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Supervised Investment Bank Holding Companies; Proposed Rules

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

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Supervised Investment Bank Holding Companies

AGENCY: Securities and Exchange Commission (the ''Commission'').

ACTION: Proposed rule.

SUMMARY: The Commission is proposing rules to implement Section 17(i) of the Securities Exchange Act of 1934, which created a new framework for supervising an investment bank holding company (''IBHC''). An IBHC that meets certain, specified criteria may voluntarily file a notice of intention with the Commission to become a supervised investment bank holding company (''SIBHC'') and be subject to supervision on a group-wide basis. Pursuant to the statute and proposed rules, an IBHC would be eligible to be an SIBHC if it is not affiliated with certain types of banks and has a substantial presence in the securities markets. The proposed rules would provide an IBHC with a process to become supervised by the Commission as an SIBHC, and would establish regulatory requirements for an SIBHC, including requirements regarding its group-wide internal risk management control system, recordkeeping, and periodic reporting (including reporting of consolidated computations of allowable capital and risk allowances consistent with the Basel Standards). The Commission is also proposing to add an exemption to the Commission's risk assessment rules to exempt a broker-dealer that is affiliated with an SIBHC because the SIBHC will be maintaining records and reporting to the Commission regarding the financial and operational condition of members of the affiliate group. Finally, the Commission is proposing to adjust the audit requirements for OTC derivative dealers to allow accountants to use agreed-upon procedures when conducting audits of risk management control systems.

DATES: Comments must be received on or before February 4, 2004.

ADDRESSES: To help us process and review your comments more efficiently, comments should be sent by hard copy or by email, but not by both methods. Comment letters sent by hard copy should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Alternatively, comment letters sent electronically should be submitted to the following electronic-mail address: *rule-comments@sec.gov.* All comment letters should refer to File No. S7–22–03. This file number should be included in the subject line if you use electronic mail. We will make all comment letters available for public inspection and copying in our public reference room at the above address. We will post electronically submitted comment letters on the Commission's Internet Web site (*http://www.sec.gov*).[1]

FOR FURTHER INFORMATION CONTACT: With respect to general questions, contact Catherine McGuire, Chief Counsel, Lourdes Gonzalez, Assistant Chief Counsel, or Linda Stamp Sundberg, Attorney Fellow, at (202) 942–0073, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–1001.

With respect to calculations of allowable capital and risk allowances, internal risk management control systems, and books and records and reporting requirements, contact Michael A. Macchiaroli, Associate Director, at (202) 942–0132, Thomas K. McGowan, Assistant Director, at (202) 942–4886, Rose Russo Wells, Attorney, at (202) 942–0143, Bonnie L. Gauch, Attorney, at (202) 942–0765, or David Lynch, Financial Economist, at (202) 942–0059, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–1001.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission is publishing for comment proposed amendments to Rule 17a–12 [17 CFR 240.17a–12] and Rules 17h–1T and 17h–2T [17 CFR 240.17h–1T and 240.17h–2T], and proposed new Rules 17i–1 through 17i–8 [17 CFR 240.17i–1 through 240.17i–8] under the Exchange Act [15 U.S.C. 78a *et seq.*]

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[1] We do not edit personal identifying information, such as names or electronic-mail addresses, from electronic submissions. You should submit only information that you wish to make publicly available.

I. Introduction

Section 231 of the Gramm-Leach-Bliley Act of 1999 [2] (the ''GLBA'') amended Section 17 of the Securities Exchange Act of 1934 (the ''Exchange Act'' or the ''Act'') to create a regulatory framework under which a holding company of a broker-dealer may voluntarily be supervised by the Commission as an SIBHC. The rules we are proposing today would create a framework for the Commission to supervise SIBHCs. These rules also would enhance the Commission's supervision of the SIBHC's subsidiary broker-dealers through collection of additional information and examinations of affiliates of those broker-dealers. This framework would include qualification criteria for IBHCs that file notices of intention to be supervised by the Commission, as well as recordkeeping and reporting requirements for SIBHCs. An IBHC that meets the criteria set forth in the proposed rules would not be required to become an SIBHC; supervision as an SIBHC is voluntary. Taken as a whole, the proposed framework would permit the Commission to better monitor the financial condition, risk management, and activities of a broker-dealer's parent and affiliates on a group-wide basis. In particular, it would create a formal process through which the Commission could access important information regarding activities of a broker-dealer's affiliates that could impair the financial and operational stability of the broker-dealer or the SIBHC.

In addition, securities firms that do business in the European Union (''EU'') have indicated that they may need to demonstrate that they have consolidated supervision at the holding company level that is ''equivalent'' to EU consolidated supervision.[3] Generally, EU ''consolidated supervision'' would take the form of a series of rules, imposed at the holding company level, regarding firms' internal controls, capital adequacy, intra-group transactions, and risk concentration. Without a demonstration of ''equivalent'' supervision, securities firms located in the EU have stated that they may either be subject to additional capital charges or required to form a sub-holding company in the EU.

Congress addressed these concerns by enacting Section 17(i) of the Exchange Act,[4] which authorizes an IBHC to voluntarily elect to be supervised by the Commission as an SIBHC.[5] Pursuant to Section 17(i)(1)(A) of the Exchange Act, an IBHC that is not: (i) An affiliate of an insured bank (with certain exceptions) or a savings association;[6] (ii) a foreign bank, foreign company, foreign bank branch agency, or a state-chartered commercial lending company;[7] or (iii) a foreign bank that controls an Edge Act Corporation [8] may elect to become an SIBHC.[9]

This regulatory framework for SIBHCs is intended to provide a basis for non-U.S. financial regulators to treat the Commission as the principal U.S. consolidated, home-country supervisor [10] for SIBHCs and their affiliated broker-dealers. This would minimize duplicative regulatory burdens on broker-dealers that are active in the EU and in other jurisdictions that may have similar laws.

Under Section 17(i) of the Exchange Act, the Commission may adopt rules regarding, among other things: (i) The form of an IBHC's notice of intention to become an SIBHC and the information and documents to be included with that notice;[11] and (ii) creation and maintenance of records and reports, and submission of those reports to the Commission.[12] Further, Section 17(i)(3)(C) of the Exchange Act authorizes the Commission to examine an SIBHC (including any affiliate) in order to (i) inform the Commission regarding the nature of the operations and financial condition of the SIBHC and its affiliates, the financial and operational risks within the SIBHC that may affect any broker-dealer controlled by the SIBHC, and the systems of the SIBHC and its affiliates for monitoring and controlling those risks; and (ii) monitor compliance with the provisions of Section 17(i) of the Exchange Act.[13] Section 17(i)(3)(C) also provides that the Commission may examine the SIBHC and any affiliate to monitor compliance with the provisions of Exchange Act Section 17(i), provisions governing transactions and relationships between any broker-dealer affiliated with the SIBHC and any of the company's other affiliates, as well as applicable provisions of the Bank Secrecy Act [31 U.S.C. 53, subchapter II].[14] While Section 17(i) of the Exchange Act authorizes the Commission to inspect any affiliate of an SIBHC, it also limits the focus and scope of any examination to the SIBHC and any affiliate of the SIBHC that, because of its size, condition, or activities, the nature or size of the transactions between such affiliate and any affiliated broker-dealer, or the centralization of functions within the holding company system, could, in the discretion of the Commission, have a materially adverse effect on the operational or financial condition of the broker-dealer.[15]

The rules proposed under Section 17(i) are not intended to duplicate regulation of banks, insurance companies, or futures commission merchants by other regulatory agencies. Section 17(i) of the Exchange Act directs the Commission to: (i) Accept, to the fullest extent possible, reports that an SIBHC or an affiliate thereof may have been required to provide to another appropriate regulatory agency or self-regulatory organization;[16] (ii) use, to the fullest extent possible, reports of examination made by the appropriate regulatory agency or state insurance regulator;[17] and (iii) defer to the appropriate regulatory agency or state insurance regulator with regard to interpretation and enforcement of banking or insurance regulations.[18]

II. Description of the Proposed Rules

A. Proposed Rule 17i–1: Definitions

Proposed Rule 17i–1 would incorporate the definitions set forth in Section 17(i)(5) of the Exchange Act [19] into the rules promulgated under Section 17(i). Although these definitions apply regardless of whether they are incorporated into these rules, incorporating them lets individuals reading the proposed rules know that the terms are defined, and directs them to those definitions. In addition, the proposed rule includes definitions of the terms ''affiliate group'' and ''material affiliate,'' which are used

[2] Pub. L. 106–102, 113 Stat. 1338 (1999).

[3] *See* ''Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002.''

[4] *See* H.R. Conf. Rep. No. 106–434, 165 (1999).

[5] Exchange Act Section 17(i) [15 U.S.C. 78q(i)].

[6] Exchange Act Section 17(i)(1)(A)(i) [15 U.S.C. 78q(i)(1)(A)(i)].

[7] Exchange Act Section 17(i)(1)(A)(ii) (State-chartered commercial lending companies described in Section 8(a) of the International Banking Act of 1978 [12 U.S.C. 3106(a)]) [15 U.S.C. 78q(i)(1)(A)(ii)].

[8] Exchange Act Section 17(i)(1)(A)(iii) (12 U.S.C. 611 (''Federal Reserve Act''), and Section 25A thereunder [12 U.S.C. 611]) [15 U.S.C. 78q(i)(1)(A)(iii)].

[9] Exchange Act Section 17(i)(1)(A) [15 U.S.C. 78q(i)(1)(A)].

[10] *See supra* note 4.

[11] Exchange Act Section 17(i)(1)(B) [15 U.S.C. 78q(i)(1)(B)].

[12] Exchange Act Section 17(i)(3)(A) [15 U.S.C. 78q(i)(3)(A)].

[13] 15 U.S.C. 78q(i)(3)(C).

[14] Exchange Act Section 17(i)(3)(C)(i) [15 U.S.C. 78q(i)(3)(C)(i)].

[15] Exchange Act Section 17(i)(3)(C)(ii) [15 U.S.C. 78q(i)(3)(C)(ii)].

[16] Exchange Act Section 17(i)(3)(B)(i) [15 U.S.C. 78q(i)(3)(B)(i)].

[17] Exchange Act Section 17(i)(3)(C)(iii) [15 U.S.C. 78q(i)(3)(C)(iii)].

[18] Exchange Act Section 17(i)(4) [15 U.S.C. 78q(i)(4)].

[19] 15 U.S.C. 78q(i)(5).

throughout proposed Rules 17i–1 through 17i–8.

Pursuant to the definitions in the Act, the term ''investment bank holding company'' means any person, other than a natural person, that owns or controls one or more broker-dealers and the associated persons of the investment bank holding company.[20] The term ''associated person of an investment bank holding company'' means any person directly or indirectly controlling, controlled by, or under common control with the IBHC.[21] Thus, an IBHC includes the holding company and all other entities within the holding company structure that meet the ''control'' test. A ''supervised investment bank holding company'' is any IBHC that is supervised by the Commission pursuant to Section 17(i) of the Exchange Act.[22]

Sections 17(i)(5)(C), (D), and (E) of the Exchange Act state that, for purposes of Section 17(i) of the Exchange Act, the terms ''affiliate,'' [23] ''bank,'' [24] ''bank holding company,'' [25] ''company,'' [26] ''control,'' [27] and ''savings association'' [28] have the same meaning as given in Section 2 of the Bank Holding Company Act of 1956 [29] (the ''Bank Holding Company Act''); the term ''insured bank'' has the same meaning as given in Section 3 of the Federal Deposit Insurance Act; [30] and the term ''foreign bank'' has the same meaning as given in Section 1(b)(7) of the International Banking Act.[31]

Proposed Rule 17i–1 also includes definitions of the terms ''affiliate group'' and ''material affiliate.'' The term ''affiliate group'' is defined to include the SIBHC and every affiliate of the SIBHC because we believe that we would need to obtain information related to all affiliates to provide effective supervision of an SIBHC. We define the term ''material affiliate'' to include any member of the affiliate group that is material to the SIBHC because, based on the Commission's experience in reviewing holding company documentation, receiving information specific to affiliates material to a holding company provides us with a better understanding of the holding company, including how risk is managed on a consolidated level.

We request comment on whether the proposed definitions of affiliate group and material affiliate are appropriate, whether it would be helpful to reproduce the statutory definitions within the rules, and whether any additional terms need to be defined in these rules.

B. Proposed Rule 17i–2: Notice of Intention To Be Supervised by the Commission as an SIBHC

Section 17(i)(1)(B) of the Exchange Act states that in order to elect to become an SIBHC, an IBHC must file with the Commission a written notice of intention to become supervised by the Commission in such form and containing such information and documents concerning the IBHC as the Commission, by rule, may prescribe as necessary and appropriate in furtherance of the purposes of Section 17 of the Act (a ''Notice of Intention'').[32] Proposed Rule 17i–2 would provide the method by which an IBHC could elect to become an SIBHC. In addition, consistent with Section 17(i)(1)(B) of the Exchange Act, proposed Rule 17i–2 indicates that the IBHC will automatically become an SIBHC 45 days after the Commission receives its completed Notice of Intention unless the Commission issues an order indicating either that it will begin its supervision sooner or that it does not believe it to be necessary or appropriate in furtherance of Section 17 of the Act for the IBHC to be so supervised. Finally, proposed Rule 17i–2 sets forth the criteria the Commission would use to make this determination.[33]

If an IBHC becomes an SIBHC, supervision of its affiliated broker-dealer and related associated persons generally would not be affected, except that a broker-dealer affiliated with an SIBHC would be exempted from the requirements of Rules 17h–1T and 17h–2T.

1. Election Criteria

Section 17(i)(1)(A) of the Exchange Act sets forth certain limitations on whether an IBHC is eligible to become an SIBHC.[34] Specifically, an IBHC that is not (i) an affiliate of an insured bank (with certain exceptions) or a savings association; [35] (ii) a foreign bank, foreign company, or a company that is described in section 8(a) of the International Banking Act of 1978; [36] or (iii) a foreign bank that controls, directly or indirectly, a corporation chartered under section 25A of the Federal Reserve Act [37] would be eligible to file a Notice of Intention. Paragraph (a) of proposed Rule 17i–2 would incorporate these statutory exclusions.

2. Notice of Intention To Become an SIBHC

Proposed Rule 17i–2(b) would require that an IBHC that elects to become an SIBHC file a written Notice of Intention with the Commission that includes (i) a request to become an SIBHC; (ii) a statement certifying that it is not affiliated with an entity listed in Section 17(i)(1)(A) of the Exchange Act; [38] (iii) documentation demonstrating that it owns or controls at least one broker-dealer that maintains a substantial presence in the securities business as evidenced either by its holding tentative net capital of $100 million or more or otherwise; and (iv) other supplemental documents described below.

To assist the Commission in evaluating the IBHC's activities, financial condition, risk management control systems, and the relationships among its associated persons in order to determine whether Commission supervision of the IBHC is necessary and appropriate in furtherance of the purposes of Section 17 of the Exchange Act, an IBHC also would be required to file the following supplemental documents with its Notice of Intention pursuant to proposed Rule 17i–2:

- A narrative describing the business and organization of the IBHC;
- An alphabetical list of the members of the affiliate group, a designation of those affiliates it considers to be ''material affiliates'' and the financial regulator(s), if any, with which the affiliate is registered;
- An organizational chart identifying the IBHC and its material affiliates;
- Consolidated and consolidating financial statements;
- Certain sample calculations of allowable capital and allowances for market, credit, and operational risk or

[20] Exchange Act Section 17(i)(5)(A) [15 U.S.C. 78q(i)(5)(A)].

[21] Exchange Act Section 17(i)(5)(F) [15 U.S.C. 78q(i)(5)(F)].

[22] 15 U.S.C. 78q(i)(5)(B).

[23] Bank Holding Company Act Section 2(k) [12 U.S.C. 1841(k)].

[24] Bank Holding Company Act Section 2(c) [12 U.S.C. 1841(c)].

[25] Bank Holding Company Act Section 2(a) [12 U.S.C. 1841(a)].

[26] Bank Holding Company Act Section 2(b) [12 U.S.C. 1841(b)].

[27] Bank Holding Company Act Section 2(a)(2) *et seq*. [12 U.S.C. 1841(a)(2) *et seq*].

[28] Bank Holding Company Act Section 2(j) [12 U.S.C. 1841(j)].

[29] 12 U.S.C. 1841.

[30] 12 U.S.C. 1813(h).

[31] 12 U.S.C. 3101(7).

[32] Exchange Act Section 17(i)(1)(B) [15 U.S.C. 78q(i)(1)(B)].

[33] *Id.*

[34] Exchange Act Section 17(i)(1)(A) [15 U.S.C. 78q(i)(1)(A)].

[35] Exchange Act Section 17(i)(1)(A)(i) [15 U.S.C. 78q(i)(1)(A)(i)].

[36] Exchange Act Section 17(i)(1)(A)(ii) [15 U.S.C. 78q(i)(1)(A)(ii)].

[37] *See* Exchange Act Section 17(i)(1)(A)(iii) (Federal Reserve Act § 25A [12 U.S.C. 611]) [15 U.S.C. 78q(i)(1)(A)(iii)].

[38] 15 U.S.C. 78q(i)(1)(A).

alternative capital assessments made in accordance with proposed Rule 17i–7;

- A list of the positions held by the affiliate group in its proprietary accounts and the methods the IBHC intends to use for computing allowances for market risk and credit risk on those positions;
- A detailed description of the mathematical models the IBHC intends to use to calculate market and credit risk;
- A description of how the IBHC proposes to calculate current exposure;
- A description of how the IBHC proposes to determine credit risk weights;
- A description of the method the IBHC proposes to use to calculate its allowance for operational risk;
- A description of the internal risk management control system established by the IBHC to manage the risks of the affiliate group and how that system satisfies the requirements of proposed Rule 17i–4;
- Sample risk reports that the holding company provides to the persons responsible for managing the risks of the affiliate group; and
- An undertaking providing that the SIBHC will cooperate with the Commission as necessary if the disclosure of any information with regard to Rules 17i–1 through 17i–8 would be prohibited by law or otherwise and that the SIBHC will obtain, for any non-U.S. affiliate, consent to the jurisdiction of the Commission and an agreement to maintain a U.S. registered agent.

Because each firm manages its internal risks differently, the Commission, in its review of the Notice of Intention, would use the information and documents provided with the Notice of Intention to assess each firm's business, financial condition, and internal risk management control systems. We have successfully used similar information in the past to evaluate and monitor risks to broker-dealers. In addition to the information and documentation described in the proposed rules, the IBHC would be required to furnish such other information and documents, including documents relating to its financial position, internal controls, and mathematical models, as the Commission may request to complete its review of the Notice of Intention. A Notice of Intention would not be complete until the IBHC has provided to the Commission all the information and documentation specified in the Rule and requested by the Commission.

Further, depending on the relationship or the geographic location of the SIBHC and its affiliates, the Commission could require that an SIBHC obtain additional agreements that may be necessary for the Commission to adequately assess any risks that affiliate may pose to the SIBHC and its subsidiary broker-dealers. For example, the Commission may have a greater concern regarding access to information if a broker-dealer's affiliate operates in a jurisdiction that limits the exchange of information through bank secrecy laws or other impediments. Paragraph (b)(xiv) of proposed Rule 17i–2 would address this issue by requiring that an SIBHC provide the Commission with an undertaking indicating that it agrees to cooperate with the Commission as needed, including by describing any secrecy laws or other impediments that could restrict the ability of the SIBHC to provide information on the operations or activities of the SIBHC. If any material impediments exist, we would require the SIBHC to describe the manner in which it proposes to provide the Commission with adequate assurances of access to information.

Pursuant to paragraph (c) of proposed Rule 17i–2, IBHCs and SIBHCs would have a continuing requirement to amend their Notices of Intention. If any of the information or documentation filed with the Commission as part of the Notice of Intention is found to be or becomes inaccurate prior to a Commission determination, the IBHC would be required to notify the Commission and provide the Commission with a description of the circumstances in which the information or documentation was found to be or became inaccurate along with updated, accurate information and documents. Whereas after a Commission determination, if an SIBHC materially changes a mathematical model or other method used to compute allowable capital or allowance for market, credit, or operational risk, or its internal risk management control systems as described in its Notice of Intention, prior to making the changes the SIBHC would be required to file an amended Notice of Intention describing the changes.

We request comment as to whether the information and documents required to be included in the Notice of Intention pursuant to paragraph (b) of proposed Rule 17i–2 are appropriate, or whether the Commission should receive other financial, operational, or other types of information. If so, please indicate what additional information or documentation the Commission should require, and how the additional information and documents may assist the Commission in evaluating the financial and operational position of an IBHC.

3. Process for Review of Notice of Intention

Pursuant to paragraph (d)(2) of proposed Rule 17i–2, an IBHC would become an SIBHC subject to Commission supervision pursuant to Section 17(i) of the Exchange Act 45 calendar days after the Commission receives a completed Notice of Intention,[39] unless the Commission issues an order determining either that (i) the Commission will begin to supervise the IBHC as an SIBHC prior to 45 calendar days after the Commission received the completed Notice of Intention to become supervised; or (ii) the Commission will not supervise the IBHC because supervision of the entity as an SIBHC is not necessary or appropriate in furtherance of the purposes of Section 17 of the Exchange Act.[40]

The Commission may begin supervising the IBHC as an SIBHC ''[u]nless the Commission finds that such supervision is not necessary or appropriate in furtherance of the purposes'' of Section 17.[41] The purposes of Section 17 are quite broad. Section 17 generally permits the Commission to carry out its regulatory oversight responsibilities regarding broker-dealers by establishing rules related to recordkeeping, reporting, and examination. In addition, Section 17(h) provides the Commission authority to require that a broker-dealer obtain information and make and keep such records and reports regarding the broker-dealer's affiliates and the financial and securities activities, capital and funding of certain of those affiliates[42] as the Commission prescribes to assess the financial and operational risks to a broker-dealer from those affiliates.

