

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34-48690; File No. S7-21-03]

RIN 3235-AI96

Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities

AGENCY: Securities and Exchange Commission (“Commission”).

ACTION: Proposed rule.

SUMMARY: We are proposing for comment rule amendments under the Securities Exchange Act of 1934 that would establish a voluntary alternative method for computing net capital charges for certain broker-dealers. If the broker-dealer is part of a holding company, that holding company must have a group-wide internal risk management control system and must consent to group-wide Commission supervision (the holding company and its affiliates are referred to in this proposal as a “consolidated supervised entity,” or “CSE”). The proposed alternative method of computing certain market and credit risk net capital charges involves the use of internal mathematical models that the broker-dealer uses to measure risk. Commission supervision would include examination of unregulated holding companies, holding companies that are not primarily in the insured depository institutions business, and affiliates that are not functionally regulated. Among other things, the CSE would comply with stringent rules regarding its group-wide internal risk management control system and would make periodic reports to the Commission, which would include group-wide financial and risk management information and a capital computation consistent with the Basel Standards. We expect that this proposal, if adopted, would improve the Commission’s oversight of broker-dealers.

DATES: Comments should 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 e-mail, but not by both methods. Comments 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.

Comments also may be submitted electronically at the following electronic mail address: *rule-comments@sec.gov*. All comment letters should refer to File

No. [S7-21-03]; please include this file number 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 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 amendments to financial responsibility rules and books and records 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 amendments to Rules 15c3-1, 15c3-4, 17a-5, 17a-11, 17h-1T, and 17h-2T under the Securities Exchange Act of 1934 (“Exchange Act”).

I. Introduction

The Commission is proposing to amend Rule 15c3-1² (“net capital rule”) under the Exchange Act to establish a voluntary alternative method for computing net capital for certain broker-dealers. If the broker-dealer is part of a holding company, that holding company must have a group-wide internal risk management control system and must consent to group-wide Commission supervision (the holding company and its affiliates are referred to in this proposal as a “consolidated supervised entity” or “CSE”).³ We have modeled the proposal on the

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.

² 17 CFR 240.15c3-1.

³ If a broker-dealer is the ultimate parent company of its affiliate group, it would be considered the holding company for purposes of this proposal. The holding company may not be a natural person. Nothing in this proposal is intended to create a preference for one organizational structure over another.

Commission’s rules pertaining to over-the-counter (“OTC”) derivative dealers.⁴ Under the proposal, a broker-dealer that maintains tentative net capital⁵ of at least \$1 billion and net capital⁶ of at least \$500 million⁷ could apply to the Commission for a conditional exemption from the application of the standard net capital rule calculation and, upon Commission approval, elect to calculate certain of its market and credit risk capital charges using the firm’s own internal mathematical models for risk measurement, including internally developed value-at-risk (“VaR”) models and scenario analysis. The standard net capital rule calculation, however, would continue to apply to the broker-dealer’s positions where the use of a VaR model or scenario analysis would not be appropriate.

Large broker-dealers typically are owned by holding companies that may also own many other entities. These affiliated entities may engage in both securities and non-securities activities worldwide. Broker-dealer holding company structures vary, and may be quite complex. Depending upon the nature of these structures, broker-dealers may incur risks due to their affiliation with unregistered entities, including the increasingly common arrangement of using unregistered affiliates to trade in derivatives and other highly structured financial products.

The principal purposes of the net capital rule are to protect customers and other market participants from broker-dealer failures and to enable those firms that fall below the minimum net capital requirements to liquidate in an orderly fashion without the need for a formal proceeding or financial assistance from the Securities Investor Protection Corporation. The net capital rule requires different minimum levels of capital based upon the nature of the firm’s business and whether the broker-dealer handles customer funds or securities.

A broker-dealer may incur many types of risk through its affiliates. For example, a broker-dealer’s access to short-term funding may be affected by the insolvency of an affiliate. In addition, management at the holding company level may attempt to divert

⁴ See Exchange Act Release No. 40594, 63 FR 59362 (November 3, 1998), effective January 1999 (adopting rules relating to OTC derivatives dealers).

⁵ See proposed Rule 15c3-1(c)(15).

⁶ See proposed Rule 15c3-1(a)(7).

⁷ According to first quarter 2003 FOCUS reports, 28 broker-dealers reported more than \$1 billion in tentative net capital and more than \$500 million in net capital.

capital from the broker-dealer, to the extent permitted by the net capital rule, to support an affiliate experiencing financial difficulty. While this shift of assets would not, in itself, place a firm in net capital violation, it could make it more likely that the firm would fail during volatile market conditions. Under the proposed rules, a broker-dealer's ability to calculate its net capital based on the alternative net capital rules would be conditioned on the Commission receiving additional information regarding the financial condition of the holding company and its affiliates, including a calculation of allowable capital at the holding company level.

The significance of a Commission assessment of group-wide risk was highlighted by the failure of the Drexel Burnham Lambert Group ("Drexel") and its impact on its then-solvent broker-dealer subsidiary.⁸ In that case, Drexel had over \$1 billion in commercial paper and other unsecured short-term borrowings outstanding. As a result of significant losses and a decline in the rating of its commercial paper, Drexel found it more difficult to renew its short-term borrowings. Drexel was then forced to look to its only liquid sources of capital—the excess net capital of its broker-dealer and an affiliated government securities dealer. Significant amounts of the broker-dealer's capital were transferred to other affiliates over several weeks.

Exchange Act section 17(h) was enacted in part as a response to the failure of Drexel and authorizes the Commission to obtain information regarding certain activities of the holding company and non-regulated affiliates of a broker-dealer. Pursuant to the rules adopted under 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.⁹

In addition, member firms of the Derivatives Policy Group ("DPG") voluntarily supply us with additional information regarding derivative

⁸ See, e.g. Breeden, Richard C., "Statement Before the Committee on Banking, Housing and Urban Affairs, United States Senate, Concerning the Bankruptcy of Drexel Burnham Lambert" (March 2, 1990) and Exchange Act Release No. 28347 (Aug. 15, 1990), 55 FR 34027 (Aug. 21, 1990) ("Recent events have indicated that the existing early warning restrictions may not be sufficient to address the problems that have arisen in connection with the development by many broker-dealers of large, complex holding companies.").

⁹ 17 CFR 240.17h-1T and 17 CFR 240.17h-2T (the "risk assessment rules").

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.

The proposed alternative net capital provisions would be conditioned on the broker-dealer and its holding company documenting a comprehensive risk management system for identifying, measuring, and managing risk, which would be subject to Commission review. Risks that are managed on a consolidated basis at the holding company level cannot be understood by reviewing risk management practices of only one regulated entity—the broker-dealer. To have a full understanding of how risks, including risks to the broker-dealer, are identified, quantified, and managed, regulators need to review how risk is managed across the organization, including how risk at the affiliate may affect other interrelated entities.

Under this proposal, a broker-dealer could use its proprietary mathematical risk measurement models under prescribed circumstances to calculate its regulatory capital requirement. Because many broker-dealers and their holding companies already manage risk on a group-wide basis using these models, the proposed supervisory structure also should be more closely aligned with the firms' group-wide financial and risk management. Broker-dealers wanting to take advantage of this alternative capital calculation would need to provide the Commission with access to group-wide information.

In most instances, the Commission's supervision on a group-wide basis would consist of analyzing records and reports provided by the holding company (or "CSE") of the broker-dealer.¹⁰ Nevertheless, a CSE that is not an entity that has a principal regulator would permit the Commission to examine its books and records. A CSE also would permit the Commission to examine the books and records of any affiliate of the broker-dealer that does

¹⁰ In some instances, another financial regulator may require reports and calculations that are similar to those we propose here. We intend to make the proposal available to broker-dealers that have regulated holding companies. We do not intend to examine holding companies that are primarily in the insured depository institution business (excluding their insurance and commercial businesses) when the Commission determines that the information the holding company provides is sufficient to meet the Commission's supervisory purposes as set forth in this proposal. We request comment on how and to what extent the Commission's recordkeeping and examination requirements applicable to the holding company should be modified.

not have a principal regulator.¹¹ As a condition to the broker-dealer's exemption from the standard net capital rule, for a holding company that has a principal regulator, the holding company would make available to the Commission such information concerning the operations of the holding company that is necessary for the Commission to evaluate the financial and operational risk within the affiliate group of the broker-dealer (including any risks that could affect the reputation of the holding company or broker-dealer) and to evaluate compliance with the conditions of eligibility for computing the broker-dealer capital charges in accordance with this proposal. The Commission would not examine any holding company that is primarily in the insured depository institutions business (excluding its insurance and commercial businesses) and that arranges to provide the records necessary to meet the Commission's supervisory purposes. The Commission also would not examine functionally regulated broker-dealer affiliates. We request comment on the adequacy of the Commission's recordkeeping and examination requirements with respect to the holding company and whether, and to what extent, they should be modified. With respect to any recordkeeping or examination requirement that should be modified, please specifically list the records that a holding company provides to its holding company regulator that could substitute for records that would be required under this proposal.

We believe that broker-dealers that may choose to apply to use the alternative net capital proposal could be affiliated with holding companies that are primarily in the insured depository institutions business. We request comment on whether we should adopt a definition of "primarily in the insured depository institutions business," and, if so, what factors we should consider.

As a condition of the broker-dealer using the alternative capital calculation, the broker-dealer's holding company would also be required to comply with stringent rules regarding its group-wide

¹¹ The rules would define affiliates with a principal regulator as banks or savings associations, entities registered with the Commodity Futures Trading Commission (other than broker-dealers), and licensed or registered insurance companies. Bank holding companies, savings and loan holding companies, and foreign banks also would be considered to have a principal regulator if: (1) The Commission determines that it has in place appropriate arrangements so that information provided to the Commission is sufficient; and (2) The holding companies or foreign banks are primarily in the insured depository business (excluding their insurance and commercial businesses).

internal risk management control system. Those rules are designed to ensure the integrity of the risk measurement, monitoring, and management process, and to clarify accountability, at the appropriate organizational level, for defining the permitted scope of activity and level of risk. This would help to ensure that the control system would adequately address the risks posed by the CSE's business and the environment in which it is being conducted. It is important that the Commission be informed that these risks are adequately addressed because financial or operational problems at the holding company or affiliate of a broker-dealer could impair the financial and operational stability of the broker-dealer.

Large broker-dealers have long expressed interest in having their supervisory risk assessment and regulatory capital requirements more closely aligned to the mathematical modeling methods they already use to manage their own business risk and capital. In response, the Commission considered reformulating its net capital rule to incorporate mathematical risk management techniques into the computation of regulatory capital charges.¹² The proposed alternative capital calculation responds to the firms' requests while recognizing the complexities of modern financial services conglomerates.

The proposal also responds to international developments. Firms that do business in the European Union ("EU") have told us that they may need to demonstrate that they have consolidated supervision at the holding company level that is "equivalent" to EU consolidated supervision.¹³ We expect that the Commission supervision contemplated by this proposal would meet this standard. As a result, we believe this proposal would minimize duplicative regulatory burdens on firms that are active in the EU as well as in

¹² In 1997, the Commission issued a concept release to solicit comment regarding whether to consider reformulating its net capital rule to incorporate mathematical risk management techniques into the computation of regulatory capital charges. *See* Securities Exchange Act Release No. 39456 (December 30, 1997), 62 FR 68011.

¹³ EU "consolidated supervision" would take the form of a series of quantitative and qualitative rules, imposed at the level of the holding company, regarding firms' internal controls, capital adequacy, intra-group transactions, and risk concentration. Without demonstration of "equivalent" supervision, we understand that an affiliate institution located in the EU may either be subject to additional capital charges or be required to form a sub-holding company in the EU. *See* "Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002."

other jurisdictions that may have similar laws.

We note that the EU uses the international regulatory standards developed by the Basel Committee on Banking Supervision ("Basel Committee"), which aim to align economic capital calculations with regulatory capital requirements for large internationally active banking institutions ("Basel Standards").¹⁴ Our proposal incorporates a capital computation for the CSE that is designed to be 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. Requiring that the CSE calculate its allowable capital based on the Basel Standards would provide the Commission with a useful measure of the CSE's financial position and allow for greater comparability of the CSE's financial position to that of international securities firms and banking institutions.

Eliminating the need to maintain a separate system to calculate regulatory capital should reduce regulatory costs for broker-dealers that have developed mathematical risk measurement models as part of a risk management system for

¹⁴ 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. Its basic consultative papers 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. In April 2003, the Basel Committee released for public comment a document entitled "The New Basel Capital Accord." Comments were accepted through July 31, 2003. On October 11, 2003, the Basel Committee announced that it had received over 200 comment letters and that there is continued broad support for the structure of the proposed New Basel Capital 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.

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). 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.

Proposed Appendix G is designed to be consistent with the Basel Standards.

business purposes. We also expect it to lower the market and credit risk deductions from net capital for eligible broker-dealers. Despite this anticipated reduction in required net capital, we believe that the proposal's safeguards, including the proposed minimum tentative net capital and net capital levels, should reduce systemic risk and not impair investor protection.

II. Alternative Capital Computation for Eligible Broker-Dealers

Exchange Act section 15(c)(3) gives the Commission broad authority to adopt rules and regulations regarding the financial responsibility of broker-dealers that we find are necessary or appropriate in the public interest or for the protection of investors.¹⁵ The Commission has promulgated various rules under this provision, including the net capital rule,¹⁶ the hypothecation rules,¹⁷ and the customer protection rule.¹⁸ Other rules, such as the Commission's books and records rules,¹⁹ reporting requirements,²⁰ and the early warning rule,²¹ support our financial responsibility framework. The Commission receives additional information, including information about affiliates of broker-dealers, 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 through the risk assessment rules and meetings with and reports from members of the Derivatives Policy Group. Since its adoption, we believe that the net capital rule and these other

¹⁵ 15 U.S.C. 78o(c)(3).

¹⁶ 17 CFR 240.15c3-1. In calculating its net capital, a broker-dealer is required to reduce the value of its proprietary positions to provide a capital cushion if the value of these positions should decline. The rule also places restrictions on the withdrawal of equity capital from a broker-dealer.

¹⁷ 17 CFR 240.15c2-1 and 240.8c-1. The hypothecation rule restricts broker-dealers' handling and use of customer securities, including prohibiting commingling of customers' securities without their consent.

¹⁸ 17 CFR 240.15c3-3. The customer protection rule requires broker-dealers to have possession or control of all fully paid and excess margin securities that they carry for their customers. In addition, the customer protection rule prohibits the broker-dealer's use of customer funds to finance the broker-dealer's proprietary business. The rule also requires broker-dealers that carry customer accounts to establish a special reserve bank account for the exclusive benefit of customers.

¹⁹ 17 CFR 240.17a-3 and 240.17a-4.

²⁰ 17 CFR 240.17a-5.

²¹ 17 CFR 240.17a-11. The early warning rule requires that if a broker-dealer's net capital falls below a certain specified level or if it discovers a material internal control inadequacy, the broker-dealer must file a notice with us and with the firm's designated examining authority.

supervisory tools generally have performed well by assisting the Commission and the self-regulatory organizations ("SROs") in identifying at an early stage firms that are experiencing financial problems.

This proposal would expand the use of mathematical model-based capital charge calculations, which the Commission has permitted for several years in the context of OTC derivatives dealers,²² to eligible broker-dealers that elect Commission supervision of their holding company and affiliates, subject to certain specified conditions.²³

A broker-dealer's use of this alternative net capital treatment would be conditioned on the CSE complying with a series of requirements. The CSE would be required on a monthly and quarterly basis to compute group-wide capital and allowances for market, credit, and operational risk as if it were subject to the Basel Standards. The CSE also would be required to provide the Commission with certain financial, operational, and risk management information. The CSE would be required to implement and maintain a consolidated internal risk management control system and procedures to monitor and manage group-wide risk, including market, credit, funding, operational, and legal risks.

We are proposing what we believe are prudent parameters for measuring a broker-dealer's net capital charges and allowances for risk for its holding company, 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 contains the requirements that the VaR model used to calculate market risk for the broker-dealer and for the holding company 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

²² The Commission permits broker-dealers that limit their business to OTC derivatives trading and ancillary cash and portfolio management activities ("OTC derivatives dealers") to calculate capital charges based on VaR models. Exchange Act Release No. 40594 (November 3, 1998), 63 FR 59362. This voluntary registration allows an OTC derivatives dealer to use mathematical models to calculate its market and credit risk capital charges upon Commission approval of an application that is subject to an intensive Commission review of how the firm manages its market, credit, liquidity and funding, legal, and operational risks. Because the amounts at risk are calculated across the affiliate group of the OTC derivatives dealer, the Commission gains a group-wide perspective on how the firm is managed and how it handles large group-wide exposures.

²³ The affiliate group, *i.e.* the CSE, includes the broker-dealer and all affiliates of the broker-dealer, including the holding company.

based on our experience and existing Commission rules and rules of other regulatory agencies where there are similar risk factors in the regulated entities. We ask for comment on all these parameters.

Proposed paragraph (a)(7) of Rule 15c3-1 provides that the Commission may grant, in whole or in part, an application, or an amendment to an application, by a broker-dealer to use the voluntary alternative net capital computation.²⁴ This proposed paragraph also provides that the broker-dealer must at all times maintain tentative net capital of not less than \$1 billion and net capital of not less than \$500 million.

We expect that net capital charges will be reduced for broker-dealers that use the proposed alternative net capital computation. The present haircut structure is designed so that firms will have a sufficient capital base to account for, in addition to market and credit risk, other types of risk, such as operational risk, leverage risk, and liquidity risk. Raising the minimum tentative net capital requirement to \$1 billion and net capital requirement to \$500 million is one way to ensure that firms that use the alternative capital computation maintain sufficient capital reserves to account for these other risks. In addition, based on our experience, firms must have this scale of operations in order to have developed internal risk management control systems necessary to support reliable VaR computations.

We request comment on these required minimum levels of tentative net capital and net capital. Should they be raised or lowered?

Proposed paragraph (c)(13) of Rule 15c3-1 defines "entity that has a principal regulator" as a person (other than a natural person) that is not a registered broker-dealer (other than a broker-dealer registered under § 15(b)(11) of the Exchange Act) and that belongs to one of two categories. Under proposed paragraph (c)(13)(i), the person could be an insured depository institution, an entity registered with the Commodities Futures Trading Commission, or a licensed or regulated insurance company. Under proposed

²⁴ The application and approval process for firms that elect this capital treatment would be similar to the one for firms using the alternative capital computation for OTC derivatives dealers. Among other things, the Commission would issue a firm-specific approval setting forth the terms of the alternative capital computation. We would expect to revise the approval when circumstances change. Changes that might necessitate revising the approval would include a change in the firm's internal risk management control systems or a change in the firm's eligibility to use models for certain categories of positions.

paragraph (c)(13)(ii), bank holding companies, savings and loan holding companies, and foreign banks that do business in the U.S. would also be considered to have a principal regulator if there are in place appropriate arrangements so that information provided to the Commission is sufficiently reliable for the purposes of proposed Appendix E and proposed Appendix G and if the entity is primarily in the insured depository institutions business (excluding its insurance and commercial businesses). We request comment on this definition of "entity that has a principal regulator."

The proposed amendment to paragraph (c)(15) of Rule 15c3-1 defines "tentative net capital" for a broker-dealer using the alternative net capital computation.

A. Proposed Appendix E to Rule 15c3-1

Proposed Appendix E to Exchange Act Rule 15c3-1 would include application requirements and the proposed new alternative method of calculating market and credit risk capital charges for the broker-dealer as well as additional supervisory conditions the Commission could impose on the broker-dealer in appropriate circumstances, such as compliance failures. Many of these requirements are similar to the rules applicable to OTC derivatives dealers. The requirements are also based on our experience with the risk assessment rules and meetings with and reports from members of the DPG and other broker-dealers. Once a broker-dealer has submitted an application, the Commission will conduct an intensive review of how the firm manages its market, credit, liquidity and funding, legal, and operational risks to determine whether the broker-dealer has met the requirements of proposed Appendix E and is in compliance with other applicable rules and whether the holding company of the broker-dealer is in compliance with the terms of its undertaking.

1. Application

Pursuant to paragraph (a) of proposed Appendix E, a broker-dealer may apply to the Commission for an exemption from the standard net capital rule to calculate certain market and credit risk capital charges in accordance with Appendix E.²⁵ Paragraph (a) describes

²⁵ From time to time, the broker-dealer will submit amendments to its application. For example, the broker-dealer will be required to submit an amendment to its application if it materially

Continued

the various documents and information which must be submitted as part of the application from the broker-dealer and from the holding company of the broker-dealer that will allow the Commission to determine whether an exemption from the net capital rule is necessary or appropriate in the public interest and consistent with the protection of investors.

The documents and information that must be submitted as part of the application are similar to those we presently obtain under the OTC derivatives dealer rules, under the risk assessment rules, and voluntarily from the DPG firms and other broker-dealers. We have found that they are useful in gaining insight into the financial condition, internal risk management control system, and activities of the broker-dealer and its holding company and affiliates and to understand and evaluate group-wide risk exposures.

