SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 200 and 240

[Release No. 34–49830; 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: Final rule.

SUMMARY: We are adopting rule amendments under the Securities Exchange Act of 1934 that establish a voluntary, alternative method of computing deductions to net capital for certain broker-dealers. This alternative method permits a broker-dealer to use mathematical models to calculate net capital requirements for market and derivatives-related credit risk. A broker-dealer using the alternative method of computing net capital is subject to enhanced net capital, early warning, recordkeeping, reporting, and certain other requirements, and must implement and document an internal risk management system. Furthermore, as a condition to its use of the alternative method, a broker-dealer's ultimate holding company and affiliates (referred to collectively as a consolidated supervised entity, or ''CSE'') must consent to group-wide Commission supervision. This supervision would impose reporting (including reporting of a capital adequacy measurement consistent with the standards adopted by the Basel Committee on Banking Supervision), recordkeeping, and notification requirements on the ultimate holding company. The ultimate holding company (other than an ''ultimate holding company that has a principal regulator'') and its affiliates also would be subject to examination by the Commission. In addition, we have modified the proposed rule amendments on Commission supervision of an ''ultimate holding company that has a principal regulator'' to avoid duplicative or inconsistent regulation. Finally, we are amending the risk assessment rules to exempt a broker-dealer using the alternative method of computing net capital from those rules if its ultimate holding company does not have a principal regulator. The rule amendments are intended to improve our oversight of broker-dealers and their ultimate holding companies.

EFFECTIVE DATE: August 20, 2004.

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SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission is amending § 200.19 and Rules 30–3, 15c3–1, 17a–4, 17a–5, 17a–11, 17h–1T, and 17h–2T under the Securities Exchange Act of 1934 (''Exchange Act''). We proposed amendments on consolidated supervised entities for comment in October of 2003.[1]

I. Introduction

The Commission is amending Rule 15c3–1[2] (the ''net capital rule'') under the Securities Exchange Act of 1934 (the ''Exchange Act'') to establish a voluntary, alternative method of computing net capital for certain broker-dealers. Under the amendments, a broker-dealer that maintains certain minimum levels of tentative net capital and net capital may apply to the Commission for a conditional exemption from the application of the standard net capital calculation. As a condition to granting the exemption, the broker-dealer's ultimate holding company[3] must consent to group-wide Commission supervision.[4] The amendments should help the Commission to protect investors and maintain the integrity of the securities markets by improving oversight of broker-dealers and providing an incentive for broker-dealers to implement strong risk management practices. Furthermore, by supervising the financial stability of the broker-dealer and its affiliates on a consolidated basis, the Commission may monitor better, and act more quickly in response to, any risks that affiliates and the ultimate holding company may pose to the broker-dealer.

These amendments are intended to reduce regulatory costs for broker-dealers by allowing very highly capitalized firms that have developed robust internal risk management practices to use those risk management practices, such as mathematical risk measurement models, for regulatory purposes. A broker-dealer's deductions for market and credit risk probably will be lower under the alternative method of computing net capital than under the standard net capital rule.

A. Broker-Dealer Requirements

The alternative method of computing net capital responds to the firms' requests to align their supervisory risk management practices and regulatory capital requirements more closely. Under the alternative method, firms with strong internal risk management practices may utilize mathematical modeling methods already used to manage their own business risk, including value-at-risk (''VaR'') models and scenario analysis, for regulatory purposes.

A broker-dealer that applies to the Commission for an exemption from the standard net capital rules also must comply with specific requirements designed to address various types of risks that the broker-dealer assumes. A broker-dealer is eligible to use the alternative method of computing net capital only if it maintains tentative net capital[5] of at least $1 billion and net capital of at least $500 million.[6] If the tentative net capital of a broker-dealer calculating net capital under this alternative method falls below $5 billion, the broker-dealer must notify the Commission and the Commission then would consider whether the broker-dealer must take appropriate remedial action.[7]

In addition, a broker-dealer that uses the alternative method must have in place comprehensive internal risk management procedures that address market, credit, liquidity, legal, and

[1] Exchange Act Release No. 48690 (Oct. 24, 2003), 68 FR 62872 (Nov. 6, 2003) (''Proposing Release'').

[2] 17 CFR 240.15c3–1.

[3] We will review, on a case-by-case basis, the broker-dealer's designation of its ultimate holding company in its application to use the alternative method of computing net capital.

We use the term ''ultimate holding company'' in the final rules, rather than the term ''holding company'' that we used in the proposed rules.

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

[5] *See* 17 CFR 240.15c3–1(c)(15).

[6] 17 CFR 240.15c3–1(a)(7)(i).

[7] 17 CFR 240.15c3–1(a)(7)(ii).

operational risk at the firm. These requirements are designed to help ensure the integrity of the broker-dealer's 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. Furthermore, a broker-dealer must provide the Commission with specified financial, operational, and risk management information on a monthly, quarterly, and annual basis.

B. Ultimate Holding Company Requirements

As a condition to a broker-dealer's use of the alternative method of computing net capital, the rule amendments require a broker-dealer's ultimate holding company, if that ultimate holding company does not have a principal regulator, to consent to certain undertakings. In particular, the ultimate holding company must:

- Provide information about the financial and operational condition of the ultimate holding company. Specifically, it must provide the Commission with certain capital and risk exposure information provided to the ultimate holding company's senior risk managers. This information would include market and credit risk exposures, as well as an analysis of the ultimate holding company's liquidity risk;
- Comply with rules regarding the implementation and documentation of a comprehensive, group-wide risk management system for identifying, measuring, and managing market, credit, liquidity, legal, and operational risk;
- Consent to Commission examination of the ultimate holding company and its material affiliates; and
- As part of its reporting requirements, compute, on a monthly basis, group-wide allowable capital and allowances for market, credit, and operational risk in accordance with the standards (''Basel Standards'') [8] adopted by the Basel Committee on Banking Supervision (''Basel Committee'').

In response to comments about bank holding companies, we have revised the proposed rules for an ultimate holding company that has a principal regulator. Generally, under the final rules, this type of ultimate holding company is not subject either to Commission examination or those rules requiring internal risk management controls outside of the broker-dealer and is subject to reduced reporting, recordkeeping, and notification requirements.

The rule amendments also respond to international developments. Affiliates of certain U.S. broker-dealers that conduct business in the European Union (''EU'') have stated that they must demonstrate that they are subject to consolidated supervision at the ultimate holding company level that is ''equivalent'' to EU consolidated supervision.[9] Commission supervision incorporated into these rule amendments is intended to meet this standard. As a result, we believe these amendments will minimize duplicative regulatory burdens on firms that are active in the EU as well as in other jurisdictions that may have similar laws.

II. Proposing Release and Comments

The Commission proposed rule amendments in October 2003 that would have established a voluntary, alternative method for computing net capital charges for certain broker-dealers. In the Proposing Release, the Commission solicited both general comments on the proposal and specific comments on each rule amendment.

The Commission received 20 comment letters in response to the proposed rule amendments: Five from broker-dealers or broker-dealer holding companies, five from bank holding companies subject to supervision by the Board of Governors of the Federal Reserve System (''Federal Reserve'') or a non-domestic ''comprehensive consolidated supervisor,'' one from a securities industry representative, six from U.S. and international banking industry representatives, two from individuals, and one from another regulator.

The majority of commenters endorsed the Commission's initiative to permit certain broker-dealers to use the alternative method of computing net capital. These commenters supported the alternative capital calculation for broker-dealers that have developed mathematical models for measuring risk and group-wide internal risk management control systems to control risk. One commenter, however, questioned the use of models to the extent that it would lower broker-dealer capital requirements, and some commenters questioned the Commission's statutory authority to adopt the proposal.

The commenters that supported the proposal suggested that the Commission modify the proposed rule amendments in various ways. Bank holding companies generally supported the alternative capital computation, but expressed concern that the proposal could impose duplicative and inconsistent requirements on holding companies and their affiliates that are subject to comprehensive consolidated supervision by the Federal Reserve and non-domestic financial regulators.

Generally, commenters addressed various aspects of the methods for calculating deductions for market and credit risk at the broker-dealer level and allowable capital at the ultimate holding company level. They also stated that the Commission should be flexible in permitting firms to use interim methods to calculate allowable capital at the ultimate holding company level until implementation of the New Basel Capital Accord. Some commenters urged the Commission to take measures to ensure the confidentiality of information that the Commission obtains as a result of the proposed rules and rule amendments. Commenters also suggested that the Commission align CSE reporting requirements with public company and other reporting requirements.

Comments on specific rule amendments and the Commission's response to those comments are discussed below in the descriptions of the final rule amendments.

III. Final Rule Amendments

A. General

After considering the comment letters, we are adopting rule amendments that provide broker-dealers with a voluntary, alternative method of computing net capital that permits very highly capitalized broker-dealers to use their internal mathematical models for net

[8] 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. The Basel Committee is currently developing a new international agreement (the ''proposed New Basel Capital Accord''). It expects to issue a final version of the New Basel Capital Accord by the end of June 2004, with an effective date for implementation of the standardized and foundation approaches by year-end 2006, and implementation of the most advanced approaches by year-end 2007.

[9] EU ''consolidated supervision'' consists of a series of quantitative and qualitative rules, imposed at the level of the ultimate holding company, regarding firms' internal controls, capital adequacy, intra-group transactions, and risk concentration. Without a demonstration of ''equivalent'' supervision, U.S. securities firms have expressed concerns that an affiliate institution located in the EU either may 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.''

capital purposes, subject to specified conditions. Generally, we revised the rule amendments related to the broker-dealer's and the ultimate holding company's computation of net capital and allowable capital, respectively. We also revised the rule amendments with respect to broker-dealers that are affiliated with ultimate holding companies that have principal regulators.

As stated in the Proposing Release, the Commission has broad authority under Exchange Act section 15(c)(3) 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.[10] The Commission has promulgated various rules under this provision regarding net capital requirements [11] and protection of customer property.[12] As part of our oversight of broker-dealers, we receive financial and risk management information about broker-dealers, their holding companies, and their affiliates. The rules and the information received have assisted the Commission and the self-regulatory organizations (''SROs'') in identifying, at an early stage, firms that are experiencing financial problems.

The principal purposes of Exchange Act Rule 15c3–1 (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.

Ultimate holding companies that own large broker-dealers also may 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 because of their affiliation with unregistered entities. 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 ultimate holding company level may attempt to divert 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 alone would not violate the net capital rule, it could make it more likely that the firm would fail during volatile market conditions.

To help ensure that the Commission can obtain information necessary to monitor the financial well-being of a broker-dealer, a broker-dealer may use the alternative method of computing net capital only if its ultimate holding company agrees to provide the Commission's with additional information about the financial condition of the ultimate holding company and its affiliates. For an ultimate holding company that does not have a principal regulator, this financial information includes a monthly computation of group-wide allowable capital and allowances for market, credit, and operational risk calculated in accordance with the Basel Standards. This type of ultimate holding company also must provide the Commission with specified financial, operational, and risk management information on a monthly, quarterly, and annual basis. Moreover, an ultimate holding company that does not have a principal regulator must 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, and make and maintain certain books and records. Both the ultimate holding company and its affiliates that do not have principal regulators must consent to Commission examination.

Under the final rules, an ultimate holding company that has a principal regulator is subject to substantially fewer requirements than one that does not have a principal regulator. As a condition to its affiliated broker-dealer's use of the alternative method of computing net capital, this category of ultimate holding company consents to provide the Commission, on a quarterly basis, with the capital measurements that it submits to its principal regulator, consolidated and consolidating balance sheets and income statements, and certain regular risk reports provided to the persons responsible for managing group-wide risk. Annually, an ultimate holding company that has a principal regulator must provide audited consolidated balance sheets and income statements and capital measurements, as submitted to its principal regulator. An ultimate holding company that has a principal regulator also is subject to more limited undertaking and information requirements related to the broker-dealer's application for exemption from the standard net capital rule as well as reduced notification and recordkeeping requirements.

We have included what we believe are prudent parameters for measurement of a broker-dealer's deductions for market and credit risk and allowances for risk for its ultimate 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, we have adopted, as proposed, rules that require the VaR model used to calculate market risk for the broker-dealer to be based on a ten business-day movement in rates and prices and calculated using a 99% confidence level. The VaR measure then must be multiplied by a factor of at least three. These parameters are based on our experience and existing Commission rules and rules of other regulatory agencies where there are similar risk factors in the regulated entities.

B. Amendments to Paragraphs (a) and (c) of Rule 15c3–1

1. Minimum and Early Warning Capital Requirements

We are revising proposed paragraph (a)(7) of Rule 15c3–1. As proposed, paragraph (a)(7) of Rule 15c3–1 would have permitted the Commission to approve, in whole or part, a broker-dealer's application, or amendment to an application, to use the alternative method of computing net capital. Proposed paragraph (a)(7) also would have required the broker-dealer to maintain at all times tentative net capital of at least $1 billion and net capital of at least $500 million.

In the Proposing Release, we requested comment on whether the proposed required minimum levels of tentative net capital and net capital described in proposed paragraph (a)(7) of Rule 15c3–1 should be raised or lowered. One commenter stated that we should permit a broker-dealer with tentative net capital of less than $1 billion to use the alternative net capital computation if it is an affiliate of an international bank with consolidated capital of over $1 billion. Another commenter asserted that ''the Commission should permit other broker-dealers in the CSE group-wide affiliate structure'' to use the alternative method of computing net capital even if those broker-dealers do not meet the minimum capital levels. These comments, however, do not take into account certain regulatory and

[10] 15 U.S.C. 78o(c)(3).

[11] 17 CFR 240.15c3–1.

[12] 17 CFR 240.15c3–3.

bankruptcy considerations.[13] Accordingly, we are adopting the $1 billion tentative net capital and $500 million net capital requirements as proposed, but are setting forth these requirements in paragraph (a)(7)(i) of Rule 15c3–1 in the final rules.

We also are adding a new requirement to paragraph (a)(7) of Rule 15c3–1, as adopted. The final rules incorporate changes to the proposed rules that may allow firms to take smaller deductions for market and credit risk than the proposed rules would have permitted. Consequently, the final rules add paragraph (a)(7)(ii), which requires a broker-dealer to notify the Commission if the broker-dealer's tentative net capital falls below $5 billion. This $5 billion early warning requirement is based upon the staff's experience and the current levels of net capital maintained by the broker-dealers most likely to apply to use the alternative method of computing net capital. Upon written application, however, the Commission may exempt, either unconditionally or on specified terms and conditions, a broker-dealer from the $5 billion early warning requirement. To obtain an exemption, the broker-dealer must satisfy the Commission that because of the special nature of the firm's business, its financial positions, its internal risk management systems, and its compliance history, among other factors, application of the requirement is unnecessary or inappropriate in the public interest or for the protection of investors.

We also are revising Rule 15c3–1 to add paragraph (a)(7)(iii). Paragraph (a)(7)(iii) generally requires a broker-dealer that computes deductions for market and credit risk under Appendix E to comply with Rule 15c3–4 [14] as though it were an OTC derivatives dealer. Paragraph (a)(7)(iii) replaces proposed amendments to Rule 15c3–4 and is discussed in greater detail in the section of this release that addresses that rule.

The requirements of paragraph (a)(7), as revised, are intended to help ensure that a broker-dealer maintains prudent amounts of liquid assets against various risks that it assumes and that it maintain a robust internal risk management system. The current haircut structure seeks to ensure that broker-dealers maintain a sufficient capital base to account for operational, leverage, and liquidity risk, in addition to market and credit risk. We expect that use of the alternative net capital computation will reduce deductions for market and credit risk substantially for broker-dealers that use that method. Moreover, inclusion in net capital of unsecured receivables and securities that do not have a ready market under the current net capital rule will reduce the liquidity standards of Rule 15c3–1. Thus, the alternative method of computing net capital and, in particular, its requirements that broker-dealers using the alternative method of computing maintain minimum tentative net capital of at least $1 billion, maintain net capital of at least $500 million, notify the Commission that same day if their tentative net capital falls below $5 billion, and comply with Rule 15c3–4 are intended to provide broker-dealers with sufficient capital reserves to account for market, credit, operational, and other risks.

2. Entities That Have Principal Regulators

We are revising proposed paragraph (c)(13) of Rule 15c3–1. Proposed paragraph (c)(13) would have defined an ''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 section 15(b)(11) of the Exchange Act) and that belongs to one of two categories. Proposed paragraph (c)(13)(i), the first category, would have included insured depository institutions, entities registered with the Commodities Futures Trading Commission, or licensed or regulated insurance companies. Proposed paragraph (c)(13)(ii), the second category, would have included bank holding companies, savings and loan holding companies, and foreign banks that do business in the U.S. The proposed rules would have required entities in this second category to have in place appropriate arrangements to ensure that information provided to the Commission was sufficiently reliable for the purposes of proposed Appendix E and proposed Appendix G. The proposed rules also would have required these entities to be primarily in the insured depository institutions business (excluding their insurance and commercial businesses).

Several commenters stated that the Commission should revise the proposed rules to minimize duplicative or inconsistent requirements for holding companies that are subject to another regulator's consolidated supervision.[15] Commenters also stated that the Commission could better use its resources to supervise holding companies that do not otherwise have principal regulators. Moreover, commenters urged the Commission to provide as much clarity as possible, both for regulated entities and consolidated supervisors, about provisions intended to avoid duplicative or inconsistent requirements.

In response to these comments, we are adopting a revised definition of ''entity that has a principal regulator'' and adding a definition of an ''ultimate holding company that has a principal regulator.'' Creation of two definitions should help to clarify the scope of paragraph (c)(13) of Rule 15c3–1. We will not examine any entity that has a principal regulator and we will use the reports that it files with its principal regulator for our regulatory purposes, to the greatest extent possible.

Under the revised definition in paragraph (c)(13)(i) of Rule 15c3–1, an entity that has a principal regulator includes certain functionally regulated affiliates of the ultimate holding company that are not registered as a broker or dealer.[16] Entities that have principal regulators include insured depository institutions; futures commission merchants or introducing brokers registered with the Commodity Futures Trading Commission; entities registered with or licensed by a State insurance regulator that issues any insurance, endowment, or annuity policy or contract; and certain foreign banks.[17]

Paragraph (c)(13)(i) also includes Edge Act and Agreement Corporations, provided they are not primarily in the securities business. We added these entities to the definition of entity that has a principal regulator because they are subject to supervision by the Federal Reserve. Under these rules, the Commission may examine Edge Act and Agreement Corporations that primarily are in the securities business.[18]

[13] Bankruptcy or other statutes, rules, and regulations may restrict transfers from an entity in bankruptcy.

[14] 17 CFR 240.15c3–4.

[15] *See, e.g.*, Letter from Messrs. Michael J. Alix and Mark W. Holloway, Co-Chairs, CSE Steering Committee of the Securities Industry Association, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated February 27, 2004.

[16] This reference is to brokers or dealers registered under section 15(b)(11) of the Act (15 U.S.C. 78o(b)(11)).

[17] This category is limited to a foreign bank as defined in section 1(b)(7) of the International Banking Act of 1978 (12 U.S.C. 3101(7)) that has its headquarters in a jurisdiction for which any foreign bank has been approved by the Federal Reserve to conduct business pursuant to the standards set forth in 12 CFR 211.24(c), provided such foreign bank represents to that Commission that it is subject to the same supervisory regime as the foreign bank previously approved by the Federal Reserve.

[18] The Federal Reserve charters an ''Edge Act Corporation'' to engage in international banking. Section 25A of the Federal Reserve Act (12 U.S.C. 611–633). A state charters an ''Agreement

Continued

We also added paragraph (c)(13)(i)(F) of Rule 15c3–1 to the final rules. Under this paragraph, the Commission may determine if other types of entities subject to comprehensive supervision by other regulators qualify as entities that have principal regulators.[19]

The new definition of ultimate holding company that has a principal regulator in paragraph (c)(13)(ii) recognizes the concept of comprehensive, consolidated supervision. Any financial holding company or a company that is treated as a financial holding company under the Bank Holding Company Act of 1956[20] will be considered an ultimate holding company that has a principal regulator. Accordingly, any U.S. holding company or foreign bank that has elected financial holding company status will be an ultimate holding company that has a principal regulator.

By adopting this new definition of an ultimate holding company that has a principal regulator, we are recognizing the comprehensive, consolidated supervision of both the Federal Reserve and non-domestic bank regulators. In addition, because we will consider the entity that elected to be treated as a financial holding company to be an ultimate holding company that has a principal regulator, we will not need to look for a higher holding company level within a consolidated group. We also understand that all of the banking organizations that have expressed interest in the CSE proposal would qualify as financial holding companies or as companies that are treated as financial holding companies.

A bank holding company may elect to become a financial holding company and be eligible to engage in expanded financial activities if it is ''well capitalized'' and ''well managed.'' [21] In connection with financial holding company elections by foreign banks, the Federal Reserve also evaluates any foreign bank that operates a branch or agency, or owns or controls a commercial lending company in the United States under capital and management standards that are comparable to the standards applicable to U.S. banks and gives due regard to the principle of national treatment and equality of competitive opportunity.[22] For these foreign banking organizations, the Federal Reserve also reviews whether they are subject to comprehensive consolidated supervision.[23] The Federal Reserve has found that home country supervision is an important element in determining if a bank is well managed.[24]

Based on these requirements, we would not examine financial holding companies or companies that are treated as financial holding companies. In addition, under the rules as adopted, these entities are subject to a streamlined application process, fewer periodic reporting requirements, and may submit to the Commission the same measurement of capital that they submit to their primary regulator. Inclusion of these entities in the definition of ''ultimate holding company that has a principal regulator'' is intended reduce duplicative or inconsistent regulation because these entities already are subject to the reporting and examination requirements of the Federal Reserve.

Under paragraph (c)(13)(ii)(B), the Commission may determine that other persons also should be included as ultimate holding companies that have principal regulators if it finds that the persons are subject to consolidated, comprehensive supervision; there are in place appropriate arrangements so that information provided to the Commission is sufficiently reliable for the purposes of determining compliance with Appendix E and Appendix G; and based on the persons' businesses, it is appropriate to consider the persons ultimate holding companies that have principal regulators for the purposes of Appendix E and Appendix G. An affiliated broker-dealer of a domestic entity or a foreign bank that has not elected to be treated as a financial holding company could apply to use the alternative method of computing net capital. Paragraph (c)(13)(ii)(B) permits us to consider whether, in appropriate circumstances, the Commission should treat the domestic entity or foreign bank as an ultimate holding company that has a principal regulator.[25]

3. Tentative Net Capital

We are adopting an amended definition of tentative net capital. The proposed amendment to paragraph (c)(15) of Rule 15c3–1 would have defined ''tentative net capital'' for a broker-dealer using the alternative method of computing net capital as the net capital of the broker or dealer before deductions for market and credit risk computed pursuant to Appendix E to Rule 15c3–1 or paragraph (c)(2)(vi) of Rule 15c3–1, if applicable, and increased by the balance sheet value (including counterparty net exposure) resulting from transactions in derivative instruments that otherwise would be deducted by virtue of paragraph (c)(2)(iv) of Rule 15c3–1.

We are amending the definition of tentative net capital to include securities for which there is no ready market, as that term is defined under paragraph (c)(2)(11) of the net capital rule. This modification is necessary because, as discussed below, we eliminated the requirement that a security have a ready market to qualify for capital treatment using VaR models. Under the final rules, a broker-dealer may include securities for which there is no ready market in calculating tentative net capital under the alternative method only if the Commission has approved the use of mathematical models for purposes of calculating deductions to net capital for those securities pursuant to Appendix E.

C. Broker-Dealer Requirements Under Appendix E

Appendix E to Exchange Act Rule 15c3–1 describes the alternative method of computing net capital that a broker-dealer may use, including related application requirements. It also imposes requirements regarding internal risk management controls and reporting, and describes additional supervisory conditions that the Commission may impose on the broker-dealer in appropriate circumstances.[26] Under the final rules, once a broker-dealer has submitted an application, the Commission will review how the firm manages its market, credit, liquidity and

Corporation'' to engage in international banking activities. The Agreement Corporation enters into an ''agreement'' with the Federal Reserve to limit its activities to those that an Edge Act Corporation may undertake. Section 25 of the Federal Reserve Act (12 U.S.C. 601–604a). The purpose of both Edge Act Corporations and Agreement Corporations is to aid in financing and stimulating foreign trade. These entities may engage only in international banking or other financial transactions related to international business. The Board of Governors approves or denies applications to establish Edge Act Corporations and also examines both Edge Act and Agreement Corporations and their subsidiaries.

[19] The Commission will determine if there are in place appropriate arrangements so that information that the person provides to the Commission is sufficiently reliable for the purposes of determining compliance with Appendices E and G, and it is appropriate to deem the person to be an entity that has a principal regulator considering all relevant circumstances, including the person's mix of business.

[20] 12 U.S.C. 1840 *et seq.*

[21] 12 U.S.C. 1843(l)(1) and 12 CFR 225.81(b).

[22] 12 U.S.C. 1843(l)(3) and 12 CFR 225.90.

[23] 12 CFR 225.92(e).

[24] *Id.*

[25] This paragraph also governs the application of 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)).

[26] We have replaced old Appendix E. Old Appendix E outlined a phase-in schedule for increased minimum net capital requirements for broker-dealers. The increased net capital minimums were fully effective as of July 1, 1994. Exchange Act Release No. 31511.

funding, legal, and operational risk, and its mathematical models, to determine if the broker-dealer has met the requirements of Appendix E and is complying with other applicable rules. The Commission also will review whether the broker-dealer's ultimate holding company is complying with the terms of the undertaking that it agrees to provide as a condition of the broker-dealer's use of the alternative method of computing net capital.

1. Application

Under proposed paragraph (a) of Appendix E, a broker-dealer would have applied to the Commission for an exemption from the standard net capital rule and for permission to calculate certain deductions for market and credit risk in accordance with Appendix E.[27] Proposed paragraph (a) described the various types of information that the broker-dealer would have submitted to allow the Commission to determine whether an exemption from the net capital rule was necessary or appropriate in the public interest or for the protection of investors.

a. Information To Be Submitted by the Broker-Dealer

As proposed, paragraph (a)(1) of Appendix E would have required a broker-dealer that applied to use the alternative method of computing net capital to include with its application financial, risk management, and other information about the firm. Specifically, broker-dealers would have been required to submit to the Commission a description of their internal risk management control system and how that system satisfies the requirements of Rule 15c3–4, together with a description of the method the broker-dealer intended to use to calculate deductions to net capital. We did not receive substantive comments on this rule related to information to be submitted about the broker-dealer and paragraph (a)(1) of Appendix E has been adopted as proposed.[28]

b. Confidential Treatment

A broker-dealer's application for exemption from the standard net capital rule and all submissions in connection with the application will be accorded confidential treatment, to the extent permitted by law. We received comments expressing some concern with the Commission's ability to maintain the confidentiality of documents and information filed with the Commission under these rules. Under the final rules, broker-dealers and ultimate holding companies will submit information to the Commission based on their understanding that the information will remain confidential. The information that we expect to receive from these entities is, by its nature, competitively sensitive. For example, we understand that broker-dealers and their holding companies have a commercial interest in their risk models, risk management systems and processes, and data that they obtain through use of these models, systems, and processes. We also have been advised that if the Commission were unable to afford confidential protection to the information that we expect to receive from broker-dealers and their ultimate holding companies, firms may hesitate to apply for the exemption from the standard net capital rule and consent to Commission supervision at the ultimate holding company level. This result would undermine and jeopardize the viability of the CSE system.

