss giving rise to the claim is discovered and which are covered by an opinion of outside counsel that the claim is valid and is covered by insurance policies presently in effect; insurance claims which are older than twenty (20) business days from the date the loss giving rise to the claim is discovered and which are covered by an opinion of outside counsel that the claim is valid and is covered by insurance policies presently in effect and which have been acknowledged in writing by the insurance carrier as due and payable: *Provided*, Such claims are not outstanding longer than twenty (20) business days from the date they are so acknowledged by the carrier;

(iii) Exclude all prepaid expenses and deferred charges;

(iv) Exclude all inventories except for:

(A) Readily marketable spot commodities; or spot commodities which "adequately collateralize" indebtedness under paragraph (c)(7) of this section;

Commodity Futures Trading Commission

§ 1.17

(B) Securities which are considered “readily marketable” (as defined in § 240.15c3-1(c)(11) of this title) or which “adequately collateralize” indebtedness under paragraph (c)(7) of this section;

(C) Work in process and finished goods which result from the processing of commodities at market value;

(D) Raw materials at market value which will be combined with spot commodities to produce a finished processed commodity; and

(E) Inventories held for resale commonly associated with the business activities of the applicant or registrant;

(v) Include fixed assets and assets which otherwise would be considered noncurrent to the extent of any long-term debt adequately collateralized by assets acquired for use in the ordinary course of the trade or business of an applicant or registrant and any other long-term debt adequately collateralized by assets of the applicant or registrant if the sole recourse of the creditor for nonpayment of such liability is to such asset: *Provided*, Such liabilities are not excluded from liabilities in the computation of net capital under paragraph (c)(4)(vi) of this section;

(vi) Exclude all assets doubtful of collection or realization less any reserves established therefor;

(vii) Include, in the case of future income tax benefits arising as a result of unrealized losses, the amount of such benefits not exceeding the amount of income tax liabilities accrued on the books and records of the applicant or registrant, but only to the extent such benefits could have been applied to reduce accrued tax liabilities on the date of the capital computation, had the related unrealized losses been realized on that date;

(viii) Include guarantee deposits with clearing organizations and stock in clearing organizations to the extent of its margin value;

(ix) In the case of an introducing broker or an applicant for registration as an introducing broker, include 50 percent of the value of a guarantee or security deposit with a futures commission merchant which carries or intends to carry accounts for the customers of the introducing broker; and

(x) Exclude exchange memberships.

(3) A loan or advance or any other form of receivable shall not be considered “secured” for the purposes of paragraph (c)(2) of this section unless the following conditions exist:

(i) The receivable is secured by readily marketable collateral which is otherwise unencumbered and which can be readily converted into cash: *Provided, however*, That the receivable will be considered secured only to the extent of the market value of such collateral after application of the percentage deductions specified in paragraph (c)(5) of this section; and

(ii)(A) The readily marketable collateral is in the possession or control of the applicant or registrant; or

(B) The applicant or registrant has a legally enforceable, written security agreement, signed by the debtor, and has a perfected security interest in the readily marketable collateral within the meaning of the laws of the State in which the readily marketable collateral is located.

(4) The term *liabilities* means the total money liabilities of an applicant or registrant arising in connection with any transaction whatsoever, including economic obligations of an applicant or registrant that are recognized and measured in conformity with generally accepted accounting principles. “Liabilities” also include certain deferred credits that are not obligations but that are recognized and measured in conformity with generally accepted accounting principles. For the purposes of computing “net capital”, the term “liabilities”:

(i) Excludes liabilities of an applicant or registrant which are subordinated to the claims of all general creditors of the applicant or registrant pursuant to a satisfactory subordination agreement, as defined in paragraph (h) of this section;

(ii) Excludes, in the case of a futures commission merchant, the amount of money, securities and property due to commodity futures or option customers which is held in segregated accounts in compliance with the requirements of the Act and these regulations: *Provided, however*, That such exclusion may be taken only if such money, securities and property held in segregated

§ 1.17

17 CFR Ch. I (4–1–11 Edition)

accounts have been excluded from current assets in computing net capital;

(iii) Includes, in the case of an applicant or registrant who is a sole proprietor, the excess of liabilities which have not been incurred in the course of business as a futures commission merchant or as an introducing broker over assets not used in the business;

(iv) Excludes the lesser of any deferred income tax liability related to the items in paragraphs (c)(4)(i) (A), (B), and (C) below, or the sum of paragraphs (c)(4)(i) (A), (B), and (C) below:

(A) The aggregate amount resulting from applying to the amount of the deductions computed in accordance with paragraph (c)(5) of this section the appropriate Federal and State tax rate(s) applicable to any unrealized gain on the asset on which the deduction was computed;

(B) Any deferred tax liability related to income accrued which is directly related to an asset otherwise deducted pursuant to this section;

(C) Any deferred tax liability related to unrealized appreciation in value of any asset(s) which has been otherwise excluded from current assets in accordance with the provisions of this section;

(v) Excludes any current tax liability related to income accrued which is directly related to an asset otherwise deducted pursuant to this section; and

(vi) Excludes liabilities which would be classified as long term in accordance with generally accepted accounting principles to the extent of the net book value of plant, property and equipment which is used in the ordinary course of any trade or business of the applicant or registrant which is a reportable segment of the applicant's or registrant's overall business activities, as defined in generally accepted accounting principles, other than in the commodity futures, commodity option, security and security option segments of the applicant's or registrant's business activities: *Provided*, That such plant, property and equipment is not included in current assets pursuant to paragraph (c)(2)(v) of this section.

(5) The term *adjusted net capital* means net capital less:

(i) The amount by which any advances paid by the applicant or reg-

istrant on cash commodity contracts and used in computing net capital exceeds 95 percent of the market value of the commodities covered by such contracts;

(ii) In the case of all inventory, fixed price commitments and forward contracts, the applicable percentage of the net position specified below:

(A) Inventory which is currently registered as deliverable on a contract market and covered by an open futures contract or by a commodity option on a physical.—No charge.

(B) Inventory which is covered by an open futures contract or commodity option.—5 percent of the market value.

(C) Inventory which is not covered.—20 percent of the market value.

(D) Inventory and forward contracts in those foreign currencies that are purchased or sold for future delivery on or subject to the rules of a contract market, and which are covered by an open futures contract.—No charge

(E) Inventory and forward contracts in euros, British pounds, Canadian dollars, Japanese yen, or Swiss francs, and which are not covered by an open futures contract or commodity option.—6 percent of the market value.

(F) Fixed price commitments (open purchases and sales) and forward contracts which are covered by an open futures contract or commodity option.—10 percent of the market value.

(G) Fixed price commitments (open purchases and sales) and forward contracts which are not covered by an open futures contract or commodity option.—20 percent of the market value.