Adverse financial or operational conditions at the holding company or an affiliate of the broker-dealer may expose the broker-dealer to additional risk. For example, the failure of an affiliate may adversely affect the ability of the broker-dealer to obtain short-term funding. Therefore, we would require receipt of these documents and information relating to the operational and financial condition of the broker-dealer, and its holding company and other affiliates, as a condition for the broker-dealer's use of proposed Appendix E to calculate certain of its capital charges. We request comment on all aspects of the application requirements.

a. Documents and Information To Be Submitted by the Broker-Dealer

Paragraph (a)(1) of proposed Appendix E lists the documents and information to be submitted by the broker-dealer as part of its application to use the alternative capital computation. The documents and information would include:

- An executive summary of the documents and information submitted to the Commission by the broker-dealer and a description of the holding company of the broker-dealer (which may not be a natural person);
- A list of types of positions the broker-dealer holds in its proprietary account and a description of the method the broker-dealer would use to compute its capital charges on those positions;
- A description of mathematical models used to price positions and to compute capital charges and how those models meet the quantitative and

amends a VaR model that it uses to calculate a market or credit risk capital charge.

qualitative requirements of proposed Appendix E;

- If the broker-dealer is applying to the Commission to use scenario analysis to calculate capital charges for certain positions, a list of the positions and a description of how the capital charges will be calculated; and
- A description of the broker-dealer's internal risk management control system and how that system satisfies the requirements set forth in Rule 15c3-4.

b. Holding Company Undertaking

As part of the application, and as a condition of the broker-dealer's use of proposed Appendix E to calculate certain of its capital charges, the broker-dealer would also be required, by paragraph (a)(1)(viii) of proposed Appendix E, to file a written undertaking by the broker-dealer's holding company, signed by a duly authorized person at the holding company, in which the holding company would agree, among other things, to:

- Comply with proposed Appendix G to Rule 15c3-1, discussed in further detail below, which generally would require that the holding company make certain capital calculations, make certain reports to the Commission, maintain and keep certain records, and notify the Commission upon the occurrence of certain events;
- Comply with all applicable provisions of proposed Appendix E;
- Comply with the provisions of Rule 15c3-4 with respect to a group-wide internal risk management control system for the CSE as if it were a broker-dealer that computes its capital charges in accordance with proposed Appendix E;
- As part of the group-wide internal risk management control system, establish, document, and maintain procedures for the detection and prevention of money laundering and terrorist financing;
- Permit the Commission to examine the books and records of any affiliate, including the holding company, if the affiliate is not an entity that has a principal regulator (as defined in proposed paragraph (c)(13) of Rule 15c3-1) for the purposes of these rules;
- For certain entities that have principal regulators (those entities listed in proposed paragraph (c)(13)(ii) of Rule 15c3-1) for the purposes of these rules, make available to the Commission such information concerning the operations of the entity that the Commission determines is necessary to evaluate risks that may affect the financial or operational condition of the holding company;

- If the disclosure to the Commission of any information required as a condition for the broker-dealer to use proposed Appendix E would be prohibited by law or otherwise, cooperate with the Commission as needed, including by describing any secrecy laws or other impediments that could restrict the ability of the broker-dealer or its affiliates from providing information to the Commission and by discussing the manner in which the broker-dealer and the holding company propose to provide the Commission with adequate assurances of access to information;

- For any non-U.S. holding company, consent to the jurisdiction of the Commission and agree to maintain a U.S. registered agent;

- Submit to the Commission all material changes to mathematical models used to calculate allowances for market and credit risk for Commission approval;

- Submit to the Commission all material changes to the group-wide internal risk management system; and

- Acknowledge that the Commission may implement additional supervisory conditions, described in detail below, if the holding company fails to comply with any provision of its undertaking.

The proposed terms of the undertaking are those that we have determined are necessary for us to understand the risks to the broker-dealer that may result from activities of its affiliates and for us to have access to information concerning the CSE. For example, permitting the Commission to examine the books and records of non-functionally regulated affiliates of the broker-dealer will provide the Commission with an understanding of the group-wide risk exposures that may have a material effect on the financial or operational condition of the broker-dealer. The requirement to establish a group-wide internal risk management control system in accordance with the standards of Rule 15c3-4 will help provide assurance that the control system that is implemented will adequately address the risks posed by the firm's business and the environment in which it is being conducted. We request comment on the documents that the broker-dealer must submit as part of its application to use proposed Appendix E to compute certain of its capital charges.

As noted above, use of the alternative net capital treatment by a broker-dealer is conditioned on the broker-dealer's holding company undertaking to comply with the above requirements. We request comment on all aspects of the holding company undertaking.

Should we consider any other conditions? Are any of the proposed conditions problematic?

c. Documents and Information To Be Submitted by the Holding Company

Under paragraph (a)(2) of proposed Appendix E, as a condition of the broker-dealer's use of the alternative capital treatment, the holding company of the broker-dealer must submit the following documents and information to the Commission as part of the application of the broker or dealer:

- A narrative description of the business and organization of the holding company;
- An organizational chart depicting the holding company and its subsidiaries and affiliates;
- An alphabetical list of the affiliates of the broker-dealer ("affiliate group"), with an identification of the financial regulator, if any, with whom the affiliate is registered and a designation of those affiliates that are material to the holding company ("material affiliates");
- Consolidated and consolidating financial statements;
- Certain sample capital calculations made according to proposed Appendix G to Rule 15c3-1;
- A description of the categories of positions held by the holding company and affiliates;
- A description of the methods the holding company intends to use for computing allowances for market risk, credit risk, and operational risk;
- A description of any differences between the models used by the holding company and those used by the broker-dealer to compute capital charges on the same instrument or counterparty;
- A description of the internal risk management control system used by the holding company to manage group-wide risk and how that system satisfies the requirements of Rule 15c3-4; and
- Sample risk reports that the holding company provides to its senior management.

Because each firm manages its internal risk differently, the Commission, during the application process, must assess each firm's business and internal risk management control systems to determine whether an exemption is appropriate. The documents and information we would require the holding company to file as a condition for the exemption would allow us to evaluate this risk. In certain circumstances, depending on the relationship or the geographic location of the holding company and its affiliates, the Commission may condition its approval on obtaining additional information or documents

necessary to adequately assess the risks to the CSE and to the broker-dealer. Paragraph (a)(3) of proposed Appendix E provides that the application shall be supplemented by such other information or documents relating to the internal risk management control system, mathematical models, and financial position of the broker-dealer or the holding company that the Commission may request to complete its review of the application.

Under paragraph (a)(4) of proposed Appendix E, the application would be considered filed when received at the Commission's principal office in Washington, DC. All information and documents submitted in connection with the application would be accorded confidential treatment under the proposal.

We request comment on the documents and information we propose to require that the broker-dealer and holding company file as a condition for the exemption. For example, are there other documents or information we should require?

As part of its group-wide internal risk management control system, the holding company would be required to establish, document, and maintain procedures for the detection and prevention of money laundering and terrorist financing. These procedures would include appropriate safeguards at the holding company level to prevent money laundering through affiliates.²⁶

Under paragraph (a)(6) of proposed Appendix E, the Commission would grant an application by a broker-dealer to use the alternative capital computation if it determines that the broker-dealer has met the requirements of Appendix E and is in compliance with other applicable Exchange Act rules and that the holding company is in compliance with the terms of its undertaking, which are conditions for the approval.

Under paragraph (a)(7) of proposed Appendix E, a broker-dealer would be required to amend and resubmit its application to use Appendix E to the Commission if the broker-dealer or its holding company desires to make a material change to a mathematical model used to calculate market or credit risk or its internal risk management control system as described in the application. Because material changes to the mathematical models may have a

significant impact on the firm's net capital or risk allowances and changes to the internal risk management control systems could result in changes to the amount of risk assumed by the broker-dealer or holding company, Commission review of those changes would be appropriate to determine if the exemption continues to be consistent with the Exchange Act. Under paragraph (a)(8) of proposed Appendix E, the broker-dealer would be required to notify the Commission of any material change to the corporate structure of the broker-dealer or the holding company as described in the application.

Under paragraph (a)(9) of proposed Appendix E, as a condition of the exemption to compute its capital charges pursuant to Appendix E, a broker-dealer would agree to provide 45 days written notice to the Commission if it chose to end its reliance on the exemption. The broker-dealer would also agree that the Commission could determine that the notice would be effective after a shorter or longer period of time if the broker-dealer consents or if the Commission determines that the shorter or longer period is necessary or appropriate in the public interest and consistent with the protection of investors. We request comment on this notice provision. For example, is 45 days an appropriate notification period? Would a shorter or longer time period be preferable?

Pursuant to paragraph (a)(10) of proposed Appendix E, the Commission may, by order, revoke the broker-dealer's exemption that allows it to use proposed Appendix E to calculate certain capital charges if the Commission finds that the exemption is no longer necessary or appropriate in the public interest or is no longer consistent with the protection of investors. A broker-dealer that is no longer permitted to calculate its regulatory capital requirements pursuant to Appendix E must compute its capital charges using the standard haircut method in the net capital rule. We request comment on the revocation provisions. Should paragraph (a)(10) of proposed Appendix E specify certain circumstances where revocation of the exemption would be appropriate?

2. Risk Management Control System

Under paragraph (b) of proposed Appendix E, the broker-dealer would be required to establish, document, and maintain an internal risk management control system that meets the requirements of § 240.15c3-4 (with proposed amendments to apply the rule

²⁶This parallels requirements in the proposed New Basel Capital Accord. 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 <http://www.FATF-GAFI.org>).

to broker-dealers using Appendix E).²⁷ Rule 15c3–4 is designed to ensure the integrity of the risk measurement, monitoring, and management process, and to clarify accountability, at the appropriate organizational level, for defining the permitted scope of activity and level of risk. We request comment on this proposed requirement.

3. Market Risk Capital Charge

Under paragraph (c) of proposed Appendix E, the market risk capital charge on certain of the broker-dealer's positions would be computed either using VaR mathematical models, scenario analysis, or the standard haircut method of paragraph (c)(2)(vi) of Rule 15c3–1. The computation of the market risk capital charge under this proposal is based on the method for computing market risk under the OTC derivatives dealer rules. Generally, when a statistical model is used to determine market risk charges, the VaR amount determined by using the model must be multiplied by a multiplication factor to take into account the risk that the model does not measure the effects of unlikely but significant events.

a. Market Risk Capital Charge Calculation Using a VaR Model

For positions for which a market risk capital charge may be computed using a VaR model,²⁸ the market risk capital charge would be the VaR of the positions, which would be multiplied by the appropriate multiplication factor to provide an adequate measure of risk during periods of market stress.²⁹

In order for the Commission to monitor whether the broker-dealer's VaR models provide an adequate measure of the broker-dealer's risk exposures, an eligible broker-dealer would be required to obtain authorization from the Commission, either in its original application or by submitting an amendment to its application, before using a VaR model to calculate market risk capital charges on particular categories of exposures. The multiplication factor would be determined by reference to Table 1 of proposed Appendix E based on the results of quarterly backtests of the VaR model, which compare the losses predicted by the model to actual losses incurred in the broker-dealer's portfolio, except that the initial multiplication factor would be three. In considering an application or amendment, the

Commission may adjust the multiplication factor or take other action, as appropriate, after evaluating the firm's adherence to robust internal risk management procedures, including a review of its VaR models.³⁰

Paragraph (e) of proposed Appendix E would set forth the qualitative and quantitative requirements for VaR models used by the broker-dealer to calculate capital charges.³¹ These requirements are intended to make the capital charges based on the VaR measures a more accurate measure of losses that may occur during periods of market stress and are based on those in the OTC derivatives dealer rules and our experience in implementing those rules. The qualitative requirements, listed in paragraph (e)(1) of proposed Appendix E, would require that the VaR models used to calculate market and credit risk be the same models used to report market and credit risk to the firm's senior management and must be integrated into the internal risk management system of the firm; that the VaR model must be reviewed by the firm periodically and annually by a registered public accounting firm, as that term is defined in the Sarbanes-Oxley Act of 2002;³² and that for purposes of computing market risk, the multiplication factor must be determined based on quarterly backtesting of the VaR model used to calculate market risk and by reference to Table 1 of proposed Appendix E.

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 firm's positions.³³

Under paragraph (c)(3) of proposed Appendix E, the Commission proposes to phase in the use of VaR models to calculate capital charges for three bands of positions over a period of at least 18 months beginning with positions with lower risk exposures and progressing to those with higher levels of risk. During the phase-in period, Commission approval of an application or amendment would be required before a broker-dealer could begin to use VaR models to calculate market risk capital charges at each of the succeeding levels of risk exposures. The phase-in of the application of mathematical models to calculate capital charges and the requirement that the previous stage VaR use must have been successful are intended to allow the Commission to determine whether an applicant has management controls that can adequately assess increasing risk levels and whether the models have flaws or other defects. A broker-dealer would request Commission approval by filing an amendment to its application.

Upon Commission approval of its application to use proposed Appendix E to calculate certain of its capital charges, the broker-dealer would be able to use VaR models to calculate market risk capital charges on the first level of eligible positions, which are generally securities with lower risk exposures: (1) U.S. government securities and derivatives on those securities; (2) investment grade corporate debt and derivatives on those securities; (3) highly rated foreign government securities and derivatives on those securities; (4) highly rated short-term asset-backed securities and derivatives on those securities; (5) highly rated municipal securities and derivatives on those securities; and (6) derivatives on major market foreign currencies.

After at least nine months of successfully using VaR models to calculate market risk capital charges on the first level of eligible positions, a broker-dealer could amend its exemptive application to request Commission approval to use VaR models to calculate market risk capital charges on the second level of eligible positions, which include equities and derivatives on equities.

After at least another nine months of successfully using VaR models to calculate market risk capital charges on the second level of eligible positions as well as continuing to successfully calculate market risk charges on the first level of eligible positions, a broker-

²⁷ See *infra*, discussion of proposed amendments to Rule 15c3–4.

²⁸ These positions include those that have a ready market and for which there is adequate historical data to support a VaR model.

²⁹ Proposed Rule 15c3–1e(c)(1).

³⁰ The Commission may take such actions, for example, in considering an application or amendment to an application of a broker-dealer to calculate certain market and credit risk capital charges in accordance with proposed Appendix E or during its routine oversight of the broker-dealer.

³¹ Proposed Rule 15c3–1e(e)(1)–(2).

³² "Registered public accounting firm" is defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (Pub. L. 107–204) as "public accounting firm registered with the [Public Company Accounting Oversight] Board in accordance with this Act." We propose that a registered public accounting firm conduct the review of the VaR models, prepare supplemental reports concerning management controls and inventory pricing and modeling for the broker-dealer and its holding company, and prepare the holding company's annual audit report because such firms would be subject to Board rules, examination, and discipline.

³³ Proposed Rule 15c3–1e(e)(2).

dealer could amend its exemptive application to request Commission approval to use VaR models to calculate market risk capital charges for other eligible positions, which would include positions for which there is a ready market and for which there is adequate historical data to support a VaR model.

The Commission seeks comment on all aspects of the phase-in timetable, including the appropriateness of the positions selected for each level of eligibility and the 9-month time periods between successive levels. Should these time periods be shorter or longer? How should the Commission evaluate the success or adequacy of the models during these phase-in periods? Are there any other additional criteria or methods the Commission should consider using?

The Commission seeks comment on all aspects of the proposed calculation of market risk capital charges. In particular, we request comment on the use of mathematical models for regulatory capital purposes, including the quantitative and qualitative requirements for VaR models, the multiplication factors used to calculate the capital charge for market risk, and the use of backtesting to determine the multiplication factor. For example, should the multiplication factors be higher or lower? How should the multiplication factors be determined? Are the backtesting procedures appropriate? Is the 99% one-tailed confidence level appropriate? Is the requirement that the price changes be equivalent to a ten business-day movement in rates and prices appropriate? If not, what parameters would be appropriate?

Because VaR models use historical price data to predict future price movements, under paragraph (c)(4) of proposed Appendix E, an eligible broker-dealer could not use VaR models to calculate capital charges on securities that do not have adequate historical data available to make the VaR models reliable. For example, a broker-dealer could not use VaR models to calculate capital charges on securities recently sold in an initial public offering or for securities without a ready market. In those cases, the broker-dealer could apply to use scenario analysis or would continue to use the standard haircut method to calculate the capital charges on those positions.

b. Market Risk Capital Charge Calculation Using Scenario Analysis

Under paragraph (c)(5) of proposed Appendix E, for positions for which the Commission has approved the broker-

dealer's use of scenario analysis³⁴ to compute a market risk capital charge (for example, positions having no ready market) the market risk capital charge would be three times the greatest adverse price movement resulting from the scenario over any ten-day period on a daily basis. The broker-dealer would be required to take a minimum market risk capital charge of \$25 per 100-share equivalent equity contract for equity positions or ½ of one percent of the face value of the contract for all other types of contracts, even if the scenario model indicates a lower amount. We believe that it is appropriate to build in minimum charges to help assure that the firm has adequate capital in view of risks that may not be captured by scenario analysis. We request comment on the proposed calculation of capital charges using scenario analysis. Specifically, is three the appropriate multiplier? Is \$25 per 100-share equivalent equity contract the appropriate minimum charge for equity positions? Is ½ of one percent of the face value of the contract the appropriate minimum for all other types of contracts? The Commission also could require a broker-dealer using scenario analysis to take additional capital charges for specific risk based on the liquidity or the perceived risks of the instruments. We request comment on the appropriate capital charge for specific risk.

The Commission solicits comment on all aspects of the use of scenario analysis to determine capital charges including the proposed multipliers and minimum charges. We are also interested in receiving any comments on other methodologies that may be appropriate to more accurately measure risk and correlate that risk to capital charges.

c. Market Risk Capital Charge Calculation for Other Positions

Under paragraph (c)(6) of proposed Appendix E, an eligible broker-dealer that computes its market risk capital charges pursuant to proposed Appendix E to Rule 15c3-1 would continue to compute market risk capital charges using paragraph (c)(2)(vi) of Rule 15c3-1 (the "haircut method") for positions for which the Commission has not approved its use of a VaR model or scenario analysis to compute those capital charges.

³⁴ Scenario analysis is the identification of the potential impact on the profit or loss on a position of various extreme events that affect the pricing of the position in the portfolio.

4. Credit Risk Capital Charge

An eligible broker-dealer would be required to use paragraph (d) of proposed Appendix E to compute its credit risk capital charge on credit exposures arising from the broker-dealer's positions in derivatives instruments if the Commission authorized the broker-dealer to use VaR or scenario analysis to compute its market risk capital charge on those positions. The credit risk capital charge computed pursuant to proposed Appendix E would be similar to the credit risk capital charge calculated pursuant to Appendix F to Rule 15c3-1, which applies to electing OTC derivatives dealers. The credit risk capital charge would be the sum of counterparty exposure charges for each counterparty, concentration charges by counterparty, and a portfolio concentration charge across all counterparties. Each of these charges is designed to address different components of credit risk.

First, for each counterparty, the broker-dealer would compute a counterparty exposure charge equal to the "credit equivalent amount" (defined below) of the broker-dealer's exposures to the counterparty, multiplied by 8%,³⁵ and further multiplied by a credit risk weight for the counterparty (or, under paragraph (d)(1) of proposed Appendix E, the counterparty exposure charge is the net replacement value in the account of a counterparty if that counterparty is insolvent, in bankruptcy, or that has senior long-term debt in default). This method for computing credit risk capital charges is consistent with the computation of credit risk capital charges for OTC derivatives dealers under Appendix F to Rule 15c3-1.

The credit equivalent amount to a counterparty would be defined in paragraph (d)(2) of proposed Appendix E as the sum of: (1) the broker-dealer's maximum potential exposure to the counterparty multiplied by the appropriate multiplication factor; and (2) the broker-dealer's current exposure to the counterparty. The multiplication factor would generally be determined based on backtesting results of the VaR model used to calculate maximum potential exposure, except that the initial multiplication factor would be one. Current exposure would be defined in paragraph (d)(3) of proposed Appendix E as the replacement value of

³⁵ The 8% multiplier is consistent with the calculation of credit risk in the OTC derivatives dealers rules and with the Basel Standards and is designed to dampen leverage to assure that the firm maintains a safe level of capital.

the counterparty's positions with the broker-dealer, after applying specified netting agreements³⁶ and taking into account the value of certain collateral³⁷ received from the counterparty.

Maximum potential exposure would be defined in paragraph (d)(4) of proposed Appendix E as the increase in the replacement value of the counterparty's positions with the broker-dealer, after applying the effect of specified netting agreements and taking into account the value of certain collateral received from the counterparty, that will not be exceeded with 99% confidence over a time horizon of one year. The broker-dealer would have to calculate maximum potential exposure using a VaR model meeting the applicable quantitative and qualitative requirements of proposed Appendix E.³⁸ The Commission requests comment on the proposed calculations of current exposure and maximum potential exposure, including the use of VaR models to measure maximum potential exposure as well as the impact of netting agreements and collateral.

The credit risk weight of the counterparty would be calculated under paragraph (d)(7) of proposed Appendix E using methods that are consistent with the computation of credit risk capital charges for OTC derivatives dealers under Appendix F to Rule 15c3-1. If a counterparty is rated by a nationally recognized statistical rating organization ("NRSRO"), the credit risk weight would range from 20% to 150% depending on the credit rating of the counterparty, which provides a measure of credit risk. If a counterparty is not rated by an NRSRO, the broker-dealer could apply to the Commission, either in its original application or by amending its application, for permission to determine a credit rating for the counterparty using internal calculations and to use the internal credit rating in lieu of a rating by an NRSRO for purposes of determining the credit risk

³⁶ Only netting agreements that meet the requirements of paragraph (d)(5) of proposed Appendix E could be used to derive current exposure and maximum potential exposure. For example, the netting agreements would have to be legally enforceable in each relevant jurisdiction, including in insolvency proceedings. These proposed requirements are designed to allow a broker-dealer to reduce its credit risk capital charge only if the netting agreement reduces credit risk.

³⁷ Only collateral that meets the requirements of paragraph (d)(6) of proposed Appendix E could be used to derive current exposure and maximum potential exposure. For example, the collateral must have a ready market or consist of certain major market foreign currency or U.S. currency. These proposed requirements are designed to allow a broker-dealer to reduce its credit risk capital charge only if the collateral reduces credit risk.

³⁸ See proposed Rule 15c3-1e(e).

weight of the counterparty. We request comment on whether the broker-dealer should also be able to apply to the Commission for permission to determine the credit risk weight of a counterparty using internal calculations. For exposures covered by guarantees, where the guarantee is an unconditional and irrevocable guarantee of the due and punctual payment and performance of the obligation and the broker-dealer can demand immediate payment from the guarantor after any payment is missed without having to make collection efforts, a broker-dealer would be able to substitute the average of the credit risk weights of the guarantor and the counterparty for the credit risk weight of the counterparty.

Concentration charges are appropriate when a lack of diversification exposes the broker-dealer to additional risk. When evaluating the debt holdings of an entity, a lack of diversification would be evidenced by either a relatively (relative to the amount of the broker-dealer's tentative net capital) large exposure to a single party (the credit rating of that counterparty would, of course, affect the amount of additional risk) or a relatively large amount of unsecured debt holdings.