The Freedom of Information Act (''FOIA'') provides at least two exemptions under which the Commission has authority to grant confidential treatment for applications filed under this rule. First, FOIA Exemption 4 provides an exemption for ''trade secrets and commercial or financial information obtained from a person and privileged or confidential.'' [29] As specified in paragraph (a)(5) of new Appendix E, ''all information submitted in connection with the application will be accorded confidential treatment to the extent permitted by law.'' The information to be filed with the Commission concerns firms' trading strategies, risk profiles, financial positions, and other information that is protected from disclosure under Exemption 4.

Second, FOIA Exemption 8 provides an exemption for matters that are ''contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions.'' Similarly, Commission Rule 80(b)(8), Commission Records and Information, implementing Exemption 8, states that the Commission generally will not publish or make available to any person matters that are ''contained in, or related to, any examination, operating, or condition report prepared by, on behalf of, or for the use of, the Commission, any other Federal, state, local, or foreign governmental authority or foreign securities authority, or any securities industry self-regulatory organization, responsible for the regulation or supervision of financial institutions.'' [30] Significantly, the courts have ruled consistently that Exemption 8 provides categorical protection for information related to such reports.

c. Commission Review

Paragraph (a)(6) of proposed Appendix E would have permitted the Commission to approve a broker-dealer's application to use the alternative method of computing net capital, subject to the imposition of any conditions or limitations that the Commission found were necessary or appropriate in the public interest or for the protection of investors, after a review of whether the broker-dealer met the requirements of Appendix E; the broker-dealer was in compliance with other, applicable Exchange Act provisions or rules or rules of a self-regulatory organization; and the ultimate holding company was in compliance with applicable terms of its undertaking, which are conditions for the approval. We did not receive comments on this provision and the Commission is redesignating paragraph (a)(6) as paragraph (a)(7) of Appendix E and adopting it as proposed, with one exception.[31] We clarify in paragraph (a)(7), as adopted, that the Commission also must approve amendments to a broker-dealer's application to use the alternative method of computing net capital. Furthermore, note that paragraph (a)(1)(ix)(D), which describes the undertaking that an ultimate holding company that has a principal regulator must provide as a condition of its affiliated broker-dealer's exemption from the standard net capital rule, limits the conditions that the Commission may place on an ultimate holding company that has a principal regulator in

[27] 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 amends a VaR model that it uses to calculate a deduction for market or credit risk.

[28] As described below, however, the Commission has amended the undertaking provisions of paragraph (a)(1) to describe separately the requirements for an undertaking that a broker-dealer must submit for an ultimate holding company that does not have a principal regulator and an ultimate holding company that has a principal regulator.

[29] *See* 5 U.S.C. 552(b)(4).

[30] *See* 5 U.S.C. 552(b)(4).

[31] In its undertaking, an ultimate holding company agrees to comply with the applicable provisions of Appendices E and G as a condition to the broker-dealer's use of the alternative method of computing net capital. Appendix E, for example, requires a broker-dealer to include specified information from the ultimate holding company with the broker-dealer's application to compute deductions for market and credit risk under Appendix E. If the ultimate holding company did not produce the requisite information, it would not be in compliance with the terms of its undertaking.

approving the broker-dealer's exemption application.[32]

Paragraph (a)(7) of proposed Appendix E would have required a broker-dealer to amend and resubmit to the Commission its application for exemption from the standard net capital rule if the broker-dealer desired to change materially a mathematical model used to calculate deductions for market or credit risk or its internal risk management control system. We did not receive comment on this requirement and are redesignating paragraph (a)(7) as paragraph (a)(8) and adopting it as proposed.

Paragraph (a)(8) of proposed Appendix E would have required a broker-dealer to report any material changes to its or its ultimate holding company's corporate structure. The final rules do not include this notification requirement because it is redundant. The Commission will receive notification of the changes as part of the regular filings that the ultimate holding company submits under paragraph (b) of Appendix G.

Paragraph (a)(9) of proposed Appendix E would have required a broker-dealer to notify the Commission 45 days before it ceased using the alternative method of computing net capital under Appendix E. Under the proposed paragraph, the Commission could have ordered a shorter or longer notification period upon broker-dealer consent or if the Commission found that a shorter or longer period was necessary or appropriate in the public interest or for the protection of investors. We did not receive any comments on this requirement. We are redesignating paragraph (a)(9) as paragraph (a)(10) and adopting it as proposed.

Paragraph (a)(10) of proposed Appendix E would have permitted the Commission, by order, to revoke a broker-dealer's exemption from the standard net capital rule under Appendix E if the Commission found that the exemption no longer was necessary or appropriate in the public interest or for the protection of investors. A broker-dealer that no longer could use Appendix E would have been required to compute its capital charges using the standard haircut method.

A commenter suggested that the Commission's authority to revoke a broker-dealer's exemption from the standard net capital rule ''should clarify that any limitations or remedial action must be narrowly circumscribed to address the relevant deficiency.'' The commenter also asserted the Commission should limit revocation of the exemption ''to instances in which the Commission finds a material capital deficiency or a substantial pattern of material non-compliance.''

In response to comments received, we are amending paragraph (a)(10). We also are redesignating paragraph (a)(10) as paragraph (a)(11) in Appendix E, as adopted. Paragraph (a)(11) adds a description of the factors that the Commission will rely evaluate in determining whether to revoke a broker-dealer's exemption from the net capital rule. Specifically, the Commission will consider the compliance history of the broker-dealer related to its use of models, the financial and operational strength of the broker-dealer and its ultimate holding company, and the broker-dealer's compliance with its internal risk management controls.

2. Risk Management Control System

Under proposed paragraph (b) of Appendix E, a broker-dealer using the alternative method of computing net capital would have been required to establish, document, and maintain an internal risk management control system that met the requirements of § 240.15c3–4.[33] The rule amendments, as adopted, do not include this requirement. Proposed paragraph (b) is omitted as unnecessary because the broker-dealer must comply with Rule 15c3–4 under Rule 15c3–1(a)(7)(iii), as adopted.

3. Computation of the Deduction for Market Risk

Commenters generally supported the method for calculating a broker-dealer's deductions for market risk described in paragraph (c) of proposed Appendix E. They raised several issues with respect to specific provisions for calculating the deduction, however. We address those issues in the sections that follow.

As a preliminary matter, we note that a broker-dealer must compute its deduction for market risk monthly. Paragraph (c) of proposed Appendix E would have required a daily computation of the deduction for market risk. Commenters raised a question as to whether a broker-dealer would be required to make daily capital computations and, if so, stated that daily computations would be unnecessary and burdensome. We have revised these sections to clarify that as part of their risk management practices, firms must compute VaR and current exposures daily. We note, however, that a broker-dealer must be in compliance with net capital requirements at all times.

Under paragraphs (c)(1) and (2) of proposed Appendix E, the deduction for market risk would have been equal to the amount of the sum of the following: (i) For positions for which the Commission has approved the use of VaR models, the VaR of those positions multiplied by the appropriate multiplication factor; (ii) for positions for which the Commission has approved the use of scenario analysis, the greatest adverse movement of the positions, or some multiple thereof based on liquidity or, if greater, a minimum deduction; and (iii) for all other positions, a deduction under the standard haircut method of paragraph (c)(2)(vi) Rule 15c3–1.

Paragraph (b)[34] of Appendix E, as adopted, describes the method of computing a broker-dealer's deduction for market risk. A broker-dealer's deduction for market risk under paragraph (b) is an amount equal to the sum of the following: (i) For positions for which the Commission has approved the broker-dealer's use of VaR models, the VaR of those positions multiplied by the appropriate multiplication factor; (ii) for positions for which the VaR model does not incorporate specific risk, a deduction for specific risk to be determined by the Commission based on a review of the broker-dealer's application and the positions involved; (iii) for positions for which the Commission has approved the use of scenario analysis, the greatest loss resulting from the scenario over any ten-day period, or some multiple thereof based on liquidity or, if greater, a minimum deduction; and (iv) for all other positions, a deduction under § 240.15c3–1(c)(2)(vi), (c)(2)(vii), and applicable appendices to § 240.15c3–1. We address each of the deductions for market risk in the sections that follow.

a. Deductions for Market Risk Using VaR Models

As noted, a broker-dealer may use a VaR model to calculate its deduction for market risk for those positions for which the Commission has approved the use of VaR models. To calculate the deduction, the broker-dealer multiplies the VaR of those positions by the appropriate multiplication factor. The multiplication factor is intended to help provide adequate capital during periods of market stress or other eventualities.[35] The results of quarterly backtests

[32] Refer to section (D)(a)(ii) of this release for a discussion of the undertaking for an ultimate holding company that has a principal regulator.

[33] *See infra,* discussion of proposed amendments to Rule 15c3–4.

[34] The final rules redesignate paragraph (c) of proposed Appendix E as paragraph (b).

[35] 17 CFR 240.15c3–1e(b)(1).

determine which of the multiplication factors contained in Table 1 of Appendix E a broker-dealer must use, except that the broker-dealer must use an initial multiplication factor of three.[36]

We have amended the proposed rules with regard to specified provisions of the VaR models used for computing a deduction for market risk.

i. Elimination of the VaR Phase-in Period

In response to comments received, Appendix E, as adopted, no longer includes the phase-in period for VaR models. Under paragraph (c)(3) of proposed Appendix E, the Commission would have phased in the use of VaR models to calculate deductions for net capital for three bands of positions over a period of at least 18 months. Commenters stated that implementation of VaR for calculation of deductions for market risk on a phased-in basis would impose unnecessary operational costs and inefficiencies. Elimination of the phase-in requirement is intended to promote more effective group-wide risk management and eliminate unnecessary operational costs and inefficiencies. Therefore, upon Commission approval of its VaR models, a broker-dealer may use its VaR models to calculate deductions for market risk capital for all positions for which the broker-dealer can demonstrate that its modeling procedures meet the applicable requirements in the final rules.

ii. Positions With No ''Ready Market'' Under VaR

Paragraph (c)(2) of proposed Appendix E generally would have prohibited the use of VaR models to compute deductions for market risk for positions with no ''ready market''; debt securities that are below investment grade; and any derivative instrument based on the value of these positions, unless the Commission granted the broker-dealer's application to use a VaR model for those positions. Under paragraph (c)(2)(vii) of the net capital rule, positions for which there is no ''ready market,'' as defined in section 240.15c3–1(c)(11),[37] would have excluded these positions from inclusion in VaR models; that is, the positions would have been subject to a 100% deduction.

Commenters asserted that, while positions with no ready market may lack historical data sufficient to allow accurate modeling, the rules should require a broker-dealer to demonstrate that its models adequately capture the material risks associated with the categories of securities in which they transact business, not limit use of VaR to those securities that have a ready market. We agree with the commenters and, therefore, Appendix E, as adopted, does not limit a broker-dealer's use of VaR models for computing deductions for market risk to securities that have a ''ready market.''

b. Deductions for Specific Risk

Paragraph (b)(2) of Appendix E may require a deduction for specific risk because of the reliance on VaR models for regulatory purposes, particularly for determining deductions for market risk for securities with no ready market. Generally, specific risk is the risk associated with how the price-change on an individual position may differ from broad, market-wide changes in prices. If the VaR models that a broker-dealer uses to compute deductions for market risk incorporate specific risk, there is no additional deduction for specific risk in determining the deduction for market risk. If, however, the VaR models do not incorporate specific risk, paragraph (b)(2) requires a broker-dealer to include separate deductions for specific risk. The Commission will determine the deduction for specific risk on a case-by-case basis based on a review of the broker-dealer's application and the positions involved.

c. Deduction for Market Risk Using Scenario Analysis

The Commission is amending the proposed rule on calculation of deductions for market risk using scenario analysis. Under the paragraph (c)(5) of proposed Appendix E, the deduction for market risk calculated using scenario analysis generally would have been three times the greatest adverse movement resulting from the scenario analysis over any ten-day period. Paragraph (b)(3)[38] of Appendix E, as adopted, permits a broker-dealer to determine a deduction for market risk using scenario analysis for those positions for which the Commission has approved the broker-dealer's application to use scenario analysis. The deduction will be the greatest loss resulting from a range of adverse movements in relevant risk factors, prices, or spreads designed to represent a negative movement greater than, or equal to, the worst ten-day movement over the four years preceding calculation of the loss, or some multiple of that movement based on liquidity. Permitting the use of scenario analysis to calculate the deduction for market risk will provide the broker-dealer with greater flexibility in determining how it may use mathematical models to calculate market risk deductions for securities for which a deduction calculated using VaR would not be appropriate. The minimum deduction for market risk computed for positions using scenario analysis is the same under the final rules as it was in the proposed rules.

The final amendments also change the period over which the greatest adverse ten-day movements of data are evaluated. Paragraph (c)(5) of proposed Appendix E would have required the scenario to include a range of adverse movements of risk factors, prices, or spreads that move by the greatest amounts over the past five years, or a three standard deviation movement in those risk factors, prices, or spreads over a ten-day period. Commenters suggested that the period related to ten-day movements be reduced from five to four years. In response to comments received, the final amendments reduce the period over which the greatest adverse ten-day movements of data are determined to four years. This change is intended to approximate more closely a ten-day movement of prices to a 99% confidence level.

The rule as proposed would have allowed for the use of a three standard deviations alternative if historical data for use in a scenario analysis were limited. Commenters expressed concern that this requirement would restrict the use of scenario analysis when historical data is limited. We are amending the proposed rule to clarify, under paragraph (b)(3) of Appendix E, as adopted, that a broker-dealer may use implied data or price histories of similar securities to calculate the three standard deviation movement if historical data is insufficient.

[36] Paragraph (e)(2)(iii) of proposed E would have required the VaR model to use an effective historical observation period of at least one year and to include periods of market stress in that historical observation period. One commenter observed that a one-year period might not contain periods of market stress. To address this concern, under paragraph (d)(2)(iii) of Appendix E, as adopted, a broker-dealer must consider the effects of market stress in its construction of the model.

[37] Under § 240.15c3–1(c)(11), ''[t]he term 'ready market' shall include a recognized established securities market in which there exists independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom.''

[38] Paragraph (c)(5) of proposed Appendix E has been redesignated as paragraph (b)(4) under Appendix E, as adopted.

d. Deductions for Market Risk Under the Standard Net Capital Rule

Paragraph (c)(6) of proposed Appendix E would have required a broker-dealer to compute a deduction for market risk using the ''haircut method'' of the standard net capital rule for a position not subject to a deduction for market risk computed using VaR models or scenario analysis. Haircuts are calculated under paragraphs (c)(2)(vi), (c)(2)(vii), and applicable appendices of the standard net capital rule, Rule 15c3–1.[39] By requiring a broker-dealer to use the haircut method of the standard net capital rule in appropriate circumstances, the Commission intended that a broker-dealer use paragraph (c)(2)(vii), if applicable. Proposed paragraph (c)(6), however, did not reference paragraph (c)(2)(vii) specifically. Paragraph (b)(4)[40] of Appendix E, as adopted, clarifies that a broker-dealer must compute deductions for market risk under both paragraphs (c)(2)(vi) and (c)(2)(vii) of the standard net capital rule, if applicable. Paragraph (c)(2)(vii), as noted, requires a 100% deduction for positions for which there is no ready market.

4. Computation of the Deduction for Credit Risk

A broker-dealer approved to calculate deductions for market risk using VaR models or scenario analysis must calculate its deduction for credit risk according to paragraph (c)[41] of Appendix E, as adopted, on credit exposures arising from the broker-dealer's positions in derivatives instruments. The deduction for credit risk is the sum of the following three categories of charges: (i) A counterparty exposure charge under paragraph (c)(1), (ii) concentration charges by counterparty under paragraph (c)(2), and (iii) a portfolio concentration charge for all counterparties under paragraph (c)(3). The deductions required for each of these categories are designed to address different components of credit risk.

a. Counterparty Exposure Charge

We are adopting the counterparty exposure charge as proposed, with the exception of the determination of counterparty credit risk weights. For each counterparty, the broker-dealer must compute a counterparty exposure charge equal to the net replacement value in the account of each counterparty that is insolvent, in bankruptcy, or has senior, unsecured long-term debt in default. For counterparties that are not insolvent, in bankruptcy, or in default, the counterparty exposure charge also includes the ''credit equivalent amount'' of the broker-dealer's exposures to the counterparty, multiplied by the credit risk weight of the counterparty, then multiplied by 8%.[42] The credit equivalent amount of a broker-dealer's exposure to a counterparty is defined in paragraph (c)(4)(i) of Appendix E, as adopted, as the sum of: (1) The broker-dealer's maximum potential exposure (''MPE'') to the counterparty multiplied by the appropriate multiplication factor, and (2) the broker-dealer's current exposure to the counterparty. Under paragraph (d)(1)(v)[43] of Appendix E, as adopted, the multiplication factor applicable to MPE generally is determined based on backtesting results of the VaR model used to calculate MPE, except that the initial multiplication factor is one.

Paragraph (c)(4)(ii) of Appendix E defines MPE as VaR of the counterparty's positions with the broker-dealer, after applying netting agreements, taking into account the value of certain collateral received from the counterparty, and taking into account the current replacement value of the counterparty's positions with the broker-dealer. The broker-dealer must calculate MPE using a VaR model that meets the applicable quantitative and qualitative requirements of Appendix E. Paragraph (c)(4)(iii) of Appendix E, as adopted, defines ''current exposure'' as the replacement value of the counterparty's positions with the broker-dealer, after applying specified netting agreements[44] and taking into account the value of certain collateral[45] received from the counterparty.

In the Proposing Release, the credit risk weights would have ranged from 20% to 150%, depending on the credit rating of the counterparty, which provides a measure of credit risk. For a counterparty not rated by a nationally recognized statistical rating agency (''NRSRO''), the broker-dealer could have applied to the Commission for permission to determine a credit rating for the counterparty using internal calculations and to use that internal rating to determine the credit risk weight of the counterparty. For exposures covered by guarantees, a broker-dealer could have substituted the average of the credit risk weights of the guarantor and the counterparty for the credit risk weight of the counterparty, subject to specified conditions. These proposed credit risk weights were based on the formulas provided in the Foundation Internal Ratings-Based approach to credit risk proposed by the Basel Committee[46] and were derived using a loss given default (the percent of the amount owed by the counterparty the firm expects to lose if the counterparty defaults) of 75%.

We requested comment on the determination of credit risk weights. In particular, we requested comment on whether a broker-dealer should be permitted to apply to the Commission for permission to determine the credit risk weights of counterparties using internal calculations. We also requested comment on whether, in a calculation of credit risk weights based on internal estimates of annual probabilities of default, the proposed table appropriately matched credit risk weights to annual probabilities of default.

Several commenters stated that broker-dealers should be allowed to calculate credit risk weights based on internal estimates of annual probabilities of default, but that a 75% loss given default assumption was too conservative. One commenter stated that the loss given default percentage should be a function of the issuer, industry type, and debt class.

Based on comments received, we are permitting a broker-dealer to request Commission approval to determine counterparty credit risk weights using internal calculations under paragraph (c)(4)(vi)(E) of Appendix E, as adopted. These internally calculated credit risk weights are in addition to the credit risk weights contained in paragraphs (c)(4)(vi)(A) through (C) of Appendix E, as adopted. Paragraph (c)(4)(vi)(E) does not include any specific maturity adjustment factor, although we note that the Basel Standards use a maturity

[39] *See* 17 CFR 240.15c3–1(c)(2)(vi) and (vii).

[40] Proposed paragraph (c)(6) has been redesignated as paragraph (b)(4) under the final rules.

[41] Paragraph (d) of proposed Appendix E has been redesignated as paragraph (c) under Appendix E, as adopted.

[42] 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 help ensure that the firm maintains a safe level of capital.

[43] Paragraph (e) of proposed Appendix E has been redesignated as paragraph (d) of Appendix E, as adopted.

[44] Only netting agreements that meet the requirements of paragraph (c)(4)(iv) of Appendix E may be used to reduce current exposure and maximum potential exposure. For example, the netting agreements must be legally enforceable in each relevant jurisdiction, including in insolvency proceedings.

[45] Only collateral that meets the requirements of paragraph (c)(4)(v) of Appendix E may be used to reduce current exposure and maximum potential exposure.

[46] The New Basel Capital Accord, Basel Committee on Banking Supervision (April 2003).

adjustment factor of 2.5 years in their standard approach. Furthermore, in the Proposing Release, we requested comment on whether a proposed table of credit risk weights appropriately matched credit risk weights to annual probabilities of default. Commenters responded that the matches were not appropriate. Accordingly, rather than provide a table of credit risk weights corresponding to internal estimates of annual probabilities of default in the final rule, we will evaluate the method of determining credit risk weights the broker-dealer proposes in its application.

b. Concentration Charge by Counterparty

The Commission is adopting paragraph (c)(2) of Appendix E, the concentration charge by counterparty,[47] as proposed.[48] This charge accounts for the additional risk resulting from a relatively large exposure to a single party. The charge consists of concentration charges by counterparty that generally would 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 is larger for counterparties with lower credit ratings and ranges 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% criterion is based on the OTC derivatives dealer rules and the experience of Commission staff.

c. Portfolio Concentration Charge

The Commission is adopting an amended portfolio concentration charge under paragraph (c)(3)[49] of Appendix E. The portfolio concentration charge for credit risk addresses the risk of holding a relatively large amount of unsecured receivables. Proposed paragraph (d)(9) would have required firms to take a portfolio concentration charge across all counterparties equal to the amount, if any, that the broker-dealer's aggregate current exposure arising from transactions in derivative instruments across all counterparties exceeded 15% of the broker-dealer's tentative net capital. Commenters expressed concern that the portfolio concentration charge would be onerous because it would attach at a relatively low threshold and, consequently, restrict the scope of derivatives activity that could be booked in the broker-dealer in a capital-efficient manner. In response to comments received, the Commission has increased the threshold at which the portfolio concentration charge attaches. Under these final rules, a broker-dealer is subject to a charge on the amount, if any, that the broker-dealer's aggregate current exposure for all counterparties for unsecured exposures exceeds 50%, rather than 15%, of the broker-dealer's tentative net capital. Based on staff experience, we believe that the threshold at which the portfolio concentration charge attaches should help a broker-dealer maintain sufficient liquid capital while allowing the broker-dealer to book derivative transactions in a capital-efficient manner.

5. Qualitative and Quantitative Standards Applicable to Calculations Under Models

Paragraph (e)[50] of proposed Appendix E set forth the qualitative and quantitative requirements that broker-dealers would have been required to comply with to calculate deductions using VaR models.[51] These requirements were intended to make the capital charges based on the VaR measures a more accurate measure of losses that could occur during periods of market stress. We derived the requirements from 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 have required that: (i) The VaR models used to calculate deductions for market and credit risk be the same models used to report market and credit risk to the firm's senior management and be integrated into the internal risk management system of the firm; (ii) the VaR models 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;[52] and (iii) for purposes of computing market risk, the multiplication factor be determined based on quarterly backtesting of the VaR models used to calculate market risk and by reference to Table 1 of Appendix E.

The proposed quantitative standards would have required each model to: (i) Use a 99 percent, one-tailed confidence level with price changes equivalent to a ten business-day or one-year movement in rates and prices for purposes of determining market and credit risk, respectively; (ii) use an effective historical observation period of at least one year in length that included periods of market stress; and (iii) take into account and incorporate all significant, identifiable market risk factors applicable to the firm's positions.[53]

In the Proposing Release, we requested comment on the proposed use of mathematical models for regulatory capital purposes, including the proposed quantitative and qualitative requirements and the proposed backtesting procedures for the models. One commenter stated that one year might not contain periods of market stress. To address this concern, the rule as adopted, in addition to the one-year minimum, provides that the broker-dealer must consider the effects of market stress in its construction of the model.

Paragraph (e)(1)(iv)[54] of proposed Appendix E would have required broker-dealers to determine multiplication factors for purposes of computing the credit equivalent amount of the firm's exposure to a counterparty based on results of backtesting of the model used to calculate MPE. This paragraph would have required firms to conduct the backtesting by comparing, for at least 40 counterparties, the daily change in current exposure based on the end of the previous day's positions with the corresponding MPE for the counterparty generated by the model.

One commenter stated that because MPE is based on a one-year time horizon, it is inconsistent to compare it with a one-day change in current exposure. The commenter also stated that the Commission should allow the use of VaR models based on information implied from market prices for one-year horizon potential exposure calculations. According to the commenter, the potential exposure models that utilize implied parameters are in widespread use in the financial industry. We will consider whether a firm should be

[47] Concentration charges are intended to provide a liquidity cushion if a lack of diversification of positions exposes the broker-dealer to additional risk. When evaluating credit risk, 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) would evidence a lack of diversification.

[48] We redesignated paragraph (d)(7) of proposed Appendix E as paragraph (c)(2) of Appendix E, as adopted.

[49] Paragraph (d)(9) of Appendix E, as proposed, has been redesignated as paragraph (c)(3) of Appendix E, as adopted.

[50] Paragraph (e) of proposed Appendix E has been redesignated as paragraph (d) of Appendix E, as adopted.

[51] 17 CFR 240.15c3–1e(e)(1) and (2).

[52] ''Registered public accounting firm'' is defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 *et seq.*) as ''a public accounting firm registered with the [Public Company Accounting Oversight] Board in accordance with this Act.''

[53] Proposed Rule 15c3–1e(e)(2).

[54] Paragraph (e)(1)(iv) of proposed Appendix E has been redesignated as paragraph (d)(1)(v) of Appendix E, as adopted.

permitted to use implied parameters in potential exposure calculations if the firm requests consideration of this issue in its application.

Furthermore, in response to comments received and to strengthen and improve the backtesting requirement we have amended both paragraphs (d)(1)(v)(A) and (B) of Appendix E, as adopted. Under these paragraphs as amended, the MPE horizon is ten business days, rather than one day. The ten-day requirement is consistent with the VaR models broker-dealers use. In conducting backtesting, the broker-dealer must compare the change in current exposure to the counterparty based on its positions held at the beginning of the ten-business day period to the corresponding ten-business day MPE for the counterparty generated by the VaR model.

