

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

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

RIN 3235-A196

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

AGENCY: Securities and Exchange Commission ("Commission").

ACTION: Proposed rule.

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

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

ADDRESSES: To help us process and review your comments more efficiently, comments should be sent by hard copy or e-mail, but not by both methods. Comments sent by hard copy should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Comments also may be submitted electronically at the following electronic mail address: rule-comments@sec.gov. All comment letters should refer to File

No. [S7-21-03] ; please include this file number in the subject line if you use electronic mail. We will make all comment letters available for public inspection and copying in our public reference room at the above address. We will post electronically submitted comment letters on the Commission's Web site (<http://www.sec.gov>).¹

FOR FURTHER INFORMATION CONTACT:

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

With respect to amendments to financial responsibility rules and books and records requirements, contact Michael A. Macchiaroli, Associate Director, at (202) 942-0132, Thomas K. McGowan, Assistant Director, at (202) 942-4886, Rose Russo Wells, Attorney, at (202) 942-0143, Bonnie L. Gauch, Attorney, at (202) 942-0765, or David Lynch, Financial Economist, at (202) 942-0059, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-1001.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission is publishing for comment amendments to Rules 15c3-1, 15c3-4, 17a-5, 17a-11, 17h-1T, and 17h-2T under the Securities Exchange Act of 1934 ("Exchange Act").

I. Introduction

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

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

² 17 CFR 240.15c3-1.

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

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

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

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

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

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

⁵ See proposed Rule 15c3-1(c)(15).

⁶ See proposed Rule 15c3-1(a)(7).

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