The second part of the credit risk capital charge, as provided in paragraph (d)(8) of proposed Appendix E, would take into account the additional risk of a relatively large exposure to a single party and would consist of concentration charges by counterparty that would generally apply when the current exposure of the broker-dealer to a single counterparty exceeds 5% of the tentative net capital of the broker-dealer. The amount of the concentration charge would be larger for counterparties with lower credit ratings and would range from 5% to 50% of the amount of the current exposure of the broker-dealer to the counterparty in excess of 5% of the broker-dealer's tentative net capital. The 5% is based on the OTC derivatives dealers rules and Commission experience.

The third part of the credit risk capital charge, as provided in paragraph (d)(9) of proposed Appendix E, would recognize the additional risk of holding a relatively large amount of unsecured debt and would consist of a portfolio concentration charge across all counterparties that would be the amount, if any, that the broker-dealer's aggregate current exposure across all counterparties for unsecured exposures exceeds 15% of the broker-dealer's tentative net capital.

The Commission requests comment on all aspects of the credit risk capital charge; in particular, the determination

of credit risk weights for counterparties. 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 Appendix E. 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 DEFAULT³⁹

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

The Commission believes that calculating a credit risk capital charge on exposures arising from transactions in derivatives instruments using a qualifying VaR model 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 use maximum potential exposure to measure and manage the credit risk of their portfolios. These broker-dealers would therefore incur small, if any, additional costs to calculate maximum potential exposure as opposed to "notional add-ons."

The Commission requests comment on all aspects of this approach to the calculation of credit risk capital charges on derivatives instruments, including the two concentration charges that are applicable both to individual counterparties and across all counterparties. The Commission also requests comment on the appropriate treatment of credit derivatives in this

³⁹ 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. *The New Basel Capital Accord*, April 2003. The credit risk weights were derived 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 that 75% is a conservative number for use in determining credit risk weights. We request comment on whether 75% is appropriate, or whether it should be increased or decreased.

context. Credit derivatives can 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 credit derivative for the credit risk weight of the counterparty. This is the treatment included in proposed Appendix E. The second would be to adjust the current exposure and the maximum potential exposure by the value of the credit derivative. We request comment on these methods of including credit derivatives in the calculation of credit risk capital charges. We also request comment on whether any special treatment should be accorded guaranteed obligations or other obligations that may have double default effects.

5. Additional Regulatory Conditions for Noncompliance With Appendices E and G, Model Failures, or Control Failures

Paragraph (f) of proposed Appendix E provides that as a condition for the broker-dealer to be permitted to use proposed Appendix E to calculate certain of its capital charges, the Commission may impose additional regulatory conditions on the broker-dealer or may condition further use of the exemption on the holding company of the broker-dealer filing more frequent reports, modifying its internal risk management control procedures or on imposing such other appropriate additional regulatory conditions that the Commission finds are necessary or appropriate in the public interest and consistent with the protection of investors. The Commission may impose these additional regulatory conditions if: the broker-dealer or the CSE fails to comply with reporting requirements under the proposal; if there is a material deficiency in the internal risk management control system or certain mathematical models of the broker-dealer or the CSE; if the CSE fails to comply with its undertakings; if the broker-dealer or the CSE notifies the Commission of the occurrence of certain events; if there is a material change in a mathematical model, internal risk management control system, or corporate structure as described in the application; or if the Commission finds that imposing an additional regulatory condition is necessary or appropriate in the public interest, and is consistent with the protection of investors. The events that require notification are specified in paragraph (e) of proposed Appendix G (for the CSE) and in the proposed amendments to Rule 17a-11 (for the broker-dealer), which are described in detail below. The proposed additional regulatory conditions include requiring the broker-dealer to restrict its

business, to provide a plan for increasing its net capital or tentative net capital, or to calculate its capital charges using the haircut method of Rule 15c3-1.

This provision is intended to identify situations where the broker-dealer may be exposed to increased levels of risk. We could respond to that increased risk level by, for example, requiring increased capital charges or requiring that we be provided more information concerning the operational or financial condition of the broker-dealer, its holding company, and its affiliates.

We seek comment on the additional conditions that would be available to the Commission under paragraph (f) of Appendix E. Are the events pursuant to which the Commission may impose additional conditions appropriate? Should any other events be added to this list? Should we specify in the rule other conditions that could be imposed if the broker-dealer or CSE did not comply with applicable requirements? What should these conditions be?

B. Proposed Appendix G to Rule 15c3-1

As a condition of Commission approval, the holding company of a broker-dealer applying for authorization to compute certain of its capital charges in accordance with proposed Appendix E would undertake to comply with the requirements listed in proposed Appendix G to Rule 15c3-1, in addition to those listed in paragraph (a)(1)(viii) of proposed Appendix E. Under Appendix G, the CSE would be required to compute allowable capital and allowances for market, credit, and operational risk on a consolidated basis for the CSE; provide the Commission with certain monthly, quarterly, and annual reports; maintain certain books and records relating to the CSE's consolidated financial reports and internal risk management controls; and notify the Commission upon the occurrence of certain events. These conditions are designed to help the Commission assess the financial and operational health of the holding company and the potential impact on the risk exposure of the broker-dealer.

We are proposing what we believe are prudent parameters for measuring allowable capital and risk allowances for the CSE and that are consistent with the Basel Standards, which are used by many other financial regulators as a method to assess capital adequacy at the holding company level. For example, the proposal contains requirements placing limits on the amount of subordinated debt that may be included in allowable capital, that the VaR model

used to calculate the allowance for market risk be based on a ten business-day movement in rates and prices, and that the VaR measure be multiplied by a factor of at least three. Requiring that a CSE calculate its allowable capital based on the Basel Standards would provide the Commission with a useful measure of the CSE's financial position and allow for greater comparability of an CSE's financial condition to that of other international securities firms and banking institutions.

1. Calculation of Allowable Capital and Allowances for Market, Credit, and Operational Risk by the CSE

Pursuant to proposed paragraph (a) of Appendix G, the CSE would be required to calculate allowable capital and allowances for market, credit, and operational risk on a consolidated basis for the affiliate group on a monthly basis, which is designed to be consistent with the Basel Standards, which will allow for greater comparability of CSEs to international securities firms and banking institutions. This requirement is necessary to monitor the financial condition of the affiliate group, which may impact the financial stability of the broker-dealer. A CSE that makes a capital calculation consistent with the Basel Standards that it is required to submit to another regulator can request in the original exemption application or in an amendment to substitute that calculation for the calculations required by paragraph (a) of proposed Appendix G. If the Commission finds that the calculation gives the Commission sufficient information about the financial health of the holding company, it will approve that request.

e. Group-Wide Allowable Capital Calculation

Under proposed paragraph (a)(1) of Appendix G, the CSE would calculate "allowable capital" on a consolidated basis for the affiliate group. Consistent with the Basel Standards, allowable capital would include common shareholders' equity (less goodwill, deferred tax assets, and certain other intangible assets), certain cumulative and non-cumulative preferred stock,⁴⁰ and certain properly subordinated debt. As set forth in detail in the rule, the cumulative and non-cumulative preferred stock and the subordinated

⁴⁰To qualify, the cumulative and noncumulative preferred stock could not have a maturity date, could not be redeemed at the option of the holder, and could not 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. Preferred stock meeting these conditions would have characteristics consistent with capital, as opposed to debt.

debt are subject to additional limitations based on comparisons of the individual components of allowable capital.

We request comment on whether goodwill should be included in allowable capital or whether it is appropriate to include goodwill subject to a phase-out. If so, we request comment on how the phase-out should be structured and how long the phase-out should last.

An entity's debt is not ordinarily regarded as capital. Because subordinated debt can provide a long-term source of working capital to the entity and may have many of the characteristics of capital, however, the Basel Standards permit unrestricted long-term subordinated debt⁴¹ to count as capital. Under paragraph (a)(1)(iii)(B) of proposed Appendix G, and consistent with the Basel Standards, subordinated debt can be included in allowable capital if it meets four criteria, which generally are designed to assure that the subordinated debt will provide a long-term source of working capital to the holding company and that it has many of the characteristics of capital. First, the original weighted average maturity of the CSE'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 CSE. Fourth, the terms of the subordinated debt agreement may permit acceleration only in the event of bankruptcy or reorganization of the CSE under Chapters 7 (liquidation) or 11 (reorganization) of the U.S. Bankruptcy Code. The intent of these four criteria is to provide for 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 CSE's business and must be available to pay other creditors if the holding company defaults on other obligations or fails. Although the customers of certain of the entities which are part of the CSE may be entitled to the protection of SIPC or a Federal agency under specific circumstances, such as the failure of a broker-dealer subsidiary, subordinated lenders of the holding company, as

subordinated lenders, would not be entitled to any such protection.

Under the proposal, to be included in allowable capital, subordinated debt must have characteristics that are consistent with capital. Therefore, the subordinated debt must be unsecured and subordinated in right of payment to all of the CSE's senior debt. Debt that, upon default, can be repaid by conversion of collateral or before other debt cannot be considered subordinated in right of repayment to all senior indebtedness of the CSE 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 holding company would not qualify for inclusion in allowable capital under the proposed rules.⁴² Acceleration clauses raise significant supervisory concerns because repayment of the debt could be accelerated at a time when a CSE may be experiencing financial difficulties. Acceleration, therefore, could inhibit a CSE's ability to resolve its financial problems in the normal course of business and force the company into involuntary bankruptcy, thereby affecting the financial stability of the broker-dealer.

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, could subordinated debt be subject to negative pledge provisions that, for example, would restrict a CSE'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 CSE under the Bankruptcy Code be included in allowable capital?

⁴² 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 CSE's resources and increase the likelihood of default on debt. Furthermore, the clause potentially would allow a subordinated lender to obtain payment before senior creditors.

- Should there be a maximum amount of subordinated debt that is includable in allowable capital? If so, what should be the amount?

- What are the additional costs of issuing subordinated debt versus long-term debt of the same maturity?

Some industry participants have suggested that certain long-term debt that cannot be accelerated should be included in allowable capital because, since at the holding company level there is no protected class of creditors, 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 subordinated debt and the lack of an active trading market for subordinated debt. They see no other legitimate purpose behind the requirement that the debt be subordinated in order to count as capital.

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?
- Does a holder of a CSE's subordinated debt have a greater incentive to monitor the financial condition of CSE than a holder of its long-term debt because its claim is more junior? Would trading in its subordinated debt provide a more reliable indication of the credit quality of the CSE than long-term debt and, if so, why?
- 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 a CSE 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 CSE?
- Would there be any other adverse effects if the CSE was 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 should permissible events of acceleration be?
- Should long-term debt be subject to a negative pledge, that, for example, would restrict a holding company's

⁴¹ By contract, subordinated debt is debt that is subordinated in right of payment to all senior indebtedness of the company.

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?

- Would the inclusion of long-term debt in allowable capital affect the liquidation priority of the customers of entities which are part of the CSE in the event of the holding company's bankruptcy?

- What other provisions concerning the inclusion of long-term debt in allowable capital should be considered?

We request comment on all aspects of the calculation of allowable capital.

b. Group-Wide Calculation of Allowance for Market Risk

Under proposed paragraph (a)(2) of Appendix G, a CSE would calculate a group-wide allowance for market risk on all proprietary positions, using a VaR model or an alternative method approved by the Commission, multiplied by an appropriate multiplication factor to provide an adequate measure of risk during periods of market stress. The calculation of the allowance for market risk is important in determining what risk due to market factors the broker-dealer may be exposed to through its affiliates. The VaR model would have to meet the qualitative and quantitative requirements of paragraph (e) of proposed Appendix E.⁴³ The computation of the allowance for market risk under this proposal is consistent with the calculation of the market risk capital charge for the broker-dealer under proposed Appendix E. The Commission seeks comment on all aspects of the proposed method of calculating an allowance for market risk. In particular, should other qualitative or quantitative requirements be included in paragraph (e) of proposed Appendix E?

c. Group-Wide Calculation of Allowance for Credit Risk

Paragraph (a)(3) of proposed Appendix G would require that a CSE calculate an allowance for credit risk daily for certain assets on the consolidated balance sheet and certain off-balance sheet items. The allowance for credit risk would be computed using the methodology set forth in paragraph (a)(3)(i) of proposed Appendix G, which is consistent with the proposed New Basel Accord, or, pursuant to paragraph (a)(3)(ii) of proposed Appendix G, if the Commission approves the broker-

⁴³ See *supra*, discussion of the broker-dealer's calculation of its market risk capital charge using a VaR model under proposed Appendix E.

dealer's request, using a calculation consistent with standards published by the Basel Committee, as modified from time to time. This choice would provide CSEs with some flexibility while the Basel Standards are under review.

The methodology set forth in paragraph (a)(3)(i) of proposed Appendix G would require that a CSE multiply the credit equivalent amount of each asset or off-balance sheet item by the appropriate credit risk weight of that asset or off-balance sheet item, and then multiply the result by 8%.⁴⁴ In general, the assets and off-balance sheet items subject to this allowance are loans and loan commitments receivable and receivables arising from derivatives contracts, repurchase and reverse repurchase agreements, stock lending transactions, and similar collateralized transactions, and other extensions of credit.

Paragraph (a)(3)(i) of proposed Appendix G would establish the manner in which the "credit equivalent amount" of a balance sheet item should be calculated, which is consistent with the proposed New Basel Capital Accord. The credit equivalent amounts for receivables relating to (i) loans and loan commitments receivable; (ii) derivatives contracts, repurchase agreements, reverse repurchase agreements, stock loans, stock borrows, and other similar collateralized transactions; and (iii) other assets would be calculated differently. These calculations are set forth in paragraphs (a)(3)(i)(A), (B), and (E) of proposed Appendix G, respectively. We request comment on the credit conversion factors set forth in paragraph (a)(3)(i)(A) of proposed Appendix G. In particular, we request comment on the credit conversion factor for margin loans.

Paragraph (a)(3)(i)(C) of proposed Appendix G would define the "current exposure" of a member of the affiliate group to a counterparty as the current replacement value of the counterparty's positions with the member of the affiliate group after applying certain netting agreements,⁴⁵ taking into account the value of certain collateral⁴⁶ pledged to and held by a member of the

⁴⁴ This is consistent with the calculation of credit risk under the OTC derivatives dealers rules (See 17 CFR 240.15c3-1f(d)(2)). In addition, use of the 8% basic multiplier to calculate credit risk is consistent with the Basel Standards.

⁴⁵ 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 36.

⁴⁶ 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 37.

affiliate group, and subtracting the fair market value of any credit derivatives that specifically change the CSE's exposure to the counterparty (as long as the credit derivatives are not used to change the credit risk weight of the counterparty).⁴⁷

Paragraph (a)(3)(i)(D) of proposed Appendix G would define the "maximum potential exposure" of a member of the affiliate group to a counterparty as the increase in the net replacement value of the counterparty's positions with the member of the affiliate group, after applying certain netting agreements,⁴⁸ taking into account the value of certain collateral⁴⁹ pledged to and held by the member of the affiliate group, and subtracting the fair market value of any credit derivatives that specifically change the CSE's exposure to the counterparty (as long as the credit derivatives are not used to change the credit risk weight of the counterparty)⁵⁰ that is obtained daily using an approved VaR model meeting the applicable qualitative and quantitative requirements of paragraph (e) of proposed Appendix E.⁵¹

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 specify how they should be changed.

Paragraph (a)(3)(i)(F) of proposed Appendix G provides that credit risk weights would generally be determined

⁴⁷ The fair market value of any credit derivatives that specifically change the CSE'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 (a)(3)(i)(I) of proposed Appendix G.

⁴⁸ See *supra*, note 36.

⁴⁹ See *supra*, note 37.

⁵⁰ See *supra*, note 47.

⁵¹ The quantitative requirements for a VaR model used to calculate maximum potential exposure would include that the model use a 99 percent, one-tailed confidence level 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 Appendix G) and to a *one-year* movement in rates and prices for other positions (See proposed paragraph (e)(2)(ii) of proposed Appendix E) (as opposed to a *ten business-day* movement in rates and prices for VaR models used to calculate the allowance for market risk. (See paragraph (e)(2)(i) of proposed Appendix E).

according to standards published by the Basel Committee, as modified from time to time. If the Commission approves an application by the broker-dealer in its initial application or an amendment to the application, the CSE may use internal credit ratings⁵² or calculate credit risk weights using internal calculations⁵³ when calculating its allowance for credit risk.

In addition, paragraph (a)(3)(i)(J) of proposed Appendix G would allow a CSE to adjust credit risk weights of receivables covered by certain types of guarantees,⁵⁴ and paragraph (a)(3)(i)(I) of proposed Appendix G would allow a CSE 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)⁵⁵ in recognition of the credit protection 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 Appendix G.⁵⁶

The Commission believes that using a VaR model that meets the applicable qualitative and quantitative requirements of paragraph (e) of proposed Appendix E 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 and their affiliates indicate that these firms generally use

maximum potential exposure to measure and manage the credit risk of their portfolios. These firms 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 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 a CSE'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 credit derivative for the credit risk weight of the counterparty for the portion of the exposure covered by the credit derivative. This is the method set forth in paragraph (a)(3)(i)(I) of proposed Appendix G. Another method would be to adjust the current exposure and the maximum potential exposure by the value of the credit derivative. We request comment on these and other methods of treating credit derivatives.

Certain accounting differences between securities firms and banking firms may necessitate certain modifications to the Basel Standards when they are applied to securities firms. For instance, broker-dealers must mark all positions to market, while banks may use historical cost for securities held for investment purposes. The Commission solicits comment on how accounting differences might affect the computation of 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 on whether the proposed method is consistent with the Basel Standards as they have been implemented. In addition, we request comment on whether the proposed rule is consistent with the proposed New Basel Capital Accord and whether it is consistent with how various financial regulators have proposed to implement the proposed New Basel Capital Accord. Should a CSE have other alternative methods for calculating the allowance for credit risk?

d. Group-Wide Calculation of Allowance for Operational Risk

The calculation of an allowance for operational risk is intended to measure risks faced by the firm other than market and credit risk; for example, operational risk would include the risk that the prescribed procedures of the firm may not be followed in a particular transaction, causing the firm to incur potentially significant losses. Such losses incurred by the holding company or an affiliate of a broker-dealer could have a significant adverse effect on the broker-dealer. The proposed rule would, therefore, require that the CSE calculate an allowance for operational risk.

Under proposed Rule 15c3-1g(a)(4), the calculation of the allowance for operational risk must be consistent with the proposed New Basel Capital Accord. The Basel Committee has proposed three methods for the calculation of an allowance for operational risk: the basic approach, the standardized approach, and the advanced measurement approach.⁵⁷ 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. For the standardized approach, the allowance for operational risk is a percentage of revenues net of interest expense, ranging from 12% to 18%, for each of eight business lines. 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 the proposed allowance for operational risk, including how to best measure operational risk and when a calculation of operational risk should be required. We request comment on whether any of the methods is preferable and, if so, why. Further, could any changes be made to these methods or percentages used to calculate the charges that would be more appropriate for the broker-dealer business? Finally, should we allow a holding company to choose one of the three methods, or should the proposal require holding companies to use the advanced measurement approach?

⁵² See paragraph (a)(3)(i)(G) of proposed Appendix G.

⁵³ See paragraph (a)(3)(i)(H) of proposed Appendix G.

⁵⁴ 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 holding company 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 holding company 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 a CSE to reduce its allowance for credit risk only if the guarantee contains features that make it more reliable.

⁵⁵ 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.

⁵⁶ See *supra*, discussion of proposed credit risk capital charge calculation for the broker-dealer.

⁵⁷ See The New Basel Capital Accord (April 2003).

e. Holding Companies Subject to Supervision by a Financial Regulator Other Than the Commission

Certain CSEs that own broker-dealers are subject to supervision at the holding company level by a financial regulator or supervisor other than the Commission. These holding companies may be required by that financial regulator to compute a capital assessment similar to that required by paragraphs (a)(1) through (a)(4) of proposed Appendix G. To reduce regulatory burdens, and because we think that such calculations will be sufficient to permit us to evaluate the risk to the broker-dealer, paragraph (a)(5) of proposed Appendix G provides that, upon Commission approval of the broker-dealer's original application or amendments to the application, the CSE may compute a capital assessment consistent with the standards issued by the Basel Committee that it is required to submit to a financial regulator or supervisor in lieu of the computations required by paragraphs (a)(1) through (a)(4) of proposed Appendix G, provided these computations are consistent with the Basel Standards. We request comment on this provision.

f. General Discussion of Basel Pillars

This proposal would apply a capital reporting requirement consistent with the Basel Standards to the CSE. 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.⁵⁸ We 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. In addition, 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 CSEs.

⁵⁸ *Id.*

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.⁵⁹

The third pillar is discussed in the U.S. banking agencies' Advanced Notice of Proposed Rulemaking on the proposed New Basel Capital Accord.⁶⁰ As the banking agencies noted, an integral part of the proposed New Basel Capital Accord is enhanced public disclosure practices. Specific disclosure requirements would be applicable to all institutions using the proposed New Basel Capital Accord 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. 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 required to file information, documents, and reports pursuant to §§ 13(a) or 15(d) of the Exchange Act.

2. Reporting Requirements for the CSE

As a condition of Commission approval, pursuant to proposed paragraph (b) of Appendix G, the CSE would be required to file certain monthly and quarterly reports, as well as annual audited statements, with the Commission. The Commission would use the information filed by the CSE to monitor the financial condition, internal risk management control system, and activities of the CSE. This would give the Commission important information regarding activities of its affiliates that could impair the financial and operational stability of the broker-dealer. These reports would also allow the Commission to monitor the condition of the affiliate group to detect

any events or trends that may adversely affect the broker-dealer. Failure to require the reports would undermine the Commission's ability to monitor the financial condition of the CSEs and could jeopardize the financial stability of broker-dealers using Appendix E to calculate certain of their capital charges. Moreover, requiring timely financial and other risk information that identifies which business line or affiliated entity may have incurred particular risks is necessary in order to identify areas for Commission examination.

Pursuant to paragraph (b)(1) of proposed Appendix G, the CSE would be required to file a monthly report with the Commission within 17 business days after the end of the month (the FOCUS reporting period) that includes certain consolidated financial and credit risk information, a graph for each business line reflecting the daily intra-month VaR calculations, and certain reports the CSE regularly provides to its senior management to assist it in monitoring and managing risk. We request comment on all aspects of this requirement, including the timing of the reports.