Moreover, we re-evaluated the requirement that the broker-dealer compare at least 40 counterparties in conducting conduct backtesting. Based on that re-evaluation and staff experience, we determined that to help ensure a sufficient number of data points and, therefore, an appropriate sample for backtesting, the broker-dealer must compare at least 80 counterparties under paragraph (d)(1)(v)(A) of Appendix E, as adopted, rather than 40 counterparties, as proposed.

Paragraph (e)(2)(ii) of proposed Appendix E would have required the VaR model to use a time horizon of one year for purposes of determining MPE. Several commenters stated that the time horizon should be ten business days if the position is marked to market daily and a written agreement enforceable against the counterparty provides that the broker-dealer or its affiliate may call for additional collateral daily.

In response to comments received, a broker-dealer may use a time horizon of not less than ten business days to calculate MPE under paragraph (d)(2)(ii) [55] of Appendix E, as adopted. Generally, if collateral is not posted to, and held by, the broker-dealer, the broker-dealer must use the one-year time horizon when calculating MPE. If, however, there is a valid collateral agreement, the Commission may approve a shorter time horizon based on a review of the broker-dealer's procedures for managing collateral. The broker-dealer also must be able to mark the collateral to market daily and have the ability to call the collateral daily. This modification of the time horizon requirement should help a broker-dealer to maintain a liquid capital base while promoting operational efficiency.

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

We are revising paragraph (f) of proposed Appendix E and redesignating it as paragraph (e) of Appendix E, as adopted. Paragraph (f) of proposed Appendix E would have permitted the Commission, in specified circumstances, to condition a broker-dealer's continued use of the alternative method of computing net capital on the broker-dealer's or its ultimate holding company's compliance with additional conditions. Additional conditions imposed on the broker-dealer could have included, but would not have been limited to, restrictions on the scope of the broker-dealer's business, submission of a plan to increase its net capital or tentative net capital, or calculation of some or all of its deductions for market and credit risk according to the standard net capital method of Rule 15c3–1.

Paragraph (e) of Appendix E, as adopted, clarifies in the rule text that we may require a broker-dealer to calculate some or all of its deductions to net capital under paragraph (c)(2)(vii) of the standard net capital rule, if applicable. As noted above, we stated in Proposing Release that we intended a broker-dealer using the alternative method of computing net capital to use the haircut method of the standard net capital rule to compute appropriate deductions to net capital when the alternative method could not be applied. A broker-dealer calculates haircuts under paragraphs (c)(2)(vi), (c)(2)(vii), and applicable appendices of Rule 15c3–1. Although we did not reference paragraph (c)(2)(vii) in the proposed rule text, we indicated that haircuts were to be used to compute deductions to net capital in specified circumstances, thus requiring a broker-dealer to make the computation under paragraph (c)(2)(vii), if appropriate, together with (c)(2)(vi) and applicable appendices of Rule 15c3–1.

As noted, paragraph (f) of proposed Appendix E also would have permitted the Commission to impose certain additional requirements on the broker-dealer's ultimate holding company, subject to specified conditions. One commenter stated that if the ultimate holding company is a bank holding company that complies with its regulator's capital requirements on a consolidated basis, any capital remedies should be imposed on the broker-dealer and not on the ultimate holding company. Another commenter stated that if the Commission has concerns about the risk models or procedures in the ultimate holding company's capital calculation, it should address the concerns by imposing additional capital charges on the broker-dealer, not by requiring a change in the risk models or procedures.

Paragraph (e) of Appendix E, as adopted, clarifies that the Commission only may impose additional conditions on an ultimate holding company that does not have a principal regulator. If the Commission has concerns with respect to the risk models or risk management system of an ultimate holding company that has a principal regulator, the Commission may impose additional regulatory requirements on the broker-dealer.

Paragraph (e) of Appendix E, as adopted, outlines circumstances under which the Commission may impose additional conditions on the broker-dealer or the ultimate holding company that does not have a principal regulator. First, as discussed above, we added a provision that states that the Commission may impose additional conditions if the broker-dealer must notify the Commission under paragraph (a)(7)(ii) of Rule 15c3–1 that its tentative net capital is below $5 billion. Notification is necessary because this event indicates that the broker-dealer or ultimate holding company might be approaching financial difficulty. Second, we added a provision that allows the Commission to impose additional regulatory requirements on the broker-dealer or an ultimate holding company that does not have a principal regulator if the broker-dealer fails to comply with Appendix E. The authority to impose these requirements is essential to the Commission's ability to address risks to the broker-dealer.

7. Recordkeeping

The Commission did not propose amendments to Rule 17a–3 because that rule already requires a broker-dealer to create and maintain records sufficient for the Commission to examine the broker-dealer adequately, regardless of whether the broker-dealer uses the alternative or standard method of computing net capital. Broker-dealers currently must make various records, including blotters containing an itemized daily record of all purchases and sales of securities, and all receipts and deliveries of securities, cash, and other debits and credits. Under the existing requirements in Rule 17a–3, a broker-dealer can provide the Commission with a separate record of all transactions between itself and all affiliates in the affiliate group. Consistent with the Commission's supervision of inter-group transactions,

[55] Paragraph (e)(2)(ii) of proposed Appendix E has been redesignated as paragraph (d)(2)(ii) of Appendix E, as adopted.

the Commission may obtain and review a record of inter-group transactions as part of its supervisory reviews under Rule 17a–3.

D. Ultimate Holding Company Requirements

Under the rule amendments, an ultimate holding company is subject to requirements under both Appendix E and Appendix G. Appendix E primarily requires the ultimate holding company to submit specified information to the Commission with the broker-dealer's application to use the alternative method of computing net capital. Appendix G outlines the ultimate holding company's obligations with respect to calculation of allowable capital, allowances for certain capital charges, and certain recordkeeping and reporting requirements.

1. Ultimate Holding Company Requirements Under Appendix E

Under Appendix E as proposed, a broker-dealer's ultimate holding company would have submitted specified information to the Commission with the broker-dealer's application to use the alternative method of computing net capital. This information would have been similar to the information that 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 this information to be useful in gaining insight into the financial condition, internal risk management control system, risk exposure, and activities of the broker-dealer and its ultimate holding company and material affiliates.[56] The information provided in these documents would have been key considerations in determining the continued viability of the broker-dealer because serious adverse conditions at the ultimate holding company or a material affiliate likely would have exposed the broker-dealer to liquidity or other risks.

In response to comments received, we have revised the final rules to set forth separately the requirements for information that an ultimate holding company that has a principal regulator must submit to the Commission from the requirements for information that an ultimate holding company that does not have a principal regulator must submit to the Commission. These requirements are addressed below in detail.

a. Ultimate Holding Company Undertaking

As a condition to a broker-dealer's use of the alternative method of computing net capital, proposed paragraph (a)(1)(viii) of Appendix E would have required the broker-dealer to include with its application a written undertaking by the broker-dealer's ultimate holding company. Other than with respect to holding companies subject to group-wide supervision by other regulators, we did not receive specific comments on these proposed requirements. Nevertheless, we are revising paragraph (a)(1)(viii) to reflect that we no longer are amending Rule 15c3–4. Moreover, we have revised the final rules to set forth separately, in paragraph (a)(1)(ix), the requirements for an undertaking submitted by an ultimate holding company that has a principal regulator.

i. Ultimate Holding Company That Does Not Have a Principal Regulator

As a condition to its use of the alternative method for computing net capital, paragraph (a)(1)(viii) of Appendix E, as adopted, requires a broker-dealer to file a written undertaking by its ultimate holding company, signed by a duly authorized person at the ultimate holding company, in which the ultimate holding company agrees, among other things, to:

- Comply with all applicable provisions of Appendices E and G to Rule 15c3–1;
- Comply with the provisions of Rule 15c3–4 with respect to a group-wide internal risk management control system for the affiliate group as if it were an OTC derivatives dealer. Paragraph (a)(1)(viii)(C) is discussed in greater detail in the section of this release that addresses Rule 15c3–4;
- As part of its group-wide internal risk management control system, to establish, document, and maintain procedures for the detection and prevention of money laundering and terrorist financing; [57]
- Permit the Commission to examine the books and records of any affiliate of the ultimate holding company, if the affiliate is not an entity that has a principal regulator; [58]
- If the disclosure to the Commission of any information required as a condition for the broker-dealer to use Appendix E is 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 material affiliates from providing information to the Commission and by discussing the manner in which the broker-dealer and the ultimate holding company propose to provide the Commission with adequate assurances of access to information; and
- Acknowledge that the Commission may implement additional supervisory conditions if the ultimate holding company fails to comply in a material manner with any provision of its undertaking.

Paragraphs (a)(1)(viii)(I) and (J) of proposed Appendix E would have required an ultimate holding company, as a condition to a broker-dealer's use of the alternative method of computing net capital, to consent in its undertaking to submit to the Commission, in advance of making them, any material changes to mathematical models and other methods used to calculate allowances for market, credit, and operational risk, and any material changes to the internal risk management control system for the affiliate group.

We are adopting these requirements as paragraph (a)(9) of Appendix E. We redesignated as paragraph (a)(9) the obligation to submit to the Commission specified material changes for prior approval to emphasize that the obligation is ongoing. Furthermore, to avoid unnecessary or duplicative requirements, paragraph (a)(9) of Appendix E, as adopted, applies only to ultimate holding companies that do not have principal regulators.

ii. Undertaking for an Ultimate Holding Company That Has a Principal Regulator

A number of commenters urged the Commission to reduce certain requirements applicable to ultimate holding companies that already are subject to another regulator's consolidated supervision. These commenters asserted that the requirements, including the undertaking

[56] We will review, on a case-by-case basis, the entities that have been identified in the application as material affiliates.

[57] This parallels requirements in the proposed New Basel Capital Accord, as amended from time to time. *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*).

[58] The primary purpose of our examination of ultimate holding companies and their affiliates is to verify their financial and operational conditions and to verify whether the internal risk management controls and the methodologies for calculating allowable capital and allowances for market, credit, and operational risk are consistent with those controls and methodologies approved by the Commission. We will not examine an entity that has a principal regulator, and we will not examine an ultimate holding company that has a principal regulator or the non broker-dealer affiliates of such a holding company.

required as part of the application process, could lead to the imposition of duplicative and possibly inconsistent requirements on these ultimate holding companies by the Commission and their current regulators.

In response to these comments and to avoid duplicative or inconsistent requirements, the Commission has amended paragraph (a)(1) to create a new sub-paragraph (ix) that specifies the more limited undertaking that a broker-dealer must submit if its ultimate holding company has a principal regulator, as that term is defined in new paragraph 15c3–1(c)(13). This undertaking, however, still enables the Commission to obtain information sufficient to evaluate the risk that the ultimate holding company may pose to the broker-dealer.

As a condition to its use of the alternative method for computing net capital, paragraph (a)(1)(ix) of Appendix E, as adopted, requires a broker-dealer to file a written undertaking by its ultimate holding company that has a principal regulator, signed by a duly authorized person at the ultimate holding company, in which the ultimate holding company agrees, among other things, to:

- Comply with applicable provisions of Appendices E and G to Rule 15c3–1;
- Make available to the Commission information about the ultimate holding company that the Commission finds necessary to evaluate the financial and operational risk within the ultimate holding company and to evaluate compliance with the conditions of eligibility of the broker-dealer to compute net capital under the alternative method of Appendix E; and
- Acknowledge that the Commission may impose additional supervisory conditions on the broker-dealer, described in detail below, if the ultimate holding company fails to comply in a material manner with any provision of its undertaking.

b. Information To Be Submitted by the Ultimate Holding Company

Paragraph (a)(2) of proposed Appendix E would have required an ultimate holding company to consent to provide specified information to the Commission with an affiliated broker-dealer's application as a condition of the broker-dealer's use of the alternative method of computing net capital. Among other things, the ultimate holding company would have consented to include an organizational chart that identified the ultimate holding company, the broker or dealer, and the material affiliates. According to some commenters, the Commission ''may wish to only require broker-dealers to submit an organizational chart that identifies the holding company, the broker-dealer, and the material, unregulated affiliates of the broker-dealer * * * and such other affiliate organizational information as it may request from time to time.'' These commenters suggested that the Commission eliminate the alphabetical list in paragraph (a)(2)(ii) of Appendix E, as proposed, because large financial services firms may have hundreds of affiliates and information and the commenters believed that information on these affiliates would not assist the Commission in its understanding of the risks to broker-dealers.

Paragraph (a)(2)(ii) of Appendix E, as adopted, retains the requirement that the ultimate holding company consent to provide an alphabetical list to the Commission of its affiliates (the ''affiliated group''). The Commission needs a comprehensive list of entities that make up the affiliate group to understand, as completely as possible, the organizational structure of which the broker-dealer is a part. Moreover, management of the ultimate holding company should have ready access to a comprehensive list of affiliates and a designation of whether the affiliates have a financial regulator as part of its internal risk management systems.

We also are making technical amendments to paragraph (a)(2)(iii) of Appendix E, as adopted. Paragraph (a)(2)(iii) of Appendix E, as proposed, would have required an ultimate holding company to consent to provide ''an organizational chart that identifies the holding company, the broker or dealer, and the material affiliates of the broker or dealer.'' Paragraph (a)(2)(ii), both as proposed and adopted, requires that the ultimate holding company consent to provide information about affiliates material to the ultimate holding company, not the broker-dealer. Likewise, we intended paragraph (a)(2)(iii) to require an ultimate holding company to provide an organizational chart that identifies the material affiliates of the ultimate holding company, not the broker-dealer. Accordingly, paragraph (a)(2)(iii) of Appendix E, as adopted, requires the ultimate holding company's organizational chart to identify affiliates material to the ultimate holding company.

Commenters also suggested that an ultimate holding company that has a principal regulator should not be required to provide all of the information to the Commission that proposed paragraph (a)(2) of Appendix E would have required. According to the commenters, an ultimate holding company that has a principal regulator already might provide some of the information required under proposed paragraph (a)(2) to its principal regulator and, therefore, the information requirements could lead to duplicative or inconsistent requirements.

To avoid potentially duplicative or inconsistent requirements, paragraph (a)(2), as adopted, applies only to an ultimate holding company that does not have a principal regulator. The Commission has revised the rules to set forth separately, in paragraph (a)(3), the documents that an ultimate holding company that has a principal regulator must submit. The following sections describe the requirements under paragraphs (a)(2) and (a)(3).

i. Ultimate Holding Company That Does Not Have a Principal Regulator

Paragraph (a)(2) of Appendix E, as adopted, specifies the information that an ultimate holding company that does not have a principal regulator must submit, as a condition of Commission approval, with the broker-dealer's application for exemption from the standard net capital rule. That information includes the following:

- A narrative description of the business and organization of the ultimate holding company;
- 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 ultimate holding company (''material affiliates'');
- An organizational chart that identifies the ultimate holding company, the broker-dealer, and the material affiliates;
- Consolidated and consolidating financial statements;
- Certain sample capital calculations made according to Appendix G to Rule 15c3–1;
- A description of the categories of positions held by the ultimate holding company and affiliates;
- A description of the methods the ultimate holding company intends to use for computing allowances for market,[59] credit, and operational risk;

[59] One commenter argued that the proposed requirement to submit a description of all mathematical models was overly broad and seemed excessive and unnecessary. In response, the Commission eliminated the word ''all'' because, although we require a description of and intend to review all models used to calculate deductions for market and credit risk, we do not intend to require a firm to describe each pricing model because we may not review all pricing models during the application process.

• A description of any differences between the models used by the ultimate holding company and those used by the broker-dealer to compute deductions for specified risks on the same instrument or counterparty;
• A description of the risk management control system the ultimate holding company uses to manage group-wide risk and how that system satisfies the requirements of Rule 15c3–4; and
• Sample risk reports that the ultimate holding company provides to its senior management.

ii. Ultimate Holding Company That Has a Principal Regulator

New paragraph (a)(3) of Appendix E, as adopted, specifies the more limited information that an ultimate holding company that has a principal regulator must include, as a condition of Commission approval, with the broker-dealer's application for exemption from the standard net capital rule. That information includes the following:
• A narrative description of the business and organization of the ultimate holding company;
• An alphabetical list of the affiliates of the broker-dealer with an identification of the financial regulator, if any, by whom the affiliate is regulated and a designation of those affiliates that are material to the ultimate holding company;
• An organizational chart that identifies the ultimate holding company, the broker-dealer, and the material affiliates;
• Consolidated and consolidating financial statements;
• A capital measurement report as provided to its principal regulator;
• A description of any differences between the models used by the ultimate holding company and those used by the broker-dealer to compute capital charges on the same instrument or counterparty; and
• Sample risk reports that the ultimate holding company provides to its senior management.

Receipt of these documents is intended to provide the Commission with insight into the ultimate holding company and the risks that it may pose to the broker-dealer without intruding upon the jurisdiction of the ultimate holding company's principal regulator.

Because each ultimate holding company manages its internal risk differently, the Commission, during the application process, must assess each ultimate holding company's business and internal risk management control systems to determine if approval of the application is appropriate. The ultimate holding company information that we require a broker-dealer to file as a condition of approval of the application for the exemption from the standard net capital rule allows us to evaluate these management control systems.

iii. Other Information

Paragraph (a)(3) of proposed Appendix E[60] would have required a broker-dealer to provide supplemental information about it or its ultimate holding company upon Commission request. The Commission would have requested supplemental information to complete its review of the broker-dealer's application to use the alternative method of computing net capital. In certain circumstances, such as consideration of the particular business or organizational structure of the ultimate holding company and its affiliates, the Commission could have conditioned its approval on obtaining additional information or documents necessary to assess adequately the risks to the ultimate holding company and to the broker-dealer. Accordingly, we are adopting paragraph (a)(4) of Appendix E as proposed. Paragraph (a)(4) requires a broker-dealer to supplement it application with other information or documents relating to the internal risk management control system, mathematical models, and financial position of the broker-dealer or the ultimate holding company that the Commission may request to complete its review of the application.

2. Ultimate Holding Company Requirements Under Appendix G

As a condition of Commission approval, the ultimate holding company of a broker-dealer applying to use the alternative method of computing net capital must undertake to comply with the requirements listed in Appendix G to Rule 15c3–1, as required by paragraphs (a)(1)(viii) or (a)(1)(ix) of Appendix E. Under Appendix G, the ultimate holding company that does not have a principal regulator must compute allowable capital and allowances for market, credit, and operational risk on a consolidated basis for the affiliated group; provide the Commission with certain monthly, quarterly, and annual reports; maintain certain books and records relating to the ultimate holding company's consolidated and consolidating 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 ultimate holding company and its potential impact on the risk exposure of the broker-dealer.

a. Calculation of Allowable Capital and Allowances for Market, Credit, and Operational Risk by an Ultimate Holding Company That Does Not Have a Principal Regulator

Under paragraph (a) of Appendix G, as adopted, an ultimate holding company must calculate allowable capital and allowances for market, credit, and operational risk on a consolidated basis for the affiliate group as a condition of the broker-dealer's use of the alternative method of computing net capital. The calculations are designed to be consistent with the Basel Standards, which should allow for greater comparability of ultimate holding companies to international securities firms and banking institutions and allow monitoring of the financial condition of the affiliate group, which may impact the financial stability of the broker-dealer.

We believe the rules contain prudent parameters for measuring allowable capital and risk allowances for the ultimate holding company. For example, the rules limit the amount of subordinated debt that may be included in allowable capital, require the VaR model used to calculate the allowance for market risk to be based on a ten business-day movement in rates and prices, and require the VaR measure to be multiplied by a factor of at least three.

i. Group-Wide Allowable Capital Calculation

a. Components of Allowable Capital

Under paragraph (a)(1) of proposed Appendix G, the ultimate holding company would have calculated allowable capital on a consolidated basis for the affiliate group. Consistent with the Basel Standards, allowable capital would have included common shareholders' equity (less goodwill, deferred-tax assets, and certain other intangible assets), certain cumulative and non-cumulative preferred stock,[61] and certain properly subordinated debt. As set forth in detail in the rule, the cumulative and non-cumulative

[60] Paragraph (a)(3) of proposed Appendix E has been redesignated as paragraph (a)(4) of Appendix E, as adopted.

[61] To qualify for inclusion in allowable capital, the cumulative and noncumulative preferred stock cannot have a maturity date, cannot be redeemed at the option of the holder, and cannot contain any other provisions that would require future redemption of the issue. In addition, the issuer must be able to defer or eliminate dividends. Preferred stock that meets these conditions has characteristics of capital (as opposed to debt).

preferred stock and subordinated debt would have been subject to additional limitations based on comparisons of the individual components of allowable capital.

In response to comments received, the Commission has expanded the definition of allowable capital in paragraph (a)(1) of Appendix G, as adopted, to include hybrid capital instruments and certain deferred-tax assets. Commenters noted that the Basel Standards and the Federal Reserve's definition of Tier 1 and Tier 2 capital include hybrid capital instruments and certain deferred-tax assets. To be more consistent with both the Basel Standards and the Federal Reserve's definition of Tier 1 and Tier 2 capital, an ultimate holding company may include in allowable capital both those hybrid capital instruments that the Federal Reserve allows for inclusion in Tier 2 capital and specified deferred-tax assets, subject to certain limitations.[62] This increased consistency should promote greater comparability of financial information among firms.

Paragraph (a)(1)(iii)(B) of proposed Appendix G would have permitted inclusion of subordinated debt in allowable capital subject to specified criteria intended to help assure that the subordinated debt provides a long-term source of working capital to the holding company and that it has many of the characteristics of capital. We did not receive comments on inclusion of subordinated debt in allowable capital and we adopt paragraph (a)(1)(iii)(B) of Appendix G as proposed.

In the Proposing Release, the Commission solicited comment on whether long-term debt, subject to appropriate limitations, should be included in allowable capital. A number of commenters argued in favor of inclusion. Those commenters noted that economic considerations primarily determine the type of debt issued, including the term, structure, and cost of borrowing. Some broker-dealer affiliates of holding companies, consequently, have relied upon long-term debt for management of their capital structures.

Other commenters suggested that long-term debt be included as allowable capital during a phase-out period. They suggested that a swift phase-out of long-term debt would be difficult. If each of the ultimate holding companies interested in this program simultaneously issued subordinated debt to replace long-term debt, these new, large issues could impact capital markets negatively, increasing funding costs.

To maintain consistency with the Basel Standards, holding companies may not include long-term capital in allowable capital. We understand, however, that an ultimate holding company might not be able to convert significant amounts of long-term debt to subordinated debt quickly without incurring significant costs and causing market disruptions. Accordingly, as part of the broker-dealer's application to compute deductions for specified risks under Appendix E, an ultimate holding company may request to phase-out the inclusion of long-term debt as allowable capital over a period of up to three years, if the long-term debt meets the criteria specified in paragraph (a)(1)(iii)(C) of Appendix G, as adopted. We believe that the three-year phase-out period is appropriate based on staff experience. After three years, a broker-dealer may submit an amendment to its application and request that the Commission grant the ultimate holding company up to two additional years to complete the phase-out of long-term debt. The Commission will determine if the amount of the ultimate holding company's long-term debt and market conditions warrant an extension.

b. The ''Aggregate'' or ''Building Block'' Approach to Calculation of Allowable Capital

Some commenters suggested that the Commission permit calculation of allowable capital using the ''aggregate,'' or ''building block,'' approach, rather than a calculation on a consolidated basis. Under the building block approach, an ultimate holding company would have sufficient allowable capital if available capital exceeds the sum of its subsidiaries' functional regulatory capital requirements.

In response to comments received, the broker-dealer may request in its initial application that the ultimate holding company be permitted to use the building block approach to computing allowable capital.[63] The request must describe a proposed building block allowable capital calculation approach that is consistent with the methods described in the Joint Forum's July 2001 paper entitled, ''Capital Adequacy Principles.''[64] Use of these principles is appropriate because they outline internationally agreed-upon standards for calculating consolidated capital.

In aggregating the capital requirements of its subsidiaries, an ultimate holding company would use the existing capital adequacy calculations prepared for each entity according to the methodology prescribed by its principal regulator. Unregulated entities, including both subsidiaries and the ultimate holding company, would be subject to proxy capital requirements calculated according to the Basel Standards. The ultimate holding company then would compare the sum of the capital requirements to total capital resources.

ii. Group-Wide Calculation of Allowance for Market Risk

Paragraph (a)(2) of proposed Appendix G would have required daily calculation of a group-wide allowance for market risk. Commenters requested that the Commission no longer require an ultimate holding company to calculate a group-wide allowance for market risk daily because an ultimate holding company only must report this information to the Commission monthly. In response to comments received, paragraph (a)(2) of Appendix G, as adopted, no longer requires computation of the allowance for market risk on a daily basis. Rather, paragraph (c)(4) of Appendix G, as adopted, requires an ultimate holding company to compute and report its group-wide allowance for market risk monthly. Nevertheless, as part of the qualitative and quantitative requirements for the use of models, an ultimate holding company must compute VaR on a daily basis as part of its internal risk management system.

We also are modifying paragraph (a)(2)(i) of Appendix G to clarify the method that an ultimate holding company must use to calculate allowances for market risk using VaR models. Under Appendix G, as adopted, an ultimate holding company calculates a group-wide allowance for market risk on all proprietary positions using a VaR model, then multiplies the VaR of those positions by an appropriate multiplication factor to provide an adequate measure of capital during periods of market stress. The VaR model used must meet the qualitative and quantitative requirements of paragraph (d) of Appendix E, as adopted.[65] Likewise, the ultimate holding company must use a multiplication factor from

[62] An ultimate holding company may include hybrid capital instruments and deferred-tax assets subject to the terms and conditions contained in 12 CFR 225, Appendix A.

[63] Use of the building block approach generally would increase capital at the holding company level.

[64] Capital Adequacy Principles and Supplement to Capital Adequacy Principles Papers, Joint Forum Compendium of Documents, Basel Committee on Banking Supervision (July 2001).

[65] *See supra,* discussion of the broker-dealer's calculation of its deduction for market risk using a VaR model under Appendix E.

Table 1 of paragraph (d) of Appendix E. The use of VaR is intended to be generally consistent with the calculation of the deduction for market risk for a broker-dealer under Appendix E and with the calculation of allowances for market risk under the Basel Standards.

iii. Group-Wide Calculation of Allowance for Credit Risk

We are modifying certain requirements for calculating the allowance for credit risk under paragraph (a)(3) of Appendix E, as adopted. Paragraph (a)(3) of proposed Appendix G would have required an ultimate holding company to calculate an allowance for credit risk for certain assets on the consolidated balance sheet and certain off-balance sheet items under either paragraph (a)(3)(i) or paragraph (a)(3)(ii). An ultimate holding company would have calculated the allowance for credit risk under paragraph (a)(3)(i) by multiplying the credit equivalent amount of each asset or off-balance sheet item by the appropriate credit risk weight [66] of that asset or off-balance sheet item, then multiplying that result by 8%.[67] We are adopting the calculation of the allowance for credit risk in paragraph (a)(3)(i) of Appendix G as proposed, although we are revising the methods of determining the credit equivalent amount and credit risk weights.