We believe that, consistent with the purposes of Section 17, the Commission's supervision of an IBHC as an SIBHC may be necessary and appropriate only when the IBHC is affiliated with a broker-dealer that has a

[39] Pursuant to paragraph (d)(1) of proposed Rule 17i–2, a Notice of Intention to be supervised by the Commission as an SIBHC would not be complete until the IBHC had filed all the documentation and information required pursuant to paragraphs (a) through (c) of that proposed Rule with the Commission.

[40] Exchange Act § 17(i)(1)(B) [15 U.S.C. 78q(i)(1)(B)].

[41] 15 U.S.C. 17(i)(1)(B).

[42] Those affiliates would include affiliates whose business activities are reasonably likely to have a ''material impact'' on the financial or operational condition of the broker-dealer.

''substantial presence'' in the securities business.[43] Supervision of an SIBHC that owns or controls a broker-dealer with a substantial presence in the securities business would permit the Commission to be better informed regarding the financial and operational conditions of broker-dealers and their holding companies whose failure could have a materially adverse impact on other securities market participants, thus reducing systemic risk and furthering the purposes of Section 17. Evidence that an IBHC owns or controls a broker-dealer that maintains $100 million in tentative net capital would be sufficient to demonstrate a substantial presence in the securities business.

Paragraph (d)(1) of proposed Rule 17i–2 states that all Notices of Intention, amendments, and other documentation and information filed pursuant to proposed Rule 17i–2 will be accorded confidential treatment. We believe it is important to accord confidential treatment to the information and documents an SIBHC would be required provide to the Commission as part of its Notice of Intention because the information and documents would generally be highly sensitive, non-public business information.

The Commission seeks comment on the requirement that an SIBHC own or control a broker-dealer that has a substantial presence in the securities business. In addition, we request comment as to whether maintenance by a broker-dealer of a specified dollar amount of tentative net capital (*e.g.,* $100 million) is an appropriate method to demonstrate whether a broker-dealer has a substantial presence in the securities business. If so, is $100 million in tentative net capital appropriate, or should the dollar amount be higher or lower?

C. Proposed Rule 17i–3: Withdrawal From Supervision as an SIBHC

Proposed Rule 17i–3 would permit an SIBHC to withdraw from Commission supervision by filing a notice of withdrawal with the Commission. Pursuant to the proposed Rule, a notice of withdrawal from supervision would take effect one year after it is filed with the Commission (or a shorter or longer period that the Commission deems necessary or appropriate to ensure effective supervision of the material risks to the SIBHC and any affiliated broker-dealer or to prevent evasion of the purposes of Section 17 of the Exchange Act).[44] The proposed Rule would also require that an SIBHC include in its notice of withdrawal a statement that it is in compliance with proposed Rule 17i–2(c) regarding amendments to its Notice of Intention to help to assure that the Commission has updated information when considering the SIBHC's withdrawal request.

Paragraph (c) of proposed Rule 17i–3 states that the Commission may discontinue supervising an SIBHC if the Commission finds that the SIBHC no longer exists or is no longer an IBHC, or that continued supervision of the SIBHC is not necessary or appropriate in furtherance of the purposes of Section 17. Among other things, if an SIBHC makes a material amendment to a mathematical model, its internal risk management control systems, or its corporate structure as described in its Notice of Intention (and as modified from time to time), the Commission would review whether the change would cause continued supervision of the SIBHC to no longer be necessary or appropriate in furtherance of the purposes of Section 17 of the Act.

In order to determine whether continued supervision of an SIBHC is necessary or appropriate in furtherance of the purposes of Section 17 of the Act, the Commission would consider the same criteria it initially considered to determine whether an IBHC will be supervised by the Commission as an SIBHC.

We request comment on all aspects of the withdrawal provisions included in proposed Rule 17i–3. Specifically, we request comment on whether the information the Commission intends to use to determine whether continued supervision of an SIBHC is necessary or appropriate in furtherance of the purposes of Section 17 of the Act is appropriate, and whether the Commission should consider any additional factors. In addition, we request comment as to whether the time frames for withdrawal included in the proposed Rule are appropriate, or whether they should be longer or shorter. If the time periods should be longer or shorter, under what circumstances?

D. Proposed Rule 17i–4: Internal Risk Management Control System Requirements for SIBHCs

Participants in the securities markets are exposed to various risks, including (i) market risk;[45] (ii) credit risk;[46] (iii) operational risk;[47] (iv) funding risk;[48] and (v) legal risk.[49] Large broker-dealers and IBHCs generally are more exposed to high levels of these types of risk due, in part, to their intricate corporate structures, the complexity of business activities in which they engage, and the diverse range of financial instruments they trade. Due to the level of risk exposures created by these types of business activities and products, it is important for firms to implement robust risk management control systems. A firm that has adopted and follows appropriate risk management controls reduces its risk of significant loss, which also reduces the risk that those losses will be spread to other market participants or throughout the financial markets as a whole.[50]

The specific elements of a risk management control system will vary depending on the size, complexity, and organization of a firm. Accordingly, the design and implementation of a system of internal controls for a particular firm or affiliate group may differ from other firms. An individual firm must have the flexibility to implement specific policies and procedures unique to its circumstances. However, as we have found before, well-developed risk management systems generally share certain core principles such as establishing clear responsibilities at each level of management, separation of certain key responsibilities, and effective monitoring and reporting.

Proposed Rule 17i–4 would require an SIBHC to establish, document and maintain a system of internal risk management controls to assist it in

[43] As set forth in paragraph (d)(2)(i)(B) of proposed Rule 17i–2.

[44] *See* paragraph (b) of proposed Rule 17i–3.

[45] Market risk involves the risk that prices or rates will adversely change due to economic forces. Such risks include adverse effects of movements in equity and interest rate markets, currency exchange rates, and commodity prices. Market risk can also include the risks associated with the cost of borrowing securities, dividend risk, and correlation risk.

[46] Credit risk comprises risk of loss resulting from counterparty default on loans, swaps, options, and during settlement.

[47] Operational risk encompasses the risk of loss due to the breakdown of controls within the firm including, but not limited to, unidentified limit excesses, unauthorized trading, fraud in trading or in back office functions, inexperienced personnel, and unstable and easily accessed computer systems.

[48] Funding risk includes the risk that a firm will not be able to raise sufficient cash to meet all its obligations that are due, which may occur even if the firm has positive net worth if some assets are not readily marketable.

[49] Legal risk arises from possible risk of loss due to an unenforceable contract or an *ultra vires* act of a counterparty.

[50] This is commonly referred to as systemic risk. Systemic risk includes the risk that the failure of one firm or within one market segment would trigger failures in other market segments or throughout the financial markets as a whole.

managing the risks associated with its business activities, including market, credit, operational, funding, and legal risks.

Proposed Rule 17i–4 would require an SIBHC to comply with present Exchange Act Rule 15c3–4 as though it were a broker-dealer.[51] Currently, Rule 15c3–4 applies to over-the-counter derivatives dealers [52] (''OTC derivatives dealers''). Based on the Commission's experience with OTC derivatives dealers, we believe this rule would require an SIBHC to develop strong internal controls that would reduce risk at the SIBHC and would require an SIBHC to adequately document those controls so the controls can be examined.

Paragraph (b) of proposed Rule 17i–4 would require that an SIBHC establish, document, and maintain procedures for the detection and prevention of money laundering and terrorist financing as part of its internal risk management control system. These procedures should include appropriate safeguards at the holding company level to prevent money laundering through affiliates.[53] This proposed requirement would allow us to adequately inspect members of the affiliate group as required by the statute.[54] We request comment on all aspects of the internal risk management control system requirements included in proposed Rule 17i–4. We also request comment on whether Rule 17i–4 should incorporate Rule 15c3–4 or should be fashioned as a stand-alone rule. In addition, we request comment as to whether any aspect of Rule 15c3–4 could be better tailored to reflect unique aspects of group risk management practices (as opposed to internal firm risk management practices).

Finally, we request comment on whether Rule 15c3–4 should be amended to require that results of the periodic reviews of the internal risk management control system conducted by an internal auditor and annual reviews of the internal risk management control system conducted by an accountant should be reported in writing to the SIBHC's Board of Directors. In addition, we request comment on whether results of these periodic reviews should be reported in writing to the Commission.

E. Proposed Rule 17i–5: Record Creation, Maintenance, and Access Requirements for SIBHCs

Pursuant to Section 17(i)(3)(A) of the Exchange Act, an SIBHC would be required to make and keep records, furnish copies thereof, and make such reports as the Commission may require by rule.[55] Proposed Rule 17i–5 would require that an SIBHC make and keep current certain records relating to its business. In addition, it would require that an SIBHC preserve those and other records for certain prescribed time periods. The purpose of this rule is to require an SIBHC to create and maintain records that would allow the Commission to remain informed as to the SIBHC's activities, financial condition, policies, systems for monitoring and controlling financial and operational risks, and transaction among members of the affiliate group, as well as determine whether the SIBHC is in compliance with the Exchange Act and rules to which it is subject.

1. Record Creation

Paragraph (a) of proposed Rule 17i–5 would require that the SIBHC make and keep current (i) a record reflecting the results of quarterly stress testing of the affiliate group's funding and liquidity with respect to certain specified events; (ii) a record of the SIBHC's contingency plans to respond to certain specified events affecting the affiliate group's funding and liquidity; and (iii) a record of the basis for credit risk weights for each counterparty.

The specified events concerning which an SIBHC would need to conduct stress tests and create a contingency plan would include, (i) a credit rating downgrade of the SIBHC; (ii) an inability of the SIBHC to access capital markets for short-term funding; (iii) an inability of the SIBHC to move liquid assets across international borders when (i) or (ii) occur; or (iv) an inability of the SIBHC to access credit or assets held at a particular institution when (i) or (ii) occur. These events are intended to identify possible liquidity and funding stress scenarios that would impose significant financial distress on the SIBHC. The Commission believes that records of the SIBHC's contingency plans to respond to those events would provide the Commission with important information during an examination that would be necessary to adequately assess the SIBHC's financial condition and financial and operational risks.

We request comment as to whether there are any other records that an SIBHC should be required to create. We also request comment as to whether it would be appropriate to expand the list of specified events described above.

2. Record Maintenance

Pursuant to paragraph (b) of proposed Rule 17i–5, the SIBHC would be required to preserve (i) the records required to be created pursuant to 17i–5(a); (ii) all Notices of Intention, amendments thereto, and other documentation and information filed with the Commission in accordance with proposed Rule 17i–2 and any responses thereto; (iii) reports and notices filed with the Commission in accordance with proposed Rules 17i–6 and 17i–8; and (iv) records documenting the internal risk management control system established in accordance with proposed Rule 17i–4 to manage the risks of the affiliate group.

Proposed Rule 17i–5 would require that an SIBHC maintain the specified records for a period of three years in an easily accessible place. Exchange Act Rule 17a–4 presently requires that broker-dealers maintain certain records for this time period, and we believe this time period is sufficient with relation to the records required pursuant to proposed Rule 17i–5 to allow effective examinations of SIBHCs. The proposed Rule would allow an SIBHC to maintain these records in any manner permitted pursuant to Rule 17a–4(f).[56]

Paragraph (c) of proposed Rule 17i–5 would allow an SIBHC to maintain the records required under the rule either at the SIBHC, at an affiliate, or at a records storage facility, provided that the records are located within the boundaries of the United States. If these records are maintained by an entity other than the SIBHC, the SIBHC would be required to file a written undertaking from the entity with the Commission. This is intended to allow the SIBHC the flexibility to maintain records, while permitting the Commission to obtain those records.

Proposed Rule 17i–5 would not require an SIBHC to maintain its required records in a prescribed standard form. To reduce the recordkeeping burden on SIBHCs, proposed Rule 17i–5 would instead allow the SIBHC to meet its

[51] In a separate release, we also proposed rules and rule amendments that would, among other things, establish optional alternative net capital requirements for certain broker-dealers. *See* Exchange Act Release No. 48690 (October 24, 2003). In connection with that proposal, we proposed amendments to Rule 15c3–4 that would apply to a broker or dealer that elects to compute its net capital under proposed Appendix E of Rule 15c3–1.

[52] *See* Exchange Act Release No. 40594 (Oct 23, 1998), 63 FR 59362 (Nov 3, 1998).

[53] This parallels requirements in the *New Basel Capital Accord* (*See infra,* note 67). *See also* Financial Action Task Force on Money Laundering (''FATF'') Recommendation 22 and *see generally* the FATF's *Special Recommendations on Terrorist Financing.* (The FATF's documents can be found at: *www.FATF–GAFI.org*).

[54] *See generally,* Exchange Act § 17(i)(3)(C)(i)(I) [15 U.S.C. 78q(i)(3)(C)(i)(I)].

[55] *See supra,* note 12.

[56] 17 CFR 240.17a–4(f).

recordkeeping requirements through records created for its own use so long as those records include the information required in the proposed rules.

We request comment on the record maintenance provisions of paragraph (b) to proposed Rule 17a–5. Specifically, are there other records that an SIBHC should preserve in order to provide the Commission with adequate information in reviewing the SIBHC's financial or operational condition or compliance with applicable rules? In addition, we request comment as to what reports an SIBHC should maintain with respect to its affiliates that may be regulated by another financial regulator (for each such report, please delineate the information contained in that report, as well as any information an SIBHC would be required to maintain pursuant to proposed Rule 17i–6 that may not be included in that report).

3. Access to Records

The Commission has authority to examine an SIBHC and its affiliates pursuant to Section 17(i)(3)(C) of the Exchange Act.[57] However, the Act limits the focus and scope of such examinations. The statutory provisions also require that the Commission use, to the fullest extent possible, examination reports regarding an examination of the SIBHC or certain regulated affiliates made by an appropriate regulator.[58]

Paragraph (d) of proposed Rule 17i–5 would specify that all information obtained by the Commission pursuant to this section from the SIBHC will be accorded confidential treatment pursuant to Section 24(b) of the Exchange Act. Section 17(j) of the Exchange Act[59] also provides for confidentiality of SIBHC documents. We believe it is important to accord confidential treatment to these documents because the information an SIBHC would be required to create, maintain, and grant the Commission access to pursuant to the proposed Rules would generally be highly sensitive, non-public business information.

We believe the requirements set forth in proposed Rule 17i–5 are necessary to keep the Commission informed as to the SIBHC's activities, financial condition, policies, systems for monitoring and controlling financial and operational risks, transactions and relationships between any broker or dealer affiliate of the SIBHC, and the extent to which the SIBHC has complied with the provisions of the Act and the regulations prescribed and orders issued under the Act.

We request comment as to whether the Commission should accord confidential treatment to the documents an SIBHC is required to create, maintain, and grant the Commission access to pursuant to proposed Rule 17i–5.

F. Proposed Rule 17i–6: Reporting Requirements for SIBHCs

Proposed Rule 17i–6 would require an SIBHC to file certain monthly and quarterly reports with the Commission, as well as an annual audit report. These reporting requirements are designed to inform the Commission about the activities of the SIBHC, as well as the financial condition, policies, systems for monitoring and controlling financial and operational risks, and transactions and relationships involving the affiliate group. In addition, these requirements are designed to keep the Commission informed of the extent to which the SIBHC or its affiliates have complied with the provisions of the Exchange Act, and regulations prescribed and orders issued under the Exchange Act.

1. Monthly Reports

Paragraph (a) of proposed Rule 17i–6 would require that the SIBHC file a monthly risk report with the Commission, within 17 business days after the end of each month that is not also the end of a quarter. This report would include consolidated financial statements for the affiliate group, computations of consolidated allowable capital and allowances for market, credit, and operational risk, a graph reflecting daily intra-month Value at Risk (''VaR'') for each business line, consolidated credit risk information, a summary report of the SIBHC's exposures on a consolidated basis for each of the top ten countries to which it is exposed, and certain regular risk reports the SIBHC generally provides to the persons responsible for managing risk for the affiliate group. These reports would be due within the same time frames as the monthly FOCUS reports broker-dealers are required to file pursuant to Rule 17a–5(a). These reports would allow the Commission to review and monitor the risk profile for the affiliate group. Further, they would alert the Commission to any deterioration in the affiliate group's financial or operational position and risk profile. Broker-dealers currently are required to file detailed financial information, which is used by the Commission and the broker-dealer's designated examining authority[60] to evaluate the broker-dealer's financial and operational condition.

We request comment on the timing of the monthly reporting requirements. Further, we request comment on whether any additional information should be included in the monthly reports to be filed with the Commission. We also request comment on whether the monthly reporting requirement should be modified for an SIBHC (or a member of the affiliate group) required to file information, documents, and reports pursuant to §§ 13(a) or 15(d) of the Exchange Act and, if so, how and why they should be modified.

2. Quarterly Reports

Paragraph (a)(2) of proposed Rule 17i–6 would require that an SIBHC file a quarterly risk report with the Commission within 35 calendar days after the end of each quarter. This report would include, in addition to all the information required to be filed on a monthly basis, (i) consolidating financial statements (that break out data regarding each material affiliate into separate columns); (ii) the results of backtesting of each of the models used to compute allowable capital and allowances for market and credit risk; (iii) a description of all material pending legal or arbitration proceedings involving any member of the affiliate group that are required to be disclosed under generally accepted accounting principles; and (iv) the aggregate debt scheduled to mature within twelve months from the most recent quarter by each affiliate that is a broker-dealer and any other material affiliate, together with the allowance for losses for such transactions. The information an SIBHC would be required to file on a quarterly basis would provide the Commission with valuable insight as to the financial and operational condition of the SIBHC.

Requiring reports to be filed within 35 calendar days after the end of each quarter provides time frames similar to those for quarterly reports due from companies required to file information, documents, and reports pursuant to §§ 13(a) or 15(d) of the Exchange Act.[61]

[57] 15 U.S.C. 78q(i)(3)(C).

[58] *See supra,* note 17.

[59] 15 U.S.C. 78q(j).

[60] Pursuant to Exchange Act Rule 17d–1 [17 CFR 240.17d–1], where a broker-dealer is a member of more than one self-regulatory organization (as defined in Exchange Act § 3(a)(26) [15 U.S.C. 78c(a)(26)]), the Commission shall ''designate'' one self-regulatory organization as responsible for examining the broker-dealer for compliance with applicable financial responsibility rules. The self-regulatory organization of a broker-dealer that has been so designated is commonly referred to as the broker-dealer's designated examining authority (or ''DEA'').

[61] *See* Release No. 33–8128 (Sep. 5, 2002), 67 FR 179 (Sep. 16, 2002).

We request comment as to whether this time period is appropriate for SIBHCs.

We request comment as to whether any additional information should be included in the quarterly reports to be filed with the Commission. We also request comment on whether the quarterly reporting requirement should be modified for an SIBHC (or member of the affiliate group) required to file information, documents, and reports pursuant to §§ 13(a) or 15(d) of the Exchange Act and, if so, how they should be modified.

3. Additional Reports

Paragraph (b) of proposed Rule 17i–6 would provide that, in addition to the monthly and quarterly reports specified in the proposed Rule, an SIBHC may be required, upon receiving written notice from the Commission, to provide the Commission with additional financial or operational information. As specified in the proposed Rule, the Commission may request additional reports in order to monitor the SIBHC's financial or operational condition, risk management system, any transactions and relationships among members of the affiliate group, and the extent to which the SIBHC has complied with the provisions of the Exchange Act and regulations and orders issued under the Exchange Act. This will allow the Commission the flexibility to obtain information, for instance, to more closely monitor the financial and operational condition of an SIBHC during periods of market stress.

In addition, if a broker-dealer affiliated with the SIBHC or the SIBHC were to file notice (pursuant to Rule 17a–11 or proposed Rule 17i–8, respectively), the Commission would be able to request additional reports from the SIBHC to fully assess the situation giving rise to the filing of the notice.

We request comment on our proposal to require that an SIBHC file such additional reports as the Commission may request.

4. Annual Audit Report

Pursuant to paragraph (c)(1) of proposed paragraph 17i–6, the SIBHC would be required to file an annual audit report containing consolidated financial statements. Paragraphs (c)(2) and (c)(3) of proposed Rule 17i–6 would require that the annual audit report be ''as of'' the same date as, and filed with the Commission concurrently with, the annual audit report of the SIBHC's subsidiary broker-dealers.

Paragraphs (d), (e), (f), (g), (h), (i), (j), (k), (l), and (m) of proposed Rule 17i–6 are based on existing Rules 17a–5 and 17a–12 regarding (i) the nature and form or reports, (ii) accountants, (iii) audit objectives, (iv) the extent and timing of audit procedures, (v) the accountant's report, (vi) supplemental reports, (vii) notification of a change in fiscal year, (viii) extensions and exemptions, (ix) how the reports should be filed, and (x) confidentiality.

Paragraph (e) would require that the audit and supplemental reports be prepared by an accountant that is a ''registered public accounting firm'' as that term is defined in the Sarbanes-Oxley Act of 2002.[62] We are proposing that the review be conducted by a registered public accounting firm because such firms would be subject to PCAOB rules, examination, and discipline.

We believe the requirements set forth in proposed Rule 17i–6 are necessary to keep the Commission informed as to the SIBHC's activities, financial condition, policies, systems for monitoring and controlling financial and operational risks, and transactions and relationships between any broker or dealer affiliate of the SIBHC and the extent to which the SIBHC has complied with the provisions of the Act and the regulations prescribed and orders issued under the Act. In addition, paragraph (k) of proposed Rule 17i–6 regarding extensions and exemptions would provide the Commission with flexibility to address firm-specific issues as they arise. Finally, we believe it is important to accord confidential treatment to the reports and statements filed pursuant to proposed Rule 17i–6, as specified in paragraph (m), because these reports would include information that generally would be non-public and highly sensitive.

We request comment on the proposed timing of the annual audit reports and whether any additional information should be included in that report. We also request comment on whether the annual audit requirements should be modified for an SIBHC (or member of the affiliate group) required to file information, documents, and reports pursuant to sections 13(a) or 15(d) of the Exchange Act and, if so, how they should be modified. In addition, we request comment as to whether the Commission should accord confidential treatment to the reports filed with the Commission by the SIBHC pursuant to proposed Rule 17i–6.