Pursuant to paragraph (b)(2) of proposed Appendix G, the CSE would be required to file a quarterly report within 35 calendar days after the end of each quarter that includes, in addition to the information required in the monthly filing, consolidating financial information, the results of backtesting of models used to compute its allowances for market and credit risk, a description of all material pending legal or arbitration proceedings required to be reported pursuant to generally accepted accounting principles ("GAAP"), and certain short-term borrowings. 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. We request comment on all aspects of this requirement, including the timing of the reports.

Paragraph (b)(3) of proposed Appendix G would require that the CSE provide the Commission upon request with such other reports as may be necessary to monitor the financial condition of the CSE and its risk exposures, as they could affect the financial condition of the broker-dealer. We request comment on this provision.

Paragraph (b)(4) of proposed Appendix G would require that the CSE file an annual audit report with the Commission concurrently with the

⁵⁹ *Id.*

⁶⁰ See Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord, 68 FR 45900 beginning at 45943 (August 4, 2003).

annual audit report filed by the broker-dealer. The annual audit report must include consolidated financial statements and must be audited by a registered public accounting firm.⁶¹ Paragraph (b)(5) of Appendix G would require that the CSE file accountants' reports prepared by a registered public accounting firm, in accordance with agreed-upon procedures, regarding management controls and inventory pricing and modeling. By performing an independent review of the firm's financial condition and risk

management practices, auditors have an important role in the Commission's regulatory framework by helping to assure that the broker-dealer and the holding company are in compliance with the conditions of the exemption. We request comment on these requirements.

The Commission seeks comment on these reporting requirements, particularly regarding the timing and other aspects of the reporting requirements. In particular, we request comment on whether the audit report and accountants' reports should be prepared by a registered public accounting firm. We request comment on whether these reporting requirements should be modified for a CSE with an affiliate required to file information, documents, and reports pursuant to §§ 13(a) or 15(d) of the Exchange Act or that is subject to supervision at the holding company level by a financial regulator or supervisor other than the Commission and, if so, how they should be modified. Should the reporting requirements under paragraph (b) of proposed Appendix G include a requirement that an electronic filing be made with the Commission before a quarterly report filed pursuant to reporting requirements for companies required to file information, documents, and reports pursuant to §§ 13(a) or 15(d) of the Exchange Act must be filed with the Commission?

3. Records To Be Made and Maintained by the CSE

The CSE of a broker-dealer that uses proposed Appendix E to calculate its capital charges would undertake to make the records listed in paragraph (c) of proposed Appendix G. The purpose of this requirement is to require that the CSE create records that would allow the Commission to determine whether the CSE is in compliance with the terms of the exemption. Most or all of these records already are generated for internal management purposes because

a prudent firm that manages risk on a group-wide basis would make and maintain these records in the ordinary course of its business. The Commission would accept the records in the format used by the firms. The records that are made must include a record indicating that the CSE has conducted stress tests of the affiliate group's funding and liquidity in response to certain events, including a credit downgrade of the CSE or an inability of the holding company to obtain short-term financing, the results of those stress tests, a record showing that the CSE has a contingency plan to respond to those events, and a record of the basis for determining credit risk weights in certain circumstances. These events are intended to identify possible liquidity and funding stress scenarios that could impose significant financial distress on the CSE and that could jeopardize the financial stability of the broker-dealer. The Commission believes that records of the CSE'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 CSE's financial condition and risk exposures. We request on whether there are any other records that the CSE should be required to create. We also request comment on whether it would be appropriate to expand the list of specified events described above. In addition, we request comment on whether Exchange Act Rule 17a-3 should be amended, or whether proposed Appendix E should be modified, to impose additional recordkeeping requirements on broker-dealers using proposed Appendix E to calculate certain of their capital charges.

Paragraph (d) of proposed Appendix G contains record maintenance requirements for CSEs. The CSE would be required to maintain, for a period of not less than three years, the records it is required to make under paragraph (c) of proposed Appendix G, its application and other documents, reports, and notices it files with the Commission pursuant to proposed Appendix E or proposed Appendix G and any written responses from the Commission, and written policies and procedures concerning its internal risk management system. Exchange Act Rule 17a-4 requires that broker-dealers maintain certain records for this time period, and we believe that this time period is sufficient for purposes of this proposal to allow effective examinations of CSEs.

We request comment on the Commission's proposed recordkeeping requirements applicable to the holding company and its regulated non-broker-

dealer affiliates and whether, and to what extent, they should be modified. With respect to any recordkeeping requirements that should be modified because records are already provided to a financial regulator, please specifically list the records that a holding company provides to its financial regulator that are equivalent to records that would be required in this proposal. Are there reports that holding companies submit to bank regulators that would provide the information required in this proposal? We request comment on whether we should amend Exchange Act Rule 17a-4 to require broker-dealers to retain certain of these records or whether proposed Appendix E should be modified to impose these additional record preservation requirements. Should certain of the record preservation requirements of proposed Appendix G be imposed on the broker-dealer rather than on the holding company?

4. Notification Requirements for the CSE

Paragraph (e) of proposed Appendix G requires that the CSE promptly notify the Commission upon the occurrence of certain events, including: the occurrence of any backtesting exception of VaR models that would require the CSE to use a higher multiplication factor; a computation showing the affiliate group's allowable capital is less than 110% of the total of its allowances for market, credit, and operational risk; a declaration of bankruptcy by an affiliate; the downgrading of the credit rating of an affiliate or certain debt of an affiliate; or the receipt of certain regulatory notices regarding an affiliate. The CSE would also be required to file a report if there is a material change in the organization of the affiliate group, the material affiliate status of any affiliate in the affiliate group, or the major business functions of any material affiliate. The notification provisions of proposed Appendix G are designed to give the Commission advance warning of situations that may pose material financial and operational risks to the CSE and the broker-dealer. These provisions are integral to Commission supervision of broker-dealers that use Appendix E.

The Commission seeks comment on all aspects of the notice requirements for CSEs. Are the events for which CSEs must report to the Commission appropriate? Should the CSE notify the Commission regarding other events? We request comment on whether these requirements should be modified for a CSE that is subject to supervision at the holding company level by a financial regulator or supervisor other than the

⁶¹ See *supra*, note 32.

Commission and, if so, how they should be modified.

C. Proposed Amendments to Rule 15c3–4

The proposed amendments to Exchange Act Rule 15c3–4 would expand its coverage to include broker-dealers that use Appendix E to calculate their capital charges, requiring them to establish a system of internal controls for monitoring and managing the risks associated with their business activities.⁶² Rule 15c3–4 is designed to improve the integrity of the risk measurement, monitoring, and management process, and to clarify accountability, at the appropriate organizational level, for defining the permitted scope of activity and level of risk.

In addition, as a condition for the broker-dealer to use Appendix E to compute certain of its capital charges, the CSE would agree to establish such a system to manage group-wide risk for the affiliate group of the broker-dealer.

Participants in the securities markets are exposed to various risks, including market risk, credit risk, funding risk, legal risk, and operational risk. These risks are due, in part, to the diverse range of financial instruments now traded by broker-dealers. Risk management controls within a broker-dealer promote the stability of the firm and, consequently, the stability of the general marketplace. A firm that has adopted and follows appropriate risk management controls reduces its risk of significant loss, which also reduces the risk of spreading the losses to other market participants or throughout the financial markets as a whole. Further, as a general prudent business practice, most securities firms have developed risk management systems to manage risk on a consolidated basis at the holding company level. To have a complete understanding of how risks are managed at the broker-dealer, regulators need to understand how risks are managed at the holding company.

The specific elements of a risk management system will vary depending on the size, complexity, and organization of a firm. As a result, the design and implementation of a system of internal controls for a particular CSE may differ from other firms. However, 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.

Individual firms must have the flexibility to implement specific policies and procedures unique to its circumstances. As a result, Rule 15c3–4 establishes only basic elements for the design, implementation, and review of a risk management control system. We previously found these elements to be the appropriate ones for an entity to use when developing such a system.

Rule 15c3–4 requires a firm to consider a number of aspects of its business when adopting its risk management control system. Although each firm must develop controls appropriate to its specific circumstances, the rule requires certain elements to be included in the firm's internal risk management control system. For example, the system must include a risk control unit that reports directly to senior management and is independent from business trading units. In addition, there must be separation of duties between personnel who enter into transactions and personnel who record the transactions.

Finally, the firm's management must periodically review the firm's business activities for consistency with established risk management guidelines to check whether firm personnel are operating within the scope of permissible activity and whether the risk management system continues to be adequate.

We request comment on the proposed amendments to Rule 15c3–4. We request comment on whether the holding company undertakings should incorporate Rule 15c3–4 or whether the requirement to establish a group-wide internal risk management control system should be a stand-alone rule. We request comment on whether any aspect of Rule 15c3–4 could be better tailored to reflect unique aspects of group-wide risk management or risk management of broker-dealers using proposed Appendix E to calculate certain capital charges. We request comment on whether Rule 15c3–4 should be amended to require that results of periodic reviews conducted by an internal auditor or annual reviews conducted by a registered public accounting firm should be reported in writing to the Board of Directors. Should we amend Rule 15c3–4 to require all broker-dealers to do so?

D. Proposed Amendments to Rule 17a–5; Broker-Dealer Reporting Requirements

The proposed amendments to Exchange Act Rule 17a–5 would require a broker-dealer that uses proposed Appendix E to file certain reports with the Commission in addition to the

reports that all broker-dealers must file under the rule. These reports would provide current detailed information regarding the financial position of the firm, which would assist us in understanding the risk profile of the firm. The Commission would use the information collected under the proposed amendment to monitor the financial condition, internal risk management control system, and activities of broker-dealers that elect the alternative capital computation.

These additional reports would include a monthly report detailing, among other things, its derivatives revenues, certain market and credit risk information, backtesting results of its mathematical models, and regular risk reports it supplies to its management, quarterly reports on, among other things, how well its daily VaR and maximum potential exposure correspond to the daily net trading loss, and certain supplemental reports concerning management controls and inventory pricing and modeling prepared by a registered public accounting firm.⁶³ We request comment on the proposed additional reporting requirements for a broker-dealer that uses Appendix E. In particular, we request comment on whether the supplemental reports should be prepared by a registered public accounting firm.

E. Proposed Amendments to Rule 17a–11; Broker-Dealer Notification Requirements

Exchange Act Rule 17a–11 requires that a broker-dealer provide notification of certain net capital levels and certain operational problems to the Commission and its designated examining authority within specified time periods. Currently, Exchange Act Rule 17a–11 also imposes certain additional notification requirements on an OTC derivatives dealer.⁶⁴ The Commission proposes to amend Rule 17a–11 to provide for additional notification requirements for a broker-dealer that uses proposed Appendix E to calculate certain of its capital charges. The events that would require Commission notification would indicate that the broker-dealer or its holding company may be experiencing financial or operational difficulty.

The proposed amendments would expand the additional notification requirements that apply to an OTC derivatives dealer to include a broker-dealer that uses Appendix E to calculate certain of its capital charges. For

⁶² See *supra*, note 32.

⁶⁴ 17 CFR 240.17a–11(b)(2).

example, the broker-dealer would be required to provide notice if its tentative net capital falls below the minimum amount required pursuant to proposed Rule 15c3-1(a)(7)⁶⁵ or if its total tentative net capital is less than 120% of its required minimum tentative net capital.⁶⁶

In addition, the proposed amendments would impose additional reporting requirements on a broker-dealer that uses Appendix E to calculate certain of its capital charges. Such a broker-dealer would have to provide notice upon the occurrence of any backtesting exception of its mathematical models that requires the broker-dealer to use a higher multiplication factor in the calculation of its market or credit risk capital charges. The amendments would also require that the broker-dealer provide notice if it becomes aware that an NRSRO has determined to reduce the credit rating of the broker-dealer, one of its affiliates, or an outstanding obligation of the broker-dealer or an affiliate, if the broker-dealer or one of its affiliates receives a notice of noncompliance from a regulatory agency or SRO, or if the broker-dealer becomes aware of a situation that may have a material adverse effect on the financial or operational condition of the holding company or an affiliate of the holding company. These notices would not be required when the holding company has provided notice to the Commission pursuant to its undertakings. We request comment on all aspects of these notification provisions.

F. Proposed Amendments to Rules 17h-1T and 17h-2T

Rule 17h-1T requires that a broker-dealer maintain and preserve records and other information concerning its holding company and affiliates, if the affiliates are likely to have a material impact on the financial or operational condition of the broker-dealer. Rule 17h-2T requires broker-dealers to report to the Commission on the information required to be maintained and preserved under Rule 17h-1T. We propose to amend these rules to exempt broker-dealers that use Appendix E to calculate certain of their capital charges. We believe that this exemption is appropriate because the holding company of the broker-dealer would be required to make and retain documents substantially similar to the documents

⁶⁵ Pursuant to proposed Rule 15c3-1(a)(7), this minimum tentative net capital amount is \$1 billion.

⁶⁶ In that case, under current rules, the broker-dealer must immediately cease doing business.

required by Rule 17h-1T and to make reports to the Commission that are substantially similar to those required by Rule 17h-2T. We request comment on these proposed amendments.

III. General Request for Comment

The Commission solicits comment on its proposal to permit certain broker-dealers to apply for approval to compute capital charges using proposed Appendix E to Exchange Act Rule 15c3-1. First, we solicit comment on whether this proposed supervisory structure would result in adequate Commission oversight on a group-wide basis of eligible broker-dealers that opt for this voluntary capital computation alternative. Second, we solicit comment on whether proposed Appendix E to the net capital rule would provide appropriate capital levels for qualifying broker-dealers and whether the Commission should modify proposed Appendix E in any way. Third, we solicit comment on whether the proposal would address any perceived competitive disadvantages that impact broker-dealers that intend to conduct a global securities business. Fourth, we solicit comment on whether the Commission should consider a different approach to setting capital requirements for the broker-dealer or to the calculation of allowances for market and credit risk for CSEs, and, if so, what that approach should be. Fifth, we solicit comment on the effects on competition from making these proposals available to only certain broker-dealers. Are there firms below the proposed capital thresholds that would benefit from computing capital charges using proposed Appendix E? Would permitting such firms to use proposed Appendix E provide sufficient net capital reserves for these firms?

In addition, we solicit comment on whether we have adequately stated our approach to making this exemption available to firms that are subject to holding company supervision by another financial regulator. We request comment on whether there are any other approaches or issues that we should consider with respect to firms affiliated with holding companies supervised by another financial regulator.

For holding companies that own more than one broker-dealer, the alternative net capital computation under this proposal would be available only to a broker-dealer that meets the minimum capital requirements. We request comment on whether this proposal would create an incentive for such a holding company to change its business structure, such as combining its securities business into a single broker-

dealer and, if so, whether there would be any resulting costs or benefits.

We note that on September 12, 2003, the Federal Reserve, OCC, OTS, and FDIC 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.⁶⁷ 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 New Basel Capital Accord.⁶⁸ Should the Commission consider any modifications to the proposed method for the group-wide calculation of allowances for market or credit risk with respect to asset-backed securitization programs? If so, how and why should the Commission modify the calculations for asset-backed securitization programs? Should the Commission consider any other issues related to the capital treatment of securitization exposures?

Finally, we invite commenters to provide views and data as to the costs and benefits associated with the proposed changes discussed above in comparison to the costs and benefits of the current regulatory framework. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, the Commission also requests information regarding the potential impact of the proposed amendments and rules on the economy on an annual basis. Commenters should provide empirical data to support their views. Comments should be submitted by February 4, 2004.

IV. Paperwork Reduction Act

Certain provisions of the proposed rule amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.⁶⁹ The Commission has submitted them to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C.

⁶⁷ Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Capital Treatment of Consolidated Asset-Backed Commercial Paper Program Assets, 68 FR 56568 (proposed rule), 68 FR 56530 (interim final rule) (Oct. 1, 2003).

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

⁶⁹ 44 U.S.C. 3501 *et seq.*

3507(d) and 5 CFR 1320.11. 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. The titles for the collections of information are: (1) Appendix E to Rule 15c3-1, Market and credit risk capital charges for certain brokers or dealers; (2) Appendix G to Rule 15c3-1, Conditions for holding companies of certain brokers or dealers; (3) Rule 15c3-4, Internal risk management control systems for certain brokers or dealers; (4) Rule 17a-5, Reports to be made by certain brokers and dealers; (5) Rule 17a-11, Notification procedures for brokers and dealers; (6) Rule 17h-1T, Risk assessment recordkeeping requirements for associated persons of brokers and dealers; and (7) Rule 17h-2T, Risk assessment reporting requirements for brokers and dealers.

The Commission proposes to implement a voluntary alternative method for computing net capital charges under the Exchange Act for certain broker-dealers that are part of a holding company that has a group-wide internal risk management system and that consents, as a condition of the net capital treatment, to group-wide Commission supervision. A broker-dealer that maintains tentative net capital of at least \$1 billion and net capital of at least \$500 million could apply to the Commission for a conditional exemption from the application of the standard net capital computation and, upon Commission approval, elect to calculate certain of its market and credit risk net capital charges using internally developed mathematical models that the firm uses to measure risk. Commission supervision would include reporting and recordkeeping requirements and Commission examination of unregulated holding companies and affiliates that are not functionally regulated.

The collection of information obligations imposed by the proposal would be mandatory. However, applying for approval to use the alternative capital calculation is voluntary.

The information collected, retained, and/or filed pursuant to the proposed rule amendments would be accorded confidential treatment.

The Commission would use the information collected under the proposed amendments to monitor the financial condition, internal risk management control system, and activities of broker-dealers that elect to compute certain of their market and credit risk capital charges under the alternative method and their holding

companies and affiliates. In particular, the proposed amendments 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.

According to March 31, 2003 FOCUS filings, 28 registered broker-dealers reported that they had tentative net capital of at least \$1 billion and net capital of at least \$500 million. Based on discussions with industry representatives, the Commission believes, however, that only broker-dealers with at least \$1 billion in deductions pursuant to (c)(2)(vi) of Rule 15c3-1 (also known as "haircuts") will find it cost effective to use the alternative capital computation. As of March 2003, based on FOCUS filings, there were 12 such broker-dealers. Therefore, the PRA estimates are based on the assumption that 12 broker-dealers will apply for an exemption under the proposal.

Many of the estimates are also based on information Commission staff receives through the risk assessment rules and meetings with and reports from member firms of the Derivatives Policy Group ("DPG") and other broker-dealers and the Commission's experience in implementing the OTC derivatives dealer rules.

A broker-dealer that applies to use proposed Appendix E and its affiliates would have discretion in allocating the paperwork burden associated with the proposal among the entities in the CSE ("consolidated supervised entity"), including the broker-dealer. In estimating the total burden associated with the proposal on the broker-dealer, we have included the burdens arising from each proposed new rule amendment.

A. Proposed Appendix E to Rule 15c3-1, Market and Credit Risk Capital Charges for Certain Brokers or Dealers

Exchange Act Rule 15c3-1 requires broker-dealers to maintain minimum levels of net capital computed in accordance with the rule's provisions. These net capital reserves are intended to ensure that broker-dealers have sufficient capital to protect the assets of customers and to meet their responsibilities to other broker-dealers.

The Commission is proposing to add Appendix E to the rule to provide an alternative method for determining certain net capital charges for certain broker-dealers that manage risk on a group-wide basis and that submit to group-wide Commission supervision.

As part of the exemptive application to use Appendix E, the broker-dealer

and its holding company would submit descriptions of internal risk management controls and methods to be used to measure risk, including descriptions of all mathematical models used to price positions and compute market and credit risk and how those models meet the requirements of proposed Appendix E. The application would also include sample capital assessments for the affiliate group and sample risk reports provided to the firm's management and a written undertaking by the holding company to comply with various requirements of the proposal, including those listed in proposed Appendix G.

Proposed Appendix E would also require that mathematical models used to compute market and credit risk be reviewed periodically and backtested quarterly. For example, the mathematical model used to calculate maximum potential exposure would be required to be backtested quarterly for at least 40 counterparties by comparing the daily change in the firm's daily exposure to the counterparty with the maximum potential exposure generated by the model.

Failure to require the current and proposed collections of information included in this proposal would undermine the Commission's ability to monitor the financial condition of these firms and could jeopardize the financial stability of broker-dealers using Appendix E to compute certain of their capital charges.

We estimate that each broker-dealer that applies under the proposal would spend approximately 1,000 hours to create and compile the various documents to be included with the application and to work with the Commission staff through the application process. This includes approximately 100 hours for an in-house attorney to complete a review of the application. Consequently, the Commission estimates the total burden associated with the application process for the 12 broker-dealers we expect to apply to be 12,000 hours.

These estimates are based on estimates the Commission made for the OTC derivatives dealer rules, which include a similar application requirement.⁷⁰ In that proposing release, we estimated that an OTC derivatives dealer would spend approximately 1,000 hours developing and submitting its VaR model and description of its risk management control system to the

⁷⁰ See 17 CFR 240.15c3-1f(a).

Commission.⁷¹ No comments were received in response to the estimates in the proposing release, and those burden estimates were not changed in the final rule release.⁷² For purposes of this proposal, we note that firms applying to use Appendix E will have already developed the VaR models that they would use to calculate market and credit risk under the proposal and will have already developed internal risk management control systems. This conclusion is based on information Commission staff has received through the risk assessment rules and meetings with and reports from the DPG and other broker-dealers and the Commission's experience in implementing the OTC derivatives dealer rules. On the other hand, we note that the proposal contains new requirements. For example, the firm must establish and document procedures to detect and prevent money laundering and terrorist financing. We also note that the application under this rule may be more complicated than the OTC derivatives dealer application and may take more time to complete.

We estimate that a broker-dealer using Appendix E would spend approximately 5,600 hours per year to review the models it uses to compute market and credit risk and approximately 160 hours each quarter, or approximately 640 hours per year, to backtest the models. Consequently, we estimate that the total burden under the proposal associated with reviewing and backtesting mathematical models for the 12 broker-dealers we expect to apply will be approximately 74,880 hours per year $((5,600 + 640) * 12)$.

B. Proposed Appendix G to Rule 15c3-1, Conditions for Holding Companies of Certain Brokers or Dealers

Under proposed Appendix G to Rule 15c3-1, the CSE would be required to calculate allowable capital and allowances for market, credit, and operational risk monthly on a consolidated basis, file certain monthly, quarterly, and annual reports with the Commission, make, keep current, and preserve certain records, and notify the Commission of certain events. These proposed conditions are needed to allow the Commission to properly oversee a broker-dealer that uses proposed Appendix E and to monitor the financial and operational condition of its affiliate group.