Paragraph (a)(3)(i)(A)(*2*) of proposed Appendix G would have required a 5% credit conversion factor for margin loans. Several commenters stated that this factor was too high. According to one commenter, most margin loans are held in broker-dealers, where the application of customer margin requirements often exceed Federal Reserve requirements, and actual losses over many decades have been very small. Another commenter stated that the proposed conversion factor should be eliminated. A commenter also asserted that margin loans that are marked to market and subject to collateral calls daily should be considered economically equivalent to secured financing transactions and should be eligible for VaR-based exposure treatment.

After considering the comments, we are not including the 5% credit conversion factor for margin loans contained in proposed paragraph (a)(3)(i)(A)(*2*). An ultimate holding company may apply to use the VaR-based exposure treatment under paragraph (a)(3)(i)(B) as a ''similar collateralized transaction.'' For unrated counterparties, the Commission could determine, after a review of the description of the margin loans in the application of the broker-dealer, that the margin loans could be treated as a pool with a very low loss history. In this case, the ultimate holding company could use internal estimates of exposure at default that consider the loss history for the pool.

Under proposed paragraph (a)(3)(i)(B), the credit equivalent amount of the ultimate holding company's exposure to a counterparty would have consisted of the ultimate holding company's current exposure to the counterparty and its maximum potential exposure, multiplied by the appropriate multiplication factor. We are adopting paragraph (a)(3)(i)(B) as proposed.

We are revising the definitions of ''current exposure'' and ''maximum potential exposure'' and adopting those revised definitions in paragraphs (a)(3)(i)(D) and (a)(3)(i)(E), respectively, of Appendix G. Paragraph (a)(3)(i)(C) of proposed Appendix G would have defined an ultimate holding company's current exposure to a counterparty as the current replacement value of a counterparty's positions, after applying specified netting agreements with the counterparty, taking into account the value of collateral from the counterparty, and subtracting the fair market value of any credit derivatives that specifically changed the exposure to the counterparty.

Under paragraph (a)(3)(i)(D) of Appendix G, as adopted, the definition of current exposure does not include a provision under which the ultimate holding company must subtract the fair market value of any credit derivatives that specifically change the exposure to a counterparty. Subtraction of the fair market value of credit derivatives could have reduced the allowance for credit risk without consideration of the ultimate holding company's credit risk exposure to the credit derivative counterparty. As part of the broker-dealer's application to use the alternative method for computing net capital or in an amendment to the application, however, the ultimate holding company may request Commission approval to reduce allowances for credit risk through the use of credit derivatives.[68] Under paragraph (a)(3)(i)(D) of Appendix G, as adopted, the Commission will consider credit risk exposure to the credit derivative counterparty in determining whether to approve the ultimate holding company's application to reduce the allowance for credit risk through the use of credit derivatives.

The Commission also is revising the definition of maximum potential exposure under paragraph (a)(3)(i)(E) of Appendix G, as adopted. Paragraph (a)(3)(i)(D) of proposed Appendix G would have defined the MPE 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, taking into account the value of certain collateral 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 ultimate holding company's exposure to the counterparty (as long as the credit derivatives are not used to change the credit risk weight of the counterparty) that is obtained using an approved VaR model meeting the applicable qualitative and quantitative requirements of paragraph (e) of Appendix E.[69]

As adopted, paragraph (a)(3)(i)(E) does not require an ultimate holding company to subtract the fair market value of any credit derivatives that change the ultimate holding company's exposure to a counterparty in calculating MPE. The Commission revised this language for the same reasons described in the section on the

[66] One commenter sought clarification on determination of credit risk weights under paragraphs (a)(3)(i)(F) and (H). Specifically, the commenter asked whether credit risk weights should be adjusted by a maturity adjustment factor to account for the effective maturity of exposures. The Commission is not adopting a maturity adjustment factor for ultimate holding companies. An ultimate holding company that determines credit risk weights according to the New Basel Capital Accord, however, may use any applicable maturity adjustment factor permitted under the Accord. There is no maturity adjustment factor applicable to broker-dealers.

[67] This is derived from 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.

[68] The credit derivative must 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, and (iii) is not held for market timing purposes.

[69] Under the quantitative requirements, a VaR model used to calculate MPE must 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 Appendix G) and equivalent to a *one-year* movement in rates and prices for other positions (*see* paragraph (e)(2(ii) of 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 (d)(2)(i) of Appendix E. Based on a review of the firm's procedures for managing collateral and if the collateral is marked to market daily and the firm has the ability to call for additional collateral daily, the Commission may approve a time horizon of not less than ten business days. *See* paragraph (d)(2)(ii) of Appendix E.

amendments to current exposure. Furthermore, under paragraph (a)(3)(i)(E), as adopted, an ultimate holding company must calculate MPE for repurchase agreements, reverse repurchase agreements, stock lending and borrowing, and similar collateralized transactions using a time horizon of not less than five days, rather than five days, as proposed. This revision clarifies that the Commission intended the time horizon to be a minimum period instead of an absolute period.

We note that under Appendix G, as adopted, an ultimate holding company may calculate MPE using a VaR model that meets the applicable qualitative and quantitative requirements of paragraph (d), rather than by using a ''notional add-on'' under the Basel Standards. We believe that the VaR approach is a more precise method of calculating MPE than using a ''notional add-on.'' Large U.S. broker-dealers and their affiliates with comprehensive internal risk management systems generally already have systems in place to calculate MPE using VaR models.

The Commission also is revising the methods of determining credit risk weights contained in paragraph (a)(3)(i)(F) of proposed Appendix G. Under proposed paragraph (a)(3)(i)(F), an ultimate holding company would have been required to use credit risk weights published by the Basel Committee. Paragraph (a)(3)(i)(F) of Appendix G, as adopted, permits an ultimate holding company to determine credit risk weights based on internal calculations, including internal estimates of the maturity adjustment. These determinations must be consistent with the Basel Standards. The ultimate holding company must follow the standards set forth in paragraph (c)(4)(vi)(E) of Appendix E in determining credit risk weights based on internal calculations.

Paragraph (a)(3)(i)(G) of proposed Appendix G would have permitted an ultimate holding company to determine credit ratings using internal calculations for counterparties that are not rated by an NRSRO. We are adopting paragraph (a)(3)(i)(G) of Appendix G as proposed, although we note that the ultimate holding company must follow the standards set forth in paragraph (c)(4)(vi)(D) of Appendix E in determining credit ratings based using internal calculations and that those determinations must be consistent with the Basel Standards. We are amending the provisions related to determination of credit risk weights and credit ratings applicable to the ultimate holding company to align them with the credit risk weight and credit risk provisions applicable to the broker-dealer. This alignment is intended to promote managerial and cost efficiencies.

Paragraph (a)(3) of proposed Appendix G would have required an ultimate holding company to calculate the group-wide allowance for credit risk daily. Commenters suggested that daily computation of the group-wide allowance for credit risk was unnecessary because the ultimate holding company only must report this information to the Commission monthly. In response to comments received, paragraph (a)(3) of Appendix G, as adopted, no longer requires daily computation of the allowance for credit risk. Rather, paragraph (c)(4) of Appendix G, as adopted, requires an ultimate holding company to compute and report its group-wide allowance for credit risk monthly. Nevertheless, as part of the qualitative and quantitative requirements for the use of models, an ultimate holding company must compute current exposure daily as part of its internal risk management system.

The Commission adopts the remaining provisions of paragraph (a)(3) of Appendix G as proposed.

iv. Group-Wide Calculation of Allowance for Operational Risk

Proposed paragraph (a)(4) would have required the calculation of the allowance for operational risk to be consistent with the proposed New Basel Capital Accord. The Basel Committee has proposed three methods for calculating an allowance for operational risk: The basic approach, the standardized approach, and the advanced measurement approach. 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.

Commenters argued that the basic and standardized approaches to calculating operational risk under The New Basel Capital Accord are not risk-based and that the advanced measurement approach is too subjective (because of scarce data and skewing from infrequent extreme events) to be used to compute an allowance for operational risk. In addition, another commenter asserted that the proposed capital regime should include a flexible framework with respect to any calculation of operational risk.

We are adopting rules governing allowances for operational risk as proposed. It is important to account for the operational risk that the ultimate holding company and its affiliates may pose to the broker-dealer. Moreover, the rules are intended to provide ultimate holding companies with flexibility by permitting the computation of allowances for operational risk in accordance with the standards published by the Basel Committee, as modified from time to time. We recognize, however, that the New Basel Capital Accord has not been adopted in its final form and that we may need to tailor our operational risk requirements. If, in finalizing the new Basel Capital Accord, the Basel Committee changes the operational risk computations or charges, we will review and consider amending our rules.

v. Trading Book Issues

In the Proposing Release, we requested comment on the use of mathematical models for regulatory capital purposes. Several commenters stated that the use of VaR or other risk-based capital models should be available for all securities that meet the definition of ''trading book'' (including initial public offering securities and below investment grade securities). The trading book [70] includes positions in financial instruments and commodities that are held for trading or for purposes of hedging other positions in the trading book, that are frequently valued, and that are part of a portfolio that is actively managed. Some securities firms believe that under this definition, a trading book would include funded loans and assets purchased in anticipation of a securitization. Commenters were concerned that unnecessarily high ''banking book'' [71] capital charges might be imposed on positions that are marked to market daily and that a hedge might be treated separately from the underlying position, which could be unduly punitive. That is, commenters were concerned that banking books charges might be

[70] *See* paragraphs 642–647 of Consultative Document to the New Basel Capital Accord (April 2003).

[71] Generally, a ''banking book'' would consist of positions that a firm does not mark to market or intend to sell as part of its business. *See* paragraphs 642–647 the New Basel Capital Accord.

imposed on trading book positions. According to commenters, categorization of trading book positions as banking book positions could significantly impact the firms' capital charges. In response to comments received, we note that in reviewing firms' proposed methods of calculating deductions for market and credit risk, we intend to apply the definitions of trading book and banking book contained in the Basel Standards.

vi. Ultimate Holding Companies That Have Principal Regulators

In response to comments, we are modifying the proposed rules to permit certain ultimate holding companies to submit to the Commission capital measurements created for other regulators. Ultimate holding companies that have principal regulators may be required to compute and report to their principal regulators a capital measurement similar to that required by paragraphs (a)(1) through (a)(4) of Appendix G. Paragraph (b)(2)(i)(B) of Appendix G, as adopted, allows an ultimate holding company that has a principal regulator to submit that capital measurement to the Commission on a quarterly basis. This provision should reduce regulatory burdens on the ultimate holding company while permitting the Commission to evaluate the risks that the ultimate holding company and its material affiliates may pose to the broker-dealer.

vii. General Discussion of Basel Pillars

These amendments apply a capital reporting requirement consistent with the Basel Standards to the ultimate holding company. The proposed New Basel Capital Accord specifies three ''pillars'' for the group-wide supervision of internationally active banks and financial enterprises. The first pillar, ''minimum regulatory capital'' requirements, requires calculations for credit and operational risk and, for firms with significant trading activity, market risk. The second pillar, ''supervisory review,'' requires that capital be assessed relative to overall risks and that supervisors review and take action in response to those assessments.

The third pillar of the current draft of the New Basel Capital Accord requires certain disclosures that are intended to allow market participants to assess key pieces of information about, for example, the capital, risk exposures, and risk assessment processes of the institution. Enhanced public disclosure practices are an integral part of the proposed New Basel Capital Accord. The purpose of the third pillar is to complement the minimum capital requirements and the supervisory review process by encouraging market discipline. Specific disclosure requirements would apply to all institutions that use the proposed New Basel Capital Accord and would encompass capital, credit risk, credit risk mitigation, securitization, market risk, operational risk, and interest rate risk. However, the proposed New Basel Capital Accord has not yet been finalized.

We requested comment on whether U.S. broker-dealers, their holding companies, and affiliates should be required to make additional disclosures to meet the requirements of the third pillar of the proposed New Basel Capital Accord. Two commenters indicated that the Commission should not require additional, specific disclosures from broker-dealers and their ultimate holding companies.

The securities industry has taken important steps to enhance public disclosure of material risks. For example, in June 1999, the Counterparty Risk Management Group (''CRMG'') (representing 12 major securities firms and banks) published a report on *Improving Counterparty Risk Management Practices.*[72] In addition, a private-sector Working Group on Public Disclosure (representing 11 major securities firms and banks), issued a report in January 2001.[73] The group recommended enhanced and more frequent public disclosure of financial information by banking and securities organizations. It also stated that financial information should be disclosed based on a firm's internal methodologies and exposure categories, and that quantitative information on a firm's risk exposure should be balanced with qualitative information describing its risk management process.

The Commission staff has taken a leading role to enhance public disclosure by financial intermediaries. It was a member of the Multidisciplinary Working Group on Enhanced Disclosure (Fisher II working group) that provided advice to its sponsoring organizations[74] on steps that would advance the state of financial institutions' disclosures of financial risks to enhance the role of market discipline. More recently, Commission staff chaired a Joint Forum[75] Working Group on Enhanced Disclosure (''Working Group''), established by the Basel Committee, IAIS and IOSCO, that is following up on the recommendations contained in the Fisher II report.[76] The Working Group expects to publish its report shortly.

Some issues remain, however. For instance, broker-dealers are interested in finding a balance so they do not have to disclose sensitive proprietary information. Because the proposed New Basel Capital Accord has not yet been finalized, we do not believe it would be appropriate to adopt additional disclosure requirements as part of these amendments.

b. Reporting Requirements for the Ultimate Holding Company

We are modifying the ultimate holding company reporting requirements contained in the Proposing Release. As a condition of Commission approval of a broker-dealer's use of the alternative method of computing net capital, paragraph (b) of proposed Appendix G would have required an ultimate holding company to file certain reports with the Commission. The Commission needs the information in the reports from the ultimate holding company to monitor the financial condition, internal risk management control system, and activities of the ultimate holding company. These reports will 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 ultimate

[72] CRMG was formed in January 1999, after the near collapse of Long-Term Capital Management. The group's ultimate mission was to redevelop standards for strengthening risk management practices at banks, securities firms, and other dealers to avoid similar difficulties in the future. Its findings were publicly released on June 21, 1999, and are available at: *http://financialservices.house.gov/banking/62499crm.pdf.* A hearing was held on June 24, 1999, regarding the group's findings and recommendations, before the U.S. House of Representatives, Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises, Committee on Banking and Financial Services. A transcript of the hearing, at which the CRMG chairs gave testimony, is available at: *http://commdocs.house.gov/committees/bank/hba57791.000/hba57791_0f.htm.*

[73] Walter V. Shipley, retired chairman of Chase Manhattan Bank, chaired the working group. His letter to the Board of Governor's of the Federal Reserve System, summarizing the group's findings, is available at: *http://www.federalreserve.gov/boarddocs/press/general/2001/20010111/DisclosureGroupLetter.pdf* (Jan. 11, 2001).

[74] The Basel Committee, the Committee on the Global Financial System of the G–10 central banks (''CGFS''), the International Association of Insurance Supervisors (''IAIS'') and the International Organisation of Securities Commissions (''IOSCO'').

[75] The Joint Forum was established in 1996 under the aegis of the Basel Committee, IOSCO, and the IAIS to address issues common to the banking, securities and insurance sectors.

[76] Final Report of the Multidisciplinary Working Group on Enhanced Disclosure (April 26, 2001). The report is available at: *http://www.bis.org/publ/joint01.pdf.*

holding companies and could jeopardize the financial stability of broker-dealers using the alternative method of computing net capital. Moreover, requiring timely financial and other risk information that identifies which business line or affiliated entity may have incurred particular risks is necessary to identify areas for Commission focus.[77]

As a condition to the broker-dealer's use of the alternative method of computing net capital, paragraph (b)(1) of proposed Appendix G would have required its ultimate holding company to file a monthly report with the Commission within 17 business days after the end of the month (the FOCUS reporting period). The monthly report would have included certain consolidated financial and credit risk information, including a consolidated balance sheet and income statement (with notes to the financial statements), a graph for each business line reflecting the daily intra-month VaR calculations, and certain reports that the ultimate holding company regularly provides to its senior management to assist in monitoring and managing risk.

As a condition to the broker-dealer's use of the alternative method of computing net capital, paragraph (b)(2) of proposed Appendix G would have required an ultimate holding company to file a quarterly report within 35 calendar days after the end of each quarter that included, 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. In the Proposing Release, we stated that requiring reports to be filed within 35 calendar days after the end of each quarter provided a filing timeframe similar to those for quarterly reports due from companies required to file information, documents, and reports pursuant to section 13(a) or 15(d) of the Exchange Act.

As a condition to the broker-dealer's use of the alternative method of computing net capital, paragraph (b)(3) of Appendix G would have required the ultimate holding company to provide to the Commission, upon request, other reports necessary to monitor the financial condition of the ultimate holding company and its affiliates to determine if those entities presented risks to the broker-dealer.

As a condition to the broker-dealer's use of the alternative method of computing net capital, paragraph (b)(4) of proposed Appendix G would have required the ultimate holding company to file an annual audited report with the Commission. Proposed paragraph (b)(4) would have required the annual audited report to include consolidated financial statements and to be audited by a registered public accounting firm.

As a condition to the broker-dealer's use of the alternative method of computing net capital, paragraph (b)(5) of proposed Appendix G would have required the ultimate holding company to file a supplemental report prepared by a registered public accounting firm, in accordance with agreed-upon procedures,[78] regarding management controls. In the Proposing Release, we stated that by performing an independent review of the firm's financial condition and risk management practices, auditors would have an important role in the Commission's regulatory framework by helping to assure that the broker-dealer and the ultimate holding company complied with the conditions of the exemption.

We requested comment in the Proposing Release concerning the reporting requirements for ultimate holding companies. Several commenters stated that the Commission should require fewer reports from an entity that has a consolidated regulator. In addition, one commenter stated that ''notes to the financial statements'' should consist of significant highlights of the financial statements.

A commenter also stated that the requirement for the quarter-end coinciding with a firm's fiscal year end be amended to align with the dates by which public companies are required to submit their annual report on Form 10–K. Another commenter stated that the 17- and 35-day requirements were too aggressive because the proposed reports will require detailed risk and capital information that typically is not readily available and takes greater time to produce. The commenter asserted that the rules should conform the content and timing of reporting requirements applicable to other Commission public reporting requirements. A commenter argued that footnotes to the financial statements should only be required with quarterly reports.

In response to comments received, we are amending the ultimate holding company reporting requirements. Paragraph (b) of Appendix G, as adopted, separates reporting requirements applicable to ultimate holding companies that do not have principal regulators into paragraph (b)(1) and those applicable to ultimate holding companies that have principal regulators into paragraph (b)(2). In light of the supervision that their principal regulators provide, ultimate holding companies that have principal regulators are subject to fewer reporting requirements than those that do not have principal regulators.

In response to comments received, we have extended the ultimate holding company's deadline for filing monthly reports under paragraph (b)(1)(i) to 30 calendar days after month-end from 17 business days after month-end.[79] We agree that an extension of the filing deadline is appropriate because an ultimate holding company must include detailed information, potentially from a number of affiliates, in these reports. The extension, moreover, does not delay significantly the time at which the Commission will receive the reports and, therefore, should provide the Commission with timely and accurate information about risks that the ultimate holding company and its affiliates may pose to the broker-dealer. Furthermore, under paragraph (b)(1)(i), a monthly report need not be filed for a month-end that coincides with a fiscal quarter-end because the quarterly report required to be filed under (b)(1)(ii) would include the information that otherwise would be contained in the monthly report.

As a condition to the broker-dealer's use of the alternative method of computing net capital, paragraph (b)(1)(i) also requires an ultimate holding company that does not have a principal regulator to include footnotes to the financial statement. In response to comments received, we are clarifying this requirement. Although we prefer that ultimate holding companies submit quarterly consolidated financials statements that include GAAP footnotes, we understand that the GAAP footnotes

[77] All reports required under paragraph (b) of Appendix G must be filed with the Division of Market Regulation at the Commission's principal office in Washington, DC.

[78] Paragraph (b)(5)(iii) of proposed Appendix G would have required the ultimate holding company to file with the Commission's principal office in Washington, DC, and the regional office of the Commission for the region in which its subsidiary broker-dealer that uses the alternative method of computing net capital has its principal place of business, the agreed-upon procedures agreed to by the ultimate holding company and the accountant. Moreover, before the commencement of each subsequent review, the ultimate holding company would have been required to notify the Commission of any change in procedures.

[79] Only ultimate holding companies that are not ultimate holding companies that have principal regulators must file monthly reports.

are not always available. Firms therefore must supply financial statements that include footnote explanations either in accordance with GAAP, when available, or as necessary for a complete understanding of the financial statements.

We have revised paragraph (b)(1)(ii) of Appendix G, as adopted. Paragraph (b)(1)(ii) clarifies that the quarterly reports must contain all of the information included in the monthly reports, as well as consolidating balance sheets and income statements and other specified information. We have not extended the deadline for filing the quarterly reports, however. The information that the ultimate holding company includes in the quarterly report must be as recent as practicable to allow the Commission to evaluate potential risks that the ultimate holding company and its affiliates may pose to the broker-dealer. Any extension of the deadline creates the risk that the Commission will receive information that is stale and, therefore, does not reflect accurately the risks to the broker-dealer. Furthermore, the deadline for submission of the quarterly reports already is five days longer than the deadline for submission of monthly reports.

Paragraphs (b)(1)(i) and (ii) of Appendix G, as adopted, allow an ultimate holding company that does not have a principal regulator to delay filing certain information that generally must be included in its monthly and quarterly reports under specified circumstances. Under paragraph (b)(1)(i), an ultimate holding company is not required to include consolidated balance sheets and income statements with the monthly report due during the first month of the fiscal year. The ultimate holding company may file this information at a later time to which the ultimate holding company and the Commission agree. Ultimate holding companies may delay submitting this information to the Commission because the information has not yet been made public in the ultimate holding company's annual report on Form 10–K. Likewise, under paragraph (b)(1)(ii), the consolidated and consolidating balance sheets and income statements need not be included in quarterly reports filed for the last quarter of the fiscal year. The consolidating balance sheets and income statements that otherwise would have been included in the quarterly report shall be filed simultaneously with the annual report, but need not be audited.[80] These provisions allow ultimate holding companies that are publicly traded to coordinate their filings of financial information with other reports that they submit to the Commission.

Paragraph (b)(2) of Appendix G, as adopted, contains the reporting requirements that an ultimate holding company that has a principal regulator must comply with as a condition to the broker-dealer's use of the alternative method of computing net capital. Paragraph (b)(2) requires the ultimate holding company to file a quarterly report that contains consolidated and consolidating balance sheets and income statements for the ultimate holding company; its most recent capital measurements under the Basel Standards, as reported to its principal regulator; and certain risk reports, as the Commission may request, provided to persons responsible for managing group-wide risk. The ultimate holding company also must provide an annual audited report as of the end of its fiscal year when required to be filed with any regulator. These requirements permit the Commission to review the financial and operational risk of the ultimate holding company and its affiliates to assess the risk that those entities may pose to the broker-dealer. The reporting requirements, however, should help to avoid duplicative or inconsistent requirements because the ultimate holding company already may provide the information in the quarterly and annual reports to its regulators.

As discussed, proposed paragraph (b)(3) of Appendix G would have required the ultimate holding company, as a condition of its broker-dealer's exemption from the standard net capital rule, to provide to the Commission, upon request, other reports necessary to monitor the financial condition of the ultimate holding company and its affiliates. We are eliminating this provision because the undertaking contained in Appendix E already imposes that same requirement on ultimate holding companies.

Paragraph (b)(6) of proposed Appendix G would have required an ultimate holding company, as a condition to the broker-dealer's ability use of the alternative method of computing net capital under Appendix E, to file reports required under paragraph (b)(1) and (b)(2) of this Appendix with the Commission at its offices in Washington, DC. We are modifying proposed paragraph (b)(6) and redesignating it as paragraph (b)(3). Paragraph (b)(3) of Appendix G, as adopted, retains the filing requirements of proposed paragraph (b)(6). It also advises ultimate holding companies seeking confidential treatment of reports filed under paragraph (b) of Appendix G to mark each page or segregable portion of each page with the words ''Confidential Treatment Requested.''

Paragraph (b)(4) of proposed Appendix G has been redesignated as paragraph (b)(1)(iii)(A) under Appendix G, as adopted. Paragraph (b)(5) of proposed Appendix G has been redesignated as paragraph (b)(4) of Appendix G, as adopted. This provision states that the Commission will accord confidential treatment, to the extent permitted by law, to the reports that ultimate holding companies file with the Commission under Appendix G.

c. Records To Be Made and Preserved by the Ultimate Holding Company

We are modifying the provisions of Appendix G related to the records that an ultimate holding company must make as a condition to a broker-dealer's use of the alternative method of computing net capital. We are revising paragraph (c) to limit its application to ultimate holding companies that do not have principal regulators. We amended this requirement to avoid imposing inconsistent or duplicative requirements on ultimate holding companies that have principal regulators. Commenters informed us that these regulators already impose recordkeeping requirements on the ultimate holding companies.

We are adding a requirement, however, that an ultimate holding company that does not have a principal regulator make a record of the calculations of allowable capital and allowances for market, credit, and operational risk computed on at least a monthly, consolidated basis. We are adopting the remaining provisions of paragraph (c) as proposed.

We require creation of these records to assist the Commission in determining whether the ultimate holding company is complying with the terms of the broker-dealer's exemption from the standard net capital rule. 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 will accept the records in the format used by the ultimate holding companies. The records must show that the ultimate holding company has conducted stress tests of the affiliate

[80] Audited consolidated balance sheets and income statements will be included in the annual audited report.

group's funding and liquidity in response to certain events, including a credit downgrade of the ultimate holding company or an inability of the ultimate holding company to obtain unsecured, short-term financing; the results of those stress tests; a record showing that the ultimate holding company has a contingency plan to respond to those events; and a record of the basis for determining credit risk weights in certain circumstances. The tests are intended to identify possible liquidity and funding stress scenarios that could impose significant financial distress on the ultimate holding company that, in turn, could jeopardize the financial stability of the broker-dealer.

We also are revising paragraph (d) of proposed Appendix G. Proposed paragraph (d) would have required an ultimate holding company to maintain, for a period of not less than three years, the records it would have been required to make under paragraph (c)(1) of Appendix G; applications, reports, notices and other documents filed with the Commission under Appendices E or G; and written policies and procedures concerning its internal risk management system.