(iii)—(iv) [Reserved]

(v) In the case of securities and obligations used by the applicant or registrant in computing net capital, and in the case of a futures commission merchant with securities in segregation pursuant to section 4d(2) of the Act and the regulations in this chapter which were not deposited by customers, 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

Commodity Futures Trading Commission

§ 1.17

in Rule 240.15c3-1(c)(2)(vii) of the Securities and Exchange Commission (17 CFR 240.15c3-1(c)(2)(vii));

(vi) In the case of securities options and/or other options for which a haircut has been specified for the option or for the underlying instrument in §240.15c3-1 appendix A of this title, the treatment specified in, or under, §240.15c3-1 appendix A, after effecting certain adjustments to net capital for listed and unlisted options as set forth in such appendix;

(vii) In the case of an applicant or registrant who has open contractual commitments, as hereinafter defined, the deductions specified in §240.15c3-1(c)(2)(viii) of this title;

(viii) In the case of a futures commission merchant, for undermargined customer commodity futures accounts and commodity option customer accounts the amount of funds required in each such account to meet maintenance margin requirements of the applicable board of trade or if there are no such maintenance margin requirements, clearing organization margin requirements applicable to such positions, after application of calls for margin or other required deposits which are outstanding three business days or less. If there are no such maintenance margin requirements or clearing organization margin requirements, then the amount of funds required to provide margin equal to the amount necessary after application of calls for margin or other required deposits outstanding three business days or less to restore original margin when the original margin has been depleted by 50 percent or more: *Provided*, To the extent a deficit is excluded from current assets in accordance with paragraph (c)(2)(i) of this section such amount shall not also be deducted under this paragraph (c)(5)(viii). In the event that an owner of a customer account has deposited an asset other than cash to margin, guarantee or secure his account, the value attributable to such asset for purposes of this subparagraph shall be the lesser of (A) the value attributable to the asset pursuant to the margin rules of the applicable board of trade, or (B) the market value of the asset after application of the percentage deductions specified in this paragraph (c)(5);

(ix) In the case of a futures commission merchant, for undermargined commodity futures and commodity option noncustomer and omnibus accounts the amount of funds required in each such account to meet maintenance margin requirements of the applicable board of trade or if there are no such maintenance margin requirements, clearing organization margin requirements applicable to such positions, after application of calls for margin or other required deposits which are outstanding two business days or less. If there are no such maintenance margin requirements or clearing organization margin requirements, then the amount of funds required to provide margin equal to the amount necessary after application of calls for margin or other required deposits outstanding two business days or less to restore original margin when the original margin has been depleted by 50 percent or more: *Provided*, To the extent a deficit is excluded from current assets in accordance with paragraph (c)(2)(i) of this section such amount shall not also be deducted under this paragraph (c)(5)(ix). In the event that an owner of a noncustomer or omnibus account has deposited an asset other than cash to margin, guarantee or secure his account the value attributable to such asset for purposes of this subparagraph shall be the lesser of (A) the value attributable to such asset pursuant to the margin rules of the applicable board of trade, or (B) the market value of such asset after application of the percentage deductions specified in this paragraph (c)(5);

(x) In the case of open futures contracts or cleared OTC derivative positions and granted (sold) commodity options held in proprietary accounts carried by the applicant or registrant which are not covered by a position held by the applicant or registrant or which are not the result of a "changer trade" made in accordance with the rules of a contract market:

(A) For an applicant or registrant which is a clearing member of a clearing organization for the positions cleared by such member, the applicable margin requirement of the applicable clearing organization;

§ 1.17

17 CFR Ch. I (4-1-11 Edition)

(B) For an applicant or registrant which is a member of a self-regulatory organization 150 percent of the applicable maintenance margin requirement of the applicable board of trade, or clearing organization, whichever is greater;

(C) For all other applicants or registrants, 200 percent of the applicable maintenance margin requirements of the applicable board of trade or clearing organization, whichever is greater; or

(D) For open contracts or granted (sold) commodity options for which there are no applicable maintenance margin requirements, 200 percent of the applicable initial margin requirement: *Provided*, The equity in any such proprietary account shall reduce the deduction required by this paragraph (c)(5)(x) if such equity is not otherwise includable in adjusted net capital;

(xi) In the case of an applicant or registrant which is a purchaser of a commodity option not traded on a contract market which has value and such value is used to increase adjusted net capital, ten percent of the market value of the physical or futures contract which is the subject of such option but in no event more than the value attributed to such option;

(xii) In the case of an applicant or registrant which is a purchaser of a commodity option which is traded on a contract market the same safety factor as if the applicant or registrant were the grantor of such option in accordance with paragraph (c)(5)(x) of this section, but in no event shall the safety factor be greater than the market value attributed to such option;

(xiii) Five percent of all unsecured receivables includable under paragraph (c)(2)(ii)(D) of this section used by the applicant or registrant in computing "net capital" and which are not due from:

(A) A registered futures commission merchant;

(B) A broker or dealer that is registered as such with the Securities and Exchange Commission; or

(C) A foreign broker that has been granted comparability relief pursuant to § 30.10 of this chapter, *Provided, however*, that the amount of the unsecured receivable not subject to the five per-

cent capital charge is no greater than 150 percent of the current amount required to maintain futures and option positions in accounts with the foreign broker, or 100 percent of such greater amount required to maintain futures and option positions in the accounts at any time during the previous six-month period, and *Provided, that*, in the case of customer funds, such account is treated in accordance with the special requirements of the applicable Commission order issued under § 30.10 of this chapter.

(xiv) For securities brokers and dealers, all other deductions specified in § 240.15c3-1 of this title.

(6) Election of alternative capital deductions that have received approval of Securities and Exchange Commission pursuant to § 240.15c3-1(a)(7) of this title.

(i) Any futures commission merchant that is also registered with the Securities and Exchange Commission as a securities broker or dealer, and who also satisfies the other requirements of this paragraph (c)(6), may elect to compute its adjusted net capital using the alternative capital deductions that, under § 240.15c3-1(a)(7) of this title, the Securities and Exchange Commission has approved by written order. To the extent that a futures commission merchant is permitted by the Securities and Exchange Commission to use alternative capital deductions for its unsecured receivables from over-the-counter transactions in derivatives, or for its proprietary positions in securities, forward contracts, or futures contracts, the futures commission merchant may use these same alternative capital deductions when computing its adjusted net capital, in lieu of the deductions that would otherwise be required by paragraph (c)(2)(ii) of this section for its unsecured receivables from over-the-counter derivatives transactions; by paragraph (c)(5)(ii) of this section for its proprietary positions in forward contracts; by paragraph (c)(5)(v) of this section for its proprietary positions in securities; and by paragraph (c)(5)(x) of this section for its proprietary positions in futures contracts.

(ii) *Notifications of election or of changes to election.* (A) No election to

Commodity Futures Trading Commission

§ 1.17

use the alternative market risk and credit risk deductions referenced in paragraph (c)(6)(i) of this section shall be effective unless and until the futures commission merchant has filed with the Commission, addressed to the Director of the Division of Clearing and Intermediary Oversight, a notice that is to include a copy of the approval order of the Securities and Exchange Commission referenced in paragraph (c)(6)(i) of this section, and to include also a statement that identifies the amount of tentative net capital below which the futures commission merchant is required to provide notice to the Securities and Exchange Commission, and which also provides the following information: a list of the categories of positions that the futures commission merchant holds in its proprietary accounts, and, for each such category, a description of the methods that the futures commission merchant will use to calculate its deductions for market risk and credit risk, and also, if calculated separately, deductions for specific risk; a description of the value at risk (VaR) models to be used for its market risk and credit risk deductions, and an overview of the integration of the models into the internal risk management control system of the futures commission merchant; a description of how the futures commission merchant will calculate current exposure and maximum potential exposure for its deductions for credit risk; a description of how the futures commission merchant will determine internal credit ratings of counterparties and internal credit risk weights of counterparties, if applicable; and a description of the estimated effect of the alternative market risk and credit risk deductions on the amounts reported by the futures commission merchant as net capital and adjusted net capital.

(B) A futures commission merchant must also, upon the request of the Commission at any time, supplement the statement described in paragraph (c)(6)(ii)(A) of this section, by providing any other explanatory information regarding the computation of its alternative market risk and credit risk deductions as the Commission may require at its discretion.

(C) A futures commission merchant must also file the following supplemental notices with the Director of the Division and Clearing and Intermediary Oversight:

(1) A notice advising that the Securities and Exchange Commission has imposed additional or revised conditions for the approval evidenced by the order referenced in paragraph (c)(6)(i) of this section, and which describes the new or revised conditions in full, and

(2) A notice which attaches a copy of any approval by the Securities and Exchange Commission of amendments that a futures commission merchant has requested for its application, filed under 17 CFR 240.15c3-1e, to use alternative market risk and credit risk deductions approved by the Securities and Exchange Commission.