We also request comment on our proposal to require that an SIBHC use a registered public accounting firm to perform its annual audit.

5. Accountant's Report on Management Controls—Paragraph (i)(2) of Proposed Rule 17i–6 and Amendment to Paragraph (*l*) of Existing Rule 17a–12

Paragraph (i)(2) of proposed Rule 17i–6 would require that the SIBHC submit a supplemental report, prepared by the accountant, regarding the accountant's review of the internal risk management control system established and documented in accordance with proposed Rule 17i–4. This review would have to be accomplished using procedures agreed-upon by the accountant and the SIBHC. The Rule also specifies that the agreed-upon procedures would be required to be performed and the report to be prepared in accordance with the rules promulgated by the PCAOB. Pursuant to paragraph (i)(4) of proposed Rule 17i–6, the SIBHC would be required to submit the agreed-upon procedures to the Commission prior to the review.

Paragraph (i)(4) of proposed Rule 17i–6 differs from present Rule 17a–12(*l*), which requires that an accountant provide an opinion regarding an OTC derivatives dealer's compliance with its internal risk management control system. Auditors of OTC derivatives dealers have stated that the lack of standards for evaluating compliance with internal risk management control systems prevents them from issuing an opinion. For this reason, the Commission is proposing to amend present Rule 17a–12(*l*) so that, similar to the requirements of paragraph (i)(2) of proposed Rule 17i–6, an OTC derivatives dealer would be required to submit a supplemental report, prepared by the accountant using agreed-upon procedures, regarding the accountant's review of the internal risk management control system established and documented in accordance with Rule 15c3–4.

Paragraph (i)(2) of proposed Rule 17i–6 and this proposed amendment to Rule 17a–12(*l*) would allow an accountant to review an SIBHC's or OTC derivatives dealer's internal risk management control systems and provide a report regarding whether the risk management control systems comply with the requirements of proposed Rule 17i–4 or Rule 15c3–4, respectively, and that the SIBHC or OTC derivatives dealer is, in fact, following its risk management system.

We request comment as to whether the proposed amendment to Rule 17a–12(*l*) would adequately resolve the lack of standards for conducting an audit of a firm's internal risk management

[62] 15 U.S.C. 7201(a)(12). The term ''registered public accounting firm'' means a public accounting firm registered with the Public Company Accounting Oversight Board (''PCAOB'') in accordance with the Sarbanes-Oxley Act of 2002.

control systems and its compliance with those systems.

G. Exemption From Risk Assessment Rules for Broker-Dealer Affiliates of SIBHCs

The Commission presently receives financial and risk information about holding companies and certain affiliates of broker-dealers, and certain off-balance sheet items of broker-dealers, their holding companies, and their affiliates pursuant to the risk assessment rules (Rules 17h–1T and 17h–2T) and through meetings with and reports from members of the Derivatives Policy Group.[63] These supervisory tools generally have performed well by assisting the Commission in identifying, at an early stage, firms that are experiencing financial problems.

As part of this rulemaking, the Commission is proposing to amend Rules 17h–1T and 17h–2T[64] to exempt broker-dealers that are affiliated with an SIBHC from those rules. Rule 17h–1T requires that a broker-dealer maintain and preserve records and other information concerning the broker-dealer's holding companies, affiliates, or subsidiaries that are likely to have a material impact on the financial or operational condition of the broker-dealer. Rule 17h–2T requires that broker-dealers file quarterly reports with the Commission concerning the information required to be maintained and preserved under Rule 17h–1T. We believe that exempting a broker-dealer that is affiliated with an SIBHC is appropriate because, pursuant to proposed Rule 17i–5, the SIBHC would be required to make and retain documents substantially similar to those the broker-dealer is required to make and retain pursuant to Rule 17h–1T. Further, pursuant to proposed Rule 17i–6, the SIBHC would be required to make reports that are substantially similar to those the broker-dealer is required to make pursuant to 17h–2T. We request comment on the proposed exemptions from Rules 17h–1T and 17h–2T for broker-dealers affiliated with an SIBHC.

H. Proposed Rule 17i–7: Calculations of Allowable Capital and Risk Allowances or Alternative Capital Assessment

Proposed Rule 17i–7 would require an SIBHC to calculate the affiliate group's allowable capital and allowances for certain types of risk. Proposed Rule 17i–7 would not set minimum group-wide capital levels for SIBHCs; rather, it would require the SIBHC to perform certain calculations that the Commission could review to gain an understanding of the financial position of the affiliate group and identify any risks it poses to the broker-dealer.

The Basel Committee on Banking Supervision[65] (''Basel Committee'') has developed international regulatory standards that aim to align economic capital calculations with regulatory capital requirements for large internationally active banking institutions (''Basel Standards'').[66] The Basel Committee has proposed to modify the Basel Standards.[67] Our proposal incorporates a capital computation for the SIBHC that is consistent with the Basel Standards. The Basel Standards have been used by many other financial regulators for many years as a method to assess capital adequacy at the holding company level.

We are proposing what we believe are prudent parameters for measuring allowable capital and allowances for risk for the SIBHC that are consistent with the Basel Standards. In some cases these parameters may be more conservative than some firms believe are necessary to account for risk. For example, the proposal would place limits on the amount of subordinated debt that may be included in allowable capital, require that the VaR model used to calculate the allowance market risk be based on a ten business-day movement in rates and prices and that a 99% confidence level be used, and require that the VaR measure be multiplied by a factor of at least three. Requiring that an SIBHC calculate its allowable capital and allowances for market, credit and operational risk based on the Basel Standards would provide the Commission with a useful measure of the SIBHC's financial position and allow for greater comparability of an SIBHC's financial condition to that of other international securities firms and banking institutions.

1. Calculation of Consolidated Allowable Capital

Consistent with the Basel Standards,[68] proposed Rule 17i–7 would require that an SIBHC calculate ''allowable capital'' for the affiliate group that would include common shareholders' equity (less goodwill, deferred tax assets, other intangible assets, and certain other deductions), certain cumulative and non-cumulative preferred stock,[69] and certain properly subordinated debt. As set forth in

[63] Pursuant to the ''risk-assessment rules,'' adopted under Exchange Act Section 17(h), broker-dealers also submit consolidated and consolidating financial statements, organizational charts of the holding company, descriptions of material legal exposures, and risk management policies and procedures to the Commission. [17 CFR 240.17h–1T and 17 CFR 240.17h–2T]. Member firms of the Derivatives Policy Group (''DPG'') also voluntarily supply us with additional information regarding derivative financial instruments, off balance sheet obligations, and the concentration of credit risk. The DPG was formed in March 1995 by the industry and the Commission to provide a voluntary oversight framework for monitoring derivatives activities of broker-dealer affiliates.

[64] 17 CFR 240.17h–1T and 240.17h–2T.

[65] The central bank governors of the Group of Ten countries (''G–10 countries'') established the Basel Committee in 1974 to provide a forum for ongoing cooperation among member countries on banking supervisory matters.

[66] The basic consultative papers developed by the Basel Committee are: the Basel Capital Accord (1988), the Core Principles for Effective Banking Supervision (1997), and the Core Principles Methodology (1999). The Basel Standards establish a common measurement system, a framework for supervision, and a minimum standard for capital adequacy for international banks in the G–10 countries. It is intended to increase the transparency and consistency of the supervision of financial companies across borders. The Basel Standards generally have been implemented for internationally active, large banking institutions by U.S. bank regulators. *See* Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, ''Risk Based Capital Standards; Market Risk,'' 61 FR 47358 (Sept. 6, 1996).

[67] In April 2003, the Basel Committee released for public comment a document entitled ''The New Basel Capital Accord'' (the ''New Basel Capital Accord'') to modify the Basel Standards. This paper can presently be found at: *http://www.bis.org/bcbs/cp3full.pdf.* Comments were accepted through July 31, 2003. On October 11, 2003, the Committee announced that it had received over 200 comment letters, that there is continued broad support for the structure of the new accord and agreement on the need to adopt a more risk-sensitive capital framework. The Committee requested comment by December 31, 2003, on an amendment to its proposed treatment of expected and unexpected losses. The Basel Committee expects to issue a final revision of the proposed *New Basel Capital Accord* by the middle of 2004, with an effective date for implementation of December 31, 2006. Currently, U.S. banking regulators have released an Advanced Notice of Proposed Rulemaking to seek comment on their preliminary views regarding the implementation of the proposed *New Basel Capital Accord* (68 FR 45900 (August 4, 2003)). Comments are due by November 3, 2003.

[68] Proposed Rule 17i–7 is generally consistent with U.S. banking regulators' interpretations of the Basel Standards and incorporates the quantitative and qualitative conditions imposed on banking institutions. However, one difference is our proposal to use maximum potential exposure as opposed to notional add-ons to calculate credit risk for OTC derivatives instruments, and our interpretation as to what instruments should be subject to market risk, as opposed to credit risk, treatment. These differences, and the reasons for them, are described more specifically in the sections relating to the calculations of allowance for market and credit risk.

[69] The cumulative and non-cumulative preferred stock could not (i) have a maturity date, (ii) be redeemed at the option of the holder, or (iii) contain any other provisions that would require future redemption of the issue. In addition, the issuer would have to be able to defer or eliminate dividends. Finally, the cumulative and non-cumulative preferred stock would be subject to certain limits (*see* paragraphs (a)(2) and (a)(3)(i) of proposed Rule 17i–7).

further detail in the proposed rule, the cumulative and non-cumulative preferred stock and the subordinated debt would be subject to additional limitations based on comparisons of the individual components of allowable capital.

When first implemented, the Basel Standards allowed national bank supervisors discretion in counting goodwill as capital during a transition period. Thus, we solicit comment on whether goodwill should be included in allowable capital for a particular transition period and, if so, the length of the transition period.

An entity's debt is not ordinarily includible in its regulatory capital. However, because debt can provide a long-term source of working capital to the entity and may have many of the characteristics of capital, the Basel Standards permit unrestricted long-term subordinated debt [70] to count as regulatory capital. Under paragraph (a)(3)(ii) of proposed Rule 17i–7, consistent with the Basel Standards, subordinated debt could be included in allowable capital if it meets four criteria. First, the original weighted average maturity of the SIBHC's subordinated debt must be at least five years. Second, the subordinated debt instrument must state clearly on its face that repayment of the debt is not protected by the Securities Investor Protection Corporation (''SIPC'') or any Federal agency. Third, the debt must be unsecured and subordinated in right of payment to all senior indebtedness of the SIBHC. Fourth, the terms of the subordinated debt agreement may permit acceleration only in the event of bankruptcy or reorganization of the SIBHC under Chapters 7 (liquidation) or 11 (reorganization) of the U.S. Bankruptcy Code.

The four criteria subordinated debt would have to satisfy to be included in allowable capital are necessary to help assure permanency of capital and to inform subordinated lenders of the risks associated with being a subordinated lender. Funds lent under a subordinated debt agreement necessarily are subject to the risks of the SIBHC's business and must be available to pay other creditors if the SIBHC defaults on other obligations. Although the customers of certain of the SIBHC's affiliates may be entitled to the protection of SIPC under specific circumstances, subordinated lenders of the SIBHC would not be entitled to that protection.

[70] By contract, subordinated debt is debt that is subordinated in right of payment to all senior indebtedness of the company.

Under the proposal, to be included in allowable capital, subordinated debt would be required to be unsecured and subordinated in right of payment to all of the SIBHC's senior debt. Debt that, upon default, can be repaid by conversion of collateral or before other debt could not be considered subordinated in right of repayment to all senior indebtedness of the SIBHC because the debt effectively would have priority over at least some other debt.

Subordinated debt instruments that permit acceleration of payment upon events other than bankruptcy or reorganization of the SIBHC would not qualify for inclusion in allowable capital under the proposed rules.[71] Acceleration clauses raise significant supervisory concerns because repayment of the debt could be accelerated at a time when an SIBHC is experiencing financial difficulties. Acceleration, therefore, could inhibit an SIBHC's ability to resolve its financial problems in the normal course of business and force the company into involuntary bankruptcy.

We request comment on the inclusion of subordinated debt in allowable capital generally and on the following questions in particular:

- Is five years the appropriate maturity for subordinated debt to be included in allowable capital? Would another term, whether longer or shorter, be more appropriate?
- To be included in allowable capital, should subordinated debt be subject to negative pledge provisions that, for example, would restrict an SIBHC's ability to pledge the equity securities of a subsidiary to secure the debt or to sell a subsidiary unless the buyer agreed to assume liability for some portion of the debt?
- Should subordinated debt that is subject to acceleration events other than bankruptcy or reorganization of the SIBHC under the Bankruptcy Code be included in allowable capital?
- What should be the maximum amount of subordinated debt that is includible in allowable capital?
- What are the additional costs of issuing subordinated debt versus long-term debt of the same maturity?

[71] The prohibition on acceleration of payment also would prohibit inclusion of credit sensitive subordinated debt in allowable capital. Credit sensitive subordinated debt ties payments to the financial condition of a borrower/holding company or its affiliates. This feature of the debt forces a holding company to make increased payments as its financial condition deteriorates and, therefore, acts as a de facto acceleration clause that may deplete the holding company's resources and increase the likelihood of default on debt. Furthermore, a credit requirement clause potentially would allow a subordinated lender to obtain payment before senior creditors.

Some industry participants have suggested that certain long-term debt that cannot be accelerated should be included in allowable capital because at the SIBHC level there is no protected class of creditors, and therefore there is no significant difference between that type of long-term debt and subordinated debt. In addition, they assert that subordinated debt is more costly to an entity than long-term debt that cannot be accelerated because of the restrictive provisions associated with, and the lack of an active trading market for, subordinated debt.

We solicit comment on whether long-term debt, subject to appropriate limitations, should be included in allowable capital. Specifically, we request comment on the following issues:

- If long-term debt is included in allowable capital, what restrictions should apply?
- Would trading in its long-term debt provide a more reliable indication of the credit quality of the SIBHC than subordinated debt and, if so, why?
- Does a holder of its subordinated debt have a greater incentive to monitor the financial condition of the SIBHC than a holder of its long-term debt because its claim is more junior?
- Are there debt instruments other than subordinated debt that provide an equivalent market signal about the credit quality of the issuer?
- Is there a material difference between the depth of the market for the long-term debt of an SIBHC and the depth of the market for its subordinated debt and, if so, how would any such difference impact the cost of financing for the SIBHC?
- Would there be any other adverse effects if the SIBHC were permitted to include long-term debt in allowable capital?
- If long-term debt could be included in allowable capital, what, if any, requirements should apply to the maturity date of the long-term debt? What events of acceleration should be permissible?
- Should long-term debt be subject to a negative pledge, that, for example, would restrict an SIBHC's ability to pledge the equity securities of a subsidiary to secure the debt or to sell a subsidiary unless the pledgor or buyer agreed to assume liability for some portion of the debt?
- What other provisions concerning the inclusion of long-term debt in allowable capital should be considered?

2. Calculation of Consolidated Allowance for Market Risk

Paragraph (b) of proposed Rule 17i–7 would require that an SIBHC calculate a consolidated allowance for market risk daily for all proprietary positions. The SIBHC would calculate an allowance for market risk for each position using either a VaR model or, if there is not adequate historical data to support a VaR model, an alternative method. Generally, the allowance for market risk would constitute three times [72] the largest amount the SIBHC could lose over a ten-day period with a 99% confidence level (as determined using the VaR model or alternative method).[73] An SIBHC would need to provide the Commission with information regarding any alternative method for computing allowance for market risk for particular positions during the Commission's review of its Notice of Intention so that the Commission could evaluate the method to determine whether it adequately measured the risks of those positions.

Paragraph (b)(1) of proposed Rule 17i–7 would require that each VaR model used to calculate allowance for market risk must meet the qualitative and quantitative requirements set forth in rules the Commission is also proposing today in a separate release, proposed Rule 15c3–1e(e).[74] The qualitative and quantitative standards set forth in proposed Rule 15c3–1e(e) are similar to the requirements for models used by OTC derivatives dealers and are consistent with the Basel Standards. The qualitative requirements would address three aspects of an SIBHC's risk management system: (i) The model would have to be integrated into, and thus relied upon, in the SIBHC's daily risk management process; (ii) the model would be required to undergo periodic reviews by the SIBHC's internal audit staff and annual reviews by an accountant; and (iii) the SIBHC would need to conduct backtesting of the model (the results of the backtests would be used by the SIBHC to determine the multiplication factors to be used when calculating market and credit risk).[75] The quantitative requirements would set forth basic standards for each model including, (i) it must use a 99 percent, one-tailed confidence level and with price changes equivalent to a ten business-day movement in rates and prices for purposes of determining market risk, (ii) it must use an effective historical observation period that must be at least one year in length and include periods of market stress, and (iii) it must take into account and incorporate all significant identifiable market risk factors applicable to the affiliate group's positions.

Consistent with the Basel Standards, paragraph (b)(1) of proposed Rule 17i–7 would require that each VaR model used to calculate allowance for market risk also must be one that can be disaggregated by each line of business exposed to market risk and by each legal entity.

We request comment on all aspects of the proposed methods for calculating market risk, including whether any other quantitative or qualitative requirements should be applied to VaR models. In addition, we request that commenters address any perceived differences between the proposed methodology for calculating market risk and the Basel Standards. Further, we request comment on alternative methods for computing allowance for market risk, and the appropriateness of those methods.

3. Calculation of Consolidated Allowance for Credit Risk

Paragraph (c) of proposed Rule 17i–7 would require that an SIBHC calculate a consolidated allowance for credit risk daily using either a calculation consistent with the Basel Standards or the methodology set forth in paragraph (c)(1) of proposed Rule 17i–7, which is similar to the proposed New Basel Capital Accord. This choice would provide SIBHCs with some flexibility while the Basel Standards are under review. The methodology set forth in paragraph (c)(1) of proposed Rule 17i–7 would require that an SIBHC multiply the credit equivalent amount of certain asset and off-balance sheet items by the appropriate credit risk weight of the asset or off-balance sheet item, and then multiply the result by 8%.[76] In general, the asset and off-balance sheet items subject to this allowance are loans and loan commitments receivable, receivables arising from derivatives contracts, repurchase and reverse repurchase agreements, structured financial products, credit substitutes, and other extensions of credit.

Consistent with the proposed *New Basel Capital Accord*, Paragraph (c)(1)(i) of proposed Rule 17i–7 would establish the manner in which the ''credit equivalent amount'' of a balance sheet item should be calculated. The credit equivalent amounts for receivables relating to (i) derivatives contracts, repurchase agreements, reverse repurchase agreements, stock loans, stock borrows, and other similar collateralized transactions; (ii) loans and loan commitments receivable; and (iii) other assets would be calculated differently, and are set forth in paragraphs (c)(1)(i)(A), (B), and (C) of proposed Rule 17i–7, respectively. Paragraph (c)(1)(i)(D) of proposed Rule 17i–7 would define the term ''current exposure'' to be the current replacement value of the counterparty's positions with the member of the affiliate group including the effect of netting agreements with that counterparty,[77] and taking into account the value of collateral from that counterparty [78] pledged to and held by any member of the affiliate group and the fair market value of any credit derivatives that specifically change the exposure to the counterparty (as long as the credit derivatives are not used to change the

[72] Paragraph (b)(1) of proposed Rule 17i–7 would establish the initial multiplication factor (three); however the multiplication factor would subsequently be set based on the number of backtesting errors generated through use of the model. The initial multiplication factor was derived from the minimum requirement set forth in 17 CFR 240.15c3–1f(e)(1)(iv)(C) (the rule used by OTC derivatives dealers to calculate market risk capital charges). This initial multiplication factor would be used until sufficient backtesting results has been collected to use the Table set forth in 17 CFR 240.15c3–1e(e)(1)(iii)(C).

[73] *See supra,* note 51. Specifically, *see* proposed 17 CFR 240.15c3–1e(e)(2)(i).

[74] *See supra,* note 51.

[75] *See supra,* note 51. Specifically, *see* proposed 17 CFR 240.15c3–1e(e)(1).

[76] This is consistent with the calculation of credit risk used by OTC derivatives dealers (*See* 17 CFR 240.15c3–1f(d)(2)). In addition, the 8% basic multiplier to calculate credit risk capital charges is consistent with the Basel Standards.

[77] Only netting agreements that meet the requirements set forth in paragraph (d)(5) of proposed Rule 15c3–1e could be used to reduce current or maximum potential exposures. *See supra* note 51. Generally, the SIBHC could use a netting agreement that allows the SIBHC to net gross receivables and gross payables with a counterparty upon default of the counterparty if (i) the netting agreement is legally enforceable in each relevant jurisdiction, including in insolvency proceedings; (ii) the gross receivables and gross payables subject to the netting agreement with a counterparty can be determined at any time; and (iii) for internal risk management purposes, the SIBHC monitors and controls its exposure to the counterparty on a net basis.

[78] Only collateral that meets the requirements set forth in paragraph (d)(6) of proposed Rule 15c3–1e could be used to reduce current or maximum potential exposures. *See supra* note 51. Generally, the SIBHC could take the fair market value of collateral pledged to and held by the SIBHC into account, provided (i) the collateral is marked to market each day and is subject to a daily margin maintenance requirement; (ii) the collateral has a ready market or consists of major market foreign currency as defined in § 240.15c3–1a(b)(1)(i)(C) or U.S. currency; (iii) the collateral agreement is legally enforceable by the SIBHC against the counterparty and any other parties to the agreement; (iv) the collateral does not consist of securities issued by the counterparty or a party related to the SIBHC or to the counterparty; and (v) the collateral is not used in determining the credit rating of the counterparty.

credit risk weight of the counterparty as provided in paragraph (c)(1)(ii)(E)).[79] Finally, paragraph (c)(1)(i)(E) of proposed Rule 17i–7 defines the term ''maximum potential exposure'' to be the increase in the net replacement value of the counterparty's positions with the member of the affiliate group, including the effect of netting agreements with that counterparty,[80] and taking into account the value of collateral from that counterparty[81] pledged to and held by any member of the affiliate group and the fair market value of any credit derivatives that specifically change the exposure to the counterparty (as long as the credit derivatives are not used to change the credit risk weight of the counterparty as provided in paragraph (c)(1)(ii)(E)).[82] Paragraph (c)(1)(i)(E) of proposed Rule 17i–7 also states that maximum potential exposure would be required to be calculated daily using a VaR model that meets the same qualitative and quantitative standards as required for models used to compute the allowance for market risk.[83]

We request comment on whether the proposed method of calculating the credit equivalent amount is appropriate, or whether it should be changed. In addition we request comment on whether the definitions of ''current exposure'' and ''maximum potential exposure'' are appropriate, or if they should be changed. If the proposed method for calculating credit equivalent amount or the definitions of ''current exposure'' or ''maximum potential exposure'' should be changed, please elaborate as to how they should be changed.