Paragraph (d)(1)(iv) of Appendix G, as adopted, only requires an ultimate holding company that does not have a principal regulator to maintain records of all written policies and procedures concerning the group-wide internal risk management control system established under paragraph (a)(1)(viii)(C) of Appendix E, as adopted. The Commission narrowed the scope of this provision to avoid duplicative or inconsistent requirements. The remaining provisions of paragraph (d) of Appendix G are adopted as proposed. The requirement to preserve records for three years is based on the retention periods in Exchange Act Rule 17a–4 and we believe that this same period of time is sufficient to meet the Commission's supervisory needs.

d. Notification Requirements for the Ultimate Holding Company

The Commission is revising paragraph (e) of proposed Appendix G. Proposed paragraph (e) would have conditioned the broker-dealer's use of the alternative method of computing net capital on the ultimate holding company's consent to specified notice provisions. Under proposed paragraphs (e)(1) and (2), an ultimate holding company would have agreed to notify the Commission promptly upon the occurrence of certain events, including the occurrence of any backtesting exception of VaR models that would require the ultimate holding company to use a higher multiplication factor; a computation showing the affiliate group's allowable capital was 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 of certain debt of an affiliate; or the receipt of certain regulatory notices regarding an affiliate. The ultimate holding company would have filed a notification if there were 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.

Paragraph (e) of Appendix G, as adopted, modifies the notification requirements applicable to ultimate holding companies. Under the final rules, certain notification provisions apply to both types of ultimate holding companies and some apply only to ultimate holdings companies that do not have principal regulators. As a condition to a broker-dealer's use of the alternative method of computing net capital, an ultimate holding company, regardless of whether it has a principal regulator, must notify the Commission promptly (within 24 hours) under paragraphs (e)(1)(i) through (iii) if certain early warning indicators of low capital occur;[81] it files a Form 8–K with the Commission; or a material affiliate declares bankruptcy or otherwise becomes insolvent.

In addition to the notification requirements contained in paragraph (e)(1), an ultimate holding company that does not have a principal regulator also must notify the Commission under paragraphs (e)(2)(i) through (iii), as a condition to the broker-dealer's net capital exemption, if an NRSRO materially reduces its assessment of the creditworthiness of a material affiliate or of the credit rating(s) assigned to one or more outstanding short or long-term obligation of a material affiliate; a financial regulator or self-regulatory organization takes significant enforcement or regulatory action against a material affiliate; or any backtesting exception occurs under section 240.15c–1e(d)(1)(iii) or (iv) that would increase the ultimate holding company's multiplication factor in calculating its allowances for market or credit risk.

These notification provisions are designed to give the Commission advance warning of situations that may pose material financial and operational risks to the ultimate holding company and the broker-dealer and are integral to Commission supervision of broker-dealers that use Appendix E. The reduced requirements applicable to an ultimate holding company that has a principal regulator, as set forth in paragraph (e)(1), are necessary to avoid imposing duplicative or inconsistent requirements.

E. Amendments to Rule 15c3–4

The Commission proposed to amend Rule 15c3–4. Rule 15c3–4 requires an OTC derivatives dealer to establish, document, and maintain a system of internal risk management controls that consider specified factors and are subject to periodic review by management. Under the Proposing Release, the Commission would have amended Rule 15c3–4 to apply to broker-dealers that use the alternative method of computing net capital under Appendix E and to affiliated ultimate holding companies.

The Commission is not amending Rule 15c3–4. Instead, under paragraph (a)(7)(iii) of Rule 15c3–1, as adopted, a broker-dealer that uses the alternative method of computing net capital must comply with Rule 15c3–4 with respect to all of its business activities as if it were an OTC derivatives dealer, subject to certain limitations.[82] Similarly, under paragraph (a)(1)(viii)(C) of Appendix E, as adopted, as a condition to its broker-dealer's use of the alternative method of computing net capital, an ultimate holding company that does not have a principal regulator must comply with Rule 15c3–4 with respect to all of its business activities as if were an OTC derivatives dealer, subject to certain limitations.[83] Paragraphs (a)(7)(iii) of Rule 15c3–1 and (a)(1)(viii)(C) of Appendix E require the broker-dealer or ultimate holding company to comply with Rule 15c3–4 with respect to all business activities. That is, compliance with Rule 15c3–4 is not limited to OTC derivatives transactions.[84] The Commission is not amending Rule 15c3–4 because we determined that we could accomplish our goal—compliance with the rule—in a more streamlined manner by requiring compliance with

[81] The Commission and the ultimate holding company will determine what the appropriate indicators of low capital are as part of the application process.

[82] Paragraphs (c)(5)(xiii), (c)(5)(xiv), (d)(8), and (d)(9) would not apply to a broker-dealer that uses the alternative method of computing net capital or to ultimate holding companies that do not have a principal regulator because those paragraphs relate solely to limitations on the types of transactions an OTC derivatives dealer may undertake.

[83] *See* footnote 82.

[84] *See* 17 CFR 240.15c3–4(c)(5)(x), (c)(5)(xi), (d)(1), (d)(5), and (d)(10).

the rule, rather than by amending the rule.

Participants in the securities markets are exposed to various risks, including market, credit, funding, legal, and operational risk. These risks result, in part, from the diverse range of financial instruments that broker-dealers now trade. Risk management controls within a broker-dealer promote the stability of the firm and, consequently, the stability of the marketplace. A firm that adopts 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. Furthermore, as a prudent business practice, large securities firms have developed risk management systems to manage risk on a consolidated basis at the ultimate holding company level. To understand how risks are managed at the broker-dealer, regulators must understand how risks are managed at the ultimate holding company.

F. Amendment to Rule 17a–4, Broker-Dealer Record Preservation Requirements

We are amending Rule 17a–4 to add paragraph (b)(12). This amendment requires a broker-dealer that uses the alternative method of computing net capital to preserve certain records required to be made under the final rules. Paragraph (d)(7)(iv) of proposed Appendix E would have required a broker-dealer to make and preserve a record related to its determination of credit ratings. We amended proposed paragraph (d)(7)(iv) and redesignated it as paragraph (c)(4)(vi)(D) of Appendix E, as adopted. Paragraph (c)(4)(vi)(D) requires a broker-dealer to keep a record related to the determination of credit ratings, but the preservation requirement for that record has been moved to Rule 17a–4(b)(12). The final rules also add paragraph (c)(4)(vi)(E) to Appendix E. Paragraph (c)(4)(vi)(E) is a new provision that permits a broker-dealer to determine credit risk weights based on internal calculations and requires the broker-dealer to make a record of this calculation to assist the Commission in monitoring financial and other risks to the broker-dealer. Rule 17a–4(b)(12) requires a broker-dealer to preserve the record of the calculation of credit risk weights. We placed the record preservation requirements for paragraphs (c)(4)(vi)(D) and (E) in Rule 17a–4(b)(12) because Rule 17a–4 is the broker-dealer record retention rule.

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

The Commission is adopting amendments to Rule 17a–5 as proposed, except as described below. The amendments to Exchange Act Rule 17a–5 require a broker-dealer that uses the alternative method of computing net capital to file certain reports with the Commission in addition to the reports that all broker-dealers must file under the rule. These reports provide current, detailed information regarding the financial position of the firm, which will assist us in understanding its risk profile. The Commission will use the information collected under the amendment to monitor the financial condition, internal risk management control system, and activities of a broker-dealer that elects the alternative method.

These additional reports include a monthly report detailing, among other things, the broker-dealer's derivatives revenues, certain market and credit risk information, and regular risk reports supplied to firm management, as well as quarterly reports on, among other things, how well the firm's daily VaR and maximum potential exposure calculations correspond to the daily net trading loss and backtesting results of mathematical models. As part of its annual audit, the broker-dealer also must include a supplemental report concerning management controls prepared by a registered public accounting firm in accordance with procedures agreed-upon by the broker-dealer and the accountant before the audit.[85]

Under paragraphs (a)(5)(i)(E)(*2*) and (*4*) of paragraph 17a–5, as revised and adopted, the broker-dealer no longer must report the five largest exposures to financial institutions for current exposure and maximum potential exposure. We have re-evaluated this requirement and believe that receipt of these reports on a monthly basis is not likely to aid the Commission in evaluating a broker-dealer's risk exposure. The remaining amendments to Rule 17a–5 are adopted as proposed.

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

We are revising the proposed amendments to Rule 17a–11. Exchange Act Rule 17a–11 requires a broker-dealer to notify the Commission and its designated examining authority of certain events within specified time periods. The occurrence of the events that require Commission notification indicate that the firm may be experiencing financial or operational difficulty.

The amendments to Rule 17a–11, as proposed, would have imposed additional notification requirements on broker-dealers that use the alternative method of computing net capital. Under these amendments, the broker-dealer would have notified the Commission if it became aware of certain credit rating downgrades relating to the broker-dealer or an affiliate of the broker-dealer; it received a notice of non-compliance from a regulatory authority; it became aware of a situation that may have had a material adverse effect on the ultimate holding company or on an affiliate of the holding company; or a backtesting exception of its mathematical models occurred that required the broker-dealer to use a higher multiplication factor in the calculation of its deductions for market or credit risk.

The revisions to Rule 17a–11, as adopted, amend only paragraphs (b)(2) and (h). Paragraph (b)(2) of Rule 17a–11, as adopted, requires a broker-dealer that computes its net capital under the alternative method of Appendix E to notify the Commission if its tentative net capital falls below the amount specified in Rule 15c3–1, which is $1 billion under Rule 15c3–1e(a)(7)(i). The notice must specify the broker-dealer's net capital and tentative net capital requirements and the current amount of its net capital and tentative net capital. We eliminated the other proposed amendments to Rule 17a–11 because they were redundant. Those proposed amendments would have required a broker-dealer to provide information to the Commission that its ultimate holding company must provide as a condition to the broker-dealer's use of the alternative method of computing net capital.

Paragraph (h), as adopted, notes that there is a notification provision in paragraph (a)(7)(ii) of Rule 15c3–1. That provision requires a broker-dealer to notify the Commission that same day if its tentative net capital falls below $5 billion. These notification provisions are necessary for the Commission to monitor the financial position of a broker-dealer that uses the alternative method of computing net capital.

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

The Commission is amending Rules 17h–1T and 17h–2T. Rule 17h–1T requires a broker-dealer to maintain and

[85] The broker-dealer must file a description of the agreed-upon procedures agreed to by the broker-dealer and the accountant and a notification of subsequent changes in those agreed-upon procedures, if any, with the Commission's principal office in Washington, DC.

preserve records and other information concerning its ultimate 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 the information required to be maintained and preserved under Rule 17h–1T. Under the proposed amendments, all broker-dealers using the alternative method of computing net capital would have been exempt from Rules 17h–1T and 17h–2T. The amendments to these rules, as adopted, exempt only broker-dealers that use the alternative method of computing net capital and are affiliated with ultimate holding companies that do not have principal regulators. This exemption is appropriate because an ultimate holding company that does not have a principal regulator would be required to make and retain documents substantially similar to the documents required by Rule 17h–1T and to make reports to the Commission that are substantially similar to those required by Rule 17h–2T. Under the rules as adopted, an ultimate holding company that has a principal regulator is not required to make and maintain these documents and, therefore, exemptions from Rules 17h–1T and 17h–2T are not appropriate.

J. Amendments to Section 240.19 and Rule 30–3

We have amended § 200.19a to expand the responsibilities of the Director of Division of Market Regulation to include administering the Commission's rules related to supervised investment bank holding companies and consolidated supervised entities, including the assessment of the internal risk management controls and mathematical models used to calculate net capital and allowances for market, credit, and operational risk.

The Commission also has adopted amendments to Rule 30–3 of its Rules of Organization and Program Management.[86] Through this rule, the Commission delegates authority to the Director of the Division of Market Regulation (''Director''). The amendments delegate the authority to the Director to: (i) Review amendments to applications of broker-dealers filed pursuant to Appendix E and Appendix G and to approve the amendments, unconditionally or subject to specified terms and conditions; (ii) grant extensions and exemptions from the notification requirements of paragraph (e) of Appendix G, unconditionally or subject to specified terms and conditions; (iii) impose additional conditions, pursuant to paragraph (e) of Appendix E, on a broker-dealer or on the ultimate holding company of a broker-dealer; (iv) require that a broker or dealer or the ultimate holding company of a broker or dealer provide information to the Commission pursuant to paragraphs (a)(1)(viii)(G), (a)(1)(ix)(C), and (a)(4) of Appendix E and paragraphs (b)(1)(i)(H) and (b)(2)(i)(C) of Appendix G; and (v) determine, pursuant to paragraph (a)(10)(ii) of Appendix E, that the notice that a broker-dealer provides to the Commission will become effective for a shorter or longer period of time.

The Commission is delegating its authority to the Director for the limited purposes described above. These delegations of authority are intended to conserve Commission resources. The Commission anticipates that the delegation of authority will facilitate the implementation of the rule amendments. The staff, however, may submit matters to the Commission for consideration as it deems appropriate.[87]

The Commission finds, in accordance with the Administrative Procedure Act, 5 U.S.C. 553(b)(3)(A), that these amendments to Rule 30–3 relate solely to agency organization, procedure, or practice. Accordingly, notice and opportunity for public comment, as well as publication 30 days before their effective date, are unnecessary.

IV. Paperwork Reduction Act

As discussed in the Proposing Release, certain provisions of the rule amendments contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995.[88] The Commission submitted them to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 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 OMB approved the information collections. The titles and OMB control numbers for the collections of information are: (1) Net capital requirements for brokers or dealers, OMB No. 3235–0200; (2) Rule 15c3–4, Internal risk management control systems for certain brokers or dealers, OMB No. 3235–0497; (3) Rule 17a–5, Reports to be made by certain brokers and dealers, OMB No. 3235–0123; (4) Rule 17a–11, Notification procedures for brokers and dealers, OMB No. 3235–0085; (5) Rule 17h–1T, Risk assessment recordkeeping requirements for associated persons of brokers and dealers, OMB No. 3235–0410; and (6) Rule 17h–2T, Risk assessment reporting requirements for brokers and dealers, OMB No. 3235–0410.

The rule amendments provide a voluntary alternative method for computing certain deductions from net capital for market and credit risk under the Exchange Act for certain broker-dealers that are part of an ultimate 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. The alternative net capital computation involves the use of internally developed mathematical models that the firm uses to measure risk.

As noted in the Proposing Release, the collection of information obligations imposed by the rule amendments is mandatory. However, applying for approval to use the alternative capital calculation is voluntary. The information collected, retained, and/or filed pursuant to the rule amendments will be accorded confidential treatment to the extent permitted by law.

The Commission will use the information collected under the rule amendments to monitor the financial condition, internal risk management control system, and activities of broker-dealers that elect to use the alternative method of computing net capital and their ultimate holding companies and affiliates. In particular, the amendments 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. Failure to require the collections of information included in the rule amendments would undermine the Commission's ability to monitor the financial condition of these firms and could jeopardize the financial stability of broker-dealers using the alternative method of computing net capital.

The Proposing Release solicited comments on the proposed collections of information. We received no comments that addressed the PRA submission. However, we did receive comments on other aspects of the proposed amendments. The Commission is adopting rule amendments that contain various modifications to the proposed amendments. As discussed below, some of those modifications, as well as comments received on other aspects of

[86] 17 CFR 200.30–3.

[87] 17 CFR 200.30–3(e) and 200.30–3(g).

[88] 44 U.S.C. 3501 *et seq.*

the proposed amendments result in changes to the PRA estimates.

Under proposed paragraph (a)(7) of Rule 15c3–1, a broker-dealer that maintained tentative net capital of at least $1 billion and net capital of at least $500 million could apply to the Commission for permission to use the alternative method of calculating net capital. Under paragraph (a)(7) as adopted, a broker-dealer is also required to notify the Commission if its tentative net capital falls below $5 billion. If a broker-dealer is required to provide that notice to the Commission, the Commission may impose additional regulatory conditions, as set forth in paragraph (e) of Appendix E, on either the broker-dealer or, if the ultimate holding company of the broker-dealer is not an ultimate holding company that has a principal regulator, on the ultimate holding company. The PRA burden associated with this notification requirement is included in the PRA burden for Rule 17a–11, which is discussed below.

We noted in the Proposing Release that, 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, we believed that only broker-dealers with at least $1 billion in deductions pursuant to Rule 15c3–1(c)(2)(vi) (also known as ''haircuts'') would 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 were based on the assumption that 12 broker-dealers would apply to use the alternative net capital computation.

According to September 30, 2003 FOCUS filings, only six registered broker-dealers reported that they had tentative net capital of at least $5 billion. Some firms, however, make certain deductions in arriving at the FOCUS tentative net capital figure (for example, relating to securities without a ready market) that would not be subtracted in the calculation of tentative net capital for purposes of the rule amendments. Based on the final rule amendments, the comments received in response to the proposal, and these facts, we now estimate that 11 broker-dealers will apply to use the alternative net capital computation.

In addition, based on comments received, the Commission has modified the proposed rules to establish exemptions from certain requirements for an ultimate holding company of a broker-dealer using the alternative method of computing net capital that is ''an ultimate holding company that has a principal regulator.'' These exemptions are intended to avoid duplicative or inconsistent regulation of these entities. Of the 11 broker-dealers that we now estimate will apply under the rule amendments, we estimate that six have an ultimate holding company that has a principal regulator. The streamlined supervisory regime for these financial holding companies affects application requirements, internal risk management control system requirements, and examination and reporting requirements, and generally results in lower PRA burden estimates.

The estimates are based on information from a variety of sources, including information that 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.

Some of the changes in our estimates result from use of certain updated data. The revised PRA burden estimates are discussed below for each rule amendment.

A. Rule 15c3–1. Net Capital Requirements for 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 has added Appendix E to the rule to provide an alternative method for determining certain deductions from net capital for market and credit risk for certain broker-dealers that manage risk on a group-wide basis and that submit to group-wide Commission supervision.

As part of the application to use Appendix E, the broker-dealer and its ultimate holding company must submit various documents to the Commission. The documents the broker-dealer must submit as part of the application are the same regardless of whether the ultimate holding company of the broker-dealer is an ultimate holding company that has a principal regulator, except that the scope of the written undertaking of the ultimate holding company is reduced if the ultimate holding company has a principal regulator. If the ultimate holding company has a principal regulator, however, the ultimate holding company is required to submit fewer documents with the application of the broker-dealer than an ultimate holding company that does not have a principal regulator. For example, an ultimate holding company that has a principal regulator will not be required to submit a description of the risk management control system for the affiliate group and will not be required to submit sample capital measurement calculations and descriptions of those calculations. An ultimate holding company that has a principal regulator will be required to submit a capital measurement that it has reported to its principal regulator.

In the Proposing Release, we estimated that each broker-dealer that applied under the rule amendments 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 included approximately 100 hours for an in-house attorney to complete a review of the application. We received no comments on these estimates and we believe that whether or not the ultimate holding company of a broker-dealer has a principal regulator, the PRA burden associated with the application process still will be approximately 1,000 hours because the documents to be submitted by the broker-dealer are substantially the same in either case. As we now estimate that approximately 11 firms will apply under the rule amendments, instead of the 12 firm-estimate we used in the Proposing Release, the new one-time PRA burden associated with the application process is approximately 11,000 hours.

As we noted in the Proposing Release, firms we expect to apply to use Appendix E already have developed the VaR models that they will use to calculate market and credit risk under these rules and already have 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 rule amendments contain additional requirements that firms may not yet have incorporated into their models and control systems.

In the Proposing Release, we estimated 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. We believe that whether or not the ultimate holding company of a broker-dealer has a principal regulator, the PRA burden would be the same. Consequently, we estimate that the total burden under the rule amendments for reviewing and backtesting mathematical models for the 11 broker-dealers we now expect to apply will be approximately 69,000 hours per year ((5,600 + 640) × 11 = 68,640).

Under proposed Appendix G to Rule 15c3–1, the ultimate holding company of a broker-dealer using the alternative method of computing net capital was 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. As we noted in the Proposing Release, capital measurement, reporting, and recordkeeping conditions are necessary to allow the Commission to oversee properly a broker-dealer that uses Appendix E and to monitor the financial and operational condition of its affiliate group. In particular, the reporting requirements of 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 ultimate holding company and affiliates of the broker-dealer and whether the holding company is in compliance with the conditions of the broker-dealer's exemption. These reports will help the Commission to anticipate the effect on the ultimate holding company and affiliates of the broker-dealer of significant economic events and their impact on the broker-dealer.

The Commission has modified the capital measurement and reporting conditions in the final rule amendments for an ultimate holding company of a broker-dealer using the alternative method of computing net capital that has a principal regulator. For such an ultimate holding company, there is no requirement to calculate allowable capital and allowances for market, credit, and operational risk monthly. Also, the ultimate holding company is not required to file monthly reports with the Commission. An ultimate holding company that has a principal regulator must file quarterly reports containing consolidated and consolidating financial statements, a capital measurement it provides to its principal regulator, and certain regular risk reports provided to the persons responsible for managing group-wide risk as the Commission may request. The holding company also must file an annual report consisting of audited consolidating and consolidated financial statements and a report of the holding company's capital measurement, as provided to its principal regulator.

In addition, the Commission has modified the reporting requirements in the final rule amendments for an ultimate holding company that does not have a principal regulator. The deadlines for the submission of the monthly and annual reports have been extended and certain financial information does not have to be filed with the monthly or quarterly reports if the information has not yet been made public in the ultimate holding company's annual report on Form 10–K. These changes should not materially affect the PRA burden estimates for the ultimate holding company that does not have a principal regulator.

In the Proposing Release, based on Commission experience and discussions with industry participants, we estimated that the 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. In addition, we estimated that it would require approximately 5,600 hours per year to review and update the mathematical models that the ultimate holding company uses to make these calculations. Finally, we estimated that it would require approximately 160 hours each quarter, or approximately 640 hours each year, to backtest the models.

The models used by the broker-dealer and the ultimate holding company to calculate risk on similar classes of products will generally be the same models. However, we expect that the ultimate holding company will use models in its risk calculations for additional products. These additional products could include, for example, loans and loan commitments, structured financial products, or various types of derivatives business not conducted in the broker-dealer.

For the five ultimate holding companies that do not have a principal regulator whose broker-dealers we expect to apply to operate under the rule amendments, our burden estimate for each ultimate holding company to comply with the capital measurement and mathematical model review, updating, and backtesting requirements of the rule amendments has not changed. Thus, the total burden on these five ultimate holding companies is approximately 37,000 hours per year ((5,600 + 640 + 1,080) × 5 = 36,600).

The rule amendments do not require an ultimate holding company that has a principal regulator to compute allowable capital or allowances for market, credit, and operational risk or to review, update, and backtest its mathematical models. As a result, we conclude that there is no PRA burden on these ultimate holding companies as a result of the capital measurement requirements of the rule amendments. The ultimate holding company must provide its principal regulator with a capital measurement, and must review, update, and backtest the mathematical models it uses to derive that measurement.

In the Proposing Release, we estimated 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. These estimates were described in the Proposing Release and elicited no comments. For each of the five broker-dealer ultimate holding companies that do not have principal regulators, our PRA burden estimate for preparing and filing the reports required under the rule amendments is unchanged. Therefore, for these holding companies, the PRA burden is approximately 1,800 hours per year ((96 + 64 + 200) × 5 = 1,800).

For ultimate holding companies that have a principal regulator, the ultimate holding company will be required only to send to the Commission reports it has prepared for other purposes. No monthly reports are required under the rule amendments, and the quarterly and annual reports consist of reports the ultimate holding company has provided to persons in the ultimate holding company responsible for managing risk or reports the ultimate holding company provides to its principal regulator. Therefore, we expect that the PRA burden for an ultimate holding company with a principal regulator as a result of the reporting requirements under the amendments will be approximately 40 hours per year. For the six ultimate holding companies that have a principal

regulator, the total burden will therefore be approximately 240 hours per year.

In the Proposing Release, we stated that we expected that any additional burden associated with the requirements of 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 estimated 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.

As the record creation and record preservation requirements under the final rule amendments for an ultimate holding company that does not have a principal regulator have not been changed from the proposal, we estimate that the one-time burden for the five ultimate holding companies will be 40 * 5 = 200 hours and the annual burden will be approximately 290 * 5 = 1,450 hours.

The final rule amendments do not impose record creation requirements on an ultimate holding company that has a principal regulator, so there will be no burden on the ultimate holding company for record creation as a result of the rule amendments. An ultimate holding company that has a principal regulator must preserve only any application or documents and all reports and notices filed with the Commission under the rule amendments and any written responses received from the Commission. We do not expect that an ultimate holding company with a principal regulator will incur any PRA burden as a result of the record preservation requirements of the rule amendments because the principal regulator will already require preservation of these records.

The notification provisions of 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 its ultimate holding company and affiliates. These provisions are integral to Commission supervision of broker-dealers that use Appendix E. We estimated in the Proposing Release that it would require a total of approximately one hour per year for all 12 of the ultimate holding companies of the broker-dealers we expected to apply under the proposal to comply with the notification provisions of Appendix G. We have not changed that estimate for the ultimate holding companies of the 11 broker-dealers we now expect to apply under the rule amendments.[89]

Rule 15c3–4 requires an OTC derivatives dealer that uses Appendix F to calculate certain its net capital to establish, document, and maintain a system of internal risk management controls. In the Proposing Release, we proposed amendments to Rule 15c3–4 to expand its coverage to broker-dealers that use Appendix E, and we proposed that the ultimate holding company of the broker-dealer, as a condition to a broker-dealer's use of the alternative method of computing net capital, would be required to comply with Rule 15c3–4 with respect to an internal risk management control system for the affiliate group. The final rule amendments do not include amendments to Rule 15c3–4. However, under the final amendments to Rule 15c3–1, a broker-dealer that uses Appendix E to calculate net capital must comply with applicable provisions of Rule 15c3–4 as though it were an OTC derivatives dealer that uses Appendix F and ultimate holding company that does not have a principal regulator must agree to comply with applicable provisions of Rule 15c3–4 with respect to an internal risk management control system for the affiliate group. Under the final rule amendments, however, an ultimate holding company that has a principal regulator is no longer required to agree to comply with Rule 15c3–4 with respect to a group-wide internal risk management control system because the principal regulator already imposes risk management control system requirements on the ultimate holding company. The additional PRA burden for Rule 15c3–4 of 3,000 hours was proposed and approved. That burden, adjusted as discussed below, is now included in the PRA burden for Rule 15c3–1.

Rule 15c3–4 requires that in implementing its internal risk management control system policies and procedures, the broker-dealer must document its system of internal risk management controls. In particular, such a firm must document its consideration of certain issues affecting its business when designing its internal controls. The broker-dealer also must prepare and maintain written guidelines that discuss its internal risk management control system.