(D) A futures commission merchant may voluntarily change its election to use the alternative market risk and credit risk deductions referenced in paragraph (c)(6)(i) of this section, by filing with the Director of the Division of Clearing and Intermediary Oversight a written notice specifying a future date as of which it will no longer use the alternative market risk and credit risk deductions, and will instead compute such deductions in accordance with the requirements otherwise applicable under paragraph (c)(2)(ii) of this section for unsecured receivables from over-the-counter derivatives transactions; by paragraph (c)(5)(ii) of this section for proprietary positions in forward contracts; by paragraph (c)(5)(v) of this section for proprietary positions in securities; and by paragraph (c)(5)(x) of this section for proprietary positions in futures contracts.

(iii) *Conditions under which election terminated.* A futures commission merchant may no longer elect to use the alternative market risk and credit risk deductions referenced in paragraph (c)(6)(i) of this section, and shall instead compute the deductions otherwise required under paragraph (c)(2)(ii) of this section for unsecured receivables from over-the-counter derivatives transactions; by paragraph (c)(5)(ii) of this section for proprietary positions in forward contracts; by paragraph (c)(5)(v) of this section for proprietary

positions in securities; and by paragraph (c)(5)(x) of this section for proprietary positions in futures contracts, upon the occurrence of any of the following:

(A) The Securities and Exchange Commission revokes its approval of the market risk and credit risk deductions for such futures commission merchant;

(B) A futures commission merchant fails to come into compliance with its filing requirements under this paragraph (c)(6), after having received from the Director of the Division of Clearing and Intermediary Oversight written notification that the firm is not in compliance with its filing requirements, and must cease using alternative capital deductions permitted under this paragraph (c)(6) if it has not come into compliance by a date specified in the notice; or

(C) The Commission by written order finds that permitting the futures commission merchant to continue to use such alternative market risk and credit risk deductions is no longer necessary or appropriate for the protection of customers of the futures commission merchant or of the integrity of the futures or options markets.

(iv) *Additional filing requirements.* Any futures commission merchant that elects to use the alternative market risk and credit risk deductions referenced in paragraph (c)(6)(i) of this section must file with the Commission, in addition to the filings required by paragraph (c)(6)(ii) of this section, copies of any and all of the following documents, at such time as the originals are filed with the Securities and Exchange Commission:

(A) Information that the futures commission merchant files on a monthly basis with its designated examining authority or the Securities and Exchange Commission, whether by way of schedules to its FOCUS reports or by other filings, in satisfaction of 17 CFR 240.17a-5(a)(5)(i);

(B) The quarterly reports required by 17 CFR 240.17a-5(a)(5)(ii);

(C) The supplemental annual filings as required by 17 CFR 240.17a-5(k);

(D) Any notification to the Securities and Exchange Commission or the futures commission merchant's designated examining authority of

planned withdrawals of excess net capital; and

(E) Any notification that the futures commission merchant is required to file with the Securities and Exchange Commission when its tentative net capital is below an amount specified by the Securities and Exchange Commission.

(7) *Liabilities* are "adequately collateralized" when, pursuant to a legally enforceable written instrument, such liabilities are secured by identified assets that are otherwise unencumbered and the market value of which exceeds the amount of such liabilities.

(8) The term *contractual commitments* shall include underwriting, when issued, when distributed, and delayed delivery contracts; and the writing or endorsement of security puts and calls and combinations thereof; but shall not include uncleared regular way purchases and sales of securities. A series of contracts of purchase or sale of the same security, conditioned, if at all, only upon issuance, may be treated as an individual commitment.

(d) Each applicant or registrant shall have equity capital (inclusive of satisfactory subordination agreements which qualify under this paragraph (d) as equity capital) of not less than 30 percent of the debt-equity total, provided, an applicant or registrant may be exempted from the provisions of this paragraph (d) for a period not to exceed 90 days or for such longer period which the Commission may, upon application of the applicant or registrant, grant in the public interest or for the protection of investors. For the purposes of this paragraph (d):

(1) Equity capital means a satisfactory subordination agreement entered into by a partner or stockholder or limited liability company member which has an initial term of at least 3 years and has a remaining term of not less than 12 months if:

(i) It does not have any of the provisions for accelerated maturity provided for by paragraphs (h)(2) (ix)(A), (x)(A), or (x)(B) of this section, or the provisions allowing for special prepayment provided for by paragraph (h)(2)(vii)(B) of this section, and is maintained as

capital subject to the provisions restricting the withdrawal thereof required by paragraph (e) of this section; or

(ii) The partnership agreement provides that capital contributed pursuant to a satisfactory subordination agreement as defined in paragraph (h) of this section shall in all respects be partnership capital subject to the provisions restricting the withdrawal thereof required by paragraph (e) of this section, and

(A) In the case of a corporation, the sum of its par or stated value of capital stock, paid in capital in excess of par, retained earnings, unrealized profit and loss, and other capital accounts.

(B) In the case of a partnership, the sum of its capital accounts of partners (inclusive of such partners' commodities, options and securities accounts subject to the provisions of paragraph (e) of this section), and unrealized profit and loss.

(C) In the case of a sole proprietorship, the sum of its capital accounts of the sole proprietorship and unrealized profit and loss.

(D) In the case of a limited liability company, the sum of its capital accounts of limited liability company members, and unrealized profit and loss.

(2) Debt-equity total means equity capital as defined in paragraph (d)(1) of this section plus the outstanding principal amount of satisfactory subordination agreements.

(e) No equity capital of the applicant or registrant or a subsidiary's or affiliate's equity capital consolidated pursuant to paragraph (f) of this section, whether in the form of capital contributions by partners (including amounts in the commodities, options and securities trading accounts of partners which are treated as equity capital but excluding amounts in such trading accounts which are not equity capital and excluding balances in limited partners' capital accounts in excess of their stated capital contributions), par or stated value of capital stock, paid-in capital in excess of par or stated value, retained earnings or other capital accounts, may be withdrawn by action of a stockholder or partner or limited liability company

member or by redemption or repurchase of shares of stock by any of the consolidated entities or through the payment of dividends or any similar distribution, nor may any unsecured advance or loan be made to a stockholder, partner, sole proprietor, limited liability company member, or employee if, after giving effect thereto and to any other such withdrawals, advances, or loans and any payments of payment obligations (as defined in paragraph (h) of this section) under satisfactory subordination agreements and any payments of liabilities excluded pursuant to paragraph (c)(4)(vi) of this section which are scheduled to occur within six months following such withdrawal, advance or loan:

(1) Either adjusted net capital of any of the consolidated entities would be less than the greatest of:

(i) 120 percent of the appropriate minimum dollar amount required by paragraphs (a)(1)(i)(A) or (a)(1)(iii)(A) of this section;

(ii) For a futures commission merchant or applicant therefor, 120 percent of the amount required by paragraph (a)(1)(i)(B) of this section;

(iii) 120 percent of the amount of adjusted net capital required by a registered futures association of which it is a member; or

(iv) For an applicant or registrant which is also a securities broker or dealer, the amount of net capital specified in Rule 15c3-1(e) of the Securities and Exchange Commission (17 CFR 240.15c3-1(e)); or

(2) In the case of any applicant or registrant included within such consolidation, if equity capital of the applicant or registrant (inclusive of satisfactory subordination agreements which qualify as equity under paragraph (d) of this section) would be less than 30 percent of the required debt-equity total as defined in paragraph (d) of this section.