Paragraph (c)(1)(ii) of proposed Rule 17i–7 provides that credit risk weights would generally be determined according to the standards published by the Basel Committee, as modified from time to time.[84] An SIBHC may also use internal credit ratings[85] or calculate credit risk weights using internal calculations[86] when calculating its allowance for credit risk.

In addition, paragraph (c)(1)(ii)(D) of proposed Rule 17i–7 would allow SIBHCs to adjust credit risk weights of receivables covered by certain types of guarantees,[87] and paragraph (c)(1)(ii)(E) of proposed Rule 17i–7 would allow SIBHCs to adjust credit risk weights of receivables covered by certain credit derivatives (such as credit default swaps, total return swaps, and similar instruments used to manage credit risk)[88] in recognition of the benefits these instruments provide.

The Commission requests comment on the determination of credit risk weights. In particular, the Commission requests comment on whether an additional method of calculating credit risk weights, based on internal estimates of annual probabilities of default, should be included in proposed Rule 17i–7. If such a method should be used, the Commission requests comment on whether the following table appropriately matches credit risk weights to annual probabilities of default:

CREDIT RISK WEIGHT OF COUNTERPARTY BASED ON ANNUAL PROBABILITY OF DEFAULT

Annual probability of default	Credit risk weight (in percent)
Less than .003%	2
0.05%	17
0.11%	30
3.80%	200
5.30% or higher	230
Event of default has occurred	1250

These credit risk weights are based on the formulas provided in the Advanced Internal Ratings-based Approach to credit risk proposed by the Basel Committee.[89] We have derived the credit risk weights using a loss given default (the percentage of the amount owed by the counterparty the firm expects to lose if the counterparty defaults) of 75%. We believe 75% to be a conservative number for use in determining credit risk weights. We request comment as to whether 75% is appropriate, or whether it should be increased or decreased.

The Commission believes that calculating a credit risk capital charge on exposures arising from transactions in OTC derivatives instruments using a VaR model that meets that qualitative and quantitative requirements set forth in proposed § 240.15c3–1e(e)[90] to calculate maximum potential exposure is a more precise method than using a ''notional add-on'' to approximate maximum potential exposure. In addition, Commission reviews of risk management systems of large U.S. broker-dealers indicate that these broker-dealers generally use maximum potential exposure to measure and manage the credit risk of their portfolios. These broker-dealers would therefore incur little, if any, additional cost to calculate credit risk using maximum potential exposure as opposed to ''notional add-ons.''

We request comment on this approach to the calculation of credit risk on OTC derivatives, repurchase agreements, reverse repurchase agreements, stock lending and borrowing, and similar collateralized transactions. In addition, we request comment on the proposed requirements for guarantees used to reduce an SIBHC's allowance for credit risk. We also request comment on the appropriate treatment of credit derivatives in this context. Credit derivatives could enter into the calculation of credit risk in two ways. The first would be to substitute the credit risk weight of the writer of the

[79] The fair market value of any credit derivatives that specifically change the SIBHC's exposure to the counterparty may be used to calculate ''current exposure'' and ''maximum potential exposure'' only to the extent that the credit derivative is not used to change the credit risk weight of the counterparty as set forth in paragraph (c)(1)(ii)(E).

[80] *See supra,* note 77.

[81] *See supra,* note 78.

[82] *See supra,* note 79.

[83] However, the quantitative requirements for a VaR model intended to calculate maximum potential exposure would be required to use a 99 percent, one-tailed confidence level and with price changes equivalent to a *five-day* movement in rates and prices for repurchase agreements, reverse repurchase agreements, stock lending and borrowing, and similar collateralized transactions (*See* paragraph (c)(1)(i)(E) of proposed Rule 17i–7) and to a *one-year* movement in rates and prices for other positions (*See* proposed 17 CFR 240.15c3–1e(e)(2)(ii)) (as opposed to a *ten business-day* movement for VaR models used to calculate the allowance for market risk (*See* proposed § 17 CFR 240.15c3–1e(e)(2)(i)).

[84] *See* paragraph (c)(1)(ii)(A) of proposed Rule 17i–7.

[85] *See* paragraph (c)(1)(ii)(B) of proposed Rule 17i–7.

[86] *See* paragraph (c)(1)(ii)(C) of proposed Rule 17i–7.

[87] The guarantee would be required to be an unconditional and irrevocable guarantee of the due and punctual payment and performance of the obligation and the SIBHC or member of the affiliate group can demand payment after any payment is missed without having to make collection efforts. Further, the guarantee would be required to be evidenced by a written obligation of the guarantor that allows the SIBHC or member of the affiliate group to substitute the guarantor for the counterparty upon default or nonpayment by the counterparty. These proposed requirements are designed to allow an SIBHC to reduce its allowance for credit risk only if the guarantee contains features that make it more reliable.

[88] The credit derivative would be required to be one that (i) provides credit protection equivalent to a guarantee, (ii) is used for bona fide hedging purposes to reduce the credit risk weight of a counterparty, (iii) is not incorporated into the VaR model used for deriving potential exposures, and (iv) is not held for market-making purposes.

[89] *See* the *New Basel Capital Accord* (April, 2003).

[90] *See supra,* note .

credit derivative for the credit risk weight of the counterparty. The second would be to adjust the current exposure and the maximum potential exposure by the value of the credit derivative.

Certain accounting differences may cause differences in application of the Basel Committee's recommendations when applied to securities firms rather than banking firms. For instance, the broker-dealers must mark all positions to market, whereas banks may use cost as a basis to value securities held for investment purposes. These differences may require the Commission to apply adjustments to the Basel Committee's recommendations, or not to apply adjustments that are in the Basel Committee's recommendations. The Commission solicits comments on how the differences in accounting standards might affect the allowance for credit risk, and what modifications the Commission should make to the proposed rules to address those differences.

The Commission seeks comment on all aspects of the proposed method of calculating the allowance for credit risk. Because the Basel Standards have been implemented by many financial regulators, we request comment as to whether the proposed rule is consistent with the Basel Standards as they have been implemented. In addition, we request comment as to whether the proposed rule is consistent with the present version of the proposed *New Basel Capital Accord* and how various financial regulators have proposed to implement the proposed *New Basel Capital Accord.* Should an SIBHC have other alternative methods for calculating the allowance for credit risk?

4. Calculation of Consolidated Allowance for Operational Risk

Under proposed Rule 17i–7, an SIBHC would be required to calculate an allowance for operational risk consistent with the appropriate standards published by the Basel Committee. The Basel Committee has proposed three methods for the calculation of an allowance for operational risk (i) the basic approach; (ii) the standardized approach; and (iv) the advanced measurement approach. For a complete discussion of the proposed operational risk calculation, please refer to the proposed *New Basel Capital Accord.*[91] The basic and standardized approach calculations are based on fixed percentages. Under the basic approach, the allowance is 15% of consolidated annual revenues net of interest expense averaged over the past three years. The standardized approach maps these revenues to eight business lines. The allowance for operational risk is then a percentage of revenues net of interest expense, ranging from 12% to 18%, attributed to each business line. The advanced measurement approach requires a system for tracking and controlling operational risk and provides that the allowance for operational risk is the largest operational loss that might be expected over a one-year period with 99.9% confidence.

We solicit comment on all aspects of these three methods for calculating consolidated allowance for operational risk. In addition, we request that commenters address whether any of the three methods is preferable and, if so, explain why. Further, could any changes be made to these methods that would better accommodate the broker-dealer business? Finally, should we allow an SIBHC to choose one of the three methods, or should the proposed Rule require that SIBHCs use the advanced measurement approach?

5. Alternative Capital Assessment

Under paragraph (e) of proposed Rule 17i–7, an SIBHC would be permitted to compute a capital assessment using the Basel Standards that the SIBHC already is required to submit to a financial regulator or supervisor in lieu of the computations described in paragraphs (a) through (d). This proposed Rule is intended to allow an entity that may already be subject to certain consolidated supervision requirements to continue to use its present systems and methodologies to compute a capital assessment for reporting purposes for the affiliate group so long as that computation is consistent with the Basel Standards.

6. General Questions Regarding Proposed Rule 17i–7

We believe the requirements set forth in proposed Rule 17i–7 are necessary to keep the Commission informed as to the SIBHC's financial condition.

We request comment on whether we should allow this alternative standard or whether some other approach may be warranted.

We are proposing what we believe are prudent parameters for computing an SIBHC's risk allowances, although in some cases these parameters may be more conservative than some firms may believe are necessary to account for risk. For example, the proposal requires that the VaR model used to calculate market risk be based on a ten business-day movement in rates and prices and that a 99% confidence level be used, and that the VaR measure be multiplied by a factor of at least three. These parameters are based on our experience and existing Commission rules (*e.g.*, Appendix F of Rule 15c3–1) and rules of other regulatory agencies where there are similar risk factors in the regulated entities. We ask for comment on all these parameters.

7. Other Questions Regarding Capital Calculation

Proposed Rules 17i–6 and 17i–7 would apply a capital reporting requirement consistent with the Basel Standards to the SIBHC. The Basel Committee is currently developing a new international agreement, the proposed *New Basel Capital Accord.* The proposed *New Basel Capital Accord* specifies three ''pillars'' for the group-wide supervision of internationally active banks and financial enterprises. The first pillar, ''minimum regulatory capital'' requirements, requires calculations for credit and operational risk and, for firms with significant trading activity, market risk. The second pillar, ''supervisory review,'' requires that capital be assessed relative to overall risks and that supervisors review and take action in response to those assessments.

The third pillar requires certain disclosures which will allow market participants to assess key pieces of information concerning, for example, the capital, risk exposures, and risk assessment processes of the institution. The purpose of the third pillar is to complement the minimum capital requirements and the supervisory review process by encouraging market discipline.

The third pillar is discussed in the U.S. banking agencies' Advanced Notice of Proposed Rulemaking on the proposed *New Basel Capital Accord.*[92] As the banking agencies noted, an integral part of the advanced approaches is enhanced public disclosure practices. Specific disclosure requirements would be applicable to all institutions using the advanced approaches and would encompass capital, credit risk, credit risk mitigation, securitization, market risk, operational risk, and interest rate risk.

We request comment on whether any additional disclosures by U.S. broker-dealer firms, their holding companies, and affiliates should be required to meet the requirements of the third pillar of the proposed *New Basel Capital Accord.*

[91] *See* the *New Basel Capital Accord* (April, 2003).

[92] *See Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord,* 68 FR 45900 (August 4, 2003), beginning at 45943.

If additional, specific disclosure is warranted, commenters are asked to address where that disclosure should be made as well as whether disclosures should be made on a quarterly, annual, or other periodic basis. In addition, we request comment on whether additional required disclosures should depend on whether a firm is privately held or is a public reporting company.

We also request comment on whether the regulatory regime outlined in this proposal together with existing Commission regulation of broker-dealers would meet the requirements of the first and second pillars of the proposed *New Basel Capital Accord* or whether changes or enhancements should be made.

We request comment on whether, if the proposed *New Basel Capital Accord* is adopted, there should be a transition period before the Commission requires its use by SIBHCs.

I. Proposed Rule 17i–8: Notification Requirements for SIBHCs

A broker-dealer that is part of a large holding company structure may be vulnerable to increased risks from the activities of its affiliates and may face difficulty in continuing its operations if a major affiliate ceased operations or encountered financial difficulties. Proposed Rule 17i–8 would require the SIBHC to notify the Commission upon the occurrence of certain events. The proposed early warning system is designed to provide the Commission with information so that it can identify these potential risks to the broker-dealer and its customers.

Paragraph (a) of proposed Rule 17i–8 would require the SIBHC to immediately notify the Commission upon the occurrence of certain events. These events include (i) the occurrence of certain backtesting exceptions; (ii) the SIBHC's computation reflects that consolidated allowable capital is less than 110% of the sum of consolidated allowances for market, credit and operational risk; (iii) an affiliate declares bankruptcy or otherwise becomes insolvent; (iv) the SIBHC becomes aware that a credit rating agency intends to decrease its evaluation of the creditworthiness of an affiliate or the credit rating assigned to one or more outstanding short or long-term obligations of an affiliate; (v) the SIBHC becomes aware that a financial regulatory agency or self-regulatory organization has taken certain regulatory actions against an affiliate; or (vi) the SIBHC becomes ineligible to be supervised by the Commission as a SIBHC (*e.g.,* the SIBHC purchases an insured bank, or the SIBHC's affiliated broker-dealer's tentative net capital falls below $100 million).[93] We believe that these events would indicate a decline in the financial and operational well-being of the firm. Were an SIBHC to file a notification as required by proposed Rule 17i–8, the Commission may be prompted to request additional reports, as contemplated by proposed Rule 17i–6(b), and otherwise begin to monitor the firm's condition more closely.

In addition, proposed Rule 17i–8 would require that an SIBHC notify the Commission if there were a material change (along with a description of that change) in the ownership or organization of the affiliate group, the status of any affiliate that is material, or the major business functions of any material affiliate.[94]

Paragraph (c) of proposed Rule 17i–8 would specify the manner in which these notices and reports should be provided to the Commission. In addition, paragraph (c) of proposed Rule 17i–8 would specify that the notices and reports filed with the Commission pursuant to Rule 17i–8 would be accorded confidential treatment. We believe it is important to accord confidential treatment to the notices and reports an SIBHC would be required provide pursuant to proposed Rule 17i–8 because the information contained in those notices and reports would generally be highly sensitive, non-public business information.

We believe the requirements set forth in proposed Rule 17i–8 are necessary to keep the Commission informed as to the SIBHC's activities, financial condition, policies, systems for monitoring and controlling financial and operational risks, and transactions and relationships between any broker or dealer affiliate of the SIBHC and the extent to which the SIBHC has complied with the provisions of the Act and the regulations prescribed and orders issued under the Act.

We request comment on all aspects of these notification requirements. In addition, we request comment as to whether the events that would trigger the notification requirement are appropriate, and whether other triggering events should be included.

III. General Request for Comment Regarding Proposed Rules

The Commission solicits comment on its proposal to supervise IBHCs as SIBHCs. The Commission solicits comments on whether this proposal would provide adequate Commission oversight on a group-wide basis of IBHCs that file a Notice of Intent to become supervised by the Commission as an SIBHCs.

We note that on September 12, 2003, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Commission requested public comment on an interim final rule and a notice of proposed rulemaking to amend their risk-based capital standards for the treatment of assets in asset-backed commercial paper programs consolidated under the recently issued Financial Accounting Standards Board Interpretation No. 46, Consolidation of Variable Interest Entities.[95] The rule would also modify the risk-based capital treatment of certain securitizations with early amortization provisions. In addition, the treatment of securitization exposures is discussed in the banking agencies Advanced Notice of Proposed Rulemaking on the proposed *New Basel Capital Accord*.[96]

Should the Commission consider any modifications to the calculations of allowances for market and credit risk for asset-backed securitization programs as contemplated by proposed Rule 17i–7? If so, how and why should the Commission modify these calculations for asset-backed securitization programs? Should the Commission consider any other issues related to the capital treatment of securitization exposures?

Commenters may also wish to discuss whether the Commission should consider a different approach, and if so, what that approach should be.

Commenters should provide empirical data to support their views. Comments should be submitted by February 4, 2004.

IV. Paperwork Reduction Act

Certain provisions of proposed new Rules 17i–1 through 17i–8 and the amendments to Rules 17h1–T and 17h–2T contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995.[97] The Commission has submitted them to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 C.F.R. 1320.11. The titles for the collections of information are (i) Rules 17h–1T and

[93] *See* paragraph (a) of proposed Rule 17i–8.

[94] *See* paragraph (b) of proposed Rule 17i–8.

[95] *See Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Asset-Backed Commercial Paper Programs and Early Amortization Provisions,* 68 FR 56568 (Oct. 1, 2003).

[96] *See Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord,* 68 FR 45900 (August 4, 2003), beginning at 45932.

[97] 44 U.S.C. 3501, *et seq.*

17h–2T Risk Assessment Rules; (ii) Rule 17i–2 Notice of Intention to be Supervised by the Commission as a Supervised Investment Bank Holding Company; (iii) Rule 17i–3 Withdrawal from Supervision as an Supervised Investment Bank Holding Company; (iv) Rule 17i–4 Internal Risk Management Control Systems Requirements for Supervised Investment Bank Holding Companies; (v) Rule 17i–5 Record Creation, Maintenance, and Access Requirements for Supervised Investment Bank Holding Companies; (vi) Rule 17i–6 Reporting Requirements for Supervised Investment Bank Holding Companies; and (vii) Rule 17i–8 Notification Requirements for Supervised Investment Bank Holding Companies. An agency may not conduct or sponsor, and a person is not required to comply with, a collection of information unless it displays a currently valid OMB control number.

A. Collection of Information Under the Amendments to Rules 17h–1T and 17h–2T and New Rules 17i–1 Through 17i–8

Proposed Rule 17i–1 through 17i–8 would create a framework for Commission supervision of SIBHCs. The collections of information included in these proposed rules are necessary to allow the Commission to effectively determine whether SIBHC supervision is necessary or appropriate in furtherance of the purposes of § 17 of the Act and allow the Commission to supervise the activities of these SIBHCs. These rules also would enhance the Commission's supervision of the SIBHCs' subsidiary broker-dealers through collection of additional information and inspections of affiliates of those broker-dealers. Regulatory oversight pursuant to this system is voluntary, and eligible IBHCs would not be required to be supervised in this manner. This framework would include procedures through which an IBHC could file a Notice of Intention to become supervised by the Commission as an SIBHC, as well as recordkeeping and reporting requirements for SIBHCs.

The amendments to Rules 17h–1T and 17h–2T [98] would exempt broker-dealers that are affiliated with an SIBHC from those rules and thus reduce their ''collection of information'' requirements. This exemption is designed to eliminate duplicative recordkeeping and reporting requirements.

[98] *See supra,* note 64.

B. Proposed Use of Information

The Commission would use the information collected under the proposed new Rules to determine whether SIBHC supervision is necessary or appropriate in furtherance of the purposes of § 17 of the Act and to monitor the financial condition, risk management, and activities of SIBHCs on a group-wide basis. In particular, it would allow the Commission access to important information regarding activities of a broker-dealer's affiliates that could impair the financial and operational stability of the broker-dealer or the SIBHC.

C. Respondents

An IBHC can file a Notice of Intention to be supervised by the Commission as an SIBHC only if it: (1) Has a subsidiary broker or dealer that can evidence that it has a substantial presence in the securities business; and (2) is not (i) affiliated with an insured bank (with certain exceptions) or a savings association, (ii) a foreign bank, foreign company, or a company that is described in section 8(a) of the International Banking Act of 1978, or (iii) a foreign bank that controls a corporation chartered under section 25A of the Federal Reserve Act.[99] Paragraph (d)(2)(i)(B) of proposed Rule 17i–2 would indicate that the Commission would not consider it to be necessary or appropriate to supervise an IBHC unless it can demonstrate that it owns or controls a broker-dealer that has a substantial presence in the securities business (which may be demonstrated by a showing that the broker-dealer maintains tentative net capital of at least $100 million).

As of March 31, 2003, approximately 100 registered broker-dealers reported their tentative net capital as being between $100 million and $1 billion.[100] Many of these broker-dealers are affiliated with another broker-dealer that reported its tentative net capital as being more than $100 million.

[99] Federal Reserve Act section 25A [12 U.S.C. 611].

[100] Per March 31, 2003, FOCUS Report filings. Broker-dealers are required to file monthly and/or quarterly reports on Form X–17A–5 pursuant to Rule 17a–5(a) (17 CFR 240.17a–5(a)), commonly referred to as FOCUS Reports. In addition, *see supra,* note, wherein we propose rules and rule amendments that would allow a holding company that owns or controls a broker-dealer that maintains more than $1 billion in tentative net capital. The supervisory framework provided by those proposed rules and rule amendments would allow the broker-dealers of those entities to calculate market and credit risk capital charges using mathematical modeling techniques, thus we believe those firms will elect that supervisory framework and will not elect to be supervised pursuant to these proposed new rules.

Approximately 35 could not be supervised by the Commission as an SIBHC due to the fact that each is either: (i) affiliated with an insured bank (with certain exceptions) or a savings association,[101] (ii) a foreign bank, foreign company, or a company that is described in section 8(a) of the International Banking Act of 1978, or (iii) a foreign bank that controls a corporation chartered under section 25A of the Federal Reserve Act.[102] In addition, some broker-dealers may not be active in jurisdictions that require securities firms to demonstrate that they have consolidated supervision at the holding company level that is equivalent to EU consolidated supervision, or may not find it to be cost-effective to register as an SIBHC for other reasons. Thus, the Commission estimates that six IBHCs will file notices of intent to be supervised by the Commission as SIBHCs.

D. Reporting and Recordkeeping Burdens

1. Amendments to Rules 17h–1T and 17h–2T

The amendments to Rules 17h–1T and 17h–2T [103] would exempt broker-dealers that are affiliated with an SIBHC from those rules and thus reduce their ''collection of information'' requirements. Rule 17h–1T requires that a broker-dealer maintain and preserve records and other information concerning the broker-dealer's holding companies, affiliates, or subsidiaries that are likely to have a material impact on the financial or operational condition of the broker-dealer. Rule 17h–2T requires broker-dealers to file with the Commission quarterly reports concerning the information required to be maintained and preserved under Rule 17h–1T. The present PRA burden for broker-dealers that are presently reporting pursuant to Rules 17h–1T and 17h–2T is 24 hours per year for each broker-dealer respondent. The estimated six firms therefore would have their annual burden reduced by an aggregate of 144 hours per year.