⁷¹ Exchange Act Release No. 39454 (Dec. 17, 1997), 62 FR 67940 (December 30, 1997).

⁷² Exchange Act Release No. 40594 (Oct. 23, 1998), 63 FR 59362 (November 3, 1998).

Based on Commission experience and discussions with industry participants, we estimate that the calculation of allowable capital and allowances for market, credit, and operational risk would require approximately 90 hours per month, or approximately 1080 hours per year. Thus, the aggregate annual burden for the 12 broker-dealers we expect to apply under the proposal would be approximately 12,960 hours. In addition, we estimate that it would require approximately 5,600 hours per year to review and update the mathematical models used to make these calculations. Thus, the aggregate annual burden to review and update the models for the 12 broker-dealers would be approximately 67,200 hours. Finally, we estimate that it would require approximately 160 hours each quarter, or approximately 640 hours each year, to backtest the models. Thus, the aggregate annual burden to backtest the models for the 12 broker-dealers we expect to apply under the proposal would be approximately 7,680 hours.

The reporting requirements of proposed Appendix G are necessary to keep the Commission informed of, among other things, the financial condition, financial and operational risk exposures, backtesting results, and management controls of the CSE and whether the CSE is in compliance with the conditions of the broker-dealer's exemption. These reports would help the Commission to anticipate the effect on the CSE of significant economic events and their related impact on the broker-dealer.

We estimate that the average amount of time necessary to prepare and file the monthly reports required by Appendix G would be approximately 8 hours per month, or approximately 96 hours per year, that the average amount of time necessary to prepare and file the quarterly reports would be about 16 hours per quarter, or approximately 64 hours per year, and that the average amount of time necessary to prepare and file the annual audit reports would be approximately 200 hours per year. Consequently, we estimate that the total annual reporting burden of proposed Appendix G for the 12 broker-dealers we expect to apply under the proposal would be approximately 4,320 hours.

We based these estimates on the PRA burden estimates for Exchange Act Rule 17a-12, Reports to be made by certain OTC derivatives dealers. The PRA burden estimate for Rule 17a-12 is 180 hours per year to prepare and file the information required by the rule (based on an average of four responses per year and an average of 20 hours preparing each response with an additional 100

hours spent preparing the annual audit). However, we believe that the burden under this proposal would be lower than the Rule 17a-12 burden estimates because CSEs already generate many of the required reports for internal management purposes.

We expect that any additional burden associated with the requirements of proposed Appendix G relating to making, keeping, and preserving records would be minimal because a prudent firm that manages risk on a group-wide basis would make and preserve these records in the ordinary course of its business. We estimate that the average one-time burden of making and preserving these records would be approximately 40 hours and that the average annual burden would be approximately 290 hours. Consequently, we estimate that the total burden for the 12 broker-dealers we expect will apply under this proposal would be approximately 480 hours on a one-time basis and approximately 3,480 hours per year.

The notification provisions of proposed Appendix G are designed to give the Commission advance warning of situations that may pose material, financial and operational risks to the broker-dealer and the CSE. These provisions are integral to Commission supervision of broker-dealers that use Appendix E. We estimate that it would require a total of approximately one hour per year for all 12 of the broker-dealers to comply with the notification provisions of proposed Appendix G.⁷³

C. Proposed Amendments to Rule 15c3-4, Internal Risk Management Control Systems

We propose to amend Rule 15c3-4, which currently applies to OTC derivatives dealers that use Appendix F to calculate certain of their capital charges, to expand its coverage to broker-dealers that use Appendix E. Rule 15c3-4 is designed to ensure the integrity of the risk measurement, monitoring, and management process, and to clarify accountability, at the appropriate organizational level, for defining the permitted scope of activity and level of risk.

⁷³ The Commission received approximately 1,067 Rule 17a-11 notifications during calendar year 2002, when there were approximately 6,800 active broker-dealers registered with the Commission. Thus, approximately 11% of registered broker-dealers filed a Rule 17a-11 notice in 2002. We therefore estimate that of the 12 broker-dealers we expect will apply under the proposal, one may be required to file an Appendix G notice each year. We estimate that, consistent with the Rule 17a-11 PRA burden estimate, it will take approximately one hour to file that notice.

The proposed rule amendments would require a broker-dealer that elects to use Appendix E to consider a number of issues affecting its business environment when creating its risk management control system. For example, such a firm would need to consider, among other things, the sophistication and experience of relevant trading, risk management, and internal 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. This would help to ensure that the control system that is implemented 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 a broker-dealer electing to use Appendix E to implement specific policies and procedures unique to its circumstances.

In implementing its policies and procedures, the broker-dealer would be required to document and record its system of internal risk management controls. In particular, such a firm would be required to document its consideration of certain issues affecting its business when designing its internal controls. The broker-dealer also would be required to prepare and maintain written guidelines that discuss its internal control system.

The proposed rule amendments would be an integral part of the Commission's financial responsibility program for broker-dealers whose applications under Appendix E are approved by the Commission. The information to be collected under the proposed amendments to Exchange Act Rule 15c3-4 would be essential to the regulation and oversight of major securities firms that voluntarily elect to use Appendix E and to the monitoring of their compliance with the proposed financial responsibility requirements. More specifically, requiring a broker-dealer that elects to use Appendix E to document the planning, implementation, and periodic review of its risk management controls are designed to ensure that all pertinent risk management issues are considered, that the risk management controls are implemented properly, and that they continue to adequately address the risks faced by major securities firms.

The following estimates of the initial and annual PRA burdens associated with the amendments to Rule 15c3-4 are based on the present Rule 15c3-4 PRA burden estimates, discussions with potential applicants, and the Commission's experience with the

implementation of Rule 15c3-4 for OTC derivatives dealers. The present Rule 15c3-4 burden estimate is an average of 2,000 hours on a one-time basis to implement the risk management control system and an average of 200 hours per year to review and update the system. This estimate was based on the implementation of a risk management control system for a single entity: the OTC derivatives dealer. In this proposal, the broker-dealer is required to implement a risk management control system and the holding company is required to implement a group-wide risk management control system. Although the 12 broker-dealers we expect to apply under this proposal have already developed internal risk management control systems, not all of them have implemented and formally documented a group-wide system. We believe that it would take more than 2,000 hours for such a broker-dealer to implement a formal, documented group-wide risk management control system. On the other hand, if a firm already has a formally documented group-wide internal risk management control system, we believe that it would take less than 2,000 hours to bring that system into compliance with amended Rule 15c3-4. Of the 12 broker-dealers we expect will apply under this proposal, we estimate that 6 have formal, documented, group-wide internal risk management control systems, and that 6 have internal risk management control systems that are not formally documented for the affiliate group. We estimate that a firm with a formal, documented group-wide internal risk management control system would spend approximately 1,000 hours on a one-time basis to comply with the proposed amendments to Rule 15c3-4 and that a firm that does not have a formally documented group-wide internal control system will spend up to approximately 3,600 hours on a one-time basis to comply with the proposed amendments to Rule 15c3-4. The total one-time burden for the twelve firms would therefore be approximately 27,600 hours. In addition, we estimate that each of the 12 broker-dealers would spend approximately 250 hours per year reviewing and updating its risk management control system, for an aggregate annual burden of 3,000 hours.

D. Proposed Amendments to Rule 17a-5, Reports To Be Made by Certain Brokers and Dealers

The proposed amendments to Exchange Act Rule 17a-5 would require broker-dealers using Appendix E to submit monthly, quarterly, and annual reports with the Commission. The

proposed amendments would be an integral part of our financial responsibility program for broker-dealers electing to use Appendix E. The information to be collected under the proposed amendments to Rule 17a-5 would be essential to the regulation of these broker-dealers and would assist us and the examining authorities responsible for reviewing the activities of these firms to monitor and enforce compliance with applicable Commission rules, including rules pertaining to financial responsibility. These periodic reports would also aid the Commission in evaluating the activities conducted by these broker-dealers and in anticipating, where possible, how these firms could be affected by significant economic events.

We estimate that the average amount of time necessary to prepare and file the additional monthly reports required by this amendment to Rule 17a-5 would be about 4 hours per month, or approximately 48 hours per year; that the average amount of time necessary to prepare and file the additional quarterly reports would be about 8 hours per quarter, or approximately 32 hours per year; and that the average amount of time necessary to prepare and file the additional supplemental reports with the annual audit required would be approximately 40 hours per year. Consequently, we estimate that the total annual additional burden attributable to the proposed amendments to Rule 17a-5 for the 12 broker-dealers we expect to apply under the proposal would be approximately 1,440 hours.

These estimates are based on our present PRA burden estimate for Rule 17a-12. The PRA burden estimate for Rule 17a-12 is 180 hours per year to prepare and file the information required by the rule (based on an average of four responses per year and an average of 20 hours preparing each response with an additional 100 hours spent on preparing the annual audit). However, the estimated burden attributable to the proposed amendments is less than those estimates because the broker-dealer is already required to file monthly, quarterly, and annual reports with the Commission under Rule 17a-5. In addition, the amendments are designed to allow a broker-dealer to provide the required information to the Commission in a form that the firm already produces for internal management purposes.

E. Proposed Amendments to Rule 17a-11, Notification Procedures for Brokers and Dealers

Under the proposed amendments to Rule 17a-11, a broker-dealer that uses

proposed Appendix E would have to give notice to the Commission of certain events beyond those the broker-dealer is currently required to give notice of. These events include, for example, that an NRSRO has determined to downgrade the credit rating of the obligations of the broker-dealer or one of its affiliates, the broker-dealer receives notice from a regulator that one of its affiliates is not in compliance with rules or agreements with the regulator, the broker-dealer becomes aware of a situation that may have a material adverse effect on a material affiliate, or the occurrence of certain backtesting exceptions of the broker-dealer's mathematical models.

These events are expected to be rare. However, they are of supervisory concern. The Commission received approximately 1,067 Rule 17a-11 notices from 731 broker-dealers during calendar year 2002. At that time, there were approximately 6,800 active broker-dealers registered with the Commission. Thus we estimate that approximately 11% of active broker-dealers filed a Rule 17a-11 notice during calendar year 2002 ($731/6,800 = .1075$) and that it would take approximately one hour to file such a notice. Therefore, we estimate that of the 12 broker-dealers we expect to apply under this proposal, approximately one may be required to file notice pursuant to the proposed amendments to Rule 17a-11 each year. Thus, we estimate that the total annual burden of the proposed amendments to Rule 17a-11 for the 12 broker-dealers we expect to apply under the proposal would be about one hour.

F. Proposed Amendments to Rules 17h-1T and 17h-2T, Risk Assessment Recordkeeping Requirements for Associated Persons of Brokers and Dealers and Risk Assessment Reporting Requirements for Brokers and Dealers

Rules 17h-1T and 17h-2T require that certain broker-dealers make records of and file quarterly reports with the Commission regarding the financial condition, organization, and risk management practices of their affiliated group. The amendments to Rules 17h-1T and 17h-2T would exempt a broker-dealer that uses Appendix E from the rules to the extent that the holding company of the broker or dealer maintains the information pursuant to proposed Appendix G.

These amendments would reduce the PRA burden for broker-dealers that use Appendix E. The current PRA burden estimate for Rules 17h-1T and 17h-2T is approximately 10 hours per year for each respondent. We estimate that the aggregate savings under the proposed

amendments for the 12 firms we expect to apply under the proposal would be approximately 120 hours per year.

G. Request for Comment

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

- Whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information has practical utility;
- The accuracy of our estimates 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 who 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. S7-21-03. 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. S7-21-03, 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 Rule Amendments

To assist the Commission in its evaluation of the costs and benefits that may result from the proposed amendments, which establish a voluntary alternative method for computing net capital charges for certain broker-dealers, commenters are

requested to provide analysis and data relating to the costs and benefits associated with the proposed amendments. In particular, the Commission requests comments on the potential costs for any necessary modifications to internal risk management control, accounting, information management, and recordkeeping systems required to comply with the proposed amendments and the potential benefits arising from participation in the regulatory scheme.

The proposed amendments would establish a voluntary alternative method for computing net capital charges for certain broker-dealers that are part of a holding company that has a group-wide internal risk management control system and that consents to group-wide Commission supervision. We have identified certain costs and benefits that would be associated with the proposal.

A broker-dealer that maintains tentative net capital of at least \$1 billion and net capital of at least \$500 million could apply to the Commission for a conditional exemption from the application of the standard net capital rule calculation and, upon Commission approval, calculate certain of its market and credit risk capital charges using the firm's own internal mathematical models for risk measurement, including internally developed VaR models and scenario analysis. According to March 31, 2003 FOCUS filings, 28 registered broker-dealers reported tentative net capital and net capital that equaled or exceeded those amounts. Based on discussions with industry representatives, we believe, however, that only broker-dealers with at least \$1 billion in deductions pursuant to paragraph (c)(2)(vi) of Rule 15c3-1 (also known as "haircuts") will find it cost effective to use the alternative capital computation. As of March 2003, based on FOCUS filings, there were 12 such broker-dealers. Therefore, our cost-benefit estimates are based on the assumption that 12 broker-dealers will apply under the proposal.

Many of the estimates are also based on information Commission staff receives through the risk assessment rules and meetings with and reports from the DPG and other broker-dealers and the Commission's experience in implementing the OTC derivatives dealer rules.

A broker-dealer that applies to use proposed Appendix E and its affiliates have discretion in allocating the costs associated with the proposal among the entities in the CSE ("consolidated supervised entity"), including the broker-dealer. In estimating the total costs associated with the proposal on

the broker-dealer, we have included the costs arising from each proposed new rule amendment.

The proposed alternative net capital system is designed to increase a broker-dealer's operational efficiency by having its supervisory risk assessment and the computation of certain capital charges more closely aligned to the mathematical model-based methods the firm already uses to manage its business risk and capital, while establishing net capital requirements sufficient to require maintenance of capital to achieve the goals of the net capital rule and Exchange Act § 15(c)(3). The incorporation of mathematical risk management techniques into the calculation of net capital charges should enable such a broker-dealer to reallocate capital from the broker-dealer to affiliates that may receive a higher return than the broker-dealer. The proposed rule amendments should also allow broker-dealers to increase operational efficiency by adopting risk management practices which have become industry best practice.

We anticipate that cost savings would result in several areas. Under the proposal, a broker-dealer would become subject to specifically tailored capital and other requirements. The broker-dealer would be able to compute certain of its net capital charges using internally developed mathematical models that the firm uses to manage risk and to report risks to the Commission using internal reports that the firm already generates for risk management purposes.

The primary benefit for the broker-dealer would be the reduction in net capital charges that we expect would result from the use of the alternative method. This benefit, however, is difficult to quantify. While reductions in net capital requirements would likely result from the use of the alternative method, broker-dealers typically maintain higher levels of capital than the rules require. Also, the mix of positions held by the broker-dealer may change if the regulatory cost of holding certain positions is reduced. Finally, the reduction in net capital charges would vary significantly among broker-dealers based on the size and risk of their portfolios.

The 12 firms we expect to apply under this proposal reported capital charges ranging from approximately \$1 billion to approximately \$4 billion, for a total of approximately \$32 billion, on their first quarter of 2003 FOCUS reports. We expect that firms with larger capital charges would realize a larger percentage reduction in their capital charges than firms with smaller capital charges. We estimate that the 12 firms

would realize an average reduction in capital charges of approximately 40%, or a total reduction in capital charges for the 12 firms of approximately \$13 billion. If the firms reallocate that capital to fund business activities for which the rate of return is 20 basis points (0.2%) higher, the 12 broker-dealers could receive a total annual benefit of approximately \$26 million.

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. Without a demonstration of "equivalent" supervision, we understand that the affiliate institution located in the EU may either be subject to additional capital charges or be required to form a sub-holding company in the EU. We expect the Commission supervision contemplated by this proposal would meet this standard. As a result, we believe this proposal would minimize duplicative regulatory burdens on firms that are active in the EU as well as in other jurisdictions that may have similar laws.

Based on the responses of five firms to a survey conducted during the OTC derivatives dealer rulemaking process, we estimate that it would cost approximately \$8 million per year for a firm to form and maintain a sub-holding company in the EU.⁷⁴ Consequently, for the 12 broker-dealers we expect will apply under this proposal, not being required to form and maintain a sub-holding company in the EU would save the firms a total of approximately \$96 million per year.

These amendments would exempt broker-dealers that use Appendix E from Rules 17h-1T and 17h-2T. The current PRA burden estimate for Rules 17h-1T and 17h-2T is approximately 10 hours per year for each respondent. We estimate that the aggregate savings under the proposed amendments for the 12 firms we expect to apply under the proposal would be approximately 120 hours per year, and we expect that a financial reporting manager would do the work. The staff estimates that the hourly salary of a financial reporting manager is \$50.63 per hour.⁷⁵ The total

⁷⁴ The five firms estimated that their annual operating costs would increase by an average of approximately \$7 million to set up a separate company operating as an OTC derivatives dealer. We multiplied by 1.12 to account for inflation since 1998.

⁷⁵ Securities Industry Association's (SIA) Report on Management and Professional Earnings in the Securities Industry—2002 ("SIA Report"). Generally, to calculate an hourly cost using the SIA's Report, the staff takes the median (or, if no median is provided, the mean) salary provided in

cost savings for the 12 firms would be approximately \$6,000 ($120 * \$50.63 = \$6,076$).

To the extent that firms electing the proposed regulatory system improve their internal risk management control systems, we would expect that the firms would realize a benefit in the form of reduced borrowing costs. This benefit will vary widely depending on the risk management practices the firms already have in place. For some firms that already have formally documented group-wide control systems, there may be no benefit.

We believe that the proposed regulatory system would also result in benefits to regulators and to financial markets. The Commission would have access to group-wide information concerning the operation and financial condition of the broker-dealer's holding company and affiliates. This information would help the Commission to assess whether the activities or financial condition of the holding company or affiliates may pose risks to the financial health of the broker-dealer. Also, the broker-dealer and holding company would have to comply with stringent requirements concerning their internal risk management control systems. We expect that this requirement would promote the financial responsibility of these entities and reduce the risk of significant losses by the broker-dealer. By reducing the risk of significant losses by a single firm, internal risk management control systems would also reduce the risk that the problems of one firm would spread, causing defaults by other firms and undermining securities markets as a whole.

Firms electing the alternative capital computation would incur various costs. These firms would incur the one-time and ongoing costs of submitting an application and amendments to the application to use the alternative computation. We estimate that each broker-dealer that applies under the proposal would spend approximately 1,000 hours to create and compile the various documents to be included with the application and to work with the Commission staff through the application process. The staff anticipates that this would include approximately 100 hours for an in-house attorney and 900 hours for a senior compliance staff member. The

the SIA's Report for the position cited, divide that amount by 1,800 hours (in the average year), then multiply the result by 135% to account for employee overhead costs. (Financial Reporting Manager) + 35% overhead (based on end-of-year 2002 figures) ($\$67,500 \text{ per year} / 1800 \text{ hours/year} * 1.35 = \50.63 per hour).

staff estimates that the hourly salary of an attorney is \$63.75 per hour,⁷⁶ for a total cost of approximately \$80,000 (\$63.75 * 100 * 12 = \$76,500). The staff estimates that the hourly salary of a senior compliance staff person is \$56.60 per hour,⁷⁷ for a total cost of approximately \$610,000 (\$56.60 * 900 * 12 = \$611,280).

These estimates are based on estimates the Commission made for the OTC derivatives dealer rules, which include a similar application requirement.⁷⁸ We estimated that an OTC derivatives dealer would spend approximately 1,000 hours developing and submitting its VaR model and description of its risk management control system to the Commission.⁷⁹ No comments were received in response to the estimates in the proposing release, and those estimates were not changed in the final rule release. For purposes of this proposal, we note that firms applying to use Appendix E will have already developed the VaR models that they will use to calculate market and credit risk under the proposal and will have already developed internal risk management control systems. This conclusion is based on information Commission staff receives through the risk assessment rules and meetings with and reports from the DPG and other broker-dealers and the Commission's experience in implementing the OTC derivatives dealer rules. On the other hand, we note that the proposal contains additional requirements. For example, the firm must establish and document procedures to detect and prevent money laundering and terrorist financing. We also note that the application under this rule may be more complicated than the OTC derivatives dealer application and may take more time to complete.

We estimate that a broker-dealer using Appendix E would spend approximately 5,600 hours per year to review the models it uses to compute market and credit risk and approximately 160 hours each quarter, or approximately 640 hours per year, to backtest the models. Consequently, we estimate that it will take approximately 74,880 hours ((5,600 + 640) * 12) per year to review and backtest mathematical models for the 12 broker-

⁷⁶ SIA Report, (Attorney) + 35% overhead (based on end-of-year 2002 figures) (\$85,00 per year/1800 hours/year * 1.35 = \$63.75 per hour).

⁷⁷ SIA Report, (Senior Compliance Staff) + 35% overhead (based on end-of-year 2002 figures) (\$75,464 per year/1800 hours/year * 1.35 = \$56.60 per hour).

⁷⁸ See 17 CFR 240.15c3-1f(a).

⁷⁹ Exchange Act Release No. 39454 (Dec. 17, 1997), 62 FR 67940 (December 30, 1997).

dealers we expect to apply under the proposal, and that a financial reporting specialist would do the work. The staff estimates that the hourly salary of a financial reporting manager is \$50.63 per hour,⁸⁰ for a total cost of approximately \$3.8 million per year (\$50.63 * 74,880 = \$3,791,174).

Based on Commission experience and discussions with industry participants, we estimate that the holding company's calculation of allowable capital and allowances for market, credit, and operational risk would require approximately 90 hours per month, or approximately 1,080 hours per year, for a total of approximately 12,960 hours per year for the 12 broker-dealers, and that a senior accountant would do the work. The staff estimates that the hourly salary of a senior accountant is \$49.87 per hour.⁸¹ The total annual cost would be approximately \$650,000 (\$49.87 * 12,960 = \$646,315). In addition, we estimate that it would require approximately 5,600 hours per year to review and update the mathematical models used to make these calculations, or approximately 67,200 hours per year for the 12 broker-dealers, and we expect that a financial reporting manager would do the work. The staff estimates that the hourly salary of a financial reporting manager is \$50.63 per hour.⁸² The total annual cost would be approximately \$3.4 million (\$50.63 * 67,200 = \$3,402,336). Finally, we estimate that it would require approximately 160 hours each quarter, or approximately 640 hours each year, to backtest the models. Thus, the aggregate annual burden to backtest the models for the 12 broker-dealers we expect to apply under the proposal would be approximately 7,680 hours, and we expect that a junior research analyst would do the work. The staff estimates that the hourly salary of a junior research analyst is \$38.92 per hour,⁸³ for a total cost of approximately \$300,000 (\$38.92 * 7,680 = \$298,906).