Provided, That this paragraph (e) shall not preclude an applicant or registrant from making required tax payments or preclude the payment to partners of reasonable compensation. The Commission may, upon application of the applicant or registrant, grant relief from this paragraph (e) if the Commission deems it to be in the public interest or

for the protection of nonproprietary accounts.

(f)(1) Every applicant or registrant, in computing its net capital pursuant to this section must, subject to the provisions of paragraphs (f)(2) and (f)(4) of this section, consolidate in a single computation, assets and liabilities of any subsidiary or affiliate for which it guarantees, endorses, or assumes directly or indirectly the obligations or liabilities. The assets and liabilities of a subsidiary or affiliate whose liabilities and obligations have not been guaranteed, endorsed, or assumed directly or indirectly by the applicant or registrant may also be so consolidated if an opinion of counsel is obtained as provided for in paragraph (f)(2) of this section.

(2)(i) If the consolidation, provided for in paragraph (f)(1) of this section, of any such subsidiary or affiliate results in the increase of the applicant's or registrant's adjusted net capital or decreases the minimum adjusted net capital requirement, and an opinion of counsel called for in paragraph (f)(2)(ii) of this section has not been obtained, such benefits shall not be recognized in the applicant's or registrant's computation required by this section.

(ii) Except as provided for in paragraph (f)(2)(i) of this section, consolidation shall be permitted with respect to any subsidiaries or affiliates which are majority owned and controlled by the applicant or registrant, and for which the applicant can demonstrate to the satisfaction of the National Futures Association, or for which the registrant can demonstrate to the satisfaction of the Commission and the designated self-regulatory organization, if any, by an opinion of counsel, that the net asset values or the portion thereof related to the parent's ownership interest in the subsidiary or affiliate, may be caused by the applicant or registrant or an appointed trustee to be distributed to the applicant or registrant within 30 calendar days. Such opinion must also set forth the actions necessary to cause such a distribution to be made, identify the parties having the authority to take such actions, identify and describe the rights of other parties or classes of parties, including but not limited to customers,

general creditors, subordinated lenders, minority shareholders, employees, litigants, and governmental or regulatory authorities, who may delay or prevent such a distribution and such other assurances as the National Futures Association, the Commission or the designated self-regulatory organization by rule or interpretation may require. Such opinion must be current and periodically renewed in connection with the applicant's or registrant's annual audit pursuant to § 1.10 or upon any material change in circumstances.

(3) In preparing a consolidated computation of adjusted net capital pursuant to this section, the following minimum and non-exclusive requirements shall be observed;

(i) Consolidated adjusted net capital shall be reduced by the estimated amount of any tax reasonably anticipated to be incurred upon distribution of the assets of the subsidiary or affiliate.

(ii) Liabilities of a consolidated subsidiary or affiliate which are subordinated to the claims of present and future creditors pursuant to a satisfactory subordination agreement shall be deducted from consolidated adjusted net capital unless such subordination extends also to the claims of present or future creditors of the parent applicant or registrant and all consolidated subsidiaries.

(iii) Subordinated liabilities of a consolidated subsidiary or affiliate which are consolidated in accordance with paragraph (f)(3)(ii) of this section may not be prepaid, repaid, or accelerated if any of the entities included in such consolidation would otherwise be unable to comply with the provisions of paragraph (h) of this section.

(iv) Each applicant or registrant included within the consolidation shall at all times be in compliance with the adjusted net capital requirement to which it is subject.

(4) No applicant or registrant shall guarantee, endorse, or assume directly or indirectly any obligation or liability of a subsidiary or affiliate unless the obligation or liability is reflected in the computation of adjusted net capital pursuant to this section except as provided in paragraph (f)(2)(i) of this section.

Commodity Futures Trading Commission

§ 1.17

(g)(1) The Commission may by order restrict, for a period up to twenty business days, any withdrawal by a futures commission merchant of equity capital, or any unsecured advance or loan to a stockholder, partner, limited liability company member, sole proprietor, employee or affiliate, if:

(i) Such withdrawal, advance or loan would cause, when aggregated with all other withdrawals, advances or loans during a 30 calendar day period from the futures commission merchant or a subsidiary or affiliate of the futures commission merchant consolidated pursuant to § 1.17(f) (or 17 CFR 240.15c3-1e), a net reduction in excess adjusted net capital (or, if the futures commission merchant is qualified to use the filing option available under § 1.10(h), excess net capital as defined in the rules of the Securities and Exchange Commission) of 30 percent or more, and

(ii) The Commission, based on the facts and information available, concludes that any such withdrawal, advance or loan may be detrimental to the financial integrity of the futures commission merchant, or may unduly jeopardize its ability to meet customer obligations or other liabilities that may cause a significant impact on the markets.

(2) The futures commission merchant may file with the Secretary of the Commission a written petition to request rescission of the order issued under paragraph (g)(1) of this section. The petition filed by the futures commission merchant must specify the facts and circumstances supporting its request for rescission. The Commission shall respond in writing to deny the futures commission merchant's petition for rescission, or, if the Commission determines that the order issued under paragraph (g)(1) of this section should not remain in effect, the order shall be rescinded.

(h) The term *satisfactory subordination agreement* ("subordination agreement") means an agreement which contains the minimum and nonexclusive requirements set forth below.

(1) Certain definitions for purposes of this section:

(i) A subordination agreement may be either a subordinated loan agree-

ment or a secured demand note agreement.

(ii) The term *subordinated loan agreement* means the agreement or agreements evidencing or governing a subordinated borrowing of cash.

(iii) The term "collateral value" of any securities pledged to secure a secured demand note means the market value of such securities after giving effect to the percentage deductions specified in Rule 240.15c3-1d(a)(2)(iii) of the Securities and Exchange Commission (17 CFR 240.15c3-1d(a)(2)(iii)).

(iv) The term *payment obligation* means the obligation of an applicant or registrant in respect to any subordination agreement:

(A) To repay cash loaned to the applicant or registrant pursuant to a subordinated loan agreement; or

(B) To return a secured demand note contributed to the applicant or registrant or to reduce the unpaid principal amount thereof and to return cash or securities pledged as collateral to secure the secured demand note; and

(C) "payment" shall mean the performance by an applicant or registrant of a payment obligation.

(v)(A) The term *secured demand note agreement* means an agreement (including the related secured demand note) evidencing or governing the contribution of a secured demand note to an applicant or registrant and the pledge of securities and/or cash with the applicant or registrant as collateral to secure payment of such secured demand note. The secured demand note agreement may provide that neither the lender, his heirs, executors, administrators, or assigns shall be personally liable on such note and that in the event of default the applicant or registrant shall look for payment of such note solely to the collateral then pledged to secure the same.

(B) The secured demand note shall be a promissory note executed by the lender and shall be payable on the demand of the applicant or registrant to which it is contributed: *Provided, however*, That the making of such demand may be conditioned upon the occurrence of any of certain events which are acceptable to the designated self-regulatory organization and the Commission.

(C) If such note is not paid upon presentment and demand as provided for therein, the applicant or registrant shall have the right to liquidate all or any part of the securities then pledged as collateral to secure payment of the same and to apply the net proceeds of such liquidation, together with any cash then included in the collateral, in payment of such note. Subject to the prior rights of the applicant or registrant as pledgee, the lender, as defined in paragraph (h)(i)(v)(F) of this section may retain ownership of the collateral and have the benefit of any increases and bear the risks of any decreases in the value of the collateral and may retain the right to vote securities contained within the collateral and any right to income therefrom or distributions thereon, except the applicant or registrant shall have the right to receive and hold as pledgee all dividends payable in securities and all partial and complete liquidating dividends.