2. Proposed Rule 17i–2

Proposed Rule 17i–2 would require that an IBHC file a Notice of Intention to become supervised by the Commission as an SIBHC. The Notice of Intention would have to set forth certain information and include a number of documents. The SIBHC would also have

[101] *See* Exchange Act section 17(i)(1)(A)(i) [15 U.S.C. 78q(i)(1)(A)(i)].

[102] Federal Reserve Act section 25A [12 U.S.C. 611].

[103] *See supra,* note 64.

to submit amendments to its Notice of Intention if certain information became incorrect or if it made certain material changes. The Commission designed Rule 17i–2 so an IBHC could compile and submit existing documents with its Notice of Intention (as opposed to requiring that an IBHC create additional documents) in order to decrease any costs or burdens involved with this proposed rule.

As stated previously in section IV.C., we estimate that approximately six IBHCs will file Notices of Intention to become SIBHCs. We estimate that each IBHC that files a Notice of Intention to become supervised by the Commission would take approximately 900 hours to draft a Notice of Intention, compile the various documents to be included with the Notice of Intention, and work with the Commission staff. Further, we believe that an IBHC would have an attorney review its Notice of Intention, and we estimate that it would take the attorney approximately 100 hours to complete such a review. Consequently, we estimate the total burden for all six firms to be approximately 6,000 hours.[104] We believe this would be a one-time burden.

The estimates of the initial burden for proposed Rule 17i–2 are based on the estimates the Commission made in adopting Rule 17c3–1f, which contained similar requirements.[105] Our burden estimates for proposed Rule 17i–2 are lower than our burden estimates relating to the application provisions of Rule 15c3–1f because our estimates relating to the creation of mathematical models have been removed from the estimate. Proposed Rule 17i–2 does not require that mathematical models be created. In addition, the requirement to create a model is not a paperwork burden. Accordingly, the costs associated with creation of mathematical models are included in the Cost-Benefit discussion regarding proposed Rule 17i–7 (which would require that an SIBHC calculate allowances for market and credit risk using mathematical models). The estimates we used here were also adjusted based on the staff's experience in implementing the OTC derivatives dealer rules. We based our burden estimates for proposed Rule 17i–2 on our burden estimates for Rule 15c3–1f because the application provisions of Rule 15c3–1f and proposed Rule 17i–2 are substantially similar and because no comments were received regarding the burden estimates for Rule 15c3–1f.

Rule 17i–2 also requires that an IBHC/SIBHC[106] update its Notice of Intention on an ongoing basis. We estimate, based on the staff's experience, that an IBHC/SIBHC will take approximately 2 hours each month to update its Notice of Intention, as necessary. Thus, we estimate that it will take the six IBHC/SIBHCs, in the aggregate, about 144 hours each year[107] to update their Notices of Intention.

3. Proposed Rule 17i–3

Proposed Rule 17i–3 would provide a method by which an SIBHC could withdraw from Commission supervision as an SIBHC. The proposed rule would require that an SIBHC file a notice of withdrawal with the Commission stating that the SIBHC wished to withdraw from Commission supervision.

Due to the benefits and costs associated with becoming supervised by the Commission as an SIBHC, we believe that an IBHC would carefully consider filing a Notice of Intention. For PRA purposes only, we estimate that one SIBHC may wish to withdraw from Commission supervision as an SIBHC over a ten-year period.

We estimate, based on the staff's experience, that an SIBHC that withdraws from Commission supervision as an SIBHC would take one attorney approximately 24 hours to draft a withdrawal notice and submit it to the Commission. Further, we believe the SIBHC would have a senior attorney or executive officer review the notice of withdrawal before submitting it to the Commission, and that it would take such person 8 hours to conduct such a review. Thus, we estimate that the annual, aggregate burden of withdrawing from Commission supervision as an SIBHC would be approximately 3.2 hours each year.[108]

4. Proposed Rule 17i–4

Proposed Rule 17i–4 would require an SIBHC to have in place a risk management control system appropriate for its business and organization. An SIBHC would need to consider, among other things, the sophistication and experience of its operations, risk management, and audit personnel, as well as the separation of duties among these personnel, when designing and implementing its internal control system's guidelines, policies, and procedures. These requirements are designed to result in control systems that would adequately address the risks posed by the firm's business and the environment in which it is being conducted. In addition, this would enable an SIBHC to implement specific policies and procedures unique to its circumstances.

Proposed Rule 17i–4 also would require that an SIBHC periodically review its internal risk management control system for integrity of the risk measurement, monitoring, and management process, and accountability, at the appropriate organizational level, for defining the permitted scope of activity and level of risk.

In implementing its policies and procedures, an SIBHC would be required to document and record its system of internal risk management controls. In particular, an SIBHC would be required to document its consideration of certain issues affecting its business when designing its internal controls. An SIBHC would also be required to prepare and maintain written guidelines that discuss its internal control system.

The information to be collected under proposed Rule 17i–4 would be essential to the supervision of SIBHCs and their compliance with the Commission's proposed rules. More specifically, the requirement that an SIBHC document the planning, implementation, and periodic review of its risk management controls is designed to assure that all pertinent issues are considered, that the risk management controls are implemented properly, and that they continue to adequately address the risks faced by SIBHCs.

As stated previously in section IV.C., we estimate that approximately six IBHCs will file Notices of Intention to be supervised by the Commission as SIBHCs. We further estimate that the average amount of time an SIBHC would spend assessing its present structure, businesses, and controls, and establishing and documenting its risk management control system would be about 3,600 hours, and that this would be a one-time burden. In addition, we estimate that an SIBHC would spend approximately 250 hours each year maintaining its risk management control system. Thus, we estimate that the total initial burden for all SIBHCs would be

[104] (900 hours + 100 hours) × 6 IBHCs/SIBHCs = 6,000 hours.

[105] *See* 17 CFR 240.15c3–1f(a).

[106] An IBHC would be required to review and update its Notice of Intention to the extent it becomes inaccurate prior to a Commission determination, and an SIBHC would be required to update its Notice of Intention if it changes a mathematical model used to calculate its risk allowances pursuant to proposed Rule 17i–7 after a Commission determination was made.

[107] (2 hours × 12 months each year) × 6 SIBHCs = 144.

[108] (1 SIBHC / every 10 years) × (24 hours to draft + 8 hours to review) = 3.2 hours.

approximately 21,600 hours [109] and the continuing annual burden would be about 1,500 hours.[110]

The estimates of the initial and annual burdens for proposed Rule 17i–4 are based on the estimates the Commission made in adopting Rule 15c3–4. Proposed Rule 17i–4 makes Rule 15c3–4 applicable to SIBHCs. Our burden estimates for proposed Rule 17i–4 are higher than our burden estimates for Rule 15c3–4 because an SIBHC would be establishing, documenting, and maintaining a system of internal risk management controls for the affiliate group, and not just for one firm. We based our burden estimates for proposed Rule 17i–4 on our burden estimates for Rule 15c3–4 because Rule 15c3–4 and proposed Rule 17i–4 are substantially similar and because no comments were received regarding the burden estimates for Rule 15c3–4.

Internationally active firms generally already have in place risk management practices, and will generally review and improve their risk management practices in the near future despite these rules. However, we recognize that, to the extent an IBHC presently has a group-wide internal risk management control system, those systems may not take into account all of the elements and issues required by proposed Rule 17i–4. In addition, these firms may not have documented their consideration of these elements and issues, or other aspects of their internal risk management control systems.

5. Proposed Rule 17i–5

Pursuant to proposed Rule 17i–5, an SIBHC would be required to make and keep current certain records relating to its business. In addition, it would be required to preserve those and other records for certain prescribed time periods. The purpose of this rule is to require that the SIBHC create and maintain records that would allow the Commission to evaluate SIBHC compliance with the rules to which it is subject. We expect that any additional burden under the proposed rule would be minimal because the information that would be called for under the proposed rule is information a prudent IBHC that manages risk on a group-wide basis would maintain in the ordinary course of its business.

Pursuant to proposed Rule 17i–5, an SIBHC would be required to make and keep records reflecting (i) the results of quarterly stress tests; (ii) that the firm had created a contingency plan to respond to certain possible funding and liquidity difficulties; and (iii) the basis for credit risk weights. We estimate that the average amount of time an SIBHC would spend to create a record regarding stress tests is about 64 hours each quarter, or approximately 256 hours each year. This estimate is based on the staff's experience working with models and dealing with firms that use models through implementation of the OTC derivatives dealers rules, as well as informal discussions with potential respondents. We further estimate that the average amount of time an SIBHC would spend to create and document a contingency plan regarding funding and liquidity of the affiliate group (which we believe an SIBHC would do only once, not on an ongoing basis) would be about 40 hours. This estimate is based on the staff's experience. In addition, we estimate that the average amount of time an SIBHC would spend to create a record regarding the basis for credit risk weights would be about 30 minutes for each counterparty, and that on average, an SIBHC will establish approximately 20 new counterparty arrangements each year.[111] This estimate is based on informal discussions the staff has had with potential respondents.

Pursuant to proposed Rule 17i–5, an SIBHC would be required to maintain these and other records for at least three years in an easily accessible place. We estimate that the average amount of time an SIBHC would spend to maintain these and other, specified records for three years would be about 24 hours per year per SIBHC. This estimate is based on our present estimates for Rule 17a–4, which previously have been subject to notice and comment and have been approved by OMB.

As stated previously in section IV.C., we estimate that approximately six IBHCs will file Notices of Intention to be supervised by the Commission as SIBHCs. Thus, the total initial burden relating to proposed new Rule 17i–5 for all SIBHCs would be approximately 240 hours [112] and the continuing annual burden would be approximately 1,740 hours.[113]

6. Proposed Rule 17i–6

Proposed Rule 17i–6 would require an SIBHC to file certain monthly and quarterly reports with the Commission, as well as an annual audit report. These reporting requirements are necessary to keep the Commission informed as to the activities of the SIBHC, as well as the financial condition, transactions and relationships involving the affiliate group, and policies, systems for monitoring and controlling financial and operational risks. In addition, these requirements are essential to keeping the Commission informed of the extent to which the SIBHC or its affiliates have complied with Section 17(i) of the Exchange Act and the rules promulgated thereunder. Finally, these reports could also be used to evaluate the activities conducted by these SIBHCs and to anticipate, where possible, how they might be affected by significant economic events.

As stated previously in section IV.C., we anticipate that the proposed rule would affect approximately six SIBHCs. We estimate that, on average, it would take an SIBHC about 8 hours each month to prepare and file the monthly reports required by this rule (or approximately 96 hours per year).[114] We estimate that, on average, it would take an SIBHC about 16 hours each quarter (or 64 hours each year) [115] to prepare and file the quarterly reports required by this rule. We estimate that, on average, it would take an SIBHC about 200 hours to prepare and file the annual audit reports required by this rule. Thus, we estimate that the total annual burden of proposed Rule 17i–6 on all SIBHCs would be approximately 2,160 hours.[116]

These estimates are based on our present estimates for 17a–12, which were previously subject to notice and comment and have been approved by OMB. However the estimates for the monthly and quarterly reports were reduced somewhat due to the fact that an SIBHC would not be required to complete specified forms, but instead could provide the required information to the Commission in its existing format. We believe that our use of existing internal reports will decrease the burden on SIBHCs because an SIBHC may compile existing documents and submit them to the Commission.

[109] (3,600 hours × 6 SIBHCs) = 21,600 hours.

[110] (250 hours per year × 6 SIBHCs) = 1,500 hours per year.

[111] We estimate that, on average, each firm presently maintains relationships with approximately 1,000 counterparties. Further, it is our understanding that firms generally already maintain documentation regarding their credit decisions, including their determination of credit risk weights, for those counterparties.

[112] (40 hours to create and document a contingency plan regarding funding and liquidity of the affiliate group) × 6 SIBHCs.

[113] ((256 hours to create a record regarding stress tests) + ((30 minutes × 20 counterparties) to create a record regarding the basis for credit risk weights) + (24 hours per year to maintain records)) × 6 SIBHCs.

[114] (8 hours × 12 months in a year) = 96 hours/year.

[115] (16 hours × 4 quarters in a year) = 64 hours/year.

[116] (96 hours per year to prepare and file monthly reports + 64 hours each year to prepare and file quarterly reports + 200 hours each year to prepare and file annual audit reports) × 6 SIBHCs = 2,160 hours.

Further, the time burden relating to the annual audit was increased in recognition of the fact that the audit of a holding company is generally more time consuming than the audit of one entity (for both the accountants and the firm employees working with them). However, many of these holding companies are already audited at the holding company level, so, aside from the special supplemental reports, no additional burden should be imposed by proposed Rule 17i–6. We believe that most well-managed SIBHCs already report to their senior management much of the information required to be provided to the Commission pursuant to proposed Rule 17i–6.

7. Proposed Rule 17i–8

Proposed Rule 17i–8 would require SIBHCs to report on the occurrence of certain events that may have a material adverse affect on the SIBHC. The proposed early warning system is modeled after the early warning system used with respect to broker-dealers in Exchange Act Rule 17a–11. Like Exchange Act Rule 17a–11, proposed Rule 17i–8 is designed to give the Commission advance warning of problems that may pose material risks to the financial and operational capability of an SIBHC and its affiliated broker-dealers. The proposed rule would be integral to the supervision of SIBHCs and their affiliated broker-dealers.

We estimate that it would take an SIBHC approximately one hour to create a notice required to be submitted to the Commission pursuant to proposed Rule 17i–8. This estimate is based on our present estimates for Rule 17a–11, which were previously subject to notice and comment and have been approved by OMB. The Commission received 692 Rule 17a–11 Notices from 627 broker-dealers during the year ending December 2001. At that time, there were approximately 7,217 active broker-dealers registered with the Commission.[117] Thus, 9% of active, registered broker-dealers had a situation arise which caused them to file a notice pursuant to Rule 17a–11. Using this 9% figure, we estimate that of the approximately six IBHCs that we believe will register to be supervised as SIBHCs, one may be required to file notice pursuant to proposed Rule every other year.[118] Thus, we estimate that the annual burden of proposed Rule 17i–8 for all SIBHCs would be about 30 minutes.

E. Collection of Information Is Mandatory

The collections of information requirements in proposed new Rules 17i–1 through 17i–8 would be mandatory for every IBHC that files a Notice of Intention to be supervised by the Commission as an SIBHC and every SIBHC that is supervised by the Commission.

F. Confidentiality

The information and documents collected, retained, and/or filed pursuant to Proposed new Rules 17i–1 through 17i–8 would be accorded confidential treatment.

G. Record Retention Period

Proposed Rule 17i–5(b) would require that an IBHC preserve for three years in an easily accessible place information relating to (i) its Notice of Intention; (ii) its group-wide system of internal risk management controls; (iii) the records it is required to make and keep current; (iv) the reports it is required to make; and (v) its calculations of allowable capital and allowances for market, credit, and operational risk.

H. Request for Comments Regarding Paperwork Burden Estimates

Under 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to evaluate:

- Whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information would have practical utility;
- The accuracy of the Commission's estimate of the burden of the proposed collection of information;
- Ways in which we might enhance the quality, utility, and clarity of the information to be collected; and
- Ways in which we might minimize the burden of the collection of information on those required to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements should address them to The Office of Management and Budget, Room 3208, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, New Executive Office Building, Washington, DC 20503; and should also send a copy of their comments to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. The submission should reference File No. S7–22–03. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this document in the **Federal Register**; therefore, comments to OMB are best assured of having full effect if OMB receives them within 30 days of this publication.

The Commission has submitted the proposed collections of information to OMB for approval. Requests for the materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7–22–03, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 Fifth Street, NW., Washington, DC 20549–0609.

V. Costs and Benefits of the Proposed Rules and Rule Amendments

The Commission has identified certain costs and benefits that would be associated with the proposed framework for supervising SIBHCs. Supervision pursuant to this system is voluntary, and eligible IBHCs would not be required to be supervised in this manner. This framework would include requirements for IBHCs that file Notices of Intention to be supervised by the Commission as SIBHCs, as well as recordkeeping and reporting requirements for SIBHCs, including a requirement that an SIBHC calculate and report a calculation of allowable capital and allowances for market, credit and operational risk.

A. Benefits

There are many quantifiable and non-quantifiable benefits that would be created by these rules. We have attempted to delineate those costs below.

U.S. securities firms that do business in the EU have indicated that they may need to demonstrate that they are subject to consolidated supervision at the holding company level that is ''equivalent'' to EU consolidated supervision. Generally, EU ''consolidated supervision'' would take the form of a series of rules, imposed at the holding company level, regarding firms' internal controls, capital adequacy, intra-group transactions, and risk concentration. Without a demonstration of ''equivalent'' supervision, securities firms located in the EU have stated that they may either be subject to additional capital charges or required to form a sub-holding

[117] Of approximately 7,739 broker-dealers registered with the Commission in 2001, approximately 341 were not yet active because their registration was pending SRO approval and approximately 181 were inactive because they had ceased doing a securities business and had filed a Form BDW with the Commission. Of those, 7217 active, registered broker-dealers, three were registered OTC derivatives dealers.

[118] (6 SIBHCs × 9%) = 0.54.

company in the EU.[119] The regulatory framework for SIBHCs set forth in the proposed rules is intended to provide a basis for non-U.S. financial regulators to treat the Commission as the principal U.S. consolidated, home-country supervisor[120] for SIBHCs and their affiliated broker-dealers. In response to a survey conducted during the rulemaking process to promulgate the OTC derivatives dealers rules, firms suggested that they would incur significant costs in creating a new, non-U.S. regulated affiliate. Based on that information, we estimate that it would cost an IBHC approximately $8 million to with create a new, non-U.S., regulated affiliate,[121] or about $48 million in the aggregate for the six IBHCs we believe will file Notices of Intention to become supervised by the Commission as SIBHCs. We do not have sufficient information to estimate what additional capital charges may be imposed on securities firms that do business in the EU if they are not subject to equivalent supervision.

Certain broker dealers must create records and file quarterly reports with the Commission regarding the financial condition, organization, and risk management practices of the affiliated group pursuant to Exchange Act Rules 17h–1T and 17h–2T.[122] Broker-dealers affiliated with IBHCs that meet the criteria set forth in proposed Rules 17i–1 through 17i–8 generally would be subject to Rules 17h–1T and 17h–2T. To the extent that the information collected or made and maintained pursuant to proposed Rule 17i–5 reports are made and filed pursuant to proposed Rule 17i–6 by the SIBHC of a broker-dealer that is subject to Rules 17h–1T and 17h–2T, that broker-dealer will be exempted from the provisions of Rules 17h–1T and 17h–2T. We estimate that, on average, a broker-dealer affiliated with one of the six SIBHCs would save about $1,215.12.[123] In the aggregate, the total cost savings associated with these amendments would be approximately $7,291.[124]

In addition, proposed Rules 17i–1 through 17i–8 would not only create a regulatory framework for the Commission to supervise SIBHCs, but they would improve the Commission's ability to supervise the financial condition and securities activities of SIBHCs' affiliated broker-dealers. The proposed requirement that an SIBHC establish, document and maintain an internal risk management control system reduces the risk of significant losses by the SIBHC's affiliated broker-dealers. The proposed internal risk management control system requirement would also reduce systemic risk. We have no way to quantify this benefit.

An additional benefit arises from the reduced borrowing costs, or increased stock price that would result from better risk management practices. Credit rating agencies analyze risk management practices, among many factors, in determining credit ratings. A firm that has better risk management systems may be rated better, and would therefore pay lower interest rates to borrow and realize higher stock prices. However it is unclear to what extent risk management factors into credit ratings. In addition, present internal risk management control systems vary widely from firm to firm. Therefore it is difficult to quantify this benefit.

However, evolving industry best practice for internationally active firms suggests that some of the firms already have group-wide internal risk management control systems in place, and some firms will implement the risk management practices in the near future.

B. Costs

IBHCs that file Notices of Intention to become supervised by the Commission as SIBHCs would incur various on-going costs and one-time costs.

1. Ongoing Costs

Proposed Rules 17i–1 through 17i–8 would cause an SIBHC to incur ongoing costs relating to: (i) Drafting and reviewing a Notice of Intention; (ii) drafting and reviewing a notice of withdrawal; (iii) updating its internal risk management control system; (iv) creating a record regarding stress tests; (v) creating a record regarding the basis for credit risk weights; (vi) maintaining its records in accordance with proposed Rule 17i–5; (vii) preparing and filing monthly and quarterly reports; (viii) preparing and filing its annual audit; (ix) calculating allowable capital and allowances for market, credit, and operational risk; (x) maintaining its models; (xi) conducting stress tests on its models; and (xii) filing notices pursuant to proposed Rule 17i–8.

Proposed Rule 17i–2 would require that an SIBHC update its Notice of Intention on an ongoing basis. We estimate, that each SIBHC will incur a cost of approximately $1,358 each year to make any necessary updates to its Notice of Intention.[125] Thus, we estimate that the total annual cost to make any updates to the notice would be, in aggregate, about $8,150 each year for all SIBHCs.[126]

Proposed Rule 17i–3 would require that an SIBHC file a notice of withdrawal with the Commission if it wished to withdraw from Commission supervision. We estimate that each SIBHC that withdraws from Commission supervision would incur a cost of about $2,130 to draft and review a notice or withdrawal to submit to the Commission.[127] However, we further estimate that one SIBHC may withdraw from Commission supervision only once every ten years. Thus, the annual cost of this rule would be approximately $213.[128]

Proposed Rule 17i–4 would require an SIBHC to maintain an internal risk management control system. We estimate that an SIBHC would incur a cost of approximately $14,150

[119] *See supra* note 3.

[120] *See supra* note 4.