We estimate that the average amount of time necessary to prepare and file the monthly reports required by Appendix

⁸⁰ SIA Report, (Financial Reporting Manager) + 35% overhead (based on end-of-year 2002 figures) (\$67,500 per year/1800 hours/year * 1.35 = \$50.63 per hour).

⁸¹ SIA Report, (Senior Accountant) + 35% overhead (based on end-of-year 2002 figures) (\$66,500 per year/1800 hours/year * 1.35 = \$49.87 per hour).

⁸² SIA Report, (Financial Reporting Manager) + 35% overhead (based on end-of-year 2002 figures) (\$67,500 per year/1800 hours/year * 1.35 = \$50.63 per hour).

⁸³ SIA Report, (Junior Research Analyst) + 35% overhead (based on end-of-year 2002 figures) (\$51,900 per year/1800 hours/year * 1.35 = \$38.92 per hour).

G would be approximately 8 hours per month, or approximately 96 hours per year, that the average amount of time necessary to prepare and file the quarterly reports would be about 16 hours per quarter, or approximately 64 hours per year, and that the average amount of time necessary to prepare and file the annual audit reports would be approximately 200 hours per year. Consequently, we estimate that the total for the 12 broker-dealers we expect to apply under the proposal would be approximately 4,320 hours ((96 + 64 + 200) * 12) per year, and we expect that a senior accountant would do the work. The staff estimates that the hourly salary of a senior accountant is \$49.87 per hour,⁸⁴ for a total of approximately \$215,000 (\$49.87 * 4,320 = \$215,438).

We based these estimates on the PRA burden estimates for Exchange Act Rule 17a-12, Reports to be made by certain OTC derivatives dealers. The PRA burden estimate for Rule 17a-12 is 180 hours per year to prepare and file the information required by the rule (based on an average of four responses per year and an average of 20 hours preparing each response with an additional 100 hours spent on preparing the annual audit). However, we believe that the cost under this proposal would be lower than the Rule 17a-12 estimates because CSEs already generate many of the required reports for internal management purposes.

We expect that any additional costs associated with the requirements of proposed Appendix G relating to making, keeping, and preserving records would be minimal because a prudent firm that manages risk on a group-wide basis would make and preserve these records in the ordinary course of its business. We estimate it would take approximately 40 one-time hours and that the average annual time spent would be approximately 290 hours. Consequently, we estimate that the 12 broker-dealers we expect will apply under this proposal would spend approximately 480 hours on a one-time basis and approximately 3,480 hours per year, and we expect that a senior accountant would do the work. The staff estimates that the hourly salary of a senior accountant is \$49.87 per hour,⁸⁵ for a total one-time cost of approximately \$24,000 (\$49.87 * 480 = \$23,938) and a total annual cost of

⁸⁴ SIA Report, (Senior Accountant) + 35% overhead (based on end-of-year 2002 figures) (\$66,500 per year/1800 hours/year * 1.35 = \$49.87 per hour).

⁸⁵ SIA Report, (Senior Accountant) + 35% overhead (based on end-of-year 2002 figures) (\$66,500 per year/1800 hours/year * 1.35 = \$49.87 per hour).

approximately \$170,000 ($\$49.87 * 3,480 = \$173,548$).

We estimate that it would require a total of approximately one hour per year for all 12 of the broker-dealers to comply with the notification provisions of proposed Appendix G,⁸⁶ and that a senior compliance staff person would do the work. The staff estimates that the hourly salary of a senior compliance staff person is \$56.60 per hour,⁸⁷ for a total cost for the 12 firms of approximately \$60.

The cost estimates regarding the amendments to Rule 15c3–4 are based on the present Rule 15c3–4 PRA burden estimates, discussions with potential applicants, and the Commission's experience with implementation of Rule 15c3–4 for OTC derivatives dealers. The present Rule 15c3–4 PRA burden estimate is an average of 2,000 hours on a one-time basis to implement the risk management control system and an average of 200 hours per year to review and update the system. This estimate was based on the implementation of a risk management control system for a single entity: the OTC derivatives dealer. In this proposal, the broker-dealer is required to implement a risk management control system and the holding company is required to implement a group-wide risk management control system. Although the 12 broker-dealers we expect to apply under this proposal have already developed internal risk management control systems, not all of them have implemented and formally documented a group-wide system. We believe that it would take more than 2,000 hours for such a broker-dealer to implement a formal, documented group-wide risk management control system. On the other hand, if a firm already has a formally documented group-wide internal risk management control system, we believe that it would take less than 2,000 hours to bring that system into compliance with amended Rule 15c3–4. Of the 12 broker-dealers we expect will apply under this proposal, we estimate that 6 have formal, documented, group-wide

internal risk management control systems, and that 6 have internal risk management control systems that are not formally documented for the affiliate group. We estimate that a firm with a formal, documented group-wide internal risk management control system would spend approximately 1,000 hours on a one-time basis to comply with the proposed amendments to Rule 15c3–4 and that a firm that does not have a formally documented group-wide internal control system will spend up to approximately 3,600 hours on a one-time basis to comply with the proposed amendments to Rule 15c3–4. The total for the twelve firms would therefore be approximately 27,600 hours ($(6 * 1,000) + (6 * 3,600)$) on a one-time basis and, on the basis of an estimate of approximately 250 hours per year to review and update its risk management control system, a total of 3,000 hours per year for the 12 firms. We expect that a senior compliance staff person would do the work. The staff estimates that the hourly salary of a senior compliance staff person is \$56.60 per hour,⁸⁸ for a total one-time cost of approximately \$1.6 million ($\$56.60 * 27,600 = \$1,562,160$) and a total annual cost of approximately \$170,000 ($\$56.60 * 3,000 = \$169,800$).

The information technology systems used by CSEs to manage risk, make and retain records, and report and calculate capital differ widely depending on the size of the CSE and the types of business it engages in. These information technology systems may be in varying stages of readiness to enable the CSE to meet the requirements of the proposal. Based on Commission experience and informal discussions with potential applicants, we estimate that it will cost a CSE that has well-developed information technology systems approximately \$5 million to upgrade its systems, that it will cost a CSE that has less well-developed systems approximately \$50 million to upgrade its systems, and that, on average, it will cost a CSE approximately \$27.5 million to upgrade its systems. Consequently, we estimate that the 12 broker-dealers we expect to apply under the proposal would spend a total of approximately \$330 million to upgrade their information technology systems. We believe that this would be a one-time cost.

We estimate that the average amount of time necessary to prepare and file the additional monthly reports required by

the proposed amendment to Rule 17a–5 would be about 4 hours per month, or approximately 48 hours per year; that the average amount of time necessary to prepare and file the additional quarterly reports would be about 8 hours per quarter, or approximately 32 hours per year; and that the average amount of time necessary to prepare and file the additional supplemental reports with the annual audit would be approximately 40 hours per year. Consequently, the 12 broker-dealers would spend approximately 1,440 hours ($(48 + 32 + 40) * 12$) per year to comply, and we expect that a senior accountant would do the work. The staff estimates that the hourly salary of a senior accountant is \$49.87 per hour,⁸⁹ for a total annual cost of approximately \$72,000 ($\$49.87 * 1,440 = \$71,813$).

We estimate that approximately 10% of active broker-dealers filed a Rule 17a–11 notice during calendar year 2001 and that it would take approximately one hour to file such a notice. Therefore, we estimate that of the 12 broker-dealers we expect to apply under this proposal, at most one may be required to file notice pursuant to the proposed amendments to Rule 17a–11 each year. Thus, we estimate that the total for the 12 broker-dealers we expect to apply under the proposal would be about one hour. The staff estimates that the hourly salary of a senior compliance staff person is \$56.60 per hour,⁹⁰ for a total cost of approximately \$60.

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

Section 3(f) of the Exchange Act⁹¹ requires us, when engaging in rulemaking that requires us to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act⁹² requires us to consider the anticompetitive effects of any rules that we adopt under the Exchange Act. Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

⁸⁶ The Commission received 692 Rule 17a–11 notifications during calendar year 2001, when there were approximately 7,217 broker-dealers registered with the Commission. Thus, approximately 10% of registered broker-dealers filed a Rule 17a–11 notice in 2001. We therefore estimate that of the 12 broker-dealers we expect will apply under the proposal, one may be required to file an Appendix G notice each year. We estimate that, consistent with the Rule 17a–11 PRA burden estimate, it will take approximately one hour to file that notice.

⁸⁷ SIA Report, (Senior Compliance Staff) + 35% overhead (based on end-of-year 2002 figures) (\$75,464 per year/1800 hours/year * 1.35 = \$56.60 per hour).

⁸⁸ SIA Report, (Senior Compliance Staff) + 35% overhead (based on end-of-year 2002 figures) (\$66,500 per year/1800 hours/year * 1.35 = \$49.87 per hour).

⁸⁹ SIA, Management and Professional Earnings, (Senior Compliance Staff) + 35% overhead (based on end-of-year 2002 figures) (\$75,464 per year/1800 hours/year * 1.35 = \$56.60 per hour).

⁹⁰ 15 U.S.C. 78c(f).

⁹¹ 15 U.S.C. 78w(a)(2).

The Commission's preliminary view is that the proposed rule amendments should promote efficiency, competition, and capital formation. These amendments should provide eligible broker-dealers an opportunity to increase operational efficiency by having their supervisory risk assessment and the computation of certain capital charges more closely aligned to the sophisticated methods the firms already use to manage their business risk and capital, while at the same time requiring sufficient net capital. The incorporation of mathematical risk management techniques into the calculation of net capital charges should enable such a broker-dealer to reallocate capital from the broker-dealer to affiliates that may receive a higher return than the broker-dealer. The proposed rule amendments should also allow broker-dealers to increase operational efficiency by adopting risk management practices which have become industry best practice. In addition, the proposed amendments should enhance the ability of U.S. securities firms to compete effectively in global securities markets.

We solicit comments on these matters with respect to the proposed rule amendments. Would the amendments have an adverse effect on competition that is neither necessary nor appropriate in furtherance of the purposes of the Exchange Act? Would the proposed amendments, if adopted, promote efficiency, competition, and capital formation? Commenters are requested to provide empirical data and other factual support for their views, if possible.

VII. Regulatory Flexibility Act Certification

The Commission hereby certifies, pursuant to 5 U.S.C. 605(b), that proposed amendments to Rules 15c3-1, 15c3-4, 17a-5, 17a-11, 17h-1T, and 17h-2T, if adopted, would not have a significant economic impact on a substantial number of small entities.

These provisions would be available only to broker-dealers that have tentative net capital of at least \$1 billion and net capital of at least \$500 million. According to March 2003 FOCUS reports, there are only 28 such firms, and, of these firms, none were small businesses.⁹³ Further, election to apply

⁹³ Pursuant to 17 CFR 240.0-10, "the term *small business* or *small organization* shall: [* * *] (c) [w]hen used with reference to a broker or dealer, mean a broker or dealer that: (1) [h]ad 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 § 240.17-5(d) or, if not required to file such statements, a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the last business

for the alternative capital regime is voluntary. The proposed rules and rule amendments, therefore, should not have a significant impact on a substantial number of small entities.

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

VIII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"⁹⁴ a rule is "major" if it has resulted, or is likely to result, in:

- An annual effect on the economy of \$100 million or more;
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effect on competition, investment or innovation.

We request comment on the potential impact of the proposed amendments on the economy on an annual basis. We request that commenters provide empirical data and other factual support for their views.

IX. Statutory Authority

The Commission proposes to amend Title 17, Chapter II of the Code of Federal Regulations pursuant to the Exchange Act (15 U.S.C. 78a *et seq.*) (particularly sections 15(c), 17(a), 23, 24(b), and 36 thereof (15 U.S.C. 78o(c), 78q(a), 78w, 78x(b), and 78mm)).

List of Subjects in 17 CFR Part 240

Broker-dealers, Reporting and recordkeeping requirements, Securities.

day of the preceding fiscal year (or in the time that it has been in business, if shorter); and (2) [i]s not affiliated with any person (other than a natural person) that is not a small business or small organization as defined in this section * * *⁹⁵ (17 CFR 240.0-10(c)). Further, pursuant to § 240.0-10(i), "[f]or purposes of paragraph (c) of this section, a broker or dealer is affiliated with another person if [* * *] [s]uch broker or dealer introduces transactions in securities, other than registered investment company securities or interests or participations in insurance company separate accounts, to such other person or introduces accounts of customers or other brokers or dealers, other than accounts that hold only registered investment company securities or interests or participations in insurance company separate accounts, to such other person that carries such accounts on a fully disclosed basis."⁹⁶ (17 CFR 240.0-10(i)).

⁹⁴ Pub. L. 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).

Text of Proposed Rule Amendments

For the reasons set forth in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

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

1. 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, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 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.
* * * * *

2. Remove the authority citations following §§ 240.15c3-1 and 240.17a-5.
3. Section 240.15c3-1 is amended by:
a. Revising the undesignated section heading preceding paragraph (a)(7);
b. Adding text to paragraph (a)(7);
c. Revising the undesignated section heading preceding paragraph (c)(13);
d. Adding text to paragraph (c)(13); and
e. Adding a sentence to the end of paragraph (c)(15).

The additions and revisions read as follows:

§ 240.15c3-1 Net capital requirements for brokers or dealers.

(a) * * *

Alternative Net Capital Computation for Broker-Dealers That Elect to be Supervised on a Consolidated Basis

(7) In accordance with Appendix E to this section (§ 240.15c3-1e), the Commission may approve, in whole or in part, an application or an amendment to an application by a broker or dealer, when calculating net capital, to use the market risk standards of Appendix E to calculate the market risk capital charge on some or all of its positions instead of the provisions of paragraph (c)(2)(vi) of this section, and to use the credit risk standards of Appendix E to calculate the credit risk capital charge on certain credit exposures arising from transactions in derivatives instruments instead of the provisions of paragraph (c)(2)(iv) of this section, subject to any conditions or limitations the Commission may require as necessary or appropriate in the public interest and consistent with the protection of investors. Such a broker or dealer must at all times maintain tentative net capital of not less than \$1 billion and net capital of not less than \$500 million.
(c) * * *

Entity That Has a Principal Regulator

(13) For purposes of Appendix E (§ 240.15c3–1e) and Appendix G (§ 240.15c3–1g) of this section, the term *entity that has a principal regulator* shall mean a person (other than a natural person) that is not a registered broker or dealer (other than a broker or dealer registered under section 15(b)(11) of the Act (15 U.S.C. 78o(b)(11)), provided that:

(i) The person is:

(A) An insured depository institution as defined in section 3(c)(2) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)(2));

(B) Registered with the Commodity Futures Trading Commission; or

(C) Registered with or licensed by a State insurance regulator and issues any insurance, endowment, or annuity policy or contract; or

(ii) There are in place appropriate arrangements so that information provided to the Commission is sufficiently reliable for the purposes of Appendix E and Appendix G, the person is primarily in the insured depository institutions business (excluding its insurance and commercial businesses), and the person is:

(A) A bank holding company as defined in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a));

(B) A savings and loan holding company as defined in Section 10(a)(1)(D) of the Home Owners' Loan Act (12 U.S.C. 1467a(1)(D)); or

(C) A foreign bank as defined in section 1(b)(7) of the International Banking Act of 1978 (12 U.S.C. 3101(7)) that is from a jurisdiction for which any foreign bank has been approved by the Board of Governors of the Federal Reserve System to conduct business under 12 CFR 211.24(c), provided such foreign bank represents that it is subject to the same supervisory regime as the foreign bank previously approved by the Board of Governors of the Federal Reserve System.

(15) * * * For a broker or dealer whose application for exemption under paragraph (a)(7) of this section has been granted by the Commission, the term *tentative net capital* means the net capital of the broker or dealer before deducting the market and credit risk capital charges computed pursuant to Appendix E to this section (§ 240.15c3–1e) or paragraph (c)(2)(vi) of this section, if applicable, and increased by the balance sheet value (including counterparty net exposure) resulting from transactions in derivative

instruments which would otherwise be deducted by virtue of paragraph (c)(2)(iv) of this section.

* * * * *

4. Section 240.15c3–1e is revised to read as follows:

§ 240.15c3–1e Market and credit risk capital charges for certain brokers or dealers (Appendix E to 17 CFR 240.15c3–1).

Application

(a) A broker or dealer may apply to the Commission for authorization to compute market risk capital charges pursuant to this Appendix E in lieu of computing haircuts pursuant to § 240.15c3–1(c)(2)(vi) and to compute credit risk capital charges pursuant to this Appendix E on some or all of its credit exposures arising from transactions in derivatives instruments (if this Appendix E is used to calculate market risk capital charges on these instruments) in lieu of computing credit risk capital charges pursuant to § 240.15c3–1(c)(2)(iv).

(1) The documents and information submitted to the Commission by the broker or dealer as part of its application shall include the following:

(i) An executive summary of the documents and information provided to the Commission as part of the application and a description of the holding company of the broker or dealer, which may not be a natural person;

(ii) A comprehensive description of the internal risk management control system of the broker or dealer and how that system satisfies the requirements set forth in § 240.15c3–4;

(iii) A detailed list of the categories of positions that the broker or dealer holds in its proprietary accounts and a brief description of the methods that the broker or dealer will use to calculate market and credit risk capital charges on those categories of positions;

(iv) A description of all mathematical models used to price positions and to compute market and credit risk capital charges; a description of the creation, use, and maintenance of the mathematical models; a description of the broker's or dealer's internal risk management controls over those models, including a description of persons who may input data into the model and persons who have access to any or all of the model's outputs; a statement regarding whether the firm has developed its own mathematical models; if a mathematical model incorporates empirical correlations across risk categories, a description of the process for measuring correlations; a description of the backtesting

procedures the broker or dealer will use to backtest the mathematical model used to calculate maximum potential exposure; a description of how each mathematical model satisfies the qualitative and quantitative requirements set forth in paragraph (e) of this Appendix E; and for each mathematical model, a statement that the model is used to analyze and report risk to senior management;

(v) If the broker or dealer is applying to the Commission for approval to use scenario analysis to calculate market risk capital charges for certain positions, a list of those positions, a description of how those charges will be calculated using scenario analysis, and an explanation of why scenario analysis is appropriate to calculate market risk capital charges on those positions;

(vi) A description of how the broker or dealer will calculate current exposure;

(vii) A description of how the broker or dealer will determine internal credit ratings of counterparties, if applicable; and

(viii) A written undertaking by the holding company of the broker or dealer, in a form acceptable to the Commission, signed by a duly authorized person at the holding company, to the effect that, as a condition of Commission approval of the application of the broker or dealer to compute certain market and credit risk capital charges pursuant to this Appendix E, the holding company agrees to:

(A) Comply with the provisions of § 240.15c3–1g;

(B) Comply with all applicable provisions of this Appendix E;

(C) Comply with the provisions of § 240.15c3–4 with respect to an internal risk management control system for the affiliate group as though it were a broker-dealer that computes certain of its capital charges in accordance with this Appendix E;

(D) As part of the internal risk management control system for the affiliate group, establish, document, and maintain procedures for the detection and prevention of money laundering and terrorist financing;

(E) Permit the Commission to examine the books and records of any affiliate of the broker or dealer, including the holding company, if the affiliate is not an entity that has a principal regulator, as defined in § 240.15c3–1(c)(13);

(F) Make available to the Commission, for an entity that has a principal regulator, as defined specifically in § 240.15c3–1(c)(13)(ii), such information concerning the operations of the entity that the Commission finds is necessary

to evaluate the financial and operational risk within the affiliate group of the broker or dealer (including any risks that may affect the reputation of the holding company or the broker or dealer) and to evaluate compliance with the conditions of eligibility for computing certain capital charges pursuant to this Appendix E;

(G) If the disclosure to the Commission of any information required as a condition for the broker or dealer to compute certain capital charges pursuant to this Appendix E would be prohibited by law or otherwise, cooperate with the Commission as needed, including by describing any secrecy laws or other impediments that could restrict the ability of the broker or dealer or any affiliates from providing information on their operations or activities and by discussing the manner in which the holding company and the broker or dealer propose to provide the Commission with adequate assurances of access to information;

(H) For any non-U.S. holding company, consent to the jurisdiction of the Commission and agree to maintain a U.S. registered agent;

(I) Submit to the Commission all material changes to mathematical models and other methods used to calculate allowances for market, credit, and operational risk;

(J) Submit to the Commission all material changes to the internal risk management control system for the affiliate group; and

(K) Acknowledge that, if the holding company fails to comply with any provision of its undertaking, the Commission may, in addition to any other supervisory conditions necessary or appropriate in the public interest and consistent with the protection of investors, increase the multiplication factors the holding company uses to calculate allowances for market and credit risk as defined in § 240.15c3–1g(a)(2) and (a)(3) or impose any regulatory condition with respect to the broker or dealer listed in paragraph (f) of this Appendix E;

(2) As a condition of Commission approval, the documents and information submitted to the Commission by the holding company of the broker or dealer as part of the application of the broker or dealer shall include the following:

(i) A narrative description of the business and organization of the holding company;

(ii) An alphabetical list of the affiliates of the broker or dealer (the “affiliate group”), with an identification of the financial regulator, if any, with

whom the affiliate is registered, and a designation of those affiliates that are material to the holding company (“material affiliates”);

(iii) An organizational chart that identifies the holding company, the broker or dealer, and the material affiliates of the broker or dealer;

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

(v) The following sample computations for the affiliate group:

(A) Allowable capital and allowances for market risk, credit risk, and operational risk, determined pursuant to § 240.15c3–1g(a)(1)–(4); or

(B) A capital assessment calculated pursuant to § 240.15c3–1g(a)(5);