(D) Subject to the prior rights of the applicant or registrant as pledgee, the lender may have the right to direct the sale of any securities included in the collateral, to direct the purchase of securities with any cash included therein, to withdraw excess collateral or to substitute cash or other securities as collateral: *Provided*, That the net proceeds of any such sale and the cash so substituted and the securities so purchased or substituted are held by the applicant or registrant as pledgee, and are included within the collateral to secure payment of the secured demand note: *And provided further*, That no such transaction shall be permitted, if, after giving effect thereto, the sum of the amount of any cash, plus the collateral value of the securities, then pledged as collateral to secure the secured demand note would be less than the unpaid principal amount of the secured demand note.

(E) Upon payment by the lender, as distinguished from a reduction by the lender which is provided for in paragraph (h)(2)(vi)(C) of this section or reduction by the applicant or registrant as provided for in paragraph (h)(2)(vii) of this section, of all or any part of the unpaid principal amount of the secured demand note, the applicant or reg-

istrant shall issue to the lender a subordinated loan agreement in the amount of such payment (or in the case of an applicant or registrant that is a partnership, credit a capital account of the lender), or issue preferred or common stock of the applicant or registrant in the amount of such payment, or any combination of the foregoing, as provided for in the secured demand note agreement.

(F) The term *lender* means the person who lends cash to an applicant or registrant pursuant to a subordinated loan agreement and the person who contributes a secured demand note to an applicant or registrant pursuant to a secured demand note agreement.

(2) Minimum requirements for subordination agreements:

(i) Subject to paragraph (h)(1) of this section, a subordination agreement shall mean a written agreement between the applicant or registrant and the lender, which:

(A) Has a minimum term of 1 year, except for temporary subordination agreements provided for in paragraph (h)(3)(v) of this section, and

(B) Is a valid and binding obligation enforceable in accordance with its terms (subject as to enforcement to applicable bankruptcy, insolvency, reorganization, moratorium, and other similar laws) against the applicant or registrant and the lender and their respective heirs, executors, administrators, successors, and assigns.

(ii) *Specific amount*. All subordination agreements shall be for a specific dollar amount which shall not be reduced for the duration of the agreement except by installments as specifically provided for therein and except as otherwise provided in this paragraph (h)(2) of this section.

(iii) *Effective subordination*. The subordination agreement shall effectively subordinate any right of the lender to receive any payment with respect thereto, together with accrued interest or compensation, to the prior payment or provision for payment in full of all claims of all present and future creditors of the applicant or registrant arising out of any matter occurring prior to the date on which the related payment obligation matures, except for

claims which are the subject of subordination agreements which rank on the same priority as or junior to the claim of the lender under such subordination agreements.

(iv) *Proceeds of subordinated loan agreements.* The subordinated loan agreement shall provide that the cash proceeds thereof shall be used and dealt with by the applicant or registrant as part of its capital and shall be subject to the risks of the business.

(v) *Certain rights of the borrower.* The subordination agreement shall provide that the applicant or registrant shall have the right to:

(A) Deposit any cash proceeds of a subordinated loan agreement and any cash pledged as collateral to secure a secured demand note in an account or accounts in its own name in any bank or trust company;

(B) Pledge, repledge, hypothecate and rehypothecate, any or all of the securities pledged as collateral to secure a secured demand note, without notice, separately or in common with other securities or property for the purpose of securing any indebtedness of the applicant or registrant; and

(C) Lend to itself or others any or all of the securities and cash pledged as collateral to secure a secured demand note.

(vi) *Collateral for secured demand notes.* Only cash and securities which are fully paid for and which may be publicly offered or sold without registration under the Securities Act of 1933, and the offer, sale, and transfer of which are not otherwise restricted, may be pledged as collateral to secure a secured demand note. The secured demand note agreement shall provide that if at any time the sum of the amount of any cash, plus the collateral value of any securities, then pledged as collateral to secure the secured demand note is less than the unpaid principal amount of the secured demand note, the applicant or registrant must immediately transmit written notice to that effect to the lender. The secured demand note agreement shall also provide that if the borrower is an applicant, such notice must also be transmitted immediately to the National Futures Association, and if the borrower is a registrant, such notice

must also be transmitted immediately to the designated self-regulatory organization, if any, and the Commission. The secured demand note agreement shall also require that following such transmittal:

(A) The lender, prior to noon of the business day next succeeding the transmittal of such notice, may pledge as collateral additional cash or securities sufficient, after giving effect to such pledge, to bring the sum of the amount of any cash plus the collateral value of any securities, then pledged as collateral to secure the secured demand note, up to an amount not less than the unpaid principal amount of the secured demand note; and

(B) Unless additional cash or securities are pledged by the lender as provided in paragraph (h)(2)(vi)(A) above, the applicant or registrant at noon on the business day next succeeding the transmittal of notice to the lender must commence sale, for the account of the lender, of such of the securities then pledged as collateral to secure the secured demand note and apply so much of the net proceeds thereof, together with such of the cash then pledged as collateral to secure the secured demand note as may be necessary to eliminate the unpaid principal amount of the secured demand note: *Provided, however,* That the unpaid principal amount of the secured demand note need not be reduced below the sum of the amount of any remaining cash, plus the collateral value of the remaining securities, then pledged as collateral to secure the secured demand note. The applicant or registrant may not purchase for its own account any securities subject to such a sale; and

(C) The secured demand note agreement may also provide that, in lieu of the procedures specified in the provisions required by paragraph (h)(2)(vi)(B) of this section, the lender, with the prior written consent of the applicant and the National Futures Association, or with the prior written consent of the registrant and the designated self-regulatory organization or, if the registrant is not a member of a designated self-regulatory organization, the Commission, may reduce the unpaid principal amount of the secured

§ 1.17

17 CFR Ch. I (4–1–11 Edition)

demand note: *Provided*, That after giving effect to such reduction the adjusted net capital of the applicant or registrant would not be less than the greatest of:

(1) 120 percent of the appropriate minimum dollar amount required by paragraphs (a)(1)(i)(A) or (a)(1)(iii)(A) of this section;

(2) For a futures commission merchant or applicant therefor, 120 percent of the amount required by paragraph (a)(1)(i)(B) of this section;

(3) 120 percent of the amount of adjusted net capital required by a registered futures association of which it is a member; or

(4) For an applicant or registrant which is also a securities broker or dealer, the amount of net capital specified in Rule 15c3–1d(b)(6)(iii) of the Securities and Exchange Commission (17 CFR 240.15c3–1d(b)(6)(iii)): *Provided, further*, That no single secured demand note shall be permitted to be reduced by more than 15 percent of its original principal amount and after such reduction no excess collateral may be withdrawn.

(vii) *Permissive prepayments and special prepayments.* (A) An applicant or registrant at its option, but not at the option of the lender, may, if the subordination agreement so provides, make a payment of all or any portion of the payment obligation thereunder prior to the scheduled maturity date of such payment obligation (hereinafter referred to as a “prepayment”), but in no event may any prepayment be made before the expiration of one year from the date such subordination agreement became effective: *Provided, however*, That the foregoing restriction shall not apply to temporary subordination agreements which comply with the provisions of paragraph (h)(3)(v) of this section nor shall it apply to “special prepayments” made in accordance with the provisions of paragraph (h)(2)(vii)(B) of this section. No prepayment shall be made if, after giving effect thereto (and to all payments of payment obligations under any other subordination agreements then outstanding, the maturity or accelerated maturities of which are scheduled to fall due within six months after the date such prepayment is to occur pur-

suant to this provision, or on or prior to the date on which the payment obligation in respect to such prepayment is scheduled to mature disregarding this provision, whichever date is earlier) without reference to any projected profit or loss of the applicant or registrant, the adjusted net capital of the applicant or registrant is less than the greatest of:

(1) 120 percent of the appropriate minimum dollar amount required by paragraphs (a)(1)(i)(A) or (a)(1)(iii)(A) of this section;

(2) For a futures commission merchant or applicant therefor, 120 percent of the amount required by paragraph (a)(1)(i)(B) of this section;

(3) 120 percent of the amount of adjusted net capital required by a registered futures association of which it is a member; or

(4) For an applicant or registrant which is also a securities broker or dealer, the amount of net capital specified in Rule 15c3–1d(b)(7) of the Securities and Exchange Commission (17 CFR 240.15c3–1d(b)(7)).