[121] Five firms responded to the survey and estimated that their annual operating costs would increase by at least $36 million in the aggregate to conduct business as an OTC derivatives dealer. ($36 million / 5 firms) = $7.2 million each. ($7.2 million × an inflation factor of 1.12 (to account for inflation from 1998 to the present)) = approximately $8 million.

[122] *See supra,* note 64.

[123] We estimate, based on the present burden for 17h–1T and 17h–2T (which has been subject to notice and comment and has been approved by OMB), that each broker-dealer affiliated with an SIBHC that will no longer have to maintain records or file reports will spend 24 hours less each year to perform these tasks. The staff believes that a broker-dealer would have a financial reporting manager perform these tasks. According to the Securities Industry Association's (''SIA'') *Report on Management and Professional Earnings in the Securities Industry—2002,* the hourly cost of a financial reporting manager is $50.63. (($50.63 × 24 hours) = $1,215.12. Generally, to achieve an hourly cost using the SIA's *Report on Management and Professional Earnings in the Securities Industry—2002,* the staff will take the median (or, if no median is provided, the mean) salary provided in that Report for the position cited, divide that amount by 1,800 hours (in the average year), and then multiply the result by 135% (to account for employee overhead costs).

[124] ($1,215.12 × six affected broker-dealers) = $7,291.

[125] We estimate that an SIBHC will take about 24 hours each year to assure that its Notice of Intention is accurate and make any necessary updates. We believe an SIBHC will have a senior compliance person perform this task. According to the SIA's *Report on Management and Professional Earnings in the Securities Industry—2002,* the hourly cost of a senior compliance person is $56.60. (24 hours × $56.60) = $1,358.40.

[126] ($1,358.40 × 6 SIBHCs) = $8,150.

[127] We estimate, based on the staff's experience, that it would take one attorney approximately 24 hours to draft a withdrawal notice and that it would take a senior attorney or executive officer 8 hours to review the notice of withdrawal before submitting it to the Commission. According to the SIA's *Report on Management and Professional Earnings in the Securities Industry—2002,* the hourly cost of an attorney is $63.75, and the average hourly cost of a senior attorney and executive officer is $75.00. ((24 hours × $63.75) + (8 hours × $75.00)) = $2,130.

[128] ($2,130.00 × 10 years) = $213.

associated with maintaining its risk management control system each year.[129] Thus, the continuing annual burden would be, in aggregate, approximately $84,897 for all six SIBHCs.[130]

Pursuant to proposed Rule 17i–5, an SIBHC would be required to create records regarding stress tests and the basis for credit risk weights, and preserve those and other records relating to its business for certain prescribed time periods. We estimate that an SIBHC would incur an annual cost of about $17,280 to create a record regarding stress tests as required by proposed Rule 17i–5.[131] Further, we estimate that, on average, an SIBHC would incur an annual cost of approximately $371 to create a record regarding the basis for credit risk weights.[132] These estimates are based on informal discussions with potential respondents. Further, we estimate that, on average, an SIBHC would incur an annual cost of $1,413 to maintain records pursuant to proposed Rule 17i–5.[133] Thus, the aggregate annual cost relating to proposed new Rule 17i–5 for all SIBHCs would be approximately $114,382.[134]

Proposed Rule 17i–6 would require an SIBHC to file certain monthly and quarterly reports with the Commission, as well as an annual audit report. We estimate that the average cost for an SIBHC to prepare and file the monthly reports would be about $399 per month, and thus approximately $4,788 per year.[135] We estimate that, on average, an SIBHC would incur a quarterly cost of $798 to prepare and file the required quarterly reports, and thus would incur an annual cost of $3,192 to file these reports.[136] Finally, we estimate that, on average, an SIBHC would incur an annual cost of $9,750 to prepare and file an annual audit.[137] Thus, we estimate that the total cost that, in aggregate, SIBHCs would incur that are associated with proposed Rule 17i–6 would be approximately $106,385.[138]

Proposed Rule 17i–7 would require an SIBHC to calculate the affiliate group's allowable capital and allowances for certain types of risk. Once the appropriate systems and models are in place, we estimate that each SIBHC would incur a cost of about $52,374 to calculate its group-wide allowances for market, credit, and operational risk.[139] In addition, we estimate that each SIBHC will incur a cost of about $378,000 to maintain its models.[140] Finally, we estimate that each SIBHC will incur an annual cost of approximately $24,915 to perform stress tests on its models at least once each quarter.[141] Thus, we estimate that the annual cost that SIBHCs will incur, in aggregate, will be approximately $2.7 million.[142]

Proposed Rule 17i–8 would require SIBHCs to report to the Commission the occurrence of certain material risks. We estimate that it would cost an SIBHC approximately $64 to create a notice required to be submitted to the Commission pursuant to Proposed Rule 17i–8.[143] However, we estimate that

[129] We estimate that it would take each SIBHC 250 hours each year to maintain its internal risk management control system, and that an SIBHC would have a senior compliance person perform that task. According to the SIA's *Report on Management and Professional Earnings in the Securities Industry—2002,* the hourly cost of a senior compliance person is $56.60. (250 hours × $56.60) = $14,149.50.

The hourly burden estimates are roughly based on the estimates made in the Commission's OTC derivatives dealer releases, through which Rule 15c3–4 was promulgated. Proposed Rule 17i–4 states that an SIBHC must comply with Rule 15c3–4 as if it were a broker-dealer. No comments were received in response to the estimates proposed in the OTC derivatives dealers proposing release, and those burden estimates were not changed in the final rule release. Those estimates were increased to account for the fact that an SIBHC would be designing and implementing a system of internal risk management controls for the affiliate group, and not just for one firm.

[130] ($14,149.50 × 6 SIBHCs) = $84,897.

[131] Based on the staff's experience working with models and dealing with firms that use models through implementation of the OTC derivatives dealers rules, as well as informal discussions with potential respondents, we estimate that an SIBHC would spend approximately 256 hours each year to create a record regarding stress tests. We believe that an SIBHC would have a trading floor supervisor or equivalent create this record. According to the SIA's *Report on Management and Professional Earnings in the Securities Industry—2002*, the hourly cost of a trading floor supervisor is $67.50. ($67.50 × 256) = $17,280.

[132] Based on the staff's informal discussions with potential respondents, we estimate that an SIBHC would spend 30 minutes per counterparty to create a record regarding credit risk weights, and that, on average, each SIBHC would initiate relationships with 20 new counterparties each year. We believe that an SIBHC would have an intermediate accountant create this record. According to the SIA's *Report on Management and Professional Earnings in the Securities Industry—2002*, the hourly cost of an intermediate accountant is $37.05. ($37.05 × (30 minutes × 20 counterparties)) = $370.50.

[133] We estimate, based on our present estimates for Rule 17a–4, which previously have been subject to notice and comment and have been approved by OMB, that an SIBHC will spend about 24 hours per year to maintain records as required pursuant to proposed Rule 17i–5. The staff believes that an SIBHC would have a programmer analyst perform this task. According to the SIA's *Report on Management and Professional Earnings in the Securities Industry—2002*, the hourly cost of a programmer analyst is $58.88. ($58.88 × 24) = $1,413.12.

[134] (($17,280 + $370.50 + $1,413.12) × 6 SIBHCs) = $114,381.72.

[135] We estimate that an SIBHC would spend about 8 hours per month and 96 hours per year to prepare and file these monthly reports. We believe that an SIBHC would have a senior accountant prepare and file these reports. According to the SIA's *Report on Management and Professional Earnings in the Securities Industry—2002*, the hourly cost of a senior accountant is $49.88. ($49.88 × 8 hours) = $399.04. ($399.04 × 12 months) = $4,788.48.

[136] We estimate that an SIBHC would spend about 16 hours per quarter and 64 hours per year to prepare and file these quarterly reports. We believe that an SIBHC would have a senior accountant prepare and file these reports. According to the SIA's *Report on Management and Professional Earnings in the Securities Industry—2002*, the hourly cost of a senior accountant is $49.88. ($49.88 × 16 hours) = $798.08. ($798.08 × 4 quarters) = $3,192.32.

[137] We estimate that an SIBHC would spend about 200 hours per year to prepare and file an annual audit. We believe that an SIBHC would have a senior internal auditor work with accountants to prepare and file these reports. According to the SIA's *Report on Management and Professional Earnings in the Securities Industry—2002*, the hourly cost of a senior internal auditor is $48.75. ($48.75 × 200 hours) = $9,750.

[138] (($4,788.48 + $3,192.32 + $9750) × 6 SIBHCs) = $106,385. The hourly burden estimates relating to proposed Rule 17i–6 are based on the present estimates for Rule 17a–12, which were previously subject to notice and comment and have been approved by OMB. However, those estimates were reduced somewhat due to the fact that SIBHCs would not be required to create any special report, but instead could provide the required information to the Commission in its existing format.

[139] We estimate, based on staff experience and discussions with industry participants, that, on average, each SIBHC will take approximately 1,050 hours per year to calculate allowable capital and allowances for market, credit, and operational risk and to verify and review that data. We believe that an SIBHC would have a senior accountant perform these calculations and verifications. According to the SIA's *Report on Management and Professional Earnings in the Securities Industry—2002*, the hourly cost of a senior accountant is $49.88. ($49.88 × 1,050 hours) = $52,374.

[140] We estimate, based on staff experience and discussions with industry participants, that each SIBHC will spend an average of approximately 5,600 hours per year maintaining its models. We believe that an SIBHC would have a senior programmer and a senior research analyst spend approximately 2,800 hours each maintaining its models. According to the SIA's *Report on Management and Professional Earnings in the Securities Industry—2002*, the hourly cost of a senior programmer is $63.75 and the hourly cost of a senior research analyst is $71.25. (($63.75 × 2,800 hours) + ($71.25 × 2,800 hours) = $378,000.

[141] We estimate, based on staff experience and discussions with industry participants, that each SIBHC will spend about 640 hours each year to conduct stress tests on its models. We believe that an SIBHC would have a junior research analyst conduct stress tests on its models. According to the SIA's *Report on Management and Professional Earnings in the Securities Industry—2002*, the hourly cost of a junior research analyst is $38.93. ($38.93 × 640 hours) = $24,915.20.

[142] (($52,374 + $378,000 + $24,915.20) × 6 SIBHCs = $2,731,735.20.

[143] We estimate that it would take an SIBHC approximately one hour to create a notice required to be submitted to the Commission pursuant to proposed Rule 17i–8. However, we further estimate that only one SIBHC may be required to submit such notice every other year. We believe that an SIBHC would have an attorney create a notice required to be submitted to the Commission pursuant to proposed Rule 17i–8. According to the SIA's *Report on Management and Professional Earnings in the Securities Industry—2002*, the

Continued

only one SIBHC may be required to send a notice as required by proposed Rule 17i–8 every other year. Thus, we estimate that the annual cost of proposed Rule 17i–8 for all SIBHCs would be about $32.[144]

2. One-time Costs

We believe that an SIBHC would incur five types of one-time costs associated with becoming an SIBHC: (i) Costs associated with drafting a Notice of Intention to submit to the Commission; (ii) costs associated with assessing its present structure, businesses, and controls, and designing and implementing a risk management control system in order to comply with proposed Rule 17i–4; (iii) costs associated with creating and documenting a contingency plan regarding funding and liquidity of the affiliate group; (iv) costs associated with upgrading the information technology (''IT'') systems it uses to manage group-wide risk, make and retain records and reports, and calculate group-wide capital; and (v) costs associated with developing mathematical models to calculate its group-wide allowances for market and credit risk as required by proposed Rule 17i–7.

Proposed Rule 17i–2 would require that an IBHC file a Notice of Intention to become supervised by the Commission that includes certain information and documents. We estimate that each IBHC that files a Notice of Intention to become supervised by the Commission as an SIBHC would incur a cost of approximately $50,940 to draft a Notice of Intention, compile the various documents to be included with the Notice of Intention, and work with the Commission staff.[145] Further, we believe that an IBHC would have an attorney review the Notice of Intention, and that it would incur a cost of approximately $6,375 relating to this review.[146] Consequently, we estimate that the total costs that would be incurred by the six IBHCs we believe will file Notices of Intention to become supervised by the Commission as SIBHCs is about $343,890.[147]

Each SIBHC would incur a one-time cost to assess its present structure, businesses, and controls, and establish, document and maintain a risk management control system in order to comply with proposed Rule 17i–4. We estimate that the one-time cost for an SIBHC to assess its present structure, businesses, and controls, and establish, document and maintain a risk management control system will cost approximately $203,760.[148] Thus, we anticipate the total aggregate cost for all SIBHCs would be about $1.2 million.[149]

Pursuant to proposed Rule 17i–5, an SIBHC would be required to document a contingency plan regarding funding and liquidity of the affiliate group. We estimate that it would cost each SIBHC about $1,958 to document such a contingency plan.[150] Consequently, it would cost the six SIBHCs we expect to file Notices of Intention to be supervised by the Commission, in aggregate, approximately $11,746.[151]

The IT systems used by IBHCs to manage risk, make and retain records and reports, and calculate capital differ widely based on the types of business and the size of the IBHC. In addition, these IT systems may be in varying stages of readiness to meet the requirements of the proposed rules. We estimate that it will cost an IBHC that has well-developed IT systems to manage group-wide risk, make and retain their records, provide reports, and calculate group-wide capital about $1 million to upgrade its IT systems. We estimate that it will cost an IBHC that has less well-developed IT systems approximately $10 million to upgrade its IT systems. Thus, we estimate that, on average, it will cost each of the six SIBHCs about $5.5 million to upgrade their IT systems, or approximately $33 million in total. We believe that the costs for an SIBHC to update information technology systems in order to comply with proposed Rules 17i–1 through 17i–8 would be an initial, one-time cost. These estimates are based on the experience of Commission staff, as well as informal discussions with potential respondents.

Pursuant to proposed Rule 17i–7 an SIBHC would be required to calculate its group-wide allowances for market, credit, and operational risk on a monthly basis. SIBHCs would generally use mathematical models to calculate market and credit risk. The SIBHC's size, the types of business in which it engages, and the complexity of its portfolio will all factor into the cost of model development. We estimate, based on staff experience, our experience with OTC derivatives dealers, and discussions with industry participants, that it will cost an SIBHC between $6,750 (if the firm already manages risks using mathematical models and simply needs to adjust those models to assure they comply with the qualitative and quantitative requirements set forth in

hourly cost of an attorney is $63.75. ($63.75 × 1 hour) = $63.75. The hourly burden estimate for proposed Rule 17i–8 is based on our present estimates for Rule 17a–11, which were previously subject to notice and comment and have been approved by OMB. The Commission received 692 Rule 17a–11 Notices from 627 broker-dealers during the year ending December 2001. At that time, there were approximately 7,217 active broker-dealers that are registered with the Commission. Thus, 9% (692/7,217) of active, registered broker-dealers had a situation arise which caused them to file a notice pursuant to Rule 17a–11. Using this 9% figure, we estimate that of the approximately 6 IBHCs that we believe will register to be supervised as SIBHCs, one may be required to file notice pursuant to proposed Rule 17i–8 every other year ((6 SIBHCs × 9%) = 0.54).

[144] ($63.75 × (30 minutes/one hour)) = $31.88.

[145] We estimate that an SIBHC will spend 900 hours to perform this task. Further, we believe that an SIBHC would have a senior compliance person perform this task. According to the SIA's *Report on Management and Professional Earnings in the Securities Industry—2002,* the hourly cost of a senior compliance person is $56.60. ($56.60 × 900 hours) = $50,940.

[146] We believe that an SIBHC will have an attorney review the Notice of Intention and that it would take an attorney 100 hours to complete this review. According to SIA's *Report on Management and Professional Earnings in the Securities Industry—2002,* the hourly cost of an attorney is $63.75. ($63.75 × 100 hours) = $6,375.

[147] ($50,940 + $6,375) × 6 SIBHCs = $343,890. The hourly burden estimates used to derive these cost estimates are based on the estimates made in the Commission's OTC derivatives dealer releases, which contained a similar requirement. No comments were received in response to the estimates proposed in the OTC derivatives dealers proposing release, and those burden estimates were not changed in the final rule release. We adjusted those estimates such that the burden hours associated with creation of VaR models was moved to the burden estimates for proposed Rule 17i–7. We also adjusted the estimates based on the staff's experience in implementing the OTC derivatives dealer rules.

[148] We estimate that the average amount of time an SIBHC would spend assessing its present structure, businesses, and controls, and designing and implementing a risk management control system would be about 3,600 hours. We believe that an SIBHC would have a senior compliance person performing this task. According to the SIA's *Report on Management and Professional Earnings in the Securities Industry—2002,* the hourly cost of a senior compliance person is $56.60. ($56.60 × 3,600 hours) = $203,760.

[149] ($203,760.00 per SIBHC × 6 SIBHCs expected to apply) = $1,222,560. The estimates of the initial and annual burdens for proposed Rule 17i–4 are based on the estimates the Commission made in adopting Rule 15c3–4. Proposed Rule 17i–4 makes Rule 15c3–4 applicable to SIBHCs. Our burden estimates for proposed Rule 17i–4 are higher than our burden estimates for Rule 15c3–4 because an SIBHC would be establishing, documenting, and maintaining a system of internal risk management controls for the affiliate group, and not just for one firm. We based our burden estimates for proposed Rule 17i–4 on our burden estimates for Rule 15c3–4 because Rule 15c3–4 and proposed Rule 17i–4 are substantially similar and because no comments were received regarding the burden estimates for Rule 15c3–4.

[150] We estimate that, on average, an SIBHC would spend about 40 hours to create and document a contingency plan regarding funding and liquidity of the affiliate group. This estimate is based on the staff's experience. Further, we believe that an SIBHC would have a senior treasury manager perform this task. According to the SIA's *Report on Management and Professional Earnings in the Securities Industry—2002,* the hourly cost of a senior treasury manager is $48.94. ($48.94 × 40 hours) = $1,957.60.

[151] ($1,957.60 × 6 SIBHCs) = $11,746.

the proposed rules) and $675,000 (if the firm is complex and does not presently use mathematical models to manage risk) to update or create mathematical models.[152] Thus, we estimate that the additional cost to create new models would be, in aggregate, between about $40,500 and about $4.1 million for all six firms.[153]

The Commission notes that broker-dealers with tentative net capital of between $100 million and $1 billion that are not affiliated with banks generally do not report a VaR figure in their market risk disclosure of their holding companies' annual reports. However, some firms of this size do report a VaR figure in their market risk disclosure of their holding companies' annual reports. IBHCs that do not presently use VaR to manage group-wide risk may not find it to be cost effective to file a Notice of Intention to be supervised by the Commission as an SIBHC. However, this regulatory framework is available to a wide range of firms as an alternative, and may allow some of them to compete more effectively.

As stated previously, there are approximately one hundred applicants who qualify based on the minimum tentative net capital requirements. In addition, it is unclear to what extent IBHCs have made these investments already in the ordinary course of business. Evolving industry best practice for internationally active firms suggests that some IBHCs will have already made some or all the investments required by the proposed rules, and some IBHCs have plans to make those investments in the near future. As stated previously in section IV.C., we believe that the six IBHCs that qualify will file a Notice of Intention to become supervised by the Commission as SIBHCs because it is cost effective and because they have made or plan to make the necessary investments regardless of Commission rule making. To the extent that a firm that becomes subject to this rule will not incur additional costs to establish, document and maintain a risk management control system, upgrade its IT, or create mathematical models, our estimates with regard to the proposed rules may be reduced. We seek specific comment on the degree to which potential applicants under this rule have already made, or are making, the necessary investments in risk management control systems, IT, and mathematical modeling.

C. Request for Comment Regarding Analysis of Costs and Benefits

To assist the Commission in evaluating the costs and benefits that may result from the proposed supervisory framework for SIBHCs, the Commission requests comments on the potential costs and benefits identified in this release, as well as any other costs or benefits that may result from the proposed rules and rule amendments. In addition, we invite commenters to provide views and data comparing the costs and benefits discussed above with the costs and benefits of the current regulatory framework. Commenters should provide analysis and data relating to the costs and benefits associated with each of the proposed Rules. In particular, we solicit comments on the potential costs for any necessary modifications to accounting, information and recordkeeping systems, and risk management control systems required to implement the proposed rules, and the potential benefits arising from participation in this optional regulatory framework.

VI. Consideration on Burden on Competition, and Promotion of Efficiency, Competition and Capital Formation

Section 3(f) of the Exchange Act[154] requires the Commission, whenever it engages in rulemaking and is required to consider or determine if an action is necessary or appropriate in the public interest, to consider if the action will promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act[155] requires the Commission, in adopting rules under the Exchange Act, to consider the impact that any such rule would have on competition. Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The Commission's preliminary view is that proposed Rules 17i–1 through 17i–8 would promote both efficiency and capital formation. The proposed rules should provide qualifying IBHCs an opportunity to increase operational efficiency by continuing to compete effectively outside of the United States in countries that require consolidated supervision as a condition of doing business. Although the proposed rules would impose new costs relating to: (i) Creation and implementation of a group-wide system of internal management controls; (ii) recordkeeping; and (iii) reporting, an IBHC filing a Notice of Intention to be supervised by the Commission as an SIBHC would not be subject to consolidated supervision in non-U.S. marketplaces. Further, as this framework for oversight is voluntary, we do not believe IBHCs will file Notices of Intention to be supervised by the Commission as an SIBHC unless the benefits of such an election outweigh the costs with respect to the applying firm.

The Commission notes that broker-dealers with tentative net capital of between $100 million and $1 billion that are not affiliated with banks generally do not report a VaR figure in their market risk disclosure of their holding companies' annual reports. However, some firms of this size do report a VaR figure in their market risk disclosure of their holding companies' annual reports. IBHCs that do not presently use VaR to manage group-wide risk may not find it to be cost effective to file a Notice of Intention to be supervised by the Commission as an SIBHC. However, this regulatory framework is available to a wide range of firms as an alternative, and may allow some of them to compete more effectively.