The rule amendments are 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 Exchange Act Rule 15c3–4 is essential to the regulation and oversight of major securities firms that voluntarily elect to use Appendix E. More specifically, requiring a broker-dealer that elects to use Appendix E (and the ultimate holding company of the broker-dealer, if the holding company does not have a principal regulator) to document the planning, implementation, and periodic review of its risk management controls is 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 11 broker-dealers we now expect to apply under these rules and their ultimate holding companies already have developed internal risk management control systems. Each broker-dealer, however, (and the ultimate holding company of the broker-dealer, if the ultimate holding company does not have a principal regulator) will have to take some additional steps to review and enhance its control system for purposes of the final rule amendments. This assessment is based on examinations of and discussions with the firms. We expect that the amount of time necessary to accomplish this will vary by broker-dealer. In the Proposing Release, we estimated that of the 12 broker-dealers we expected to apply under the amendments, six would spend approximately 1,000 hours and six would spend approximately 3,600 hours to amodify their internal risk management control systems for purposes of the rule amendments. In addition, we estimated that each of the 12 broker-dealers would spend approximately 250 hours per year reviewing and updating its risk management control system.

We now estimate that 11 broker-dealers will apply under the final rule amendments and that, although the amount of time required to modify its internal risk management control system to comply with the final rule amendments will vary, we estimate that on average a broker-dealer (and its ultimate holding company, if

[89] The Commission received approximately 841 Rule 17a–11 notifications from 562 broker-dealers during calendar year 2003, when there were approximately 6,800 active broker-dealers registered with the Commission. Thus, approximately 8% of registered broker-dealers filed a Rule 17a–11 notice in 2003 (562 / 6,800 = .0826). Therefore, we estimate that of the 11 ultimate holding companies of broker-dealers we expect to apply under the rule amendments, approximately one may be required to file notice under this provision. We estimate that, consistent with the Rule 17a–11 PRA burden estimate, it will take approximately one hour to prepare and file that notice.

applicable) will spend approximately 2,000 hours to accomplish this task. The total burden is therefore approximately 22,000 hours on a one-time basis. As in the Proposing Release, we expect that it will take an average of approximately 250 hours per year for each firm to review and update its internal risk management control system, for a total annual burden of 2,750 hours (250 * 11 = 2,750).

B. Rule 17a–4. Records To Be Preserved by Certain Exchange Members, Brokers and Dealers

The final rules add an amendment to Rule 17a–4, which was not contained in the proposed rule amendments. The amendment requires a broker-dealer taking advantage of the alternative capital calculation to preserve records made under paragraphs (c)(4)(vi)(D) and (E) of Appendix E. These records relate to the broker-dealer's determination of credit ratings and credit risk weights, respectively.

Paragraph (c)(4)(vi)(E) was not contained in the proposed rule amendments. The Proposing Release, however, would have required a broker-dealer to preserve the record made pursuant to paragraph (c)(4)(vi)(D) (designated as paragraph (d)(7)(iv) in the Proposing Release). Rule 17a–4 is the broker-dealer record retention rule and it is therefore appropriate to amend Rule 17a–4 to require a broker-dealer to preserve the records made under paragraphs (c)(4)(vi)(D) and (E). We estimate that it will take an average of approximately one hour per year for the 11 broker-dealers we expect to apply under the rule amendments to comply with this record preservation requirement, for a total burden of 11 hours per year for the 11 broker-dealers.

C. Rule 17a–5. Reports To Be Made by Certain Brokers and Dealers

The amendments to Exchange Act Rule 17a–5 require broker-dealers using Appendix E to submit monthly, quarterly, and annual reports to the Commission. The amendments are an integral part of our financial responsibility program for broker-dealers electing to use Appendix E. The information to be collected under the amendments to Rule 17a–5 are essential to the regulation of these broker-dealers and will assist us and the SROs responsible for reviewing the activities of these broker-dealers to monitor and enforce compliance with applicable Commission rules, including rules pertaining to financial responsibility. These periodic reports will 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.

In the Proposing Release, we estimated 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. The final amendments to Rule 17a–5 are similar to those proposed. We therefore estimate for the 11 broker-dealers we now expect to apply under the rule amendments that the total annual burden is approximately 1,320 hours ((48 + 32 + 40)* 11 = 1,320).

D. Rule 17a–11. Notification Procedures for Brokers and Dealers

We are revising the proposed amendments to Rule 17a–11. Exchange Act Rule 17a–11 requires that a broker-dealer provide notification of certain events to the Commission and its designated examining authority within specified time periods. The events that require Commission notification indicate that the firm may be experiencing financial or operational difficulty.

The amendments to Rule 17a–11, as proposed, would have imposed additional notification requirements on broker-dealers that use the alternative method of computing net capital. Under these amendments, the broker-dealer would have notified the Commission if it became aware of certain credit rating downgrades relating to the broker-dealer or an affiliate of the broker-dealer; it received a notice of non-compliance from a regulatory authority; it became aware of a situation that may have had a material adverse effect on the ultimate holding company or on a material affiliate of the holding company; or a backtesting exception of its mathematical models occurred that required the broker-dealer to use a higher multiplication factor in the calculation of its deductions for market or credit risk.

The revisions to Rule 17a–11, as adopted, amend only paragraphs (b)(2) and (h). Paragraph (b)(2) of Rule 17a-11, as adopted, requires a broker-dealer that computes its net capital under the alternative method of Appendix E to notify the Commission if its tentative net capital falls below $1 billion, the required minimum under Rule 15c3–1e(a)(7)(i). The notice must specify the broker-dealer's net capital and tentative net capital requirements and the current amount of its net capital and tentative net capital. Paragraph (h), as adopted, notes that there is a notification provision in Rule 15c3–1e(a)(7)(ii). That provision requires a broker-dealer to notify the Commission that same day if its tentative net capital falls below $5 billion. These notification provisions are necessary for the Commission to monitor the financial position of a broker-dealer that uses the alternative method of computing net capital.

Although they are of supervisory concern, the events requiring notification under the rule amendments are expected to be rare. In the Proposing Release, we based our estimate of the number of broker-dealers who might be required to file notice pursuant to the amendments on the number of Rule 17a–11 notices we received in calendar year 2002. We are now basing our estimate on year 2003 data.

The Commission received approximately 841 Rule 17a–11 notices from 562 broker-dealers during calendar year 2003. At that time, there were approximately 6,800 active broker-dealers registered with the Commission, so we estimate that approximately 8% of active broker-dealers filed a Rule 17a–11 notice during calendar year 2003 (562/6,800 = .0826). Therefore, we estimate that, of the 11 broker-dealers we now expect to apply under the rule amendments, approximately one may be required to file notice pursuant to these amendments. In the Proposing Release, we estimated that it would take approximately one hour per year to prepare and file such a notice. As the notification requirements of the final amendments to Rule 17a–11 are similar, we have not changed that estimate.

E. 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 current burden estimate for Rules 17h–1T and 17h–2T is approximately 10 hours per year for each respondent. The proposed amendments to Rules 17h–1T and 17h–2T exempted a broker-dealer that used Appendix E from the rules to the extent

that the ultimate holding company of the broker or dealer maintained the information pursuant to Appendix G.

In the final rule amendments, only a broker-dealer with an ultimate holding company that does not have a principal regulator is exempted from Rules 17h–1T and 17h–2T. As we estimate that five broker-dealers that have holding companies that do not have a principal regulator will apply under the rule amendments, the savings will be approximately 50 hours per year.

F. Conclusion

Based on the above analysis, we estimate that the total additional PRA burden as a result of the final rule amendments is approximately 33,200 hours on a one-time basis and approximately 113,600 hours per year. We estimate that the PRA burden will be reduced by approximately 50 hours per year as a result of the rule amendments.

V. Costs and Benefits of the Rule Amendments

A. Introduction

The rule amendments provide a voluntary, alternative method for computing net capital deductions for market and credit risk under the Exchange Act for certain broker-dealers that are part of an ultimate holding company that has a group-wide internal risk management control system and that consents, as a condition of the net capital treatment, to group-wide Commission supervision. The alternative net capital computation involves the use of internally developed mathematical models that the firm uses to measure risk.

The Commission is sensitive to the costs and benefits that result from its rules. We have identified certain costs and benefits associated with the rule amendments.

The Proposing Release solicited comments relating to the costs and benefits associated with the proposed rule amendments. We received no comments that addressed the costs and benefits of the proposal. However, we did receive comments on other aspects of the proposed amendments. The Commission is adopting rule amendments that contain various modifications to the proposed amendments. As discussed below, some of those modifications, as well as comments received on other aspects of the proposed amendments, result in changes to the costs and benefits of the rule amendments.

Under proposed paragraph (a)(7) of Rule 15c3–1, a broker-dealer that maintained tentative net capital of at least $1 billion and net capital of at least $500 million could apply to the Commission for permission to use the alternative method of calculating net capital. Under paragraph (a)(7) as adopted, a broker-dealer is also required to notify the Commission if its tentative net capital falls below $5 billion. If a broker-dealer is required to provide that notice to the Commission, the Commission may impose additional regulatory conditions on either the broker-dealer or, if the ultimate holding company of the broker-dealer does not have a principal regulator, on the ultimate holding company.

We noted in the Proposing Release that, based on discussions with industry representatives, we believed that 12 broker-dealers would have sufficient net capital deductions pursuant to Rule 15c3–1(c)(2)(vi) (also known as ''haircuts'') to find it cost effective to use the alternative capital computation. Therefore, the cost-benefit analysis was based on the assumption that 12 broker-dealers would apply to use the alternative capital computation.

According to September 30, 2003 FOCUS filings, only six registered broker-dealers reported that they had tentative net capital of at least $5 billion. Some firms, however, make certain deductions in arriving at the FOCUS tentative net capital figure (for example, relating to securities without a ready market) that would not be subtracted in the calculation of tentative net capital for purposes of the rule amendments. Based on the final rule amendments, the comments received in response to the proposal, and these facts, we now estimate that 11 broker-dealers will apply to use the alternative net capital computation.

In addition, the Commission has modified the proposed rules to establish a streamlined group-wide supervisory regime for an ultimate holding company of a broker-dealer taking advantage of the rule amendments that is ''an ultimate holding company that has a principal regulator'' to avoid duplicative or inconsistent regulation of these entities. Of the 11 broker-dealers we now estimate will apply under the rule amendments, we estimate that six have an ultimate holding company that has a principal regulator. The streamlined supervisory regime for these holding companies reduces application requirements, internal risk management control system requirements, and examination and reporting requirements, and generally results in lower costs.

The estimates are based on information from a variety of sources, including information that Commission staff receives through the risk assessment rules and meetings with and reports from member firms of the DPG and other broker-dealers and the Commission's experience in implementing the OTC derivatives dealer rules.

Some of the changes to our estimates result from use of certain updated data. The revised cost and benefit estimates are discussed below for each rule amendment.

B. Benefits

We anticipate that cost savings will result in several areas. If permitted to operate under the amendments, a broker-dealer will become subject to specifically tailored capital and other requirements. The broker-dealer will be able to compute certain of its deductions for market and credit risk 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 incorporation of mathematical risk management techniques into the capital calculation 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.

A major benefit for the broker-dealer will be lower deductions from net capital for market and credit risk that we expect will result from the use of the alternative method. This benefit, however, is difficult to quantify. While reductions in net capital requirements will 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 deductions will vary significantly among broker-dealers based on the size and risk of their portfolios.

We expect that firms with larger net capital deductions will realize a larger percentage reduction than firms with smaller capital deductions. In the Proposing Release, we estimated that broker-dealers taking advantage of the alternative capital computation would realize an average reduction in capital deductions of approximately 40%. We estimated that a broker-dealer could reallocate capital to fund business activities for which the rate of return would be approximately 20 basis points (0.2%) higher.

According to third quarter 2003 FOCUS data, the 11 firms we expect to apply under the rule amendments could realize a total reduction in haircuts of approximately $13 billion. We estimate that they will realize a total annual benefit of approximately $26 million (.2% * $13 billion = $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 ultimate 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 net capital deductions or be required to form a sub-holding company in the EU. We expect that the Commission supervision contemplated by these amendments will meet this standard. As a result, we believe these amendments will minimize duplicative regulatory burdens on firms that do not have ultimate holding companies that have a principal regulator that are active in the EU as well as in other jurisdictions that may have similar laws.

Based on staff experience, 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. Consequently, for the five broker-dealers we expect will apply under these amendments that do not have an ultimate holding company that has a principal regulator, not being required to form and maintain a sub-holding company in the EU would save the firms a total of approximately $40 million per year.

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 current PRA estimate for Rules 17h–1T and 17h–2T is approximately 10 hours per year for each respondent. The proposed amendments to Rules 17h–1T and 17h–2T exempted a broker-dealer that used Appendix E from the rules to the extent that the ultimate holding company of the broker or dealer maintained the information pursuant to Appendix G.

In the final rule amendments, only a broker-dealer that has an ultimate holding company that does not have a principal regulator is exempted from Rules 17h–1T and 17h–2T. As we estimate that five broker-dealers will apply under the rule amendments that have ultimate holding companies that do not have a principal regulator, the savings are approximately 50 hours per year. We expect that a financial reporting manager will do this work. The staff estimates that the hourly salary of a financial reporting manager is $92 per hour.[90] We estimate that the total cost savings for the 5 firms will be approximately $4,600 per year (50 * $92 = $4,600).

To the extent that firms electing this regulatory system improve their internal risk management control systems, we expect that the firms will 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 this regulatory system also will result in benefits to regulators and, as a result, to financial markets. The Commission will have access to group-wide information concerning the operation and financial condition of the broker-dealer's ultimate holding company and affiliates. This information will help the Commission to assess whether the activities or financial condition of the ultimate holding company or affiliates may pose risks to the financial health of the broker-dealer and should therefore promote the stability of the financial markets.

Also, the broker-dealer must comply with stringent requirements concerning its internal risk management control system. We expect that these requirements will reduce the risk of significant losses by the broker-dealer. The internal risk management control system requirements also should reduce the risk that the problems of one firm will spread, causing defaults by other firms and undermining securities markets as a whole.

C. Costs

Firms electing the alternative capital computation will incur various costs. In estimating the total costs associated with the amendments on the broker-dealer, we have included the costs arising from each rule amendment.

As part of the application to use Appendix E, the broker-dealer and its ultimate holding company must submit various documents to the Commission. We estimate that each broker-dealer that applies to calculate its net capital under the amendments will 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 will include approximately 100 hours for an in-house attorney and 900 hours for a senior compliance staff member. The staff estimates that the hourly salary of an attorney is $82 per hour,[91] for a total cost for the 11 firms of approximately $90,000 ($82 * 100 * 11 = $90,200). The staff estimates that the hourly salary of a senior compliance staff person is $71 per hour,[92] for a total cost of approximately $703,000 ($71 * 900 * 11 = $702,900).

We note that broker-dealers we expect to apply to use Appendix E already have developed the VaR models that they will use to calculate market and credit risk under the amendments and already have 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 amendments contain additional requirements that broker-dealers may not yet have incorporated into their models and control systems.

We estimate that a broker-dealer using Appendix E will spend approximately 5,600 hours per year to review and update 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. We believe that whether or not the ultimate holding company of a broker-dealer is an ultimate holding company that has a principal regulator, this time requirement would be the same. Consequently, we estimate that it would take approximately 69,000 hours per year ((5,600 + 640) * 11 = 68,640) to review, update, and backtest mathematical models for the 11 broker-dealers we now expect to apply under the amendments and that a financial

[90] Generally, to calculate an hourly cost, the staff takes the median (or, if no median is provided, the mean) salary provided in the latest annual Securities Industry Association's Report on Management and Professional Earnings in the Securities Industry (''SIA Report'') for the position cited, divides that amount by 1,800 hours (in the average work year), then multiplies the result by 135% to account for employee overhead costs. For a Financial Reporting Manager, the hourly cost is computed as follows: $123,000 salary per year (based on end of year 2003 SIA Report figures)/1800 hours per year * 1.35 = $92 per hour.

[91] SIA Report (Attorney) + 35% overhead (based on end-of-year 2003 figures) ($109,000 per year/1800 hours/year * 1.35 = $82 per hour).

[92] SIA Report (Senior Compliance Staff) + 35% overhead (based on end-of-year 2003 figures) ($94,700 per year/1800 hours/year * 1.35 = $71 per hour).

reporting specialist will do the work. The staff estimates that the hourly salary of a financial reporting manager is $92 per hour,[93] for a total cost of approximately $6.3 million per year ($92 * 69,000 = $6,348,000).

Under proposed Appendix G to Rule 15c3–1, the ultimate holding company of a broker-dealer using the alternative capital computation would have been 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. As we noted in the Proposing Release, capital measurement, reporting, and recordkeeping conditions are necessary to allow the Commission to oversee properly a broker-dealer that uses Appendix E and to monitor the financial and operational condition of its affiliate group. In particular, the proposed reporting requirements of 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 ultimate holding company and affiliates of the broker-dealer and whether the ultimate holding company is in compliance with the conditions of the broker-dealer's exemption. These reports will help the Commission to anticipate the effect on the ultimate holding company and affiliates of significant economic events and their impact on the broker-dealer.

The Commission has modified the capital measurement and reporting conditions in the final rule amendments for an ultimate holding company that is an ultimate holding company that has a principal regulator. For such an ultimate holding company, there is no requirement to calculate allowable capital and allowances for market, credit, and operational risk monthly. Also, the ultimate holding company is not required to file monthly reports with the Commission. An ultimate holding company that has a principal regulator must file quarterly reports containing consolidated and consolidating financial statements, a capital measurement it provides to its principal regulator, and certain regular risk reports provided to the persons responsible for managing group-wide risk as the Commission may request. The ultimate holding company also must file an annual report consisting of audited consolidating and consolidated financial statements and a report of the ultimate holding company's capital measurement, as provided to its principal regulator.

In addition, the Commission has modified the reporting requirements in the final rule amendments for an ultimate holding company that does not have a principal regulator. The deadlines for the submission of the monthly and annual reports have been extended and certain financial information does not have to be filed with the monthly or quarterly reports if the information has not yet been made public in the holding company's annual report on Form 10–K. These changes should not materially affect the burden estimates for the ultimate holding company that does not have a principal regulator.

In the Proposing Release, based on Commission experience and discussions with industry participants, we estimated that the 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. In addition, we estimated that it would require approximately 5,600 hours per year to review and update the mathematical models the holding company uses to make these calculations. Finally, we estimated that it would require approximately 160 hours each quarter, or approximately 640 hours each year, to backtest the models.

The broker-dealer and the ultimate holding company generally will use the same models to calculate risk on similar classes of products. However, we expect that the ultimate holding company will use models in its risk calculations for additional products. These additional products could include, for example, loans and loan commitments, structured financial products, or various types of derivatives business not conducted in the broker-dealer.

For the five ultimate holding companies that do not have a principal regulator whose broker-dealers we expect to apply to operate under the rule amendments, our estimates from the Proposing Release have not changed. We estimate that to compute allowable capital and allowances for market, credit, and operational risk for the five ultimate holding companies would take approximately 5,400 hours (1,080 * 5 = 5,400). We expect that a senior accountant would do the work. The staff estimates that the hourly salary of a senior accountant is $55 per hour.[94] The total annual cost is approximately $300,000 ($55 * 5,400 = $297,000). 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 28,000 hours per year for the five ultimate holding companies, 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 $92 per hour.[95] The total annual cost is approximately $2.6 million ($92 * 28,000 = $2,576,000). Finally, we estimate that it will require approximately 640 hours per year per firm to backtest the models, or approximately 3,200 hours for the five ultimate holding companies, 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 $50 per hour,[96] for a total annual cost of approximately $160,000 ($50 * 3,200 = $160,000).

The rule amendments do not require an ultimate holding company that has a principal regulator to compute allowable capital or allowances for market, credit, and operational risk or to review, update, and backtest its mathematical models. As a result, we conclude that there will be minimal costs, if any, to such ultimate holding companies as a result of the capital measurement requirements of the rule amendments. The ultimate holding company must provide its principal regulator with a capital measurement, and must review, update, and backtest the mathematical models it uses to derive that measurement.

In the Proposing Release, we estimated 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

[93] SIA Report (Financial Reporting Manager) + 35% overhead (based on end-of-year 2003 figures) ($123,000 per year/1800 hours/year * 1.35 = $92 per hour).

[94] SIA Report (Senior Accountant) + 35% overhead (based on end-of-year 2003 figures) ($72,850 per year/1800 hours/year * 1.35 = $55 per hour).

[95] SIA Report (Financial Reporting Manager) + 35% overhead (based on end-of-year 2003 figures) ($123,000 per year/1800 hours/year * 1.35 = $92 per hour).

[96] SIA Report (Junior Research Analyst) + 35% overhead (based on end-of-year 2003 figures) ($67,200 per year/1800 hours/year * 1.35 = $50 per hour).

approximately 200 hours per year. These estimates were described in the Proposing Release and elicited no comments. For the five broker-dealer ultimate holding companies that do not have principal regulators, our estimate for the amount of time necessary for preparing and filing the reports required under the rule amendments is unchanged. Therefore, for these firms, it will take a total of approximately 1,800 hours ((96 + 64 + 200) * 5 = 1,800) to comply with these requirements.

For ultimate holding companies that have a principal regulator, the ultimate holding company must send to the Commission only the reports it has prepared for other purposes. No monthly reports are required under the rule amendments, and the quarterly and annual reports consist of reports the ultimate holding company has provided to persons in the ultimate holding company responsible for managing risk or reports the ultimate holding company provides to its principal regulator. Therefore, we expect that the time required for an ultimate holding company with a principal regulator as a result of the reporting requirements under the amendments will be minimal. We estimate that this time requirement is approximately 40 hours per year. For the six broker-dealers with ultimate holding companies that have principal regulators that we expect to apply under the rule amendments, the total time required will therefore be approximately 240 hours per year.

We expect that a senior accountant will do the work necessary to comply with the reporting requirements of the rule amendments. The staff estimates that the hourly salary of a senior accountant is $55 per hour,[97] for a total annual cost of approximately $110,000 ((1,800 + 240) * $55 = $112,200).

In the Proposing Release, we stated that we expected that any additional cost associated with the requirements of 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 estimated that the average time required to make and preserve these records would be approximately 40 hours and that the average annual time requirement would be approximately 290 hours.

As the record creation and record preservation requirements under the final rule amendments for an ultimate holding company that does not have a principal regulator have not been changed from the proposal, we estimate that for the five ultimate holding companies it would take approximately 200 hours (40 * 5 = 200) on a one-time basis and approximately 1450 hours per year (290 * 5 = 1,450) to comply with these requirements. We expect that a senior accountant would do the work. The staff estimates that the hourly salary of a senior accountant is $55 per hour,[98] for a total one-time cost of approximately $11,000 (200 *55 = $11,000) and a total annual cost of approximately $80,000 (1,450 * $55 = $79,750).

The final rule amendments do not impose record creation requirements on an ultimate holding company that has a principal regulator, so there will be no costs to the ultimate holding company for record creation as a result of the rule amendments. An ultimate holding company that has a principal regulator must preserve only any application or documents and all reports and notices filed with the Commission under the rule amendments and any written responses received from the Commission. We expect that an ultimate holding company that has a principal regulator will incur minimal costs, if any, as a result of the record preservation requirements of the rule amendments because the principal regulator will already require preservation of these records.

We estimated in the Proposing Release that it would require a total of approximately one hour per year for all 12 of the ultimate holding companies of the broker-dealers we expected to apply under the proposal to comply with the notification provisions of Appendix G. We have not changed that estimate for the ultimate holding companies of the 11 broker-dealers we now expect to apply under the rule amendments.[99] We expect that a senior compliance staff person will do the work. The staff estimates that the hourly salary of a senior compliance staff person is $71 per hour,[100] for a total annual cost for each of the 11 firms of approximately $71.

Rule 15c3–4 requires an OTC derivatives dealer that uses Appendix F to calculate net capital to establish, document, and maintain a system of internal risk management controls. In the Proposing Release, we proposed amendments to Rule 15c3–4 to expand its coverage to broker-dealers that use Appendix E, and we proposed that the ultimate holding company of the broker-dealer agree to comply with Rule 15c3–4 with respect to an internal risk management control system for the affiliate group. The final rule amendments do not include amendments to Rule 15c3–4. However, under Rule 15c3–1(a)(7)(iii), as adopted, a broker-dealer that uses Appendix E to calculate net capital must comply with applicable provisions of Rule 15c3–4 as though it were an OTC derivatives dealer that uses Appendix F. The final rule amendments also continue to require an ultimate holding company that does not have a principal regulator to agree to comply with applicable provisions of Rule 15c3–4 with respect to an internal risk management control system for the affiliate group. Under the final rule amendments, however, an ultimate holding company that has a principal regulator is no longer required to agree to comply with Rule 15c3–4 with respect to a group-wide internal risk management control system because the principal regulator already imposes risk management control system requirements on the ultimate holding company.

Rule 15c3–4 requires that in implementing its internal risk management control system policies and procedures, the broker-dealer must document its system of internal risk management controls. In particular, such a firm must document its consideration of certain issues affecting its business when designing its internal controls. The broker-dealer also must prepare and maintain written guidelines that discuss its internal risk management control system.

The rule amendments are 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 Exchange Act Rule 15c3–4 is essential to the regulation and

[97] SIA Report (Senior Accountant) + 35% overhead (based on end-of-year 2003 figures) ($72,850 per year/1800 hours/year * 1.35 = $55 per hour).

[98] SIA Report (Senior Accountant) + 35% overhead (based on end-of-year 2003 figures) ($72,850 per year/1800 hours/year * 1.35 = $55 per hour).

[99] The Commission received approximately 841 Rule17a–11 notifications from 562 broker-dealers during calendar year 2003, when there were approximately 6,800 active broker-dealers registered with the Commission. Thus, approximately 8% of registered broker-dealers filed a Rule 17a–11 notice in 2003 (562/6,800 = .0826). Therefore, we estimate that of the 11 ultimate holding companies of broker-dealers we expect to apply under the rule amendments, approximately one may be required to file notice under this provision. We estimate that it will take approximately one hour to prepare and file that notice.

[100] SIA Report (Senior Compliance Staff) + 35% overhead (based on end-of-year 2003 figures) ($94,700 per year/1800 hours/year * 1.35 = $71 per hour).

oversight of major securities firms that voluntarily elect to use Appendix E. More specifically, requiring a broker-dealer that elects to use Appendix E (and the ultimate holding company of the broker-dealer, if the holding company does not have a principal regulator) to document the planning, implementation, and periodic review of its risk management controls is designed to ensure that all pertinent risk management issues are considered, that the risk management controls are implemented properly, and that they continue to address adequately the risks faced by major securities firms.

The 11 broker-dealers we now expect to apply to use Appendix E and their ultimate holding companies already have developed internal risk management control systems. Each broker-dealer, however, (and the ultimate holding company of the broker-dealer, if the holding company does not have a principal regulator) must take some additional steps to review and enhance its control system for purposes of the final rule amendments. This assessment is based on examinations of and discussions with the firms. We expect that the amount of time necessary to accomplish this will vary by broker-dealer. In the Proposing Release, we estimated that of the 12 broker-dealers we expected to apply under the amendments, six would spend approximately 1,000 hours each and six would spend approximately 3,600 hours each to modify their internal risk management control system for purposes of the rule amendments. In addition, we estimated that each of the 12 broker-dealers would spend approximately 250 hours per year reviewing and updating its risk management control system.