(B) An applicant or registrant at its option, but not at the option of the lender, may, if the subordination agreement so provides, make a payment at any time of all or any portion of the payment obligation thereunder prior to the scheduled maturity date of such payment obligation (hereinafter referred to as a “special prepayment”). No special prepayment shall be made if, after giving effect thereto (and to all payments of payment obligations under any other subordination agreements then outstanding, the maturity or accelerated maturities of which are scheduled to fall due within six months after the date such special prepayment is to occur pursuant to this provision, or on or prior to the date on which the payment obligation in respect to such special prepayment is scheduled to mature disregarding this provision, whichever date is earlier) without reference to any projected profit or loss of the applicant or registrant, the adjusted net capital of the applicant or registrant is less than the greatest of:

(1) 200 percent of the appropriate minimum dollar amount required by paragraphs (a)(1)(i)(A) or (a)(1)(iii)(A) of this section;

Commodity Futures Trading Commission

§ 1.17

(2) For a futures commission merchant or applicant therefor, 125 percent of the amount required by paragraph (a)(1)(i)(B) of this section;

(3) 120 percent of the amount of adjusted net capital required by a registered futures association of which it is a member; or

(4) For an applicant or registrant which is also a securities broker or dealer, the amount of net capital specified in Rule 15c3-1d(c)(5)(ii) of the Securities and Exchange Commission (17 CFR 240.15c3-1d(c)(5)(ii)): *Provided, however,* That no special prepayment shall be made if pre-tax losses during the latest three-month period were greater than 15 percent of current excess adjusted net capital.

(C)(I) Notwithstanding the provisions of paragraphs (h)(2)(vii)(A) and (h)(2)(vii)(B) of this section, in the case of an applicant, no prepayment or special prepayment shall occur without the prior written approval of the National Futures Association; in the case of a registrant, no prepayment or special prepayment shall occur without the prior written approval of the designated self-regulatory organization, if any, or of the Commission if the registrant is not a member of a self-regulatory organization.

(2) A registrant may make a prepayment or special prepayment without the prior written approval of the designated self-regulatory organization: *Provided,* That the registrant: Is a securities broker or dealer registered with the Securities and Exchange Commission; files a request to make a prepayment or special prepayment with its applicable securities designated examining authority, as defined in Rule 15c3-1(c)(12) of the Securities and Exchange Commission (17 CFR 240.15c3-1(c)(12)), in the form and manner prescribed by the designated examining authority; files a copy of the prepayment request or special prepayment request with the designated self-regulatory organization at the time it files such request with the designated examining authority in the form and manner prescribed by the designated self-regulatory organization; and files a copy of the designated examining authority's approval of the prepayment or special prepayment with the des-

ignated self-regulatory organization immediately upon receipt of such approval. The approval of the prepayment or special prepayment by the designated examining authority will be deemed approval by the designated self-regulatory organization, unless the designated self-regulatory organization notifies the registrant that the designated examining authority's approval shall not constitute designated self-regulatory organization approval.

(3) The designated self-regulatory organization shall immediately provide the Commission with a copy of any notice of approval issued where the requested prepayment or special prepayment will result in the reduction of the registrant's net capital by 20 percent or more or the registrant's excess adjusted net capital by 30 percent or more.

(viii) *Suspended repayment.* (A) The payment obligation of the applicant or registrant in respect of any subordination agreement shall be suspended and shall not mature if, after giving effect to payment of such payment obligation (and to all payments of payment obligations of the applicant or registrant under any other subordination agreement(s) then outstanding which are scheduled to mature on or before such payment obligation), the adjusted net capital of the applicant or registrant would be less than the greatest of:

(1) 120 percent of the appropriate minimum dollar amount required by paragraphs (a)(1)(i)(A) or (a)(1)(iii)(A) of this section;

(2) For a futures commission merchant or applicant therefor, 120 percent of the amount required by paragraph (a)(1)(i)(B) of this section;

(3) 120 percent of the amount of adjusted net capital required by a registered futures association of which it is a member; or

(4) For an applicant or registrant which is also a securities broker or dealer, the amount of net capital specified in Rule 15c3-1d(b)(8)(i) of the Securities and Exchange Commission (17 CFR 240.15c3-1d(b)(8)(i)): *Provided,* That the subordination agreement may provide that if the payment obligation of the applicant or registrant thereunder does not mature and is suspended as a

result of the requirement of this paragraph (h)(2)(viii) for a period of not less than six months, the applicant or registrant shall then commence the rapid and orderly liquidation of its business, but the right of the lender to receive payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of this section.

(B) [Reserved]

(ix) *Accelerated maturity.* Obligation to repay to remain subordinate:

(A) Subject to the provisions of paragraph (h)(2)(viii) of this section, a subordination agreement may provide that the lender may, upon prior written notice to the applicant and the National Futures Association, or upon prior written notice to the registrant and the designated self-regulatory organization or, if the registrant is not a member of a designated self-regulatory organization, the Commission, given not earlier than six months after the effective date of such subordination agreement, accelerate the date on which the payment obligation of the borrower, together with accrued interest or compensation, is scheduled to mature to a date not earlier than six months after giving of such notice, but the right of the lender to receive payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of this paragraph (h)(2) of this section.

(B) Notwithstanding the provisions of paragraph (h)(2)(viii) of this section, the payment obligation of the applicant or registrant with respect to a subordination agreement, together with accrued interest and compensation, shall mature in the event of any receivership, insolvency, liquidation pursuant to the Securities Investor Protection Act of 1970 or otherwise, bankruptcy, assignment for the benefit of creditors, reorganization whether or not pursuant to the bankruptcy laws, or any other marshalling of the assets and liabilities of the applicant or registrant, but the right of the lender to receive payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of paragraph (h)(2) of this section.

(x) *Accelerated maturity of subordination agreements on event of default and event of acceleration.* Obligation to repay to remain subordinate:

(A) A subordination agreement may provide that the lender may, upon prior written notice to the applicant and the National Futures Association, or upon prior written notice to the registrant and the designated self-regulatory organization or, if the registrant is not a member of a designated self-regulatory organization, the Commission, of the occurrence of any event of acceleration (as hereinafter defined) given no sooner than six months after the effective date of such subordination agreement, accelerate the date on which the payment obligation of the applicant or registrant, together with accrued interest or compensation, is scheduled to mature, to the last business day of a calendar month which is not less than six months after notice of acceleration is received by the applicant and by the National Futures Association, or by the registrant and the designated self-regulatory organization or, if the registrant is not a member of a designated self-regulatory organization, the Commission. Any subordination agreement containing such events of acceleration may also provide that, if upon such accelerated maturity date the payment obligation of the applicant or registrant is suspended as required by paragraph (h)(2)(viii) of this section and liquidation of the applicant or registrant has not commenced on or prior to such accelerated maturity date, notwithstanding paragraph (h)(2)(viii) of this section, the payment obligation of the applicant or registrant with respect to such subordination agreement shall mature on the day immediately following such accelerated maturity date and in any such event the payment obligations of the applicant or registrant with respect to all other subordination agreements then outstanding shall also mature at the same time but the rights of the respective lenders to receive payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of paragraph (h)(2) of this section. Events of acceleration which may be included in a subordination agreement complying

with this paragraph (h)(2)(x) of this section shall be limited to:

(1) Failure to pay interest or any installment of principal on a subordination agreement as scheduled;