The Commission's preliminary view is that the proposed rules would not have anti-competitive effects on smaller broker-dealers because smaller broker-dealers are generally not interested in consolidated supervision.[156] These rules

[152] We estimate that an SIBHC that already manages risk using mathematical models may need to spend 100 hours to review its models and adjust them to assure they comply with the qualitative and quantitative requirements set forth in the proposed rules. We believe that an SIBHC would have a senior programmer and a senior research analyst spend approximately 50 hours each to perform this task. According to the SIA's *Report on Management and Professional Earnings in the Securities Industry—2002,* the hourly cost of a senior programmer is $63.75 and the hourly cost of a senior research analyst is $71.25. (($63.75 × 50 hours) + ($71.25 × 50 hours) = $6,750. Further, we estimate that a complex SIBHC that does not presently use mathematical models to manage risk would spend approximately 10,000 hours to create mathematical models to use in calculating market and credit risk as required by the proposed rules. We believe that an SIBHC would have a senior programmer and a senior research analyst spend approximately 5,000 hours each to perform this task. According to the SIA's *Report on Management and Professional Earnings in the Securities Industry—2002,* the hourly cost of a senior programmer is $63.75 and the hourly cost of a senior research analyst is $71.25. (($63.75 × 5,000 hours) + ($71.25 × 5,000 hours) = $675,000. These hourly burden estimates are based on staff experience and discussions with industry participants.

[153] ($6,750 × 6 SIBHCs) = $40,500. ($675,000 × 6 SIBHCs) = $4,050,000.

[154] 15 U.S.C. 78c(f).

[155] 15 U.S.C. 78w(a)(2).

[156] Generally, smaller broker-dealers are organized in a simpler manner, and they do not

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implement Section 17(i) of the Exchange Act. These rules are intended, in part, to allow U.S. broker-dealers to compete more effectively in the global securities markets.

- We solicit comment on whether the proposal would promote both efficiency and capital formation.
- We request comment on the competitive benefits to broker-dealers that may result under the proposed rules.
- We also request comment on any anticompetitive effects that may result under the proposed rules.

VII. Regulatory Flexibility Act Certification

The Commission hereby certifies, pursuant to 5 U.S.C. 605(b), that proposed new Rules 17i–1 through 17i–8, and proposed amendments to Rules 17h–1T, 17h–2T, and 17a–12(l) under the Exchange Act, if adopted, would not have a significant economic impact on a substantial number of small entities.

Proposed new Rules 17i–1 through 17i–8 would create a framework for the Commission to supervise SIBHCs. These rules also would enhance the Commission's supervision of the SIBHC's subsidiary broker-dealers through collection of additional information and examinations of affiliates of those broker-dealers. This framework would include qualification criteria for IBHCs that file Notices of Intention to be supervised by the Commission, as well as recordkeeping and reporting requirements for SIBHCs. An IBHC that meets the criteria set forth in the proposed rules would not be required to become an SIBHC; supervision as an SIBHC is voluntary. Taken as a whole, the proposed framework would permit the Commission to better monitor the financial condition, risk management, and activities of a broker-dealer's parent and affiliates on a group-wide basis. In particular, it would create a formal process through which the Commission could access important information regarding activities of a broker-dealer's affiliates that could impair the financial and operational stability of the broker-dealer or the SIBHC. Further, as this framework for oversight is voluntary, we do not believe IBHCs will file Notices of Intention to be supervised by the Commission as SIBHCs unless the benefits of such supervision outweigh the costs with respect to the applying firm. The Commission is also proposing to add an exemption to the risk assessment rules to exempt a broker-dealer that is affiliated with an SIBHC because the SIBHC will be maintaining records and reporting to the Commission regarding the financial and operational condition of members of the affiliate group. Finally, the Commission is proposing to adjust the audit requirements for OTC derivative dealers to allow accountants to use agreed-upon procedures when conducting audits of risk management control systems.

An IBHC can apply to become an SIBHC only if it is not affiliated with an insured bank (with certain exceptions) or a savings association,[157] (ii) a foreign bank, foreign company, or a company that is described in section 8(a) of the International Banking Act of 1978, or (iii) a foreign bank that controls a corporation chartered under section 25A of the Federal Reserve Act.[158] In addition, pursuant to paragraph (d)(2)(i)(B) of proposed Rule 17i–2, the Commission would not consider such supervision necessary or appropriate unless the investment bank holding company demonstrates that it owns or controls a broker or dealer that has a substantial presence in the securities business, which may be demonstrated by a showing that the broker or dealer maintains tentative net capital of $100 million or more. Accordingly, an IBHC could not be a small entity.[159]

The proposed changes to Rules 17h–1T and 17h–2T would apply only to broker-dealers that are affiliated with an IBHC that becomes supervised by the Commission as an SIBHC. In addition, Rules 17h–1T and 17h–2T only require that one broker-dealer within a holding company structure obtain and maintain the required records and file the required reports. Generally, a broker-dealer would be exempt from Rules 17h–1T and 17h–2T if it (i) maintains less than $250,000 in net capital, (ii) is exempt from Rule 15c3–3 pursuant to § 240.15c3–3(k)(1), (iii) maintains less than $20 million in net capital and is either exempt from Rule 15c3–3 pursuant to § 240.15c3–3(k)(2) or is not exempt from Rule 15c3–3 but does not hold funds or securities for, nor owe money or securities to customers. Thus, no small broker-dealers are subject to Rules 17h–1T and 17h–2T.

Rule 17a–12 is only applicable to OTC derivatives dealers. As stated previously, a broker-dealer generally would be considered a small entity if (i) it has total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a–5(d) or, if not required to file such statements, a broker-dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and (ii) it is not affiliated with any person (other than a natural person) that is not a small business or small organization.[160] An OTC derivatives dealer is a ''dealer'' under the Exchange Act.[161] The minimum capital requirements for an OTC derivatives dealer are tentative net capital of at least $100 million and net capital of at least $20 million. Thus, no small broker-dealers are subject to Rule 17a–12.

Accordingly, proposed new Rules 17i–1 through 17i–8, and the proposed amendments to Rules 17h–1T, 17h–2T, and 17a–12(l), if adopted, would not have a significant economic impact on a substantial number of small entities.

We encourage written comments regarding this certification. We solicit comment as to whether the proposed rules and rule amendments could have an effect that we have not considered. We request that commenter describe the nature of any effect on small entities and provide empirical data to support the extent of the effect.

VIII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or ''SBREFA,''[162] we must advise OMB as to whether the proposed regulation constitutes a ''major'' rule. Under SBREFA, a rule is considered ''major'' where, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effect on competition, investment or innovation.

If a rule is ''major,'' its effectiveness will generally be delayed for 60 days pending Congressional review. We request comment on the potential impact of the proposed regulation on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

engage in international transactions that could cause them to be subject to regulation by international securities regulatory agencies.

[157] *See supra,* note 6.

[158] Federal Reserve Act § 25A [12 U.S.C. 611].

[159] *See* 17 CFR 240.0–10(c).

[160] Exchange Act Rule 0–10 [17 CFR 240.0–10].

[161] *See* Section 3(a)(5) of the Exchange Act [15 U.S.C. 78c(a)(5)].

[162] Pub. L. No. 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C., and as a note to 5 U.S.C. 601).

IX. Statutory Authority

The amendments are proposed pursuant to the authority conferred on the Securities and Exchange Commission by the Exchange Act (15 U.S.C. 78a, *et seq.*) (particularly sections 17, 23, and 24(b) thereof (15 U.S.C. 78q, 78w, and 78x(b))).

List of Subjects in 17 CFR Part 240

Brokers, OTC derivatives dealers, Reporting and recordkeeping requirements, Securities, Supervised investment bank holding companies.

Text of Proposed Rules and Rule Amendments

In accordance with the foregoing, the Securities and Exchange Commission hereby proposes to amend Title 17 Chapter II of the Code of Federal Regulations as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

3. The authority citation for Part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78*ll*, 78mm, 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, 7202, 7241, 7262, and 7263; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

4. Section 240.17a–12, paragraph (l) is revised to read as follows:

§ 240.17a–12 Reports to be made by certain OTC derivatives dealers.

* * * * *

(l) *Accountant's report on management controls.* (1) The OTC derivatives dealer shall file concurrently with the annual audit report a supplemental report by the certified public accountant indicating the results of the certified public accountant's review of the OTC derivatives dealer's internal risk management control system with respect to the requirements of § 240.15c3–4. This review shall be conducted in accordance with procedures agreed to by the OTC derivatives dealer and the certified public accountant conducting the review. The purpose of the review is to confirm that the OTC derivatives dealer has established, documented, and maintained an internal risk management control system in accordance with § 240.15c3–4, and is in compliance with that internal risk management control system.

(2) The agreed-upon procedures are to be performed, and the report is to be prepared, in accordance with U.S. Generally Accepted Attestation Standards.

(3) Prior to the commencement of the review, every OTC derivatives dealer shall file the procedures to be performed pursuant to paragraph (l)(1) of this section with the Commission's principal office in Washington, DC. Prior to the commencement of any subsequent review, every OTC derivatives dealer shall file with the Commission's principal office in Washington, DC a notice of changes in the agreed-upon procedures. If there are no changes, the OTC derivatives dealer should indicate in the notice that no changes have been made to those procedures.

* * * * *

5. Section 240.17h–1T is amended by:

a. Redesignating paragraph (d)(5) as paragraph (d)(6); and

b. Adding new paragraph (d)(5).

The addition reads as follows:

§ 240.17h–1T Risk assessment recordkeeping requirements for associated persons of brokers and dealers.

* * * * *

(d) * * *

(5) The provisions of this section shall not apply to a broker or dealer affiliated with a supervised investment bank holding company, as defined in § 240.17i–1(a).

* * * * *

6. Section 240.17h–2T is amended by:

a. Redesignating paragraph (b)(5) as paragraph (b)(6); and

b. Adding new paragraph (b)(5).

The addition reads as follows:

§ 240.17h–2T Risk assessment reporting requirements for brokers and dealers.

* * * * *

(b) * * *

(5) The provisions of this section shall not apply to a broker or dealer affiliated with a supervised investment bank holding company, as defined in § 240.17i–1(a).

* * * * *

7. Sections 240.17i–1 through 240.17i–8 are added to read as follows:

Supervised Investment Bank Holding Company Rules

§ 240.17i–1. Definitions.

(a) For purposes of §§ 240.17i–1 through 240.17i–8, the terms *investment bank holding company, supervised investment bank holding company, affiliate, bank, bank holding company, company, control, savings association, insured bank, foreign bank, person associated with an investment bank holding company* and *associated person of an investment bank holding company* shall be defined as set forth in section 17(i)(5) of the Act.

(b) For purposes of §§ 240.17i–2 through 240.17i–8, the term *affiliate group* shall include the supervised investment bank holding company and every affiliate of the supervised investment bank holding company.

(c) For purposes of §§ 240.17i–1 through 240.17i–8, the term *material affiliate* shall mean any member of the affiliate group that is material to the supervised investment bank holding company.

§ 240.17i–2. Notice of intention to be supervised by the Commission as a supervised investment bank holding company.

(a) An investment bank holding company that owns or controls a broker or dealer may file with the Commission a written notice of intention to become supervised by the Commission pursuant to section 17(i) of the Act (15 U.S.C. 78q(i)), provided that the investment bank holding company is not:

(1) An affiliate of an insured bank (other than an institution described in paragraph (D), (F), or (G) of section 2(c)(2), or held under section 4(f), of the Bank Holding Company Act of 1956) (12 U.S.C. 1841(c)(2)(D), (F), or (G) and 12 U.S.C. 1843(f)) or a savings association;

(2) A foreign bank, foreign company, or company that is described in section 8(a) of the International Banking Act of 1978 (12 U.S.C. 3106(a)); or

(3) A foreign bank that controls, directly or indirectly, a corporation chartered under section 25A of the Federal Reserve Act (12 U.S.C. 611).

(b) To become supervised as a supervised investment bank holding company an investment bank holding company shall file a notice of intention that includes the following:

(1) A request to become supervised as a supervised investment bank holding company;

(2) A statement certifying that the investment bank holding company is not an entity described in section 17(i)(1)(A)(i)—(iii) of the Act (15 U.S.C. 78q(i)(1)(A)(i)—(iii));

(3) Documentation demonstrating that the investment bank holding company owns or controls a broker or dealer that maintains a substantial presence in the securities business as evidenced either by its holding $100 million or more in tentative net capital as calculated pursuant to § 240.15c3–1 or by any other information and documentation as the Commission determines is appropriate; and

(4) Supplemental documents including:

(i) A narrative describing the business and organization of the investment bank holding company;

(ii) An alphabetical list of each member of the affiliate group, an indication of which affiliates the investment bank holding company regards as material to the holding company, and the financial regulator(s), if any, with which the affiliate is registered;

(iii) An organizational chart that identifies the investment bank holding company, each broker or dealer owned or controlled by the investment bank holding company, and each material affiliate;

(iv) Consolidated and consolidating financial statements of the affiliate group as of the end of the quarter preceding the filing of the notice of intention;

(v) The following computations for the affiliate group:

(A) Allowable capital and allowances for market risk, credit risk, and operational risk; or

(B) A computation made pursuant to § 240.17i–7(e);

(vi) A list of the positions that the affiliate group holds in any proprietary accounts and a brief description of the method that the investment bank holding company will use to calculate allowances for market and credit risk on those positions pursuant to § 240.17i–7(b) and (c);

(vii) A description of each mathematical model that the investment bank holding company intends to use to price positions and to calculate allowances for market and credit risk (as specified in § 240.17i–7(b) and (c)), including:

(A) A statement of whether the model was developed by the investment bank holding company, one of its affiliates or subsidiaries, or another person;

(B) If the mathematical model incorporates correlations across risk factors, a description of the process used to measure these correlations;

(C) A description of the tests performed on the mathematical model and the results of those tests, including a description of back tests and alternative tests to estimate risk, such as stress tests and scenario tests, and procedures instituted to respond to test results (including a schedule of multiplication factors to apply to the credit equivalent amount based on backtesting results);

(D) A description of how the mathematical model satisfies the qualitative and quantitative requirements listed in § 240.15c3–1e(e);

(E) A description of the internal controls relating to the creation, use and maintenance of the mathematical model, including a description of who may input data into the model, who has access to any or all of the model's outputs, and what outputs are accessible to whom; and

(F) A statement that the model is used to analyze and report risk to senior management;

(viii) A description of any positions for which the investment bank holding company proposes to use an alternative method for computing an allowance for market risk and a description of how that allowance would be determined;

(ix) A description of how the investment bank holding company proposes to calculate current exposure (as defined in § 240.17i–7(c)(1)(i)(E));

(x) A description of how the investment bank holding company proposes to determine or calculate credit risk weights and internal credit ratings;

(xi) A description of the method the investment bank holding company proposes to use to calculate its allowance for operational risk pursuant to § 240.17i–7(e);

(xii) A comprehensive description of the internal risk management control system of the investment bank holding company established to manage the risks of the affiliate group, including market, credit, liquidity and funding, legal and compliance, and operational risks, and how that system satisfies the requirements set forth in § 240.17i–4;

(xiii) Sample risk reports provided to the persons responsible for managing the risks of the affiliate group that the investment bank holding company proposes to provide to the Commission pursuant to § 240.17i–6(a)(1)(v);

(xiv) An undertaking that provides:

(A) If the disclosure of any information with regard to §§ 240.17i–1 through 240.17i–8 would be prohibited by law or otherwise, the supervised investment bank holding company will cooperate with the Commission as needed, including by describing any secrecy laws or other impediments that could restrict the ability of the supervised investment bank holding company or any material affiliate from providing information on its operations or activities and by discussing the manner in which the supervised investment bank holding company proposes to provide the Commission with adequate assurances of access to information; and

(B) For any non-U.S. affiliate of the supervised investment bank holding company, the supervised investment bank holding company will obtain consent to the jurisdiction of the Commission and an agreement to maintain a U.S. registered agent; and

(xv) Any other information and documents relating to the investment bank holding company's activities, financial condition, policies, systems for monitoring and controlling financial and operational risks, and transactions and relationships among members of the affiliate group that the Commission may request to complete its review of the notice of intention.

(c) *Amendments to the notice of intention.* (1) *Prior to Commission determination.* If any of the information or documentation filed with the Commission as part of the notice of intention to become a supervised investment bank holding company described in paragraph (b) of this section is found to be or becomes inaccurate prior to the Commission determination, the investment bank holding company shall promptly notify the Commission and provide the Commission with a description of the circumstances in which the information or documentation was found to be or has become inaccurate along with updated, accurate information and documents.

(2) *Subsequent to Commission determination.* If, subsequent to the Commission determination of a notice of intention to become a supervised investment bank holding company, the supervised investment bank holding company materially changes a mathematical model or other method used to compute allowable capital or allowance for market, credit, or operational risk, or its internal risk management control systems as described in its notice of intention (and as modified from time to time), prior to making the changes the supervised investment bank holding company shall file an amended notice of intention describing the changes.

(d) *Process for review of notice of intention.* (1) *When filed.* A notice of intention to be supervised by the Commission as a supervised investment bank holding company shall not be complete until the investment bank holding company has filed with the Commission all the documentation and information specified in this section. Any documentation and information submitted, and any amendments thereto, shall be considered filed when received at the Office of the Secretary at the Commission's principal office in Washington DC. All notices, amendments thereto, and other documentation and information filed pursuant to this section shall be accorded confidential treatment.

(2) *Commission determination.* (i) An investment bank holding company shall become a supervised investment bank holding company pursuant to section 17(i) of the Act (15 U.S.C. 78q(i)) 45

calendar days after the Commission receives a completed notice of intention to register as a supervised investment bank holding company pursuant to paragraph (a) of this section, unless the Commission issues an order determining either that:

(A) The Commission will begin to supervise the investment bank holding company prior to 45 calendar days after the Commission receives the completed notice of intention; or

(B) The Commission will not supervise the investment bank holding company because supervision of the investment bank holding company as a supervised investment bank holding company is not necessary or appropriate in furtherance of the purposes of section 17 of the Act (15 U.S.C. 78q). The Commission will not consider such supervision necessary or appropriate unless the investment bank holding company demonstrates that it owns or controls a broker or dealer that has a substantial presence in the securities business, which may be demonstrated by a showing that the broker or dealer maintains tentative net capital of $100 million or more.

(ii) The Commission will, upon the filing of an amendment to the notice of intention submitted by a supervised investment bank holding company pursuant to paragraph (c) of this section, determine whether continued supervision of the investment bank holding company is necessary or appropriate in furtherance of the purposes of section 17 of the Act (15 U.S.C. 78q) after reviewing the amended notice of intention to determine whether the supervised investment bank holding company and its subsidiary brokers or dealers are in compliance with the requirements of §§ 240.17i–1, 240.17i–2, 240.17i–3, 240.17i–4, 240.17i–5, 240.17i–6, 240.17i–7, and 240.17i–8 and other applicable rules promulgated under section 17 of the Act (15 U.S.C. 78q).

§ 240.17i–3. Withdrawal from supervision by the Commission as a supervised investment bank holding company.

(a) A supervised investment bank holding company may withdraw from supervision by the Commission as a supervised investment bank holding company by filing a notice of withdrawal with the Commission. The notice of withdrawal shall include a statement that the supervised investment bank holding company is in compliance with § 240.17i–2(c) regarding amendments to its notice of intention to be supervised by the Commission as a supervised investment bank holding company.

(b) A notice of withdrawal from supervision as a supervised investment bank holding company shall become effective one year after it is filed with the Commission, or within such shorter or longer period as the Commission determines to be necessary or appropriate to ensure effective supervision of the material risks to the supervised investment bank holding company and to any associated person of the supervised investment bank holding company that is a broker or dealer, or to prevent evasion of the purposes of section 17 of the Act (15 U.S.C. 78q).

(c) Notwithstanding paragraphs (a) and (b) of this section, the Commission, by order, may discontinue supervision of any supervised investment bank holding company if the Commission finds that:

(1) The supervised investment bank holding company is no longer in existence;

(2) The supervised investment bank holding company has ceased to be an investment bank holding company; or

(3) Continued supervision by the Commission of the supervised investment bank holding company is not necessary or appropriate in furtherance of the purposes of section 17 of the Act (15 U.S.C. 78q).

§ 240.17i–4. Internal risk management control system requirements for supervised investment bank holding companies.

(a) A supervised investment bank holding company shall comply with § 240.15c3–4 as though it were a broker or dealer.

(b) As part of its internal risk management control system, a supervised investment bank holding company shall establish, document, and maintain procedures for the detection and prevention of money laundering and terrorist financing.

§ 240.17i–5. Record creation, maintenance, and access requirements for supervised investment bank holding companies.

(a) A supervised investment bank holding company shall make and keep current the following records:

(1) A record reflecting the results of stress tests, conducted at least once each quarter, of the affiliate group's funding and liquidity with respect to the following events:

(i) A credit rating downgrade of the supervised investment bank holding company;

(ii) An inability of the supervised investment bank holding company to access capital markets for short-term funding;

(iii) An inability of the supervised investment bank holding company to move liquid assets across international borders when the events described in paragraphs (a)(1)(i) or (ii) of this section occur; or

(iv) An inability of the supervised investment bank holding company to access credit or assets held at a particular institution when the events described in paragraphs (a)(1)(i) or (ii) of this section occur;

(2) The supervised investment bank holding company's contingency plans to respond to the events outlined in paragraphs (a)(1)(i) through (iv) of this section; and

(3) A record of the basis for the determination of the credit risk weight for each counterparty.

(b) Except as provided in paragraphs (c) of this section, the supervised investment bank holding company shall preserve for a period of not less than three years in an easily accessible place using any storage media acceptable under § 240.17a–4(f):

(1) The documents created in accordance with paragraph (a) of this section;

(2) All notices of intention, amendments thereto, and other documentation and information filed with the Commission pursuant to § 240.17i–2, and any responses thereto;

(3) All reports and notices the supervised investment bank holding company shall file pursuant to § 240.17i–6;

(4) All notices the supervised investment bank holding company shall file pursuant to § 240.17i–8; and

(5) Records documenting the system of internal risk management controls for market, credit, leverage, funding, legal and operational risks required to be established pursuant to § 240.17i–4 to manage the risks of the affiliate group, including written guidelines, policies, and procedures.

