

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

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

Exchange Act section 17(h) was enacted in part as a response to the failure of Drexel and authorizes the Commission to obtain information regarding certain activities of the holding company and non-regulated affiliates of a broker-dealer. Pursuant to the rules adopted under section 17(h), broker-dealers also submit consolidated and consolidating financial statements, organizational charts of the holding company, descriptions of material legal exposures, and risk management policies and procedures to the Commission.⁹

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

financial instruments, off balance sheet obligations, and the concentration of credit risk. The DPG was formed in March 1995 by the industry and the Commission to provide a voluntary oversight framework for monitoring derivatives activities of broker-dealer affiliates.

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

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

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

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

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

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

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

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

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

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