(2) Failure to pay when due other money obligations of a specified material amount;

(3) Discovery that any material, specified representation or warranty of the applicant or registrant which is included in the subordination agreement and on which the subordination agreement was based or continued was inaccurate in a material respect at the time made;

(4) Any specified and clearly measurable event which is included in the subordination agreement and which the lender and the applicant or registrant agree, (a) is a significant indication that the financial position of the applicant or registrant has changed materially and adversely from agreed upon specified norms; or (b) could materially and adversely affect the ability of the applicant or registrant to conduct its business as conducted on the date the subordination agreement was made; or (c) is a significant change in the senior management of the applicant or registrant or in the general business conducted by the applicant or registrant from that which obtained on the date the subordination agreement became effective;

(5) Any continued failure to perform agreed covenants included in the subordination agreement relating to the conduct of the business of the applicant or registrant or relating to the maintenance and reporting of its financial position; and

(B) Notwithstanding the provisions of paragraph (h)(2)(viii) of this section, a subordination agreement may provide that, if liquidation of the business of the applicant or registrant has not already commenced, the payment obligation of the applicant or registrant shall mature, together with accrued interest or compensation, upon the occurrence of an event of default (as hereinafter defined). Such agreement may also provide that, if liquidation of the business of the applicant or registrant has not already commenced, the rapid and orderly liquidation of the business of the applicant or registrant shall then com-

mence upon the happening of an event of default. Any subordination agreement which so provides for maturity of the payment obligation upon the occurrence of an event of default shall also provide that the date on which such event of default occurs shall, if liquidation of the applicant or registrant has not already commenced, be the date on which the payment obligation of the applicant or registrant with respect to all other subordination agreements then outstanding shall mature but the rights of the respective lenders to receive payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of paragraph (h)(2) of this section. Events of default which may be included in a subordination agreement shall be limited to:

(1) The making of an application by the Securities Investor Protection Corporation for a decree adjudicating that customers of the applicant or registrant are in need of protection under the Securities Investor Protection Act of 1970 and the failure of the applicant or registrant to obtain the dismissal of such application within 30 days;

(2) Failure to meet the minimum capital requirements of the designated self-regulatory organization, or of the Commission, throughout a period of 15 consecutive business days, commencing on the day the borrower first determines and notifies the designated self-regulatory organization, if any, of which he is a member and the Commission, in the case of a registrant, or the National Futures Association, in the case of an applicant, or commencing on the day any self-regulatory organization, the Commission or the National Futures Association first determines and notifies the applicant or registrant of such fact;

(3) The Commission shall revoke the registration of the applicant or registrant;

(4) The self-regulatory organization shall suspend (and not reinstate within 10 days) or revoke the applicant or registrant's status as a member thereof;

(5) Any receivership, insolvency, liquidation pursuant to the Securities Investor Protection Act of 1970 or otherwise, bankruptcy, assignment for the benefit of creditors, reorganization

whether or not pursuant to bankruptcy laws, or any other marshalling of the assets and liabilities of the applicant or registrant. A subordination agreement which contains any of the provisions permitted by this subparagraph (2)(x) shall not contain the provision otherwise permitted by paragraph (h)(2)(ix)(A) of this section.

(3) *Miscellaneous provisions*—(i) *Prohibited cancellation*. The subordination agreement shall not be subject to cancellation by either party; no payment shall be made with respect thereto and the agreement shall not be terminated, rescinded or modified by mutual consent or otherwise if the effect thereof would be inconsistent with the requirements of paragraph (h) of this section.

(ii) *Notice of maturity or accelerated maturity*. Every applicant or registrant shall immediately notify the National Futures Association, and the registrant shall immediately notify the designated self-regulatory organization, if any, and the Commission if, after giving effect to all payments of payment obligations under subordination agreements then outstanding which are then due or mature within the following six months without reference to any projected profit or loss of the applicant or registrant, its adjusted net capital would be less than:

(A) 120 percent of the appropriate minimum dollar amount required by paragraphs (a)(1)(i)(A) or (a)(1)(iii)(A) of this section;

(B) For a futures commission merchant or applicant therefor, 120 percent of the amount required by paragraph (a)(1)(i)(B) of this section;

(C) 120 percent of the amount of adjusted net capital required by a registered futures association of which it is a member; or

(D) For an applicant or registrant which is also a securities broker or dealer, the amount of net capital specified in Rule 15c3–1d(c)(2) of the Securities and Exchange Commission (17 CFR 240.15c3–1d(c)(2)).

(iii) *Certain legends*. If all the provisions of a satisfactory subordination agreement do not appear in a single instrument, then the debenture or other evidence of indebtedness shall bear on its face an appropriate legend stating that it is issued subject to the provi-

sions of a satisfactory subordination agreement which shall be adequately referred to and incorporated by reference.

(iv) *Legal title to securities*. All securities pledged as collateral to secure a secured demand note must be in bearer form, or registered in the name of the applicant or registrant or the name of its nominee or custodian.

(v) *Temporary subordinations*. To enable an applicant or registrant to participate as an underwriter of securities or undertake other extraordinary activities and remain in compliance with the adjusted net capital requirements of this section, an applicant or registrant shall be permitted, on no more than three occasions in any 12-month period, to enter into a subordination agreement on a temporary basis which has a stated term of no more than 45 days from the date the subordination agreement became effective: *Provided*, That this temporary relief shall not apply to any applicant or registrant if the adjusted net capital of the applicant or registrant is less than the greatest of:

(A) 120 percent of the appropriate minimum dollar amount required by paragraphs (a)(1)(i)(A) or (a)(1)(iii)(A) of this section;

(B) For a futures commission merchant or applicant therefor, 120 percent of the amount required by paragraph (a)(1)(i)(B) of this section;

(C) 120 percent of the amount of adjusted net capital required by a registered futures association of which it is a member;

(D) For an applicant or registrant which is also a securities broker or dealer, the amount of net capital specified in Rule 15c3–1d(c)(5)(i) of the Securities and Exchange Commission (17 CFR 240.15c3–1d(c)(5)(i)); or

(E) The amount of equity capital as defined in paragraph (d) of this section is less than the limits specified in paragraph (d) of this section. Such temporary subordination agreement shall be subject to all the other provisions of this section.

(vi) *Filing*. An applicant shall file a signed copy of any proposed subordination agreement (including nonconforming subordination agreements) with the National Futures Association

Commodity Futures Trading Commission

§ 1.17

at least ten days prior to the proposed effective date of the agreement or at such other time as the National Futures Association for good cause shall accept such filing. A registrant that is not a member of any designated self-regulatory organization shall file two signed copies of any proposed subordination agreement (including nonconforming subordination agreements) with the regional office of the Commission nearest the principal place of business of the registrant at least ten days prior to the proposed effective date of the agreement or at such other time as the Commission for good cause shall accept such filing. A registrant that is a member of a designated self-regulatory organization shall file signed copies of any proposed subordination agreement (including nonconforming subordination agreements) with the designated self-regulatory organization in such quantities and at such time as the designated self-regulatory organization may require prior to the effective date. The applicant or registrant shall also file with said parties a statement setting forth the name and address of the lender, the business relationship of the lender to the applicant or registrant and whether the applicant or registrant carried funds or securities for the lender at or about the time the proposed agreement was so filed. A proposed agreement filed by an applicant with the National Futures Association shall be reviewed by the National Futures Association, and no such agreement shall be a satisfactory subordination agreement for the purposes of this section unless and until the National Futures Association has found the agreement acceptable and such agreement has become effective in the form found acceptable. A proposed agreement filed by a registrant shall be reviewed by the designated self-regulatory organization with whom such an agreement is required to be filed prior to its becoming effective or, if the registrant is not a member of any designated self-regulatory organization, by the regional office of the Commission where the agreement is required to be filed prior to its becoming effective. No proposed agreement shall be a satisfactory subordination agreement for the purposes of this section unless