(c) A supervised investment bank holding company may maintain the records specified in paragraph (b) of this section either at the supervised investment bank holding company, at an affiliate, or at a records storage facility, provided that the records are located within the boundaries of the United States. If the records are maintained by an entity other than the supervised investment bank holding company, the supervised investment bank holding company shall file with the Commission a written undertaking in a form acceptable to the Commission from the entity, signed by a duly authorized person at the entity maintaining the records, to the effect that the records will be treated as if the supervised investment bank holding company were maintaining the records

pursuant to this section and that the entity maintaining the records undertakes to permit examination of those records at any time or from time to time during business hours by representatives or designees of the Commission and to promptly furnish the Commission or its designee a true, correct, complete and current copy of any or all or any part of those records in either paper, or electronically if the records are stored electronically. The election to store records pursuant to the provisions of this paragraph (c) shall not relieve the supervised investment bank holding company from any of its responsibilities under this section or § 240.17i–6.

(d) All information obtained by the Commission pursuant to this section from the supervised investment bank holding company shall be accorded confidential treatment.

§ 240.17i–6. Reporting requirements for supervised investment bank holding companies.

(a) *Filing of monthly reports.* The supervised investment bank holding company shall file:

(1) A monthly risk report not later than 17 business days after the end of each month that does not end a quarter, which shall include:

(i) A consolidated balance sheet, income statement, and computations of allowable capital and allowances for market, credit, and operational risk pursuant to § 240.17i–7 (including notes to the financial statements) for the affiliate group; and

(ii) A graph reflecting, for each business line, the daily intra-month VaR;

(iii) Consolidated credit risk information, including:

(A) Aggregate current exposure and current exposures (including commitments) listed by counterparty for:

(*1*) The 15 largest exposures; and

(*2*) The 5 largest exposures to regulated financial institutions;

(B) The 10 largest commitments by counterparty;

(C) Maximum potential exposure listed by counterparty for:

(*1*) The 15 largest exposures; and

(*2*) The 5 largest exposures to regulated financial institutions;

(D) The aggregate maximum potential exposure;

(iv) A summary report reflecting the geographic distribution of the supervised investment bank holding company's exposures on a consolidated basis for each of the top ten countries to which it is exposed (by residence of the main operating group of the counterparty); and

(v) Certain regular risk reports provided to the persons responsible for managing risk for the affiliate group as the Commission may request from time to time.

(2) A quarterly risk report, which may be unaudited, not later than 35 calendar days after the end of each quarter, including:

(i) The information described in paragraph (a)(1) of this section;

(ii) A consolidating balance sheet and income statement (including notes to the financial statements) for the affiliate group. The consolidating balance sheet shall break out information regarding each material affiliate into separate columns, but may consolidate information regarding affiliate group entities that are not material affiliates into one column;

(iii) The results of backtesting of all models used to compute allowable capital and allowances for market and credit risk indicating, for each model, the number of backtesting exceptions;

(iv) A description of all material pending legal or arbitration proceedings involving any member of the affiliate group that are required to be disclosed by the supervised investment bank holding company under generally accepted accounting principles; and

(v) The aggregate amount of commercial paper, secured and other unsecured borrowing, bank loans, lines of credit, or any other borrowings, and the principal installments of long-term or medium-term debt, scheduled to mature within twelve months from the most recent quarter by each affiliated broker or dealer and any other material affiliate, together with the allowance for losses for those transactions.

(b) *Additional reports.* In addition to the reports required by paragraph (a) of this section, upon receiving written notice from the Commission, the supervised investment bank holding company shall file other information as the Commission may request in order to monitor:

(1) The supervised investment bank holding company's financial or operational condition, risk management system, and transactions and relationships among members of the affiliate group; or

(2) The extent to which the supervised investment bank holding company has complied with the provisions of the Act and regulations prescribed and orders issued under the Act.

(c) *Annual filing of audited financial statements.*

(1) A supervised investment bank holding company shall file annually, on a calendar or fiscal year basis, an annual audit report containing a consolidated balance sheet, income statement, and computations of allowable capital and allowances for market, credit and operational risk computed in accordance with § 240.17i–7 (including notes to the financial statements).

(2) Annual audit reports prepared pursuant to this paragraph (c) shall be prepared as of the same date as the annual audit of the supervised investment bank holding company's subsidiary broker or dealer.

(3) Annual audit reports prepared pursuant to this paragraph (c) shall be filed concurrently with the annual audit of its affiliated broker or dealer (as required pursuant to § 240.17a–5(d)) as follows:

(i) Two copies shall be filed at the Commission's principal office in Washington, DC; and

(ii) One copy shall be filed at the regional office of the Commission for the region in which the supervised investment bank holding company's subsidiary broker or dealer is located.

(d) *Nature and form of reports.* A supervised investment bank holding company shall file the financial statements pursuant to paragraph (c) of this section in accordance with the following requirements:

(1) An accountant that meets the requirements of paragraph (e) of this section shall conduct an audit and give an opinion covering the statements filed pursuant to paragraph (c) of this section.

(2) The supervised investment bank holding company shall attach to the report required by paragraph (c)(1) of this section an oath or affirmation that to the best knowledge and belief of the individual making the oath or affirmation the information contained in the report is true and correct. The oath or affirmation shall be made before a person duly authorized to administer the oath or affirmation. If the supervised investment bank holding company is a partnership, the oath or affirmation shall be made by a general partner; if a corporation, the oath or affirmation shall be made by the chief executive officer, or, in the absence of a chief executive officer, by the person authorized to act in that officer's place.

(e) *Accountants.* (1) The provisions of § 240.17a–5(f) shall apply to a supervised investment bank holding company as though the supervised investment bank holding company were a broker or dealer, except that, a supervised investment bank holding company shall not be required to send notice to any designated examining authority as indicated in § 240.17a–5(d)(2)(i) and (d)(4).

(2) In addition to the qualification and independence requirements set forth in § 240.17a–5(f), an accountant shall be a registered public accounting firm as that term is defined in the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201(a)(12)).

(f) *Audit objectives.* The audit shall be conducted in accordance with the rules promulgated by the Public Company Accounting Oversight Board and shall include a review of the accounting system and the internal accounting controls (including appropriate tests thereof) for the period since the date of the prior audited financial statements. The audit shall include all procedures necessary under the circumstances to enable the accountant to express an opinion on the statement of financial condition, results of operations, cash flows, and the computations of allowable capital and allowances for market, credit, and operational risk under § 240.17i–7. The scope of the audit and review of the accounting system and the internal accounting controls shall be sufficient to provide reasonable assurance that any material inadequacies that exist at the date of the examination in the accounting system or internal accounting controls would be disclosed.

(g) *Extent and timing of audit procedures.* The extent and timing of audit procedures are matters for the accountant to determine on the basis of its review and evaluation of existing internal controls and other audit procedures performed in accordance with the rules promulgated by the Public Company Accounting Oversight Board and the audit objectives listed in paragraph (f) of this section.

(h) *Accountant's report, general provisions.* The provisions of § 240.17a–5(i) shall apply to a supervised investment bank holding company and its audit.

(i) *Supplemental reports.* The supervised investment bank holding company shall file, concurrently with the annual audit report, the following supplemental reports prepared by the accountant in accordance with the rules promulgated by the Public Company Accounting Oversight Board:

(1) A supplemental report entitled ''Accountant's Report on Reportable Conditions'' describing any matter that would be deemed to be a reportable condition under the rules promulgated by the Public Company Accounting Oversight Board that is unresolved as of the date of the accountant's report. The supplemental report shall indicate any corrective action taken or proposed by the supervised investment bank holding company with regard to any identified reportable conditions. If the audit did not disclose any reportable conditions, the supplemental report shall so state.

(2) A supplemental report entitled ''Accountant's Report on Internal Risk Management Control System'' indicating the results of the accountant's review of the internal risk management control system established and documented by the supervised investment bank holding company in accordance with § 240.17i–4 and utilized by the affiliate group. This review shall be conducted by the accountant in accordance with procedures agreed to by the supervised investment bank holding company and the accountant conducting the review. The agreed-upon procedures are to be performed in accordance with the rules promulgated by the Public Company Accounting Oversight Board. The purpose of the review is to confirm that the internal risk management control system complies with the requirements of § 240.17i–4 and that the supervised investment bank holding company and its affiliate group are adhering to the requirements of that internal risk management control system.

(3) A supplemental report entitled ''Accountant's Report on Inventory Pricing and Modeling'' indicating the results of the accountant's review of the procedures for pricing financial instrument inventory (including modeling procedures) established by the supervised investment bank holding company and utilized by the affiliate group. This review shall be conducted by the accountant in accordance with procedures agreed to by the supervised investment bank holding company and the accountant conducting the review. The agreed-upon procedures are to be performed in accordance with the rules promulgated by the Public Company Accounting Oversight Board. The purpose of the review is to confirm that the financial instrument pricing procedures relied upon by the affiliate group conform to the procedures established by the supervised investment bank holding company pursuant to § 240.17i–4 and comply with the qualitative and quantitative standards set forth in § 240.15c3–1e(e) (as required pursuant to § 240.17i–7(b)(1)).

(4) The supervised investment bank holding company shall file, prior to the commencement of the review and no later than December 10 of each year, a statement with the Commission's principal office in Washington, DC that includes:

(i) A description of the procedures for conducting the audit agreed to by the supervised investment bank holding company and the accountant (pursuant to paragraphs (i)(2) and (i)(3) of this section); and

(ii) A notice describing any changes in those agreed-upon procedures, if any. If there are no changes, the supervised investment bank holding company should indicate that no changes have been made to those procedures.

(j) *Notification of change of fiscal year.* If a supervised investment bank holding company changes its fiscal year, it must file a notice of the change (including a detailed explanation of the reason for the change) with the Commission.

(k) *Extensions and exemptions.* Upon the written request of the supervised investment bank holding company, or on its own motion, the Commission may grant an extension of time or an exemption from any of the requirements of paragraphs (a) through (j) of this section either unconditionally or on specified terms and conditions.

(l) *When filed.* The reports provided for in this section shall be considered filed when two copies are received at the Commission's principal office in Washington, DC, and one copy is received at the regional or district office of the Commission for the region or district in which the broker or dealer has its principal place of business. The copies sent to the Commission's principal office shall be addressed to the Division of Market Regulation.

(m) *Confidentiality.* All reports and statements filed by the supervised investment bank holding company with the Commission pursuant to this section shall be accorded confidential treatment.

§ 240.17i–7. Calculations of allowable capital and risk allowances or alternative capital assessment.

(a) *Computation of allowable capital.* The supervised investment bank holding company shall calculate allowable capital on a consolidated basis, which shall be the sum of:

(1) Common shareholders' equity on the consolidated balance sheet of the supervised investment bank holding company less:

(i) Goodwill;

(ii) Deferred tax assets;

(iii) Other intangible assets; and

(iv) Other deductions from common stockholders' equity as required by the Federal Reserve Board in calculating Tier 1 capital (as defined in 12 CFR 225, Appendix A).

(2) Cumulative and non-cumulative preferred stock, except that the amount of the cumulative preferred stock may not exceed 33% of the items included in allowable capital pursuant to paragraph (a)(1) of this section, provided that:

(i) The stock does not have a maturity date;

(ii) The stock cannot be redeemed at the option of the holder of the instrument;

(iii) The stock has no other provisions that will require future redemption of the issue; and

(iv) The issuer of the stock can defer or eliminate dividends; and

(3) The sum of the following items on the consolidated balance sheet, to the extent that sum does not exceed the sum of the items included in allowable capital pursuant to paragraphs (a)(1) and (a)(2) of this section:

(i) Cumulative preferred stock in excess of the 33% limit specified in paragraph (a)(2) of this section; and

(ii) Subordinated debt if:

(A) The original weighted average maturity of the subordinated debt is at least five years;

(B) Each subordinated debt instrument states clearly on its face that repayment of the debt is not protected by any Federal agency or the Securities Investor Protection Corporation;

(C) The subordinated debt is unsecured and subordinated in right of payment to all senior indebtedness of the holding company; and

(D) The subordinated debt instrument permits acceleration only in the event of bankruptcy or reorganization of the holding company under Chapters 7 (liquidation) and 11 (reorganization) of the U.S. Bankruptcy Code (11 U.S.C 7 and 11 U.S.C. 11, respectively).

(b) *Allowance for market risk.* The supervised investment bank holding company shall calculate its allowance for market risk on a consolidated basis daily for all proprietary positions, including debt instruments, equity instruments, commodity instruments, foreign exchange contracts, and derivative contracts, which shall be the sum of:

(1) *Value at risk.* The value at risk (''VaR'') measure obtained by applying one or more approved VaR models to each position and multiplying the result by the appropriate multiplication factor. Each VaR model shall meet the applicable qualitative and quantitative requirements set forth in § 240.15c3–1e(e). In addition, the model shall be one that can be disaggregated by each line of business and by each legal entity exposed to market risk. The initial multiplication factor shall be three, unless the Commission determines pursuant to § 240.17i–2(a) or (c), based on a review of the supervised investment bank holding company's internal risk management and control system and the VaR model, that another multiplication factor is appropriate. A supervised investment bank holding company may use a VaR model to determine its allowance for market risk only for positions for which there is adequate historical data to support a VaR model; and

(2) *Alternative method.* If there is not adequate historical data to support a VaR model for certain positions, the supervised investment bank holding company shall use the method described in its notice of intention to calculate the allowance for market risk.

(c) *Allowance for credit risk.* The supervised investment bank holding company shall compute an allowance for credit risk daily for certain assets on the consolidated balance sheet and certain off-balance sheet items, including loans and loan commitments, exposures due to derivatives contracts, structured financial products, other extensions of credit, and credit substitutes as follows:

(1) Multiplying the credit equivalent amount of the asset or off-balance sheet item by the appropriate credit risk weight of the asset or off-balance sheet item or counterparty as determined according to paragraph (c)(1)(ii) of this section, then multiplying the product by 8%, in accordance with the following:

(i) *Credit equivalent amount:*

(A) The *credit equivalent amount for receivables relating to derivative contracts, repurchase agreements, reverse repurchase agreements, stock loans, stock borrows, and other similar collateralized transactions* is the sum of;

(*1*) The supervised investment bank holding company's current exposure to the counterparty (as defined in paragraph (c)(1)(i)(E) of this section); and

(*2*) The supervised investment bank holding company's maximum potential exposure to the counterparty (as defined in paragraph (c)(1)(i)(F) of this section) multiplied by the appropriate multiplication factor. The initial multiplication factor shall be one, unless the Commission determines pursuant to § 240.17i–2(a) or (c), based on a review of the group-wide internal risk management control system, including a review of the VaR model used to determine maximum potential exposure, that another multiplication factor is appropriate;

(B) The *credit equivalent amount for certain loans and loan commitments receivable* shall be determined by multiplying the nominal amount of the contract by the following credit conversion factors:

(*1*) 0% credit conversion factor for loan commitments that:

(*i*) May be unconditionally cancelled by the lender; or

(*ii*) May be cancelled by the lender due to credit deterioration of the borrower;

(*2*) 5% credit conversion factor for margin loans extended by members of the affiliate group in compliance with applicable self-regulatory organization rules and Federal regulations;

(*3*) 20% credit conversion factor for:

(*i*) Loan commitments of less than one year; or

(*ii*) Short term self-liquidating trade related contingencies, including letters of credit;

(*4*) 50% credit conversion factor for loan commitments with an original maturity of greater than one year that contain transaction contingencies, including performance bonds, revolving underwriting facilities, note issuance facilities and bid bonds; and

(*5*) 100% credit conversion factor for bankers' acceptances, standby letters of credit, and forward purchases of assets, and similar direct credit substitutes;

(C) *Credit equivalent amount for other assets.* The credit equivalent amount for other assets shall be the asset's book value on the supervised investment bank holding company's consolidated balance sheet;

(D) The *current exposure* of a member of the affiliate group to a counterparty is the current replacement value of the counterparty's positions with the member of the affiliate group, including the effect of netting agreements with that counterparty meeting the requirements of § 240.15c3–1e(d)(5) and taking into account the value of collateral from the counterparty pledged to and held by any member of the affiliate group meeting the requirements of § 240.15c3–1e(d)(6), and the fair market value of any credit derivatives that specifically change the exposure to the counterparty (as long as the credit derivatives are not used to change the credit risk weight of the counterparty as provided in paragraph (c)(1)(ii)(E) of this section);

(E) The *maximum potential exposure* of a member of the affiliate group to a counterparty is the increase in the net replacement value of the counterparty's positions with the member of the affiliate group, including the effect of netting agreements with that counterparty meeting the requirements of § 240.15c3–1e(d)(5) and taking into account the value of collateral from the counterparty pledged to and held by any member of the affiliate group meeting the requirements of § 240.15c3–1e(d)(6), and the fair market value of any credit derivatives that specifically change the exposure to the counterparty (as long as the credit derivatives are not used to change the credit risk weight of the

counterparty as provided in paragraph (c)(1)(ii)(E) of this section) calculated daily using a VaR model that meets the requirements of § 240.15c3–1e(e), except that for repurchase agreements, reverse repurchase agreements, stock lending and borrowing, and similar collateralized transactions, maximum potential exposure shall be calculated using a time horizon of five days;

(ii) *Credit risk weights.* (A) *General standard.* The credit risk weights that shall be applied to certain assets and counterparties shall be determined according to standards published by the Basel Committee on Banking Supervision, as modified from time to time;

(B) *Internal credit ratings.* The supervised investment bank holding company may, upon a determination by the Commission pursuant to § 240.17i–2(a) or (c), determine credit ratings for counterparties that are not rated using internal calculations, and the supervised investment bank holding company may use these internal credit ratings in lieu of ratings issued by a nationally recognized statistical rating organization for purposes of determining credit risk weights;

(C) *Internal calculations.* The supervised investment bank holding company may, upon a determination by the Commission pursuant to § 240.17i–2(a) or (c), determine credit risk weights of counterparties based on internal calculations;

(D) *Receivables covered by guarantees.* For the portion of a current exposure covered by a guarantee, where that guarantee is an unconditional and irrevocable guarantee of the due and punctual payment and performance of the obligation and the supervised investment bank holding company or member of the affiliate group can demand payment after any payment is missed without having to make collection efforts, the supervised investment bank holding company or member of the affiliate group may substitute the credit risk weight of the guarantor for the credit risk weight of the counterparty if the guarantee is evidenced by a written obligation of the guarantor that allows the holding company or member of the affiliate group to substitute the guarantor for the counterparty upon default or nonpayment by the counterparty;

(E) *Receivables covered by credit derivatives.* The supervised investment bank holding company may reduce the credit risk weight of a counterparty by using credit derivatives (such as credit default swaps, total return swaps, and similar instruments used to manage credit risk) that provide credit protection equivalent to guarantees, if the credit derivative is used for bona fide hedging purposes to reduce the credit risk weight of a counterparty, is not incorporated into the VaR model used for deriving potential exposures, and is not held for market-making purposes. The credit risk weight for the covered portion of the exposure shall be the credit risk weight of the writer of the derivative. The uncovered portion of the exposure shall be assigned the credit risk weight of the counterparty; or

(2) Upon a determination by the Commission pursuant to § 240.17i–2(a) or (c), using a calculation consistent with standards published by the Basel Committee on Banking Supervision, as modified from time to time.

(d) *Allowance for operational risk.* A supervised investment bank holding company shall compute an allowance for operational risk on a consolidated basis consistent with the appropriate standards published by the Basel Committee on Banking Supervision, as modified from time to time.

(e) *Alternative capital assessment.* If the Commission determines pursuant to § 240.17i–2(a) or (c), the supervised investment bank holding company may compute a capital assessment using the standards promulgated by the Basel Committee on Banking Supervision (as modified from time to time) that it is required to submit to a financial regulator or supervisor in lieu of the computations described in paragraphs (a) through (d) of this section.

§ 240.17i–8. Notification provisions for supervised investment bank holding companies.

(a) A supervised investment bank holding company shall send written notice promptly (but within 24 hours), in accordance with paragraph (c) of this section, after the occurrence of the following events:

(1) Any backtesting exception determined in accordance with § 240.15c3–1e(e)(1)(iii) and (iv) that would require that the supervised investment bank holding company use a higher multiplication factor in the calculation of its allowances for market or credit risk;

(2) If a computation shows that allowable capital (calculated in accordance with § 240.17i–7(a)) is less than 110% of the sum of the affiliate group's allowances for market, credit, and operational risk (calculated in accordance with § 240.17i–7(b), (c), and (d));

(3) An affiliate declares bankruptcy or otherwise becomes insolvent;

(4) The supervised investment bank holding company becomes aware that a nationally recognized statistical rating organization has determined to reduce its assessment of the creditworthiness of an affiliate or the credit rating(s) assigned to one or more outstanding short or long-term obligations of an affiliate;

(5) The supervised investment bank holding company becomes aware that any financial regulatory agency or self-regulatory organization has taken enforcement action or some other, similar formal regulatory action against an affiliate; or

(6) The supervised investment bank holding company becomes ineligible to be supervised by the Commission as a supervised investment bank holding company.

(b) The supervised investment bank holding company shall file a written report if there is a material change, along with a description of the reason for the change, in:

(1) The ownership or organization of the affiliate group;

(2) The material affiliate status of any affiliate group entity; or

(3) The major business functions of any material affiliate.

(c) Every notice or report required to be given or transmitted pursuant to this section shall be given or transmitted to the principal office of the Commission in Washington, DC, and the regional or district office of the Commission for the region or district in which the supervised investment bank holding company's subsidiary broker or dealer has its principal place of business. For the purposes of this section, ''notice'' shall be given or transmitted by telegraphic notice or facsimile transmission. The reports required by paragraph (b) of this section may be transmitted by overnight delivery. The notices and reports filed under this section shall be accorded confidential treatment.

Dated: October 24, 2003.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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