# CFTC Letter No. 00-79

**June 30, 2000**

**No-Action**

**Division of Trading & Markets**

Re: Request for Relief from Commission Regulation 1.17(c)(5)(x) -- Capital Charge on Proprietary Futures and Option Positions

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Dear:

This is in response to letters and electronic mail messages dated April 3 through June 8, 2000, to the Division of Trading and Markets ("Division") of the Commodity Futures Trading Commission ("Commission"). By this correspondence, as supplemented by telephone conversations with Division staff, you request, on behalf of "X", that the Division not recommend that the Commission commence any enforcement action against "X" for failure to comply with Section 4f(b) of the Commodity Exchange Act ("Act") and Commission Regulation 1.17(c)(5)(x) if "X", in computing its adjusted net capital, does not take full capital charges on open futures positions associated with its market making activities in the Goldman Sachs Commodity Index ("GSCI") futures contract.[1]

Based upon your representations, we understand the facts to be as follows. "X", a registered futures commission merchant ("FCM") and commodity trading advisor, is a clearing member of the Chicago Mercantile Exchange ("CME"). "X" engages in market making activities in the GSCI futures contract, which trades on the CME. The GSCI is an index developed by Goldman Sachs & Co that tracks the performance of a "basket" of 26 commodity futures contracts traded on nine exchanges worldwide.[2]

The primary long participants in the GSCI contract are large pension funds and other professionally managed pools of capital (hereinafter "Institutional Traders"), which hold the GSCI contract as a diversification to their existing stock and bond portfolios. "X" estimates that 95 percent of the open interest of the GSCI futures contract represents this type of long-term, professional position.

"X" and two other CME member firms generally hold the majority of the short open interest. These three firms act as market makers by facilitating the trading activities of the Institutional Traders.

"X" manages the risk associated with its short position by hedging each GSCI futures contract with long positions in the 26 futures contracts comprising the GSCI. Because each GSCI futures contract is hedged by a "basket" of underlying futures contracts, the daily change in value of each GSCI futures contract relative to the underlying "basket" of futures contracts is minimal. In this regard, "X" represents that the gross account value fluctuation (on a per unit basis) for "X's" GSCI futures position is generally under $100 per day. In the few instances in which the daily valuation fluctuation exceeds $100, these changes are temporary and generally represent timing differences in the settlements of certain of the 26 underlying commodity futures contracts. These settlement differences are generally caused by divergent holiday closures between U.S. and foreign exchanges.

Commission Regulation 1.17 sets forth minimum capital requirements for FCMs. Regulation 1.17(c)(5)(x) requires an FCM, in computing its adjusted net capital, to take a capital charge on all open proprietary futures and short option positions carried by the FCM that are not "covered" by positions held by the FCM.[3] The capital charge for an FCM that is a clearing member of the clearing organization that clears the positions is the applicable margin requirement of such clearing organization. For an FCM that is a member of a self-regulatory organization, but not a clearing member of the exchange that lists the futures contract, the capital charge is equal to 150 percent of the maintenance margin requirement of the applicable exchange, or clearing organization, whichever is greater.

For purposes of establishing original and maintenance margin for the GSCI futures contract, the CME credits customers or members that hedge their GSCI contracts with appropriate "baskets" of underlying futures contracts.[4] The lower margin reflects the CME's assessment of the reduced market risk of the fully hedged GSCI futures contracts. Since "X" hedges each GSCI futures contract with an appropriate "basket", it is currently permitted to post reduced margin with the CME and to take a correspondingly reduced capital charge for each GSCI futures contract.

The exchanges that list the futures contracts comprising the GSCI, however, do not provide margin relief for contracts hedging a GSCI position. Accordingly, "X" is required to pay full margins on these exchanges and does not receive a reduction in the capital charge under Regulation 1.17(c)(5)(x).

In light of the foregoing, the Division will not recommend that the Commission initiate an enforcement action against "X" based solely upon Section 4f(b) of the Act and/or Commission Regulation 1.17(c)(5)(x) if, in computing its adjusted net capital, "X" takes a capital charge on each "basket" of futures contracts hedging open positions in the GSCI futures contract equal to the speculative initial margin requirement set by the CME for GSCI futures contracts that are appropriately hedged by the underlying futures contracts. "X" further represents that it will not reduce the capital charge if the "basket" is deemed, for any reason, to be ineligible for favorable margin treatment by the CME.

Because this position is based upon facts and representations contained in your letter and subsequent conversations with Division staff, it should be noted that any different, omitted or changed facts or conditions might require a different conclusion. This letter represents the views of the Division only and does not necessarily represent the views of the Commission or any other office or division of the Commission. If you have any questions concerning this correspondence, please contact Thomas J. Smith, Special Counsel, at (202) 418-5495.

Very truly yours,

John C. Lawton
Acting Director

cc: Barbara Lorenzen, Chairman, Joint Audit Committee

1 The Act may be found at 7 U.S.C. §1 *et seq.* (1994). Commission regulations cited herein may be found at 17 C.F.R. Ch. 1. (2000).

2 The futures contracts comprising the GSCI are listed on the Chicago Board of Trade (wheat, corn, and soybeans); CME (lean hogs and live cattle); Coffee, Sugar & Cocoa Exchange (coffee, sugar, and cocoa); Commodity Exchange Inc. (gold and silver); International Petroleum Exchange (Brent crude and gasoil); Kansas City Board of Trade (hard red winter wheat); London Metals Exchange (aluminum, copper, lead, nickel, zinc, and tin); New York Cotton Exchange (cotton and frozen concentrate orange juice); and New York Mercantile Exchange (crude oil, heating oil, unleaded gasoline, natural gas, and platinum).

3 "Cover" is generally defined as transactions or positions in a contract for future delivery on a board of trade or 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. *See* Regulation 1.17(j).

4 The CME requires that all positions in the GSCI "basket" must be carried in a single account in order to obtain the reduced margin requirement. "X's" "baskets" are carried by one FCM, which confirms to the CME that "X's" account holds the required number of contracts in each commodity.