and until the designated self-regulatory organization or, if a registrant is not a member of any designated self-regulatory organization, the Commission, has found the agreement acceptable and such agreement has become effective in the form found acceptable: Provided, however, That a proposed agreement shall be a satisfactory subordination agreement for purpose of this section if the registrant: is a securities broker or dealer registered with the Securities and Exchange Commission; files signed copies of the proposed subordination agreement with the applicable securities designated examining authority, as defined in Rule 15c3-1(c)(12) of the Securities and Exchange Commission (17 CFR 240.15c3-1(c)(12)), in the form and manner prescribed by the designated examining authority; files signed copies of the proposed subordination agreement with the designated self-regulatory organization at the time it files such copies with the designated examining authority in the form and manner prescribed by the designated self-regulatory organization; and files a copy of the designated examining authority's approval of the proposed subordination agreement with the designated self-regulatory organization immediately upon receipt of such approval. The designated examining authority's determination that the proposed subordination agreement satisfies the requirements for a satisfactory subordination agreement will be deemed a like finding by the designated self-regulatory organization, unless the designated self-regulatory organization notifies the registrant that the designated examining authority's determination shall not constitute a like finding by the designated self-regulatory organization.

(vii) *Subordination agreements that incorporate adjusted net capital requirements in effect prior to September 30, 2004.* Any subordination agreement that incorporates the adjusted net capital requirements in paragraphs (h)(2)(vi)(C)(2), (h)(2)(vii)(A)(2) and (B)(2), (h)(2)(viii)(A)(2), (h)(3)(ii)(B), and (h)(3)(v)(B) of this section, as in effect prior to September 30, 2004, and which has been deemed to be satisfactorily subordinated pursuant to this section

prior to September 30, 2004, shall continue to be deemed a satisfactory subordination agreement until the maturity of such agreement. In the event, however, that such agreement is amended or renewed for any reason, then such agreement shall not be deemed a satisfactory subordination agreement unless the amended or renewed agreement meets the requirements of this section.

(4) A designated self-regulatory organization and the Commission may allow debt with a maturity date of 1 year or more to be treated as meeting the provisions of this paragraph (h): *Provided*, (i) Such exemption shall only be given when the registrant's adjusted net capital is less than the minimum required by this section or by the capital rule of the designated self-regulatory organization to which such registrant is subject;

(ii) That such debt did not exist prior to its use under this paragraph (h)(4);

(iii) Such exemption shall be for a period of 30 days or such lesser period as the designated self-regulatory organization and the Commission may determine;

(iv) Such exemption shall not be allowed more than once in any 12 month period; and

(v) At all times during such exemption the registrant shall make a good faith effort to comply with the provisions of this section or the capital rule of the designated self-regulatory organization to which such registrant is subject exclusive of any benefits derived from this paragraph (h)(4).

(i) [Reserved]

(j) For the purposes of this section *cover* is defined as follows:

(1) *General definition.* Cover shall mean transactions or positions in a contract for future delivery on a board of trade or a commodity option where such transactions or positions normally represent a substitute for transactions to be made or positions to be taken at a later time in a physical marketing channel, and where they are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, and where they arise from:

(i) The potential change in the value of assets which a person owns, pro-

duces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising.

(ii) The potential change in the value of liabilities which a person owes or anticipates incurring, or

(iii) The potential change in the value of services which a person provides, purchases or anticipates providing or purchasing. Notwithstanding the foregoing, no transactions or positions shall be classified as cover for the purposes of this section unless their purpose is to offset price risks incidental to commercial cash or spot operations and such positions are established and liquidated in accordance with sound commercial practices and unless the provisions of paragraphs (j) (2) and (3) of this section have been satisfied.

(2) *Enumerated cover transactions.* The definition of covered transactions and positions in paragraph (j)(1) of this section includes, but is not limited to, the following specific transactions and positions:

(i) Ownership or fixed-price purchase of any commodity which does not exceed in quantity (A) the sales of the same commodity for future delivery on a board of trade or (B) the purchase of a put commodity option of the same commodity for which the market value for the actual commodity or futures contract which is the subject of the option is less than the strike price of the option or (C) the ownership of a commodity option position established by the sale (grant) of a call commodity option of the same commodity for which the market value for the actual commodity or futures contract which is the subject of the option is more than the strike price of the option: *Provided*, That for purposes of paragraph (c)(5)(x) of this section the market value for the actual commodity or futures contract which is the subject of such option need not be more than the strike price of that option;

(ii) Fixed-price sale of any commodity which does not exceed in quantity (A) the purchase of the same commodity for future delivery on a board of trade or (B) the purchase of a call commodity option of the same commodity for which the market value for

the actual commodity or futures contract which is the subject of such option is more than the strike price of the option or (C) ownership of a commodity option position established by the sale (grant) of a put commodity option of the same commodity for which the market value for the actual commodity or futures contract which is the subject of the option is less than the strike price of the option: *Provided*, That for purposes of paragraph (c)(5)(x) of this section the market value for the actual commodity or futures contract which is the subject of such option need not be less than the strike price of that option; and

(iii) Ownership or fixed-price contracts of a commodity described in paragraphs (j)(2)(i) and (j)(2)(ii) of this section may also be covered other than by the same quantity of the same cash commodity, provided that the fluctuations in value of the position for future delivery or commodity option are substantially related to the fluctuations in value of the actual cash position.

(3) *Nonenumerated cases.* Upon specific request, the Commission may recognize transactions and positions other than those enumerated in paragraph (j)(2) of this section as cover in amounts and under the terms and conditions as it may specify. Any applicant or registrant who wishes to avail itself of the provisions of this paragraph (j)(3) must apply to the Commission in writing at its principal office in Washington, DC giving full details of the transaction including detailed information which will demonstrate that the transaction is economically appropriate to the reduction of risk exposure attendant to the conduct and management of a commercial enterprise.

(Approved by the Office of Management and Budget under control number 3038-0024)

[43 FR 39972, Sept. 8, 1978]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.17, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at www.fdsys.gov.

§ 1.18 Records for and relating to financial reporting and monthly computation by futures commission merchants and introducing brokers.

(a) No person shall be registered as a futures commission merchant or as an introducing broker under the Act unless, commencing on the date his application for such registration is filed, he prepares and keeps current ledgers or other similar records which show or summarize, with appropriate references to supporting documents, each transaction affecting his asset, liability, income, expense and capital accounts, and in which (except as otherwise permitted in writing by the Commission) all his asset, liability and capital accounts are classified into either the account classification subdivisions specified on Form 1-FR-FCM or Form 1-FR-IB, respectively, or, if such person is registered with the Securities and Exchange Commission as a securities broker or dealer and he files (in accordance with § 1.10(h)) a copy of his Financial and Operational Combined Uniform Single Report under the Securities Exchange Act of 1934, Part II, Part IIA, or Part II CSE (FOCUS report) in lieu of Form 1-FR-FCM or Form 1-FR-IB, the account classification subdivisions specified on such FOCUS report, or categories that are in accord with generally accepted accounting principles. Each person so registered shall prepare and keep current such records.

(b)(1) Each applicant or registrant must make and keep as a record in accordance with § 1.31 formal computations of its adjusted net capital and of its minimum financial requirements pursuant to § 1.17 or the requirements of the designated self-regulatory organization to which it is subject as of the close of business each month. Such computations must be completed and made available for inspection by any representative of the National Futures Association, in the case of an applicant, or of the Commission or designated self-regulatory organization, if any, in the case of a registrant, within 17 business days after the date for which the computations are made, commencing the first month end after the date the application for registration is filed.