We now estimate that 11 broker-dealers will apply under the final rule amendments and that, although the amount of time required to modify its internal risk management control system to comply with paragraph (a)(7)(iii) of Rule 15c3–1 will vary, we estimate that, on average, a broker-dealer (and its holding company, if applicable) will spend approximately 2,000 hours to accomplish this task, for a total of 22,000 hours for the 11 firms. We estimate that each of the 11 broker-dealers will spend an average of approximately 250 hours per year reviewing and updating its internal risk management control system for a total for the 11 broker-dealers of 2,750 hours per year (250 * 11 = 2,750). We expect that a senior compliance staff person will do the work. The staff estimates that the hourly salary of a senior compliance staff person is $71 per hour,[101] for a total one-time cost of approximately $1,600,000 (22,000 * 71 = $1,562,000) and a total annual cost of approximately $195,000 (2,750 * 71 = $195,250).

The information technology systems used by broker-dealers to manage risk, make and retain records, and report and calculate capital differ widely depending on the size of the firm and the types of business it engages in. Based on discussions with the firms, we believe that the 11 broker-dealers we expect to apply under the amendments have strong information technology systems. These information technology systems may be in varying stages of readiness to enable the holding company to meet the requirements of the amendments, however, so the cost of modifying their information technology systems to meet these requirements could vary significantly for the 11 firms. In the Proposing Release, we estimated that, on average, it would cost a broker-dealer an average of approximately $27.5 million to modify its systems. To take account of the fact that these firms regularly update their information technology systems for business purposes, we have lowered our estimate of the average amount that it would cost broker-dealers to modify their systems to meet the requirements of the rule amendments. We now estimate that it will cost broker-dealers an average of approximately $8 million each to modify their information technology systems to meet the requirements of the rule amendments, for a total for the 11 broker-dealers of approximately $88 million.

The final rule amendments add an amendment to Rule 17a–4, which was not contained in the proposed rule amendments. The amendment requires a broker-dealer using the alternative method of computing net capital to preserve records made under paragraphs (c)(4)(vi)(D) and (E) of Appendix E. These records relate to the broker-dealer's determination of credit ratings and credit risk weights, respectively.

Paragraph (c)(4)(vi)(E) was not contained in the proposed rule amendments. The Proposing Release, however, would have required a broker-dealer to preserve the record made pursuant to paragraph (c)(4)(vi)(D) (designated as paragraph (d)(7)(iv) in the Proposing Release). Rule 17a–4 is the broker-dealer record retention rule and it is therefore appropriate to amend Rule 17a–4 to require a broker-dealer to preserve the records made under paragraphs (c)(4)(vi)(D) and (E). We estimate that it will take an average of approximately one hour per year for the 11 broker-dealers we expect to apply under the rule amendments to comply with this record preservation requirement, for a total of 11 hours per year for the 11 broker-dealers, and we expect that a senior compliance staff person will do the work. The staff estimates that the average salary for a senior compliance staff person is $71 per hour [102] for a total annual cost of approximately $800 ($71 * 11 = $781).

The amendments to Exchange Act Rule 17a–5 require broker-dealers using Appendix E to submit monthly, quarterly, and annual reports to the Commission. The amendments are an integral part of our financial responsibility program for broker-dealers electing to use Appendix E. The information to be collected under the amendments to Rule 17a–5 are essential to the regulation of these broker-dealers and will assist us and the SROs 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 also will 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.

In the Proposing Release, we estimated 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. The final amendments to Rule 17a–5 are similar to those proposed. We therefore estimate for the 11 broker-dealers we now expect to apply under the rule amendments that the total annual time required is approximately 1,320 hours per year ((48 + 32 + 40)* 11 = 1,320). We expect that a senior accountant would do the work. The staff estimates that the hourly salary of a senior

[101] 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).

[102] SIA Report (Senior Compliance Staff) + 35% overhead (based on end-of-year 2003 figures) ($94,700 per year/1800 hours/year * 1.35 = $71 per hour).

accountant is $55 per hour,[103] for a total annual cost of approximately $73,000 (1,320 * $55 = $72,600).

We are revising the proposed amendments to Rule 17a–11. Exchange Act Rule 17a–11 requires that a broker-dealer provide notification of certain events to the Commission and its designated examining authority within specified time periods. The events that require Commission notification indicate that the firm may be experiencing financial or operational difficulty.

The amendments to Rule 17a–11, as proposed, would have imposed additional notification requirements on broker-dealers that use the alternative method of computing net capital. Under these amendments, the broker-dealer would have notified the Commission if it became aware of certain credit rating downgrades relating to the broker-dealer or an affiliate of the broker-dealer; it received a notice of non-compliance from a regulatory authority; it became aware of a situation that may have had a material adverse effect on the ultimate holding company or on an affiliate of the holding company; or a backtesting exception of its mathematical models occurred that required the broker-dealer to use a higher multiplication factor in the calculation of its deductions for market or credit risk.

The revisions to Rule 17a–11, as adopted, amend only paragraphs (b)(2) and (h). Paragraph (b)(2) of Rule 17a–11, as adopted, requires a broker-dealer that computes its net capital under the alternative method of Appendix E to notify the Commission if its tentative net capital falls below $1 billion, the required minimum under Rule 15c3–1e(a)(7)(i). The notice must specify the broker-dealer's net capital and tentative net capital requirements and the current amount of its net capital and tentative net capital. Paragraph (h), as adopted, notes that there is a notification provision in Rule 15c3–1e(a)(7)(ii). That provision requires a broker-dealer to notify the Commission that same day if its tentative net capital falls below $5 billion. These notification provisions are necessary for the Commission to monitor the financial position of a broker-dealer that uses the alternative method of computing net capital.

Although they are of supervisory concern, the events requiring notification under the rule amendments are expected to be rare. In the Proposing Release, we based our estimate of the number of broker-dealers who might be required to file notice pursuant to the amendments on the number of Rule 17a–11 notices we received in calendar year 2002. We are now basing our estimate on year 2003 data.

The Commission received approximately 841 Rule 17a–11 notices from 562 broker-dealers during calendar year 2003. At that time, there were approximately 6,800 active broker-dealers registered with the Commission, so we estimate that approximately 8% of active broker-dealers filed a Rule 17a–11 notice during calendar year 2003 (562 / 6,800 = .0826). Therefore, we estimate that, of the 11 broker-dealers we now expect to apply under the rule amendments, approximately one may be required to file notice pursuant to these amendments. In the Proposing Release, we estimated that it would take approximately one hour to prepare and file such a notice. As the notification requirements of the final amendments to Rule 17a–11 are similar, we estimate that it will take approximately one hour to prepare and file such a notice and that a senior compliance staff person will do the work. The staff estimates that the hourly salary of a senior compliance staff person is $71 per hour,[104] for a total annual cost of approximately $71.

D. Conclusion

Based on the above analysis, we estimate that the quantifiable benefits of the rule amendments are approximately $66 million per year. We estimate that the quantifiable costs of the rule amendments are approximately $10 million per year and approximately $90 million on a one-time basis.

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

Section 3(f) of the Exchange Act [105] requires us, when engaging in rulemaking that requires us to consider or determine whether an action is necessary or appropriate in the public interest or for the protection of investors, to consider whether the action will promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act [106] 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.

The Commission believes that the amendments should promote efficiency, competition, and capital formation. The amendments are intended to reduce regulatory costs for broker-dealers by allowing very highly capitalized firms that have developed sophisticated internal risk management systems and procedures, such as mathematical risk measurement models, to use those risk management systems and procedures (with any modifications required by the amendments) for regulatory purposes. The Commission believes that it would not be cost effective for a firm that does not maintain the requisite capital levels to develop the systems and procedures required under the amendments. The amendments should provide eligible broker-dealers an opportunity to increase operational efficiency by aligning their supervisory risk assessment and their computation of certain net capital deductions more closely with the sophisticated methods the firms already use to manage their business risk and capital, while at the same time requiring that the firms maintain sufficient capital. The incorporation of mathematical risk management techniques into the calculation of net capital deductions 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. In addition, the amendments should enhance the ability of U.S. securities firms to compete effectively in global securities markets.

VII. Regulatory Flexibility Act Certification

The Commission has certified, pursuant to section 605(b) of the Regulatory Flexibility Act,[107] that the amendments to Rules 15c3–1, 17a–4, 17a–5, 17a–11, 17h–1T, and 17h–2T would not have a significant economic impact on a substantial number of small entities. This certification was incorporated into the Proposing Release. We received no comments concerning the impact on small entities or the Regulatory Flexibility Act certification.

VIII. Statutory Authority

The Commission is amending 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, 23, 24(b), and 36 thereof (15 U.S.C. 78o(c), 78q(a), 78w, 78x(b), and 78mm)).

[103] SIA Report (Senior Accountant) + 35% overhead (based on end-of-year 2003 figures) ($72,850 per year/1800 hours/year * 1.35 = $55 per hour).

[104] SIA Report (Senior Compliance Staff) + 35% overhead (based on end-of-year 2003 figures) ($94,700 per year/1800 hours/year * 1.35 = $71 per hour).

[105] 15 U.S.C. 78c(f).

[106] 15 U.S.C. 78w(a)(2).

[107] 5 U.S.C. 605(b).

List of Subjects

17 CFR Part 200

Administrative practice and procedure, Authority delegations (Government agencies).

17 CFR Part 240

Broker-dealers, Reporting and recordkeeping requirements, Securities.

Text of Rule Amendments

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

PART 200—ORGANIZATION; CONDUCT AND ETHICS; AND INFORMATION AND REQUESTS

Subpart A—Organization and Program Management

■ 1. The authority citation for Part 200, subpart A, is revised to read as follows:

Authority: 15 U.S.C. 77s, 77o, 77sss, 78d, 78d–1, 78d–2, 78w, 78*11*(d), 78mm, 79t, 80a–37, 80b–11, and 7202, unless otherwise noted.

* * * * *

■ 2. Section 200.19a is amended by adding two sentences following the third sentence in the introductory text to read as follows:

§ 200.19a Director of the Division of Market Regulation.

* * * In addition, these responsibilities include administering the Commission's rules related to supervised investment bank holding companies and ultimate holding companies of brokers or dealers that compute deductions for market and credit risk pursuant to § 240.15c3–1e of this chapter. This supervision includes the assessment of internal risk management controls and mathematical models used to calculate net capital and allowances for market, credit, and operational risks. * * *

* * * * *

■ 3. Section 200.30–3 is amended by:

■ a. Removing the period after paragraph (a)(7)(v) and in its place adding ''; and''; and

■ b. Adding paragraph (a)(7)(vi).

The addition reads as follows:

§ 200.30–3 Delegation of authority to Director of Division of Market Regulation.

* * * * *

(a) * * *

(7) * * *

(vi) (A) To review amendments to applications of brokers or dealers filed pursuant to § 240.15c3–1e and § 240.15c3–1g of this chapter and to approve such amendments, unconditionally or subject to specified terms and conditions;

(B) To grant extensions and exemptions from the notification requirements of § 240.15c3–1g(e) of this chapter, unconditionally or subject to specified terms and conditions;

(C) To impose additional conditions, pursuant to § 240.15c3–1e(e) of this chapter, on a broker or dealer that computes certain of its net capital deductions pursuant to § 240.15c3–1e of this chapter or on an ultimate holding company of the broker or dealer that is not an ultimate holding company that has a principal regulator, as defined in § 240.15c3–1(c)(13)(ii) of this chapter;

(D) To require that a broker or dealer or the ultimate holding company of the broker or dealer provide information to the Commission pursuant to § 240.15c3–1e(a)(1)(viii)(G), § 240.15c3–1e(a)(1)(ix)(C), § 240.15c3–1e(a)(4), § 240.15c3–1g(b)(1)(i)(H), and § 240.15c3–1g(2)(i)(C) of this chapter; and

(E) To determine, pursuant to § 240.15c3–1e(a)(10)(ii), that the notice that a broker or dealer must provide to the Commission pursuant to § 240.15c3–1e(a)(10)(i) of this chapter will become effective for a shorter or longer period of time.

* * * * *

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

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

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

* * * * *

■ 5. Section 240.15c3–1 is amended by:

■ a. Removing the authority citations following § 240.15c3–1;

■ b. Revising the undesignated section heading preceding paragraph (a)(7);

■ c. Adding text to paragraph (a)(7);

■ d. Revising the undesignated section heading preceding paragraph (c)(13);

■ e. Adding text to paragraph (c)(13); and

■ f. Adding two sentences 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 to calculate net capital using the market risk standards of Appendix E to compute a deduction for market risk on some or all of its positions, instead of the provisions of paragraphs (c)(2)(vi) and (c)(2)(vii) of this section, and using the credit risk standards of Appendix E to compute a deduction for credit risk 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 on the broker or dealer the Commission may require as necessary or appropriate in the public interest or for the protection of investors. A broker or dealer that has been approved to calculate its net capital under Appendix E must:

(i) At all times maintain tentative net capital of not less than $1 billion and net capital of not less than $500 million;

(ii) Provide notice that same day in accordance with § 240.17a–11(g) if the broker's or dealer's tentative net capital is less than $5 billion. The Commission may, upon written application, lower the threshold at which notification is necessary under this paragraph (a)(7)(ii), either unconditionally or on specified terms and conditions, if a broker or dealer satisfies the Commission that notification at the $5 billion threshold is unnecessary because of, among other factors, the special nature of its business, its financial position, its internal risk management system, or its compliance history; and

(iii) Comply with § 240.15c3–4 as though it were an OTC derivatives dealer with respect to all of its business activities, except that paragraphs (c)(5)(xiii), (c)(5)(xiv), (d)(8), and (d)(9) of § 240.15c3–4 shall not apply.

* * * * *

(c) * * *

Entities That Have a Principal Regulator

(13)(i) For purposes of § 240.15c3–1e and § 240.15c3–1g, 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 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 as a futures commission merchant or an introducing broker with the Commodity Futures Trading Commission;

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

(D) A foreign bank as defined in section 1(b)(7) of the International Banking Act of 1978 (12 U.S.C. 3101(7)) that has its headquarters in a jurisdiction for which any foreign bank has been approved by the Board of Governors of the Federal Reserve System to conduct business pursuant to the standards set forth in 12 CFR 211.24(c), provided such foreign bank represents to the Commission 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;

(E) Not primarily in the securities business, and the person is:

(*1*) A corporation organized under section 25A of the Federal Reserve Act (12 U.S.C. 611 through 633); or

(*2*) A corporation having an agreement or undertaking with the Board of Governors of the Federal Reserve System under section 25 of the Federal Reserve Act (12 U.S.C. 601 through 604a); or

(F) A person that the Commission finds is another entity that is subject to comprehensive supervision, has in place appropriate arrangements so that information that the person provides to the Commission is sufficiently reliable for the purposes of determining compliance with § 240.15c3–1e and § 240.15c3–1g, and it is appropriate to consider the person to be an entity that has a principal regulator considering all relevant circumstances, including the person's mix of business.

(ii) For purposes of § 240.15c3–1e, § 240.15c3–1g, § 240.17h–1T, and § 240.17h2T, the term *ultimate holding company that has a principal regulator* shall mean a person (other than a natural person) that:

(A) Is a financial holding company or a company that is treated as a financial holding company under the Bank Holding Company Act of 1956 (12 U.S.C. 1840 *et seq.*), or

(B) The Commission determines to be an ultimate holding company that has a principal regulator, if that person is subject to consolidated, comprehensive supervision; there are in place appropriate arrangements so that information that the person provides to the Commission is sufficiently reliable for the purposes of determining compliance with § 240.15c3–1e and § 240.15c3–1g; and it is appropriate to consider the person to be an ultimate holding company that has a principal regulator in view of all relevant circumstances, including the person's mix of business.

* * * * *

(15) * * * For purposes of paragraph (a)(7) of this section, the term *tentative net capital* means the net capital of the broker or dealer before deductions for market and credit risk computed pursuant to § 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. Tentative net capital shall include securities for which there is no ready market, as defined in paragraph (c)(11) of this section, if the use of mathematical models has been approved for purposes of calculating deductions from net capital for those securities pursuant to § 240.15c3–1e.

* * * * *

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

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

Preliminary Note: Appendices E and G to the net capital rule set forth a program that allows a broker or dealer to use an alternative approach to computing net capital deductions, subject to the conditions described in the Appendices, including supervision of the broker's or dealer's ultimate holding company under the program. The program is designed to reduce the likelihood that financial and operational weakness in the holding company will destabilize the broker or dealer, or the broader financial system. The focus of this supervision of the ultimate holding company is its financial and operational condition and its risk management controls and methodologies.

Application

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

(1) A broker-dealer shall submit the following information to the Commission with its application:

(i) An executive summary of the information provided to the Commission with its application and an identification of the ultimate holding company of the broker or dealer;

(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 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 deductions for market and credit risk on those categories of positions;

(iv) A description of the mathematical models to be used to price positions and to compute deductions for market risk, including those portions of the deductions attributable to specific risk, if applicable, and deductions for credit risk; 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 each category of persons who may input data into the 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 applicable qualitative and quantitative requirements set forth in paragraph (d) of this Appendix E; and a statement describing the extent to which each mathematical model used to compute deductions for market and credit risk will be used as part of the risk analyses and reports presented to senior management;

(v) If the broker or dealer is applying to the Commission for approval to use scenario analysis to calculate deductions for market risk for certain positions, a list of those types of positions, a description of how those deductions will be calculated using scenario analysis, and an explanation of why each scenario analysis is appropriate to calculate deductions for market risk on those types of 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 and internal credit risk weights of counterparties, if applicable;

(viii) A written undertaking by the ultimate holding company of the broker or dealer, if it is not an ultimate holding company that has a principal regulator, in a form acceptable to the Commission, signed by a duly authorized person at the ultimate holding company, to the effect that, as a condition of Commission approval of the application of the broker or dealer to compute deductions for market and credit risk pursuant to this Appendix E, the ultimate holding company agrees to:

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

(B) Comply with all applicable provisions of § 240.15c3–1g;

(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 an OTC derivatives dealer with respect to all of its business activities, except that paragraphs (c)(5)(xiii), (c)(5)(xiv), (d)(8), and (d)(9) of § 240.15c3–4 shall not apply;

(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 the ultimate holding company and any of its affiliates, if the affiliate is not an entity that has a principal regulator;

(F) If the disclosure to the Commission of any information required as a condition for the broker or dealer to compute deductions for market and credit risk pursuant to this Appendix E could be prohibited by law or otherwise, cooperate with the Commission, to the extent permissible, including by describing any secrecy laws or other impediments that could restrict the ability of material affiliates to provide information on their operations or activities and by discussing the manner in which the ultimate holding company and the broker or dealer propose to provide the Commission with adequate information or assurances of access to information;

(G) Make available to the Commission information about the ultimate holding company or any of its material affiliates that the Commission finds is necessary to evaluate the financial and operational risk within the ultimate holding company and its material affiliates and to evaluate compliance with the conditions of eligibility of the broker or dealer to compute deductions to net capital under the alternative method of this Appendix E;

(H) Make available examination reports of principal regulators for those affiliates of the ultimate holding company that are not subject to Commission examination; and

(I) Acknowledge that, if the ultimate holding company fails to comply in a material manner with any provision of its undertaking, the Commission may, in addition to any other conditions necessary or appropriate in the public interest or for the protection of investors, increase the multiplication factors the ultimate 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 condition with respect to the broker or dealer listed in paragraph (e) of this Appendix E; and

(ix) A written undertaking by the ultimate holding company of the broker or dealer, if the ultimate holding company has a principal regulator, in a form acceptable to the Commission, signed by a duly authorized person at the ultimate holding company, to the effect that, as a condition of Commission approval of the application of the broker or dealer to compute deductions for market and credit risk pursuant to this Appendix E, the ultimate holding company agrees to:

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

(B) Comply with all applicable provisions of § 240.15c3–1g;

(C) Make available to the Commission information about the ultimate holding company that the Commission finds is necessary to evaluate the financial and operational risk within the ultimate holding company and to evaluate compliance with the conditions of eligibility of the broker or dealer to compute net capital under the alternative method of this Appendix E; and

(D) Acknowledge that if the ultimate holding company fails to comply in a material manner with any provision of its undertaking, the Commission may, in addition to any other conditions necessary or appropriate in the public interest or for the protection of investors, impose any condition with respect to the broker or dealer listed in paragraph (e) of this Appendix E;

(2) As a condition of Commission approval, the ultimate holding company of the broker or dealer, if it is not an ultimate holding company that has a principal regulator, shall include the following information with the application:

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

(ii) An alphabetical list of the affiliates of the ultimate holding company (referred to as the ''affiliate group,'' which shall include the ultimate holding company), with an identification of the financial regulator, if any, that regulates the affiliate, and a designation of the members of the affiliate group that are material to the ultimate holding company (''material affiliates'');

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

(iv) Consolidated and consolidating financial statements of the ultimate holding company as of the end of the quarter preceding the filing of the application;

(v) Sample computations for the ultimate holding company of allowable capital and allowances for market risk, credit risk, and operational risk, determined pursuant to § 240.15c3–1g(a)(1)–(a)(4);

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

(vii) A description of the mathematical models to be used to price positions and to compute the allowance for market risk, including those portions of the allowance attributable to specific risk, if applicable, and the allowance for credit risk; a description of the creation, use, and maintenance of the mathematical models; a description of the ultimate holding company's internal risk management controls over those models, including a description of each category of persons who may input data into the 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 ultimate holding company will use to backtest the mathematical model used to calculate maximum potential exposure; a description of how each mathematical model satisfies the applicable qualitative and quantitative requirements set forth in paragraph (d) of this Appendix E; a statement describing the extent to which each mathematical model used to compute allowances for market and credit risk is used as part of the risk analyses and

reports presented to senior management; and a description of any positions for which the ultimate holding company proposes to use a method other than VaR to compute an allowance for market risk and a description of how that allowance would be determined;

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

(ix) A description of how the ultimate holding company will determine the credit risk weights of counterparties and internal credit ratings of counterparties, if applicable;

(x) A description of how the ultimate holding company will calculate an allowance for operational risk under § 240.15c3–1g(a)(4);

(xi) For each instance in which a mathematical model used by the broker or dealer to calculate a deduction for market risk or to calculate maximum potential exposure for a particular product or counterparty differs from the mathematical model used by the ultimate holding company to calculate an allowance for market risk or to calculate 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 ultimate 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 that are provided to the persons at the ultimate holding company who are responsible for managing group-wide risk and that will be provided to the Commission pursuant to § 240.15c3–1g(b)(1)(i)(H);

(3) As a condition of Commission approval, the ultimate holding company of the broker or dealer, if the ultimate holding company has a principal regulator, shall include the following information with the broker's or dealer's application:

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

(ii) An alphabetical list of the affiliates of the ultimate holding company (referred to as the ''affiliate group,'' which shall include the ultimate holding company), with an identification of the financial regulator, if any, that regulates the affiliate, and a designation of those affiliates that are material to the ultimate holding company (''material affiliates'');

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

(iv) Consolidated and consolidating financial statements of the ultimate holding company as of the end of the quarter preceding the filing of the application;

(v) The most recent capital measurements of the ultimate holding company, as reported to its principal regulator, calculated in accordance with the standards published by the Basel Committee on Banking Supervision, as amended from time to time;

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

(vii) Sample risk reports that are provided to the persons at the ultimate holding company who are responsible for managing group-wide risk and that will be provided to the Commission under § 240.15c3–1g(b)(1)(i)(H);

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

(5) The application shall be considered filed when received at the Commission's principal office in Washington, DC. A person who files an application pursuant to this section for which it seeks confidential treatment may clearly mark each page or segregable portion of each page with the words ''Confidential Treatment Requested.'' All information submitted in connection with the application will be accorded confidential treatment, to the extent permitted by law;

(6) If any of the information 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 notify the Commission promptly and provide the Commission with a description of the circumstances in which the information was found to be or has become inaccurate along with updated, accurate information;

(7) The Commission may approve the application or an amendment to the application, in whole or in part, subject to any conditions or limitations the Commission may require, if the Commission finds the approval to be necessary or appropriate in the public interest or for the protection of investors, after determining, among other things, whether the broker or dealer has met the requirements of this Appendix E and is in compliance with other applicable rules promulgated under the Act and by self-regulatory organizations, and whether the ultimate holding company of the broker or dealer is in compliance with the terms of its undertakings, as provided to the Commission;

(8) A broker or dealer shall amend its application to calculate certain deductions for market and credit risk under this Appendix E and submit the amendment to the Commission for approval before it may change materially a mathematical model used to calculate market or credit risk or before it may change materially its internal risk management control system;

(9) As a condition to the broker's or dealer's calculation of deductions for market and credit risk under this Appendix E, an ultimate holding company that does not have a principal regulator shall submit to the Commission, as an amendment to the broker's or dealer's application, any material changes to a mathematical model or other methods used to calculate allowances for market, credit, and operational risk, and any material changes to the internal risk management control system for the affiliate group. The ultimate holding company must submit these material changes to the Commission before making them;

(10) As a condition for the broker or dealer to compute deductions for market and credit risk under this Appendix E, the broker or dealer agrees that:

(i) It will notify the Commission 45 days before it ceases to compute deductions for market and credit risk under this Appendix E; and

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

(11) Notwithstanding paragraph (a)(10) 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 deductions for market risk, instead of the provisions of § 240.15c3–1(c)(2)(vi) and (c)(2)(vii), and the exemption to use the credit risk standards of this Appendix E to calculate deductions for credit risk 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 for the protection of investors. In making its finding, the Commission will consider the compliance history of the broker or dealer related to its use of models, the financial and operational strength of the broker or dealer and its ultimate holding company, the broker's or dealer's compliance with its internal risk management controls, and the ultimate holding company's compliance with its undertakings.

Market Risk

(b) A broker or dealer whose application, including amendments, has been approved under paragraph (a) of this Appendix E shall compute a deduction for market risk in an amount equal to the sum of the following:

(1) For positions for which the Commission has approved the broker's or dealer's use of value-at risk (''VaR'') models, the VaR of the positions multiplied by the appropriate multiplication factor determined according to paragraph (d)(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 application or an amendment to the application under paragraph (a) of this Appendix E, including a review of its internal risk management control system and practices and VaR models, that another multiplication factor is appropriate;

(2) For positions for which the VaR model does not incorporate specific risk, a deduction for specific risk to be determined by the Commission based on a review of the broker's or dealer's application or an amendment to the application under paragraph (a) of this Appendix E and the positions involved;

(3) For positions for which the Commission has approved the broker's or dealer's application to use scenario analysis, the greatest loss resulting from a range of adverse movements in relevant risk factors, prices, or spreads designed to represent a negative movement greater than, or equal to, the worst ten-day movement over the four years preceding calculation of the greatest loss, or some multiple of the greatest loss based on the liquidity of the positions subject to scenario analysis. If historical data is insufficient, the deduction shall be the largest loss within a three standard deviation movement in those risk factors, prices, or spreads over a ten-day period, multiplied by an appropriate liquidity adjustment factor. Irrespective of the deduction otherwise indicated under scenario analysis, the resulting deduction for market risk 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 qualifying scenario must include the following:

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

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

(iii) Data demonstrating the effectiveness of the scenario in capturing market risk, including specific risk; and

(4) For all remaining positions, the deductions specified in §§ 240.15c3–1(c)(2)(vi), (c)(2)(vii), and applicable appendices to § 240.15c3–1.