(vi) A detailed list of the categories of positions that the affiliate group holds in its proprietary accounts and a brief description of the method that the holding company proposes to use to calculate allowances for market and credit risk, pursuant to § 240.15c3–1g(a)(2) and (3), on those positions;

(vii) A description of all mathematical models used to price positions and to compute market and credit risk capital charges; a description of the creation, use, and maintenance of the mathematical models; a description of the holding company’s internal risk management controls over those models, including a description of persons who may input data into the model and persons who have access to any or all of the model’s outputs; a statement regarding whether the firm has developed its own mathematical models; if a mathematical model incorporates empirical correlations across risk categories, a description of the process for measuring correlations; a description of the backtesting procedures the holding company will use to backtest the mathematical model used to calculate maximum potential exposure; a description of how each mathematical model satisfies the qualitative and quantitative requirements set forth in paragraph (e) of this Appendix E; for each

mathematical model, a statement that the model is used to analyze and report risk to senior management; and a description of any positions for which the 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;

(viii) A description of how the holding company will calculate current exposure;

(ix) A description of how the holding company will calculate the credit risk

weights of counterparties and internal credit ratings of counterparties, if applicable;

(x) A description of how the holding company will calculate its allowance for operational risk;

(xi) For each instance in which a mathematical model used by the broker or dealer to calculate a market risk capital charge or maximum potential exposure for a particular product or counterparty differs from the mathematical model used by the holding company to calculate an allowance for credit risk or maximum potential exposure for that same product or counterparty, a description of the difference(s) between the mathematical models;

(xii) A comprehensive description of the risk management control system for the affiliate group that the holding company has established to manage affiliate group-wide risk, including market, credit, liquidity and funding, legal and compliance, and operational risks, and how that system satisfies the requirements of § 240.15c3–4; and

(xiii) Sample risk reports provided to the persons who are responsible for managing group-wide risk that the holding company will provide to the Commission pursuant to § 240.15c3–1g(b)(1)(viii);

(3) The application of the broker or dealer shall be supplemented by such other information or documents relating to the internal risk management control system, mathematical models, and financial position of the broker or dealer or the holding company of the broker or dealer that the Commission may request to complete its review of the application;

(4) The application shall be considered filed when received at the Commission’s principal office in Washington, DC. All information and documents submitted in connection with the application will be accorded confidential treatment;

(5) If any of the information or documents filed with the Commission as part of the application of the broker or dealer is found to be or becomes inaccurate before the Commission approves the application, the broker or dealer must promptly notify the Commission and provide the Commission with a description of the circumstances in which the information or documents was found to be or has become inaccurate along with updated, accurate information and documents;

(6) The Commission may approve the application, in whole or in part, subject to any conditions or limitations the Commission may require if the Commission finds it to be necessary or

appropriate in the public interest and consistent with the protection of investors after determining, among other things, whether: The broker or dealer has met the requirements of this Appendix E; the broker or dealer is in compliance with other applicable rules promulgated under the Act and self-regulatory organization rules; and the holding company of the broker or dealer is in compliance with the terms of its undertaking, provided to the Commission pursuant to paragraph (a)(1)(viii) of this Appendix E;

(7) The broker or dealer shall amend and resubmit to the Commission its application to calculate certain market and credit risk capital charges in accordance with this Appendix E if the broker or dealer or its holding company desires to make any material change to a mathematical model used to calculate market or credit risk or its internal risk management control system as described in the application;

(8) The broker or dealer shall notify the Commission of any material change to the corporate structure of the broker or dealer or the holding company as described in the application;

(9) As a condition for the broker or dealer to compute its capital charges under this Appendix E, the broker or dealer agrees that:

(i) The broker or dealer will provide 45 days written notice to the Commission if it intends to cease to use the market risk standards of this Appendix E to calculate its market risk capital charge instead of the provisions of § 240.15c3–1(c)(2)(vi) and the credit risk standards of this Appendix E to calculate its credit risk capital charge on certain credit exposures arising from transactions in derivatives instruments instead of the provisions of § 240.15c3–1(c)(2)(iv); and

(ii) The Commission may determine by order that such notice will become effective after a shorter or longer period of time if the broker or dealer consents or if the Commission determines that the shorter or longer period of time is necessary or appropriate in the public interest and consistent with the protection of investors; and

(10) Notwithstanding paragraph (a)(9) of this section, the Commission, by order, may revoke a broker's or dealer's exemption that allows it to use the market risk standards of this Appendix E to calculate the market risk capital charge instead of the provisions of § 240.15c3–1(c)(2)(vi), and the exemption to use the credit risk standards of this Appendix E to calculate the credit risk capital charge on certain credit exposures arising from transactions in derivatives instruments

instead of the provisions of § 240.15c3–1(c)(2)(iv), if the Commission finds that such exemption is no longer necessary or appropriate in the public interest, or is no longer consistent with the protection of investors.

Compliance With § 240.15c3–4

(b) A broker or dealer that computes its market and credit risk capital charges under this Appendix E must comply in all material respects with § 240.15c3–4 regarding its internal risk management control system in order to be in compliance with § 240.15c3–1.

Market Risk

(c) A broker or dealer whose application has been approved under paragraph (a) of this Appendix E shall compute a market risk capital charge daily in accordance with the following:

(1) The broker or dealer shall compute a market risk capital charge on eligible positions, in accordance with the phase-in schedule of paragraph (c)(3) of this Appendix E, equal to the VaR of those positions multiplied by the appropriate multiplication factor. The VaR of the positions must be obtained using approved VaR models meeting the applicable qualitative and quantitative requirements of paragraph (e) of this Appendix E. The broker or dealer must use the multiplication factor determined according to paragraph (e)(1)(iii) of this Appendix E, except that the initial multiplication factor shall be three, unless the Commission determines, based on a review of the broker's or dealer's internal risk management control system and practices, including a review of the VaR models, that another multiplication factor is appropriate;

(2) The broker or dealer may not use a VaR model to determine a capital charge for positions having no ready market or for debt securities which are below investment grade or for any derivative instrument based on the value of these positions, unless the Commission has granted, pursuant to § 240.15c3–1(a)(7), its application to use its VaR model for any such positions. The broker or dealer may apply pursuant to paragraph (c)(5) of this Appendix E to calculate its market risk capital charge for any such positions using scenario analysis. If that application is denied, the broker or dealer must calculate the market risk capital charge for such positions under § 240.15c3–1(c)(2)(vi);

(3) The broker or dealer shall use approved VaR models to compute its market risk capital charge in accordance with the following phase-in schedule:

(i) Upon Commission approval of its application under paragraph (a) of this

Appendix E, the broker or dealer may use approved VaR models to calculate its market risk capital charge for the following positions:

- (A) U.S. government securities and derivatives on those securities;
- (B) Corporate debt securities rated in one of the four highest rating categories by two nationally recognized statistical rating organizations ("NRSROs") and derivatives on those securities;
- (C) Foreign government securities rated in one of the four highest rating categories by two NRSROs and derivatives on those securities;
- (D) Derivatives on major market foreign currencies as defined in § 240.15c3–1a(b)(1)(i)(C);
- (E) Asset-backed securities with less than 5 years to maturity that are rated in one of the four highest rating categories by two NRSROs and derivatives on those securities; and
- (F) Municipal securities rated in one of the four highest rating categories by two NRSROs and derivatives on those securities;
- (ii) Nine months after Commission approval of its application under paragraph (a) of this Appendix E, the broker or dealer may amend its application to request approval to use one or more approved VaR models to calculate its market risk capital charge for equities and derivatives on equities; and
- (iii) Nine months after the amendment filed pursuant to paragraph (c)(3)(ii) of this Appendix E has been approved, a broker or dealer may amend its application to request approval to use one or more approved VaR models to calculate its market risk capital charge for other eligible positions;
- (4) Notwithstanding any other provision in this Appendix E, a broker or dealer that computes its capital charges under this Appendix E may use a VaR model to determine market risk capital charges only for positions for which there is adequate historical data to support a VaR model;
- (5) The broker or dealer must request, either in its initial application or an amendment, to use scenario analysis to compute its market risk capital charge for a category of positions. For positions for which the Commission has approved the broker's or dealer's application to use scenario analysis, the market risk capital charge shall be three times the greatest adverse movement resulting from the scenario analysis over any ten-day period on a daily basis, except that the resulting market risk capital charge must be at least \$25 per 100 share equivalent contract for equity positions, or one-half of one percent of the face value of the contract for all other types

of contracts, even if the scenario analysis indicates a lower amount. A scenario qualifying for use under this Appendix E must include:

(i) A set of pricing equations for the positions or derivatives based on, for example, arbitrage relations, statistical analysis, historic relationships, merger evaluation, or fundamental valuation of an offering of securities;

(ii) A range of adverse movements of risk factors, prices, or spreads that moved by the greatest amounts over the past 5 years or a 3 standard deviation movement in those risk factors, prices, or spreads over a ten day period;

(iii) Auxiliary relationships mapping risk factors to prices; and

(iv) Data demonstrating the effectiveness of the scenario in capturing market risk; and

(6) For all other positions, the broker or dealer must compute a market risk capital charge pursuant to § 240.15c3-1(c)(2)(vi) and applicable Appendices.

Credit Risk

(d) A broker or dealer whose application, including amendments, has been approved under paragraph (a) of this Appendix E shall compute its credit risk capital charge daily on credit exposures to all counterparties arising from the broker's or dealer's transactions in derivatives instruments (if this Appendix E is used to calculate the market risk capital charge on those instruments) that is the sum of: A counterparty exposure charge to each counterparty, concentration charges by counterparty, and a portfolio concentration charge across all counterparties, determined as follows:

(1) For each counterparty, the *counterparty exposure charge* is:

(i) The net replacement value in the account of the counterparty that is insolvent, or in bankruptcy, or that has senior unsecured long-term debt in default; or

(ii) As to a counterparty not otherwise described in paragraph (d)(1)(i) of this Appendix E, the credit equivalent amount of the broker's or dealer's exposure to the counterparty, as defined in paragraph (d)(2) of this Appendix E, multiplied by the credit risk weight of the counterparty, as determined according to paragraph (d)(7) of this Appendix E, multiplied by 8%;

(2) The *credit equivalent amount* of the broker's or dealer's exposure to a counterparty is the sum of the broker's or dealer's maximum potential exposure to the counterparty, as defined in paragraph (d)(4) of this Appendix E, multiplied by the appropriate multiplication factor, and the broker's or dealer's current exposure to the

counterparty, as defined in paragraph (d)(3) of this Appendix E. The broker or dealer must use the multiplication factor determined according to paragraph (e)(1)(iv) of this Appendix E, except that the initial multiplication factor shall be one, unless the Commission determines, based on a review of the broker's or dealer's internal risk management control system and practices, including a review of the VaR models, that another multiplication factor is appropriate;

(3) The *current exposure* of the broker or dealer to a counterparty is the current replacement value of the counterparty's positions with the broker or dealer, after applying netting agreements with the counterparty meeting the requirements of paragraph (d)(5) of this Appendix E and taking into account the value of collateral from the counterparty held by the broker or dealer in accordance with paragraph (d)(6) of this Appendix E;

(4) The *maximum potential exposure* of the broker or dealer to a counterparty is the increase in the replacement value of the counterparty's positions with the broker or dealer, after applying netting agreements with the counterparty meeting the requirements of paragraph (d)(5) of this Appendix E and taking into account the value of collateral from the counterparty held by the broker or dealer in accordance with paragraph (d)(6) of this Appendix E, that is computed daily using approved VaR models meeting the applicable quantitative and qualitative requirements of paragraph (e) of this Appendix E;

(5) *Netting agreements.* When calculating current exposure or maximum potential exposure, a broker or dealer may include the effect of netting agreements that allow a broker or dealer 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 broker or dealer monitors and controls its exposure to the counterparty on a net basis;

(6) *Collateral.* When calculating current exposure and maximum potential exposure, the fair market value of collateral pledged and held may be taken 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 United States currency;

(iii) The collateral agreement is legally enforceable by the broker or dealer 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 broker or dealer or to the counterparty;

(v) The Commission has approved the broker's or dealer's use of a VaR model to calculate market risk capital charges for the type of security used as collateral in accordance with § 240.15c3-1(a)(7) and paragraphs (g)(2) and (g)(3) of this Appendix E; and

(vi) The collateral is not used in determining the credit rating of the counterparty;

(7) *Credit risk weights of counterparties.* A broker or dealer that computes its credit risk capital charges pursuant to this Appendix E shall determine the credit risk weight of a counterparty as follows:

(i) 20% credit risk weight for transactions with counterparties with ratings for senior unsecured long-term debt or commercial paper in one of the two highest rating categories by an NRSRO or equivalent internal rating, if applicable;

(ii) 50% credit risk weight for transactions with counterparties with ratings for senior unsecured long-term debt or commercial paper in the third and fourth highest rating categories by an NRSRO or equivalent internal rating, if applicable;

(iii) 150% credit risk weight for transactions with counterparties with ratings for senior unsecured long-term debt or commercial paper below the fourth highest rating category by an NRSRO or equivalent internal rating, if applicable;

(iv) As part of its initial application or in an amendment, the broker or dealer may request Commission approval to determine credit ratings using internal calculations for counterparties that are not rated by an NRSRO, and the broker or dealer may use these internal credit ratings in lieu of ratings issued by an NRSRO for purposes of determining credit risk weights. Based on the strength of the broker's or dealer's internal credit risk management system, the Commission may approve the application. The broker or dealer must make and keep current a record of the basis for the credit rating for each counterparty. The record must be preserved for a period of not less than three years, the first two years in an easily accessible place; and

(v) 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 broker or dealer can demand immediate payment from the guarantor after any payment is missed without having to make collection efforts, the broker or dealer 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 broker or dealer to substitute the guarantor for the counterparty upon default or nonpayment by the counterparty;

(8) *Concentration charges by counterparty.* The concentration charge, where the current exposure of the broker or dealer to a counterparty exceeds 5% of the tentative net capital of the broker or dealer, is calculated as follows:

(i) For counterparties with credit risk weights of 20%, 5% of the amount of the current exposure to the counterparty in excess of 5% of the tentative net capital of the broker or dealer;

(ii) For counterparties with credit risk weights of 50%, 20% of the amount of the current exposure to the counterparty in excess of 5% of the tentative net capital of the broker or dealer; and

(iii) For counterparties with credit risk weights of 150%, 50% of the amount of the current exposure to the counterparty in excess of 5% of the tentative net capital of the broker or dealer; and

(9) *Portfolio concentration charge across all counterparties.* The concentration charge across all counterparties for unsecured receivables is 100% of the amount of the broker's or dealer's aggregate current exposure arising from the broker's or dealer's transactions in derivatives instruments across all counterparties in excess of 15% of the tentative net capital of the broker or dealer.

VaR Models

(e) Each VaR model must meet the following minimum qualitative and quantitative requirements:

(1) *Qualitative requirements.* (i) The VaR model used to calculate market or credit risk for a position must be the same model used to report the market or credit risk of that position to senior management and must be integrated into the daily internal risk management system of the firm;

(ii) The VaR model must be reviewed both periodically and annually. The periodic review may be conducted by the firm's internal audit staff, but the

annual review must be conducted by a registered public accounting firm, as that term is defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (Pub. L. 107-204);

(iii) For purposes of computing market risk, the firm must determine the appropriate multiplication factor as follows:

(A) Beginning three months after the firm begins using the VaR model to calculate market risk, the firm must conduct backtesting of the model by comparing its actual daily net trading profit or loss with the corresponding VaR measure generated by the VaR model, using a 99 percent, one-tailed confidence level with price changes equivalent to a one business-day movement in rates and prices, for each of the past 250 business days;

(B) On the last business day of each quarter, the firm must identify the number of backtesting exceptions of the VaR model, that is, the number of business days in the past 250 business days for which the actual net trading loss, if any, exceeds the corresponding VaR measure; and

(C) The firm must use the multiplication factor indicated in Table 1 of this Appendix E in determining its market risk until it obtains the next quarter's backtesting results, unless the Commission determines, based, among other relevant factors, on a review of the firm's internal risk management control system, including a review of its VaR model, that a different adjustment or other action is appropriate; and

TABLE 1.—MULTIPLICATION FACTOR BASED ON THE NUMBER OF BACKTESTING EXCEPTIONS OF THE VAR MODEL IN THE PAST 250 BUSINESS DAYS

Number of exceptions	Multiplication factor
4 or fewer	3.00
5	3.40
6	3.50
7	3.65
8	3.75
9	3.85
10 or more	4.00

(iv) For purposes of computing the credit equivalent amount of the firm's exposures to a counterparty, the firm must determine the appropriate multiplication factor as follows:

(A) Beginning three months after the firm begins using the VaR model to calculate maximum potential exposure, the firm must conduct backtesting of the model by comparing, for at least 40 counterparties with widely varying

types and sizes of positions with the firm, the daily change in its current exposure to the counterparty based on the end of the previous day's positions with the corresponding maximum potential exposure for the counterparty generated by the VaR model;

(B) Once each quarter, on the last business day of the quarter, the firm must identify the number of backtesting exceptions of the VaR model, that is, the number of business days in the past 250 business days for which the change in current exposure to a counterparty exceeds the corresponding maximum potential exposure; and

(C) Based on the number of backtesting exceptions of the VaR model, the firm will propose, as part of its application, a schedule of multiplication factors, which must be approved by the Commission. The firm must use the multiplication factor indicated in the approved schedule in determining the credit equivalent amount of the firm's exposures to a counterparty until it obtains the next quarter's backtesting results, unless the Commission determines, based, among other relevant factors, on a review of the firm's internal risk management control system, including a review of the VaR model, that a different adjustment or other action is appropriate;

(2) *Quantitative requirements.* (i) For purposes of determining market risk, the VaR model must use a 99 percent, one-tailed confidence level with price changes equivalent to a ten business-day movement in rates and prices;

(ii) For purposes of determining maximum potential exposure, the VaR model must use a 99 percent, one-tailed confidence level with price changes equivalent to a one-year movement in rates and prices;

(iii) The VaR model must use an effective historical observation period of at least one year. The historical observation period must include periods of market stress. Historical data sets must be updated at least monthly and reassessed whenever market prices or volatilities change significantly; and

(iv) The VaR model must take into account and incorporate all significant, identifiable market risk factors applicable to positions in the accounts of the firm, including:

(A) Risks arising from the non-linear price characteristics of derivatives and the sensitivity of the market value of the positions to changes in the volatility of options positions due to different maturities;

(B) Empirical correlations with and across risk factors or, alternatively, risk factors sufficient to cover all the market risk inherent in the positions in the

proprietary or other trading accounts of the firm, including interest rate risk, equity price risk, foreign exchange risk, and commodity price risk;

(C) Spread risk, where applicable, and segments of the yield curve sufficient to capture differences in volatility and imperfect correlation of rates along the yield curve for securities and derivatives that are sensitive to different interest rates; and

(D) Specific risk for individual securities and derivatives.

Additional Regulatory Conditions

(f) As a condition for the broker or dealer to use this Appendix E to calculate certain of its capital charges, the Commission may impose additional regulatory conditions on the broker or dealer, which may include: Restricting its business (on a product-specific, category-specific, or general basis); submitting to the Commission a plan to increase its net capital or tentative net capital; filing more frequent reports with the Commission; Modifying its internal risk management control procedures; or computing its market and credit risk capital charges in accordance with § 240.15c3-1(c)(2)(vi) and (c)(2)(iv), as appropriate. The Commission may also require, as a condition of continuation of the exemption, the holding company of the broker or dealer to file more frequent reports or to modify its group-wide internal risk management control procedures. The Commission may impose such additional regulatory conditions if:

(1) The broker or dealer or the holding company of the broker or dealer fails to meet the reporting requirements set forth in § 240.17a-5 or 240.15c3-1g(b), as applicable;

(2) Any event specified in § 240.17a-11 or 240.15c3-1g(e) occurs;

(3) There is a material deficiency in the internal risk management control system or in the mathematical models used to price securities or to calculate market and credit risk capital charges or allowances for market and credit risk, as applicable, of the broker or dealer or the holding company of the broker or dealer;

(4) The holding company of the broker or dealer fails to comply with its undertakings that the broker or dealer has filed with its application pursuant to paragraph (a)(1)(viii) of this Appendix E;

(5) The broker or dealer or the holding company of the broker or dealer materially amends a mathematical model or its internal risk management control system or its corporate structure as described in the application the

broker or dealer has submitted to the Commission under this Appendix E; or

(6) The Commission finds that imposing other regulatory conditions are necessary or appropriate in the public interest, and for the protection of investors.

5. Section 240.15c3-1g is added to read as follows:

§ 240.15c3-1g Conditions for holding companies of certain brokers or dealers (Appendix G to 17 CFR 240.15c3-1).