Credit Risk

(c) A broker or dealer whose application, including amendments, has been approved under paragraph (a) of this Appendix E shall compute a deduction for credit risk on transactions in derivative instruments (if this Appendix E is used to calculate a deduction for market risk on those instruments) in an amount equal to the sum of the following:

(1) A counterparty exposure charge in an amount equal to the sum of the following:

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

(ii) For a counterparty not otherwise described in paragraph (c)(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 (c)(4)(i) of this Appendix E, multiplied by the credit risk weight of the counterparty, as defined in paragraph (c)(4)(vi) of this Appendix E, multiplied by 8%;

(2) A concentration charge by counterparty in an amount equal to the sum of the following:

(i) For each counterparty with a credit risk weight of 20% or less, 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 each counterparty with a credit risk weight of greater than 20% but less than 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 each counterparty with a credit risk weight of greater than 50%, 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

(3) A portfolio concentration charge of 100% of the amount of the broker's or dealer's aggregate current exposure for all counterparties in excess of 50% of the tentative net capital of the broker or dealer;

(4) *Terms.* (i) 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 (c)(4)(ii) 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 (c)(4)(iii) of this Appendix E. The broker or dealer must use the multiplication factor determined according to paragraph (d)(1)(v) 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 application or an amendment to the application approved under paragraph (a) of this Appendix E, including a review of its internal risk management control system and practices and VaR models, that another multiplication factor is appropriate;

(ii) The *maximum potential exposure* is the VaR of the counterparty's positions with the broker or dealer, after applying netting agreements with the counterparty meeting the requirements of paragraph (c)(4)(iv) of this Appendix E, taking into account the value of collateral from the counterparty held by the broker or dealer in accordance with paragraph (c)(4)(v) of this Appendix E, and taking into account the current replacement value of the counterparty's positions with the broker or dealer;

(iii) 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 (c)(4)(iv) 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 (c)(4)(v) of this Appendix E;

(iv) *Netting agreements.* A broker or dealer may include the effect of a netting agreement that allows the broker or dealer to net gross receivables from and gross payables to a counterparty upon default of the counterparty if:

(A) The netting agreement is legally enforceable in each relevant jurisdiction, including in insolvency proceedings;

(B) The gross receivables and gross payables that are subject to the netting agreement with a counterparty can be determined at any time; and

(C) For internal risk management purposes, the broker-dealer monitors and controls its exposure to the counterparty on a net basis;

(v) *Collateral.* When calculating maximum potential exposure and current exposure to a counterparty, the fair market value of collateral pledged and held may be taken into account provided:

(A) The collateral is marked to market each day and is subject to a daily margin maintenance requirement;

(B) The collateral is subject to the broker's or dealer's physical possession or control;

(C) The collateral is liquid and transferable;

(D) The collateral may be liquidated promptly by the firm without intervention by any other party;

(E) The collateral agreement is legally enforceable by the broker or dealer against the counterparty and any other parties to the agreement;

(F) The collateral does not consist of securities issued by the counterparty or a party related to the broker or dealer or to the counterparty;

(G) The Commission has approved the broker's or dealer's use of a VaR model to calculate deductions for market risk for the type of collateral in accordance with this Appendix E; and

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

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

(A) 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;

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

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

(D) 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;

(E) As part of its initial application or in an amendment, the broker or dealer may request Commission approval to determine credit risk weights based on internal calculations, including internal estimates of the maturity adjustment. 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 risk weight of each counterparty;

(F) For the portion of a current exposure covered by a written 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; and

(G) As part of its initial application or in an amendment, the broker or dealer may request Commission approval to reduce deductions for credit risk through the use of credit derivatives.

VaR Models

(d) To be approved, 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 integrated into the daily internal risk management system of the broker or dealer;

(ii) The VaR model must be reviewed both periodically and annually. The periodic review may be conducted by the broker's or dealer'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 (15 U.S.C. 7201 *et seq.*); and

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

(A) Beginning three months after the broker or dealer begins using the VaR model to calculate market risk, the broker or dealer 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, or other period as may be appropriate for the first year of its use;

(B) On the last business day of each quarter, the broker or dealer must identify the number of backtesting exceptions of the VaR model, that is, the number of business days in the past 250 business days, or other period as may be appropriate for the first year of its use, for which the actual net trading loss, if any, exceeds the corresponding VaR measure; and

(C) The broker or dealer 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;

TABLE 1.—MULTIPLICATION FACTOR BASED ON THE NUMBER OF BACKTESTING EXCEPTIONS OF THE VAR MODEL

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 incorporating specific risk into a VaR model, a broker or dealer must demonstrate that it has methodologies in place to capture liquidity, event, and default risk adequately for each position.

Furthermore, the models used to calculate deductions for specific risk must:

(A) Explain the historical price variation in the portfolio;

(B) Capture concentration (magnitude and changes in composition);

(C) Be robust to an adverse environment; and

(D) Be validated through backtesting; and

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

(A) Beginning three months after it begins using the VaR model to calculate maximum potential exposure, the broker or dealer must conduct backtesting of the model by comparing, for at least 80 counterparties with widely varying types and sizes of positions with the firm, the ten-business day change in its current exposure to the counterparty based on its positions held at the beginning of the ten-business day period with the corresponding ten-business day maximum potential exposure for the counterparty generated by the VaR model;

(B) As of the last business day of each quarter, the broker or dealer must identify the number of backtesting exceptions of the VaR model, that is, the number of ten-business day periods in the past 250 business days, or other period as may be appropriate for the first year of its use, for which the change in current exposure to a counterparty exceeds the corresponding maximum potential exposure; and

(C) The broker or dealer will propose, as part of its application, a schedule of multiplication factors, which must be approved by the Commission based on the number of backtesting exceptions of the VaR model. The broker or dealer must use the multiplication factor indicated in the approved schedule in determining the credit equivalent amount of its exposures to a counterparty until it obtains the next quarter's backtesting results, unless the Commission determines, based on, among other relevant factors, a review of the broker's or dealer'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; or based on a review of the broker's or dealer's procedures for managing collateral and if the collateral is marked to market daily and the broker or dealer has the ability to call for additional collateral daily, the Commission may approve a time horizon of not less than ten business days;

(iii) The VaR model must use an effective historical observation period of at least one year. The broker or dealer must consider the effects of market stress in its construction of the model. 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 broker or dealer, including:

(A) Risks arising from the non-linear price characteristics of derivatives and the sensitivity of the market value of those positions to changes in the volatility of the derivatives' underlying rates and prices;

(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 broker or dealer, 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 positions.

Additional Conditions

(e) 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 conditions on the broker or dealer, which may include, but are not limited to restricting the broker's or dealer's business on a product-specific, category-specific, or general basis; submitting to the Commission a plan to increase the broker's or dealer's net capital or tentative net capital; filing more frequent reports with the Commission; modifying the broker's or dealer's internal risk management control procedures; or computing the broker's or dealer's deductions for market and credit risk in accordance with § 240.15c3–1(c)(2)(vi), (c)(2)(vii), and (c)(2)(iv), as appropriate. If it is not an ultimate holding company that has a principal regulator, the Commission also may require, as a condition of continuation of the exemption, the ultimate holding company of the broker or dealer to file more frequent reports or to modify its group-wide internal risk management control procedures. If the Commission finds it is necessary or appropriate in the public interest or for the protection of investors, the Commission may impose additional conditions on either the broker-dealer, or the ultimate holding company, if it is an ultimate holding company that does not have a principal regulator, if:

(1) The broker or dealer is required by § 240.15c3–1(a)(7)(ii) to provide notice to the Commission that the broker's or dealer's tentative net capital is less than $5 billion;

(2) The broker or dealer or the ultimate 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;

(3) Any event specified in § 240.17a–11 occurs;

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

(5) The ultimate 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) or (a)(1)(ix) of this Appendix E;

(6) The broker or dealer fails to comply with this Appendix E; or

(7) The Commission finds that imposition of other conditions is necessary or appropriate in the public interest or for the protection of investors.

■ 7. Section 240.15c3–1g is added to read as follows:

§ 240.15c3–1g Conditions for ultimate 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 deductions to capital in accordance with § 240.15c3–1e, pursuant to its undertaking, the ultimate holding company of the broker or dealer shall:

Conditions Regarding Computation of Allowable Capital and Risk Allowances

(a) If it is not an ultimate holding company that has a principal regulator, as that term is defined in § 240.15c3–1(c)(13), calculate allowable capital and allowances for market, credit, and operational risk on a consolidated basis as follows:

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

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

(A) Goodwill;

(B) Deferred tax assets, except those permitted for inclusion in Tier 1 capital by the Board of Governors of the Federal Reserve System (''Federal Reserve'') (12 CFR 225, Appendix A);

(C) Other intangible assets; and

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

(ii) Cumulative and non-cumulative preferred stock, except that the amount of cumulative preferred stock may not exceed 33% of the items included in allowable capital pursuant to paragraph (a)(1)(i) of this Appendix G, excluding 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;

(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 subject to the conditions of paragraphs (a)(1)(ii)(A) through (D) of this Appendix G;

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

(C) As part of the broker's or dealer's application to calculate deductions for market and credit risk under § 240.15c3–1e, an ultimate holding company may request to include, for a period of three years after adoption of this Appendix G, long-term debt that has an original weighted average maturity of at least five years and that cannot be accelerated, except upon the occurrence of certain events as the Commission may approve. As part of a subsequent amendment to the broker's or dealer's application, the broker or dealer may request permission for the ultimate holding company to include long-term debt that meets these criteria in allowable capital for up to an additional two years; and

(iv) Hybrid capital instruments that are permitted for inclusion in Tier 2 capital by the Federal Reserve (as defined in 12 CFR 225, Appendix A);

(2) *Allowance for market risk.* The ultimate holding company shall compute an allowance for market risk 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 as set forth in § 240.15c3–1e(d). The VaR of the positions must be obtained using approved VaR models meeting the applicable qualitative and quantitative requirements of § 240.15c3–1e(d); and

(ii) *Alternative method.* For positions for which there does not exist adequate historical data to support a VaR model, the ultimate holding company must propose a model that produces a suitable allowance for market risk for those positions;

(3) *Allowance for credit risk.* The ultimate holding company shall compute an allowance for credit risk 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) By multiplying the credit equivalent amount of the ultimate holding company's exposure to the counterparty, as defined in paragraphs (a)(3)(i)(A), (B) and (C) of this Appendix G, by the appropriate credit risk weight, as defined in paragraph (a)(3)(i)(F) of this Appendix G, of the asset, off-balance sheet item, or counterparty, then multiplying that product by 8%, in accordance with the following:

(A) For certain loans and loan commitments, 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*) 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;

(*3*) 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

(*4*) 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 is the sum of the ultimate holding company's maximum potential exposure to the counterparty, as defined in paragraph (a)(3)(i)(E) of this Appendix G, multiplied by the appropriate multiplication factor, and the ultimate holding company's current exposure to the counterparty, as defined in paragraph (a)(3)(i)(D) of this Appendix G. The ultimate holding company must use the multiplication factor determined according to § 240.15c3–1e(d)(1)(v), 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 credit equivalent amount for other assets shall be the asset's book value on the ultimate holding company's consolidated balance sheet or other amount as determined according to the standards published by the Basel Committee on Banking

Supervision, as amended from time to time;

(D) The *current exposure* is the current replacement value of a counterparty's positions, after applying netting agreements with that counterparty meeting the requirements of § 240.15c3–1e(c)(4)(iv) and taking into account the value of collateral from the counterparty in accordance with § 240.15c3–1e(c)(4)(v);

(E) The *maximum potential exposure* is the VaR of the counterparty's positions with the member of the affiliate group, after applying netting agreements with the counterparty meeting the requirements of paragraph (c)(4)(iv) of § 240.15c3–1e, taking into account the value of collateral from the counterparty held by the member of the affiliate in accordance with paragraph (c)(4)(v) of § 240.15c3–1e, and taking into account the current replacement value of the counterparty's positions with the member of the affiliate group, 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 not less than five days;

(F) Credit ratings and credit risk weights shall be determined according to the provisions of paragraphs (c)(4)(vi)(D) and (c)(4)(vi)(E) of § 240.15c3–1e, respectively;

(G) As part of the broker's or dealer's initial application or in an amendment, the ultimate holding company may request Commission approval to reduce allowances for credit risk through the use of credit derivatives;

(H) For the portion of a current exposure covered by a written guarantee, where that guarantee is an unconditional and irrevocable guarantee of the due and punctual payment and performance of the obligation and the ultimate holding company or member of the affiliate group can demand payment after any payment is missed without having to make collection efforts, the ultimate 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; or

(ii) As part of the broker's or dealer's initial application or in an amendment to the application, the ultimate holding company may request Commission approval to use a method of calculating credit risk that is consistent with standards published by the Basel Committee on Banking Supervision in International Convergence of Capital Measurement and Capital Standards (July 1988), as amended from time to time; and

(4) *Allowance for operational risk.* The ultimate holding company shall compute an allowance for operational risk in accordance with the standards published by the Basel Committee on Banking Supervision, as amended from time to time.

Conditions Regarding Reporting Requirements

(b) File reports with the Commission in accordance with the following:

(1) If it is not an ultimate holding company that has a principal regulator, as that term is defined in § 240.15c3–1(c)(13), the ultimate holding company shall file with the Commission:

(i) A report as of the end of each month, filed not later than 30 calendar days after the end of the month. A monthly report need not be filed for a month-end that coincides with a fiscal quarter-end. The monthly report shall include:

(A) A consolidated balance sheet and income statement (including notes to the financial statements) for the ultimate holding company and statements of allowable capital and allowances for market, credit, and operational risk computed pursuant to paragraph (a) of this Appendix G, *except* that the consolidated balance sheet and income statement for the first month of the fiscal year may be filed at a later time to which the Commission agrees (when reviewing the affiliated broker's or dealer's application under § 240.15c3–1e(a)).

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

(C) Consolidated credit risk information, including aggregate current exposure and current exposures (including commitments) listed by counterparty for the 15 largest exposures;

(D) The 10 largest commitments listed by counterparty;

(E) Maximum potential exposure listed by counterparty for the 15 largest exposures;

(F) The aggregate maximum potential exposure;

(G) A summary report reflecting the geographic distribution of the ultimate 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

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

(ii) A quarterly report as of the end of each fiscal quarter, filed not later than 35 calendar days after the end of the quarter. The quarterly report shall include, in addition to the information contained in the monthly report as required by paragraph (b)(1)(i) of this Appendix G, the following:

(A) Consolidating balance sheets and income statements for the ultimate holding company. The consolidating balance sheet must provide information regarding each material affiliate of the ultimate holding company in a separate column, but may aggregate information regarding members of the affiliate group that are not material affiliates into one column;

(B) 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;

(C) A description of all material pending legal or arbitration proceedings, involving either the ultimate holding company or any of its affiliates, that are required to be disclosed by the ultimate holding company under generally accepted accounting principles;

(D) The aggregate amount of unsecured borrowings and lines of credit, segregated into categories, scheduled to mature within twelve months from the most recent fiscal quarter as to each material affiliate; and

(E) For a quarter-end that coincides with the ultimate holding company's fiscal year-end, the ultimate holding company need not include consolidated and consolidating balance sheets and income statements in its quarterly reports. The consolidating balance sheet and income statement for the quarter-end that coincides with the fiscal year-end may be filed at a later time to which the Commission agrees (when reviewing the affiliated broker's or dealer's application under § 240.15c3–1e(a));

(iii) An annual audited report as of the end of the ultimate holding company's fiscal year, filed not later than 65 calendar days after the end of the fiscal year. The annual report shall include:

(A) Consolidated financial statements for the ultimate holding company audited by a registered public accounting firm, as that term is defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 *et seq.*). The audit shall be made in accordance with the rules promulgated by the Public Company Accounting Oversight Board. The audited financial statements must include a supporting schedule containing statements of allowable capital and allowances for market,

credit, and operational risk computed pursuant to paragraph (a) of this Appendix G; and

(B) A supplemental report entitled ''Accountant's Report on Internal Risk Management Control System'' prepared by a registered public accounting firm, as that term is defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 *et seq.*), indicating the results of the registered public accounting firm's review of the ultimate 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 upon by the ultimate holding company and the registered public accounting firm conducting the review. 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. The ultimate holding company must file, before commencement of the initial review, the procedures agreed upon by the ultimate holding company and the registered public accounting firm with the Division of Market Regulation, Office of Financial Responsibility, at Commission's principal office in Washington, DC. Before commencement of each subsequent review, the ultimate holding company must notify the Commission of any changes in the procedures;

(iv) An organizational chart, as of the ultimate holding company's fiscal year-end, concurrently with its quarterly report for the quarter-end that coincides with its fiscal year-end. The ultimate holding company must provide quarterly updates of the organizational chart if a material change in the information provided to the Commission has occurred;

(2) If the ultimate holding company is an entity that has a principal regulator, as that term is defined in § 240.15c3–1(c)(13), the ultimate holding company must file with the Commission:

(i) A quarterly report as of the end of each fiscal quarter, filed not later than 35 calendar days after the end of the quarter, or a later time to which the Commission may agree upon application. The quarterly report shall include:

(A) Consolidated (including notes to the financial statements) and consolidating balance sheets and income statements for the ultimate holding company;

(B) Its most recent capital measurements computed in accordance with the standards published by the Basel Committee on Banking Supervision, as amended from time to time, as reported to its principal regulator;

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

(D) For a quarter-end that coincides with the ultimate holding company's fiscal year-end, the ultimate holding company need not include consolidated and consolidating balance sheets and income statements in its quarterly reports. The consolidating balance sheet and income statement for the quarter-end that coincides with the fiscal year-end may be filed at a later time to which the Commission agrees (when reviewing the affiliated broker's or dealer's application under § 240.15c3–1e(a)).

(ii) An annual audited report as of the end of the ultimate holding company's fiscal year, filed with the Commission when required to be filed by any regulator;

(3) The reports that the ultimate holding company must file in accordance with paragraph (b) of this Appendix G will be considered filed when two copies are received at the Commission's principal office in Washington, DC. A person who files reports pursuant to this section for which he or she seeks confidential treatment may clearly mark each page or segregable portion of each page with the words ''Confidential Treatment Requested.'' The copies shall be addressed to the Division of Market Regulation, Risk Assessment Group; and

(4) The reports that the ultimate holding company must file with the Commission in accordance with paragraph (b) of this Appendix G will be accorded confidential treatment to the extent permitted by law.

Conditions Regarding Records To Be Made

(c) If it is not an ultimate holding company that has a principal regulator, make and keep current the following records:

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

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

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

(iii) An inability of the ultimate 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 ultimate 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;

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

(4) A record of the calculations of allowable capital and allowances for market, credit and operational risk computed currently at least once per month on a consolidated basis.

Conditions Regarding Preservation of Records

(d)(1) 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) 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) If the ultimate holding company does not have a principal regulator, all written policies and procedures concerning the group-wide internal risk management control system established pursuant to § 240.15c3–1e(a)(1)(viii)(C); and

(2) The ultimate holding company may maintain the records referred to in paragraph (d)(1) of this Appendix G either at the ultimate holding company, at an affiliate, or at a records storage facility, provided that the records are located within the United States. If the records are maintained by an entity other than the ultimate holding company, the ultimate 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 ultimate 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, legible, complete, and current paper 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 ultimate 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) The ultimate holding company of a broker or dealer that computes certain of its capital charges in accordance with § 240.15c3–1e shall:

(1) Send notice promptly (but within 24 hours) after the occurrence of the following events:

(i) The early warning indications of low capital as the Commission may agree;

(ii) The ultimate holding company files a Form 8–K (17 CFR 249.308) with the Commission; and

(iii) A material affiliate declares bankruptcy or otherwise becomes insolvent; and

(2) If it is not an ultimate holding company that has a principal regulator, as defined in § 240.15c3–1(c)(13), send notice promptly (but within 24 hours) after the occurrence of the following events:

(i) The ultimate holding company becomes aware that an NRSRO has determined to reduce materially its assessment of the creditworthiness of a material affiliate or the credit rating(s) assigned to one or more outstanding short or long-term obligations of a material affiliate;

(ii) The ultimate holding company becomes aware that any financial regulatory agency or self-regulatory organization has taken significant enforcement or regulatory action against a material affiliate; and

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

(3) Every notice given or transmitted by paragraph (e) of this Appendix G will be given or transmitted to the Division of Market Regulation, Office of Financial Responsibility, at the principal office of the Commission in Washington, DC. A person who files notification pursuant to this section for which he or she seeks confidential treatment may clearly mark each page or segregable portion of each page with the words ''Confidential Treatment Request.'' For the purposes of this Appendix G, ''notice'' shall be given or transmitted by telegraphic notice or facsimile transmission. The notice described by paragraph (e)(2) of this Appendix G may be transmitted by overnight delivery. Notices filed pursuant to this paragraph will be accorded confidential treatment to the extent permitted by law; and

(4) Upon the written request of the ultimate holding company, or upon its own motion, the Commission may grant an extension of time or an exemption from any of the requirements of this paragraph (e) either unconditionally or on specified terms and conditions as are necessary or appropriate in the public interest or for the protection of investors.

■ 8. Section 240.17a–4 is amended by adding paragraph (b)(12) to read as follows:

§ 240.17a–4 Records to be preserved by certain exchange members, brokers and dealers.

* * * * *

(b) * * *

(12) The records required to be made pursuant to § 240.15c3–1e(c)(4)(vi)(D) and (E).

* * * * *

■ 9. 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) * * *

(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 deduction for market risk other than in accordance with § 240.15c3–1e(b)(1) or (b)(3), the product category and the amount of the deduction for market risk;

(B) A graph reflecting, for each business line, the daily intra-month 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 deduction for market risk;

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

(*1*) Overall current exposure;

(*2*) Current exposure (including commitments) listed by counterparty for the 15 largest exposures;

(*3*) The 10 largest commitments listed by counterparty;

(*4*) The broker or dealer's maximum potential exposure listed by counterparty for the 15 largest exposures;

(*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; and

(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 a supplemental report on management controls, 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 (15 U.S.C. 7201 *et seq.*)). The supplemental report shall indicate 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 upon by the broker or dealer and the registered public accounting firm conducting the review. The agreed upon procedures are to be performed and the report is to be prepared in accordance with the rules promulgated by the Public Company Accounting Oversight

Board. 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. Before commencement of the review and no later than December 10 of each year, the broker or dealer shall file a statement with the Division of Market Regulation, Office of Financial Responsibility, at the Commission's principal office in Washington, DC that includes:

(1) A description of the agreed-upon procedures agreed to by the broker or dealer and the registered public accounting firm; and

(2) A notice describing changes in those agreed-upon procedures, if any. If there are no changes, the broker or dealer should so indicate.

* * * * *

■ 10. Section § 240.17a–11 is amended by revising paragraph (b)(2) and (h) to read as follows:

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

* * * * *

(b)(1) * * *

(2) In addition to the requirements of paragraph (b)(1) of this section, an OTC derivatives dealer or broker or dealer permitted to compute net capital pursuant to the alternative method of § 240.15c3–1e shall also provide notice if its tentative net capital falls below the minimum amount required pursuant to § 240.15c3–1. The notice shall specify the tentative net capital requirements, and current amount of net capital and tentative net capital, of the OTC derivatives dealer or the broker or dealer permitted to compute net capital pursuant to the alternative method of § 240.15c3–1e.

* * * * *

(h) Other notice provisions relating to the Commission's financial responsibility or reporting rules are contained in § 240.15c3–1(a)(6)(iv)(B), § 240.15c3–1(a)(6)(v), § 240.15c3–1(a)(7)(ii), § 240.15c3–1(a)(7)(iii), § 240.15c3–1(c)(2)(x)(B)(*1*), § 240.15c3–1(c)(2)(x)(F)(*3*), § 240.15c3–1(e), § 240.15c3–1d(c)(2), § 240.15c3–3(i), § 240.17a–5(h)(2) and § 240.17a–12(f)(2).

* * * * *

■ 11. 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) * * *

(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 if that broker or dealer is affiliated with an ultimate holding company that is not an ultimate holding company that has a principal regulator, as defined in § 240.15c3–1(c)(13).

* * * * *

■ 12. 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) * * *

(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 if that broker or dealer is affiliated with an ultimate holding company that is not an ultimate holding company that has a principal regulator, as defined in § 240.15c3–1(c)(13).

* * * * *

By the Commission.

Dated: June 8, 2004.

Jill M. Peterson,

Assistant Secretary.

[FR Doc. 04–13412 Filed 6–18–04; 8:45 am]

BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 200 and 240

[Release No. 34–49831; File No. S7–22–03]

RIN 3235–AI97

Supervised Investment Bank Holding Companies

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (''Commission'') is adopting rules to implement Section 17(i) of the Securities Exchange Act of 1934, which created a new framework for supervising an investment bank holding company (''IBHC''). An IBHC that meets specified criteria may elect to become a supervised investment bank holding company (''SIBHC'') and be subject to supervision on a group-wide basis by filing a notice of intention with the Commission. Pursuant to the statute and these new rules, an IBHC is eligible to be an SIBHC if it is not affiliated with certain types of banks and has a subsidiary broker-dealer with a substantial presence in the securities markets. These rules provide an IBHC with a process to become supervised by the Commission as an SIBHC, and establish regulatory requirements for an SIBHC, including requirements regarding its group-wide internal risk management control system, recordkeeping, and periodic reporting (including reporting of consolidated computations of allowable capital and risk allowances consistent with the standards published by the Basel Committee on Banking Supervision). The Commission also is adopting an exemption to the Commission's risk assessment rules to exempt a broker-dealer that is affiliated with an SIBHC from those rules because these new SIBHC rules will require that an SIBHC maintain substantially the same records and make substantially the same reports to the Commission that a broker-dealer must maintain and make pursuant to the risk assessment rules. Finally, the Commission is amending the audit requirements for over-the-counter (''OTC'') derivatives dealers to permit OTC derivatives dealers to file, as part of their annual audits, a supplemental report regarding the firm's internal risk management control systems based on agreed-upon procedures rather than auditing standards.

EFFECTIVE DATE: August 20, 2004.

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

With respect to general questions, contact 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.

SUPPLEMENTARY INFORMATION:

Table of Contents