As a condition for a broker or dealer to compute certain of its capital charges in accordance with § 240.15c3-1e, the holding company of the broker or dealer shall comply with the conditions set forth below:

Conditions Regarding Computation of Allowable Capital and Risk Allowances

(a) As a condition of the exemption, the holding company of a broker or dealer that computes certain of its capital charges in accordance with § 240.15c3-1e must calculate allowable capital and allowances for market, credit, and operational risk on a consolidated basis as follows:

(1) *Allowable capital.* The holding company must compute allowable capital monthly as the sum of:

(i) Common shareholders' equity on the consolidated balance sheet of the holding company less:

(A) Goodwill;

(B) Deferred tax assets;

(C) Other intangible assets; and

(D) 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);

(ii) Cumulative and non-cumulative preferred stock, provided that:

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

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

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

(D) The issuer of the stock can defer or eliminate dividends, except that the amount of such cumulative preferred stock may not exceed 33% of the items included in allowable capital pursuant to paragraph (a)(1)(i) of this Appendix G; and

(iii) The sum of the following items on the consolidated balance sheet, to the extent that the sum does not exceed the sum of the items included in allowable capital pursuant to paragraphs (a)(1)(i) and (ii) of this Appendix G:

(A) Cumulative preferred stock in excess of the 33% limit specified in

paragraph (a)(1)(ii) of this Appendix G; and

(B) Subordinated debt if the original weighted average maturity of the subordinated debt is at least five years; 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; the subordinated debt is unsecured and subordinated in right of payment to all senior indebtedness of the holding company; and 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;

(2) *Allowance for market risk.* The holding company shall compute an allowance for market risk daily for all proprietary positions, including debt instruments, equity instruments, commodity instruments, foreign exchange contracts, and derivative contracts, as the aggregate of the following:

(i) *Value at risk.* The VaR of its positions, multiplied by the appropriate multiplication factor. The VaR of the positions must be obtained using approved VaR models meeting the applicable qualitative and quantitative requirements of § 240.15c3-1e(e). The holding company must use the multiplication factor determined according to § 240.15c3-1e(e)(1)(iii), except that the initial multiplication factor shall be three, unless the Commission determines, based on a review of the group-wide internal risk management control system and practices, including a review of the VaR models, that another multiplication factor is appropriate. The VaR model must be one that can be disaggregated by each line of business exposed to market risk and by each legal entity exposed to market risk. The holding company may use a VaR model to determine an allowance for market risk only for positions for which there is adequate historical data to support a VaR model; and

(ii) *Alternative method.* For positions for which there does not exist adequate historical data to support a VaR model, an allowance for market risk using a method described in the broker's or dealer's application to use § 240.15c3-1e to calculate certain of its capital charges that produces a suitable allowance for market risk for those positions;

(3) *Allowance for credit risk.* The 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, and other extensions of credit, and credit substitutes as follows:

(i) The credit equivalent amount of the asset or off-balance sheet item multiplied by the appropriate credit risk weight of the asset or off-balance sheet item or counterparty, determined according to paragraph (a)(3)(i)(F) of this Appendix G, multiplied by 8%, in accordance with the following:

(A) For certain loans and loan commitments made by members of the affiliate group of the broker-dealer, the credit equivalent amount is 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 of the broker or dealer in compliance with applicable self-regulatory organization 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, stand-by letters of credit, and forward purchases of assets, and similar direct credit substitutes;

(B) For derivatives contracts and for repurchase agreements, reverse repurchase agreements, stock lending and borrowing, and similar collateralized transactions, the credit equivalent amount of the holding company's exposure to a counterparty is the sum of the holding company's maximum potential exposure to the counterparty, as defined in paragraph (a)(3)(i)(D) of this Appendix G, multiplied by the appropriate multiplication factor, and the holding company's current exposure to the counterparty, as defined in paragraph (a)(3)(i)(C) of this Appendix G. The holding company must use the

multiplication factor determined according to § 240.15c3-1e(e)(1)(iv), except that the initial multiplication factor shall be one, unless the Commission determines, based on a review of the group-wide internal risk management control system and practices, including a review of the VaR models, that another multiplication factor is appropriate;

(C) 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, after applying netting agreements with that counterparty meeting the requirements of § 240.15c3-1e(d)(5), taking into account the value of collateral from the counterparty pledged to and held by any member of the affiliate group in accordance with § 240.15c3-1e(d)(6), and subtracting 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 (a)(3)(i)(I) of this Appendix G);

(D) 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, after applying netting agreements with that counterparty meeting the requirements of § 240.15c3-1e(d)(5), taking into account the value of collateral from the counterparty held by any member of the affiliate group in accordance with § 240.15c3-1e(d)(6), and subtracting 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 (a)(3)(i)(I) of this Appendix G), that is obtained daily using an approved VaR model meeting the applicable qualitative and quantitative 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 must be calculated using a time horizon of five days;

(E) The credit equivalent amount for other assets shall be the asset's book value on the holding company's consolidated balance sheet;

(F) 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;

(G) The holding company or other member of the affiliate group may, upon approval by the Commission of a request by the broker or dealer in its initial application or in an amendment, determine credit ratings using internal calculations for counterparties that are not rated by an NRSRO, and the holding company may use these internal credit ratings in lieu of ratings issued by an NRSRO for purposes of determining credit risk weights;

(H) The holding company or other member of the affiliate group may, upon approval by the Commission of a request by the broker or dealer in its initial application or in an amendment, determine credit risk weights of counterparties using internal calculations;

(I) The holding company or member of the affiliate group 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, that are used for bona fide hedging purposes to reduce the credit risk weight of a counterparty, that are not incorporated into the VaR model used for deriving potential exposures, and that are 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;

(J) 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 holding company or member of the affiliate group can demand payment after any payment is missed without having to make collection efforts, the 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;

(K) The holding company may recognize a cross-product netting agreement that meets the requirements set forth in § 240.15c3-1e(j); and

(L) The fair market value of collateral may be used to offset the net replacement value of receivables from a

counterparty provided the requirements set forth in § 240.15c3–1e(k) are met; or

(ii) If the Commission approves the request of the broker or dealer, in its initial application or in an amendment, the holding company may use a calculation consistent with standards published by the Basel Committee on Banking Supervision, as modified from time to time;

(4) *Allowance for operational risk.*

The holding company shall compute an allowance for operational risk determined consistent with appropriate standards published by the Basel Committee on Banking Supervision, as modified from time to time; and

(5) If the Commission approves the request of the broker or dealer, in its initial application or in an amendment, after reviewing the methodology of the computation, the holding company may compute a capital assessment consistent with 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)(1) through (a)(4) of this Appendix G.

Conditions Regarding Reporting Requirements

(b) As a condition of the exemption, the holding company of a broker or dealer that computes certain of its capital charges in accordance with § 240.15c3–1e must file the following reports with the Commission:

(1) A monthly report as of the end of the month, filed 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 and income statement (including notes to the financial statements) for the holding company and computations of allowable capital and allowances for market, credit, and operational risk computed pursuant to paragraph (a) of this Appendix G;

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

(iii) Consolidated credit risk information, including aggregate current exposure and current exposures (including commitments) listed by counterparty for:

(A) The 15 largest exposures; and

(B) The 5 largest exposures to regulated financial institutions;

(iv) The 10 largest commitments listed by counterparty;

(v) Maximum potential exposure listed by counterparty for:

(A) The 15 largest exposures; and

(B) The 5 largest exposures to regulated financial institutions;

(vi) The aggregate maximum potential exposure;

(vii) A summary report reflecting the geographic distribution of the 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

(viii) Certain regular risk reports provided to the persons responsible for managing group-wide risk as the Commission may request from time to time;

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

(i) The information that the holding company files monthly pursuant to paragraph (b)(1) of this Appendix G;

(ii) A consolidating balance sheet and income statement (including notes to the financial statements). The consolidating balance sheet must provide information regarding each material affiliate of the holding company in a separate column, but may aggregate information regarding members of the affiliate group that are not material affiliates into one column;

(iii) The results of backtesting of all internal 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 either the holding company or any of its affiliates, that are required to be disclosed by the holding company under generally accepted accounting principles;

(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 fiscal quarter by each subsidiary broker or dealer and each material affiliate; and

(vi) A capital assessment computed pursuant to paragraph (a) of this Appendix G;

(3) Upon receiving written notice from the Commission, such other financial or operational information as the Commission may request in order to monitor the holding company's financial condition or risk exposures;

(4) Annually, on a calendar or fiscal year basis, financial statements which must be audited by a registered public

accounting firm, as that term is defined in Section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (Pub. L. 107–204), in accordance with the following:

(i) The audited financial statements must include a consolidated balance sheet, income statement, and computations of allowable capital and allowances for market, credit, and operational risk computed pursuant to paragraph (a) of this Appendix G; and

(ii) The audited financial statements must meet the substantive and administrative requirements of § 240.17a–12(b)(5), (b)(6), (c)(1), (c)(3), (d), (e)(1), (e)(2), (e)(3), (f), (g), (h), (i), (j), (n), and (o), as to the holding company and the audited financial statements it must file in accordance with this paragraph;

(5) Concurrently with the audited financial statements, supplemental reports prepared by a registered public accounting firm, as that term is defined in Section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (Pub. L. 107–204), in accordance with the following:

(i) The supplemental reports must include:

(A) *Accountant's report on management controls.* A supplemental report by the registered public accounting firm indicating the results of the registered public accounting firm's review of holding company's compliance with § 240.15c3–4. The procedures are to be performed and the report is to be prepared in accordance with procedures agreed to by the holding company and the registered public accounting firm conducting the review; and

(B) *Accountant's report on inventory pricing and modeling.* A supplemental report by the registered public accounting firm indicating the results of the registered public accounting firm's review of the inventory pricing and modeling procedures. This review must be conducted in accordance with procedures agreed to by the holding company and the registered public accounting firm conducting the review. The purpose of the review is to confirm that the pricing and modeling procedures relied upon by the holding company conform to the procedures submitted to the Commission as part of the application of the broker or dealer, comply with written guidelines pursuant to § 240.15c3–4, and comply with the qualitative and quantitative standards of § 240.15c3e(e);

(ii) The agreed upon procedures are to be performed and the report is to be prepared in accordance with rules promulgated by the Public Company Accounting Oversight Board; and

(iii) The holding company must file, prior to the commencement of the initial review, the procedures agreed to by the holding company and the registered public accounting firm with the Commission's principal office in Washington, DC. Prior to the commencement of each subsequent review, the holding company must notify the Commission of any changes in the procedures;

(6) The reports that the holding company must file pursuant to paragraph (b) of this Appendix G 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, Risk Assessment Group; and

(7) The statements filed by the holding company with the Commission pursuant to paragraph (b) of this Appendix G will be accorded confidential treatment.

Conditions Regarding Records To Be Made

(c) As a condition of the exemption, the holding company of a broker or dealer that computes certain of its capital charges in accordance with § 240.15c3-1e must make and keep current the following records:

(1) A record of the results of stress tests the holding company has conducted of the holding company's funding and liquidity in response to the following events at least once each quarter and a record of the contingency plan to respond to these events:

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

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

(iii) An inability of the holding company to access liquid assets in regulated entities across international borders when the events described in paragraphs (c)(1)(i) or (ii) of this Appendix G occur; and

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

(2) A record of the basis for the determination of credit risk weights for each counterparty; and

(3) A record of the basis for the determination of internal credit ratings for each counterparty.

Conditions Regarding Preservation of Records

(d)(1) As a condition of the exemption, the holding company of a broker or dealer that computes certain of its capital charges in accordance with § 240.15c3-1e must preserve the following information, documents, and reports for a period of not less than three years in an easily accessible place using any media acceptable under § 240.17a-4(f):

(i) The documents created in accordance with paragraph (c)(1) of this Appendix G;

(ii) Any application or documents filed with the Commission pursuant to § 240.15c3-1e and this Appendix G and any written responses received from the Commission;

(iii) All reports and notices filed with the Commission pursuant to § 240.15c3-1e and this Appendix G; and

(iv) All written policies and procedures concerning the group-wide internal risk management control system established pursuant to § 240.15c3-1e(a)(1)(viii)(B); and

(2) The holding company may maintain the records referred to in paragraph (d)(1) of this Appendix G either at the 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 holding company, the holding company shall obtain and file with the Commission a written undertaking by the entity maintaining the records, in a form acceptable to the Commission, signed by a duly authorized person at the entity maintaining the records, to the effect that the records will be treated as if the holding company were maintaining the records pursuant to this section and that the entity maintaining the records will permit examination of such records at any time or from time to time during business hours by representatives or designees of the Commission and will promptly furnish the Commission or its designee a true, correct, complete and current hard copy of any or all or any part of such records. The election to operate pursuant to the provisions of this paragraph shall not relieve the holding company that is required to maintain and preserve such records from any of its reporting or recordkeeping responsibilities under this section.

Conditions Regarding Notification

(e) As a condition of the exemption, the holding company of a broker or dealer that computes certain of its

capital charges in accordance with § 240.15c3-1e shall notify the Commission of certain events as follows:

(1) The holding company shall send notice promptly (but within 24 hours) after the occurrence of the following events:

(i) The occurrence of any backtesting exception under § 240.15c3-1e(e)(1)(iii) or (iv) that would require that the holding company use a higher multiplication factor in the calculation of its allowances for market or credit risk;

(ii) A computation shows that allowable capital (as defined in § 240.15c3-1g(a)(1)) is less than 110% of the sum of the allowances for market, credit, and operational risk (as defined in § 240.15c3-1g(a)(2)-(a)(4));

(iii) An affiliate declares bankruptcy or otherwise goes into default;

(iv) The holding company becomes aware that an NRSRO has determined to materially 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; or

(v) The holding company becomes aware that any financial regulatory agency or self-regulatory organization has taken enforcement or regulatory action against an affiliate;

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

(i) Its corporate structure;

(ii) The material affiliate status of any member of the affiliate group; or

(iii) The major business functions of any material affiliate; and

(3) Every notice or report given or transmitted by paragraph (e) of this Appendix G will be given or transmitted to the principal office of the Commission in Washington, DC, and to 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. For the purposes of this Appendix G, "notice" shall be given or transmitted by telegraphic notice or facsimile transmission. The report described by paragraph (e)(2) of this Appendix G may be transmitted by overnight delivery. Notices and reports filed pursuant to this paragraph will be accorded confidential treatment.

(f) The holding company of a broker or dealer that computes certain of its capital charges in accordance with § 240.15c3-1e must comply with the requirements listed in § 240.15c3-1e(a)(1)(viii)(B) through (K) and

understands that failure to comply may result in revocation of the exemption.

6. Section 240.15c3-4 is amended by:

a. Revising the section heading;
b. In paragraph (a) and the introductory text of paragraph (b), revising the phrase "An OTC derivatives dealer" to read "A broker or dealer that computes certain of its capital charges in accordance with § 240.15c3-1e or § 240.15c3-1f";

c. Revising the introductory text of paragraphs (c) and (d) and paragraphs (b)(5), (c)(5)(xiii) and (xiv), (d)(1), (d)(8), and (d)(9);

d. Adding paragraph (c)(5)(xv);

e. Revising the phrase "OTC derivatives dealer" to read "broker or dealer" in paragraphs (b)(1), (b)(2), (b)(3), (c)(2), (c)(5)(xii), and (d)(7);

f. Revising the phrase "OTC derivatives dealer's" to read "broker's or dealer's" in paragraph (c)(3), the introductory text of paragraph (c)(5), paragraphs (c)(5)(i), (c)(5)(iii), and the introductory text of paragraph (d)(3);

g. Revising the phrase "an OTC derivatives transaction" to read "a securities transaction" in paragraph (d)(5); and

h. Revising the phrase "OTC derivatives" to read "securities" in paragraphs (c)(5)(x), (c)(5)(xi), and (d)(10).

The revisions and additions read as follows:

§ 240.15c3-4 Internal risk management control systems for certain brokers or dealers.

* * * * *

(b) * * *

(5) For a broker or dealer that computes certain of its capital charges in accordance with § 240.15c3-1e, the scope and nature of the permissible OTC derivatives activities.

* * * * *

(c) The internal risk management control system of the broker or dealer that computes certain of its capital charges in accordance with § 240.15c3-1e or § 240.15c3-1f shall include the following elements:

* * * * *

(5) * * *

(xiii) For a broker or dealer that computes certain of its capital charges in accordance with § 240.15c3-1e, the procedures to prevent the broker or dealer from engaging in any securities transaction that is not permitted under § 240.15a-1;

(xiv) For a broker or dealer that computes certain of its capital charges in accordance with § 240.15c3-1e, the procedures to prevent the broker or dealer from improperly relying on the exceptions to § 240.15a-1(c) and

§ 240.15a-1(d), including the procedures to determine whether a counterparty is acting in the capacity of principal or agent; and

(xv) The procedures for reviewing the pricing of positions independent of the business unit.

* * * * *

(d) Management must periodically review, in accordance with written procedures, the business activities of the broker or dealer that computes certain of its capital charges in accordance with § 240.15c3-1e or 240.15c3-1f:

(1) Risks arising from the broker's or dealer's trading activities are consistent with prescribed guidelines;

* * * * *

(8) For a broker or dealer that computes certain of its capital charges in accordance with § 240.15c3-1e, procedures are in place to prevent the broker or dealer from engaging in any securities transaction that is not permitted under § 240.15a-1;

(9) For a broker or dealer that computes certain of its capital charges in accordance with § 240.15c3-1e, procedures are in place to prevent the broker or dealer from improperly relying on the exceptions to § 240.15a-1(c) and § 240.15a-1(d), including the procedures to determine whether a counterparty is acting in the capacity of principal or agent;

* * * * *

7. Section 240.17a-5 is amended by:

a. Redesignating paragraph (a)(5) as paragraph (a)(6), and adding new paragraph (a)(5); and

b. Redesignating paragraphs (k), (l), (m), (n), and (o) as paragraphs (l), (m), (n), (o), and (p) and adding new paragraph (k).

The additions read as follows:

§ 240.17a-5 Reports to be made by certain brokers and dealers.

(a) *Filing of monthly and quarterly reports.* * * *

(5) Each broker or dealer that computes certain of its capital charges in accordance with § 240.15c3-1e must file the following additional reports:

(i) Within 17 business days after the end of each month that is not a quarter, as of month-end:

(A) For each product for which the broker or dealer calculates a market risk capital charge other than in accordance with § 240.15c3-1e(c)(1) or (c)(5), the product category and the amount of the market risk capital charge;

(B) A graph reflecting, for each business line, the daily intramonth VaR;

(C) The aggregate value at risk for the broker or dealer;

(D) For each product for which the broker or dealer uses scenario analysis,

the product category and the market risk capital charge;

(E) Credit risk information on derivatives exposures, including:

(1) Overall current exposure;
(2) Current exposure (including commitments) listed by counterparty for:

(i) The 15 largest exposures; and

(ii) The 5 largest exposures to regulated financial institutions;

(3) The 10 largest commitments listed by counterparty;

(4) The broker or dealer's maximum potential exposure listed by counterparty for:

(i) The 15 largest exposures; and

(ii) The 5 largest exposures to regulated financial institutions;

(5) The broker or dealer's aggregate maximum potential exposure;

(6) A summary report reflecting the broker or dealer's current and maximum potential exposures by credit rating category; and

(7) A summary report reflecting the broker or dealer's current exposure for each of the top ten countries to which the broker or dealer is exposed (by residence of the main operating group of the counterparty); and

(F) Regular risk reports supplied to the broker's or dealer's senior management in the format described in the application;

(ii) Within 17 business days after the end of each quarter:

(A) Each of the reports required to be filed in paragraph (a)(5)(i) of this section;

(B) A report identifying the number of business days for which the actual daily net trading loss exceeded the corresponding daily VaR; and

(C) The results of backtesting of all internal models used to compute allowable capital, including VaR and credit risk models, indicating the number of backtesting exceptions.

* * * * *

(k) *Supplemental reports.* Each broker or dealer that computes certain of its capital charges in accordance with § 240.15c3-1e shall file concurrently with the annual audit report supplemental reports, which shall be prepared by a registered public accounting firm (as that term is defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (Public Law 107-204)), in accordance with the following:

(1) *Accountant's report on management controls.* The broker or dealer shall file a supplemental report indicating the results of the accountant's review of the internal risk management control system established and documented by the broker or dealer in

accordance with § 240.15c3–4. This review shall be conducted in accordance with procedures agreed to by the broker or dealer and the registered public accounting firm conducting the review. The purpose of the review is to confirm that the broker or dealer has established, documented, and is in compliance with the internal risk management controls established in accordance with § 240.15c3–4;

(2) *Accountant's report on inventory pricing and modeling.* The broker or dealer shall file a supplemental report indicating the results of the accountant's review of the procedures for pricing financial instrument inventory (including modeling procedures) established by the broker or dealer and approved for use by the Commission. This review shall be conducted in accordance with procedures agreed to by the broker or dealer and the registered public accounting firm conducting the review. The purpose of the review is to confirm that the financial instrument pricing procedures relied upon by the broker or dealer conform to the procedures established by the broker or dealer pursuant to § 240.15c3–4 and comply with the qualitative and quantitative standards set forth in § 240.15c3–1e(e); and

(3) The broker or dealer 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 agreed-upon procedures agreed to by the broker or dealer and the registered public accounting firm (pursuant to paragraphs (l)(1) and (l)(2) of this section); and

(ii) A notice describing changes in those agreed-upon procedures, if any. If

there are no changes, the broker or dealer should so indicate.

* * * * *

8. Section § 240.17a–11 is amended by:

a. Revising the phrase "an OTC derivatives dealer" to read "a broker or dealer that computes certain of its capital charges in accordance with § 240.15c3–1e or 240.15c3–1f" in paragraphs (b)(2) and (c)(3); and

b. Adding paragraph (j);

The addition reads as follows:

§ 240.17a–11 Notification procedures for brokers and dealers.

* * * * *

(j) A broker or dealer that computes certain of its capital charges in accordance with § 240.15c3–1e shall also give notice that same day in accordance with paragraph (g) of this section whenever:

(1) The broker or dealer is notified by an NRSRO or otherwise becomes aware that an NRSRO has determined to reduce its assessment of the creditworthiness of the broker or dealer or of an affiliate of the holding company of the broker or dealer, or has determined to reduce the credit rating(s) assigned to one or more outstanding short or long-term obligations of the broker or dealer or an affiliate of the holding company of the broker or dealer;

(2) The broker or dealer becomes subject to any supervisory agreement, order, resolution, or other notice of non-compliance from, or report of an instance of non-compliance, issued by an appropriate regulatory agency or self-regulatory organization;

(3) The broker or dealer becomes aware of a situation that may have a material adverse effect on the financial or operational condition of the holding

company of the broker or dealer or an affiliate of the holding company of the broker or dealer; or

(4) The occurrence of any backtesting exception under § 240.15c3–1e(e)(1)(iii) or (iv) that would require that the broker or dealer use a higher multiplication factor in the calculation of its market or credit risk capital charges.

9. Section 240.17h–1T is amended by:

a. Redesignating paragraph (d)(4) as paragraph (d)(5); and

b. Adding new paragraph (d)(4).

The addition reads as follows:

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

* * * * *

(d) *Exemptions.* * * *

(4) The provisions of this section shall not apply to a broker or dealer that computes certain of its capital charges in accordance with § 240.15c3–1e.

10. Section 240.17h–2T is amended by:

a. Redesignating paragraph (b)(4) as paragraph (b)(5); and

b. Adding new paragraph (b)(4).

The addition reads as follows:

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

* * * * *

(b) *Exemptions.* * * *

(4) The provisions of this section shall not apply to a broker or dealer that computes certain of its capital charges in accordance with § 240.15c3–1e.

* * * * *

Dated: October 24, 2003.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–27306 Filed 11–5–03; 8:45 am]

BILLING CODE 8010–01–P