

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

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

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

other jurisdictions that may have similar laws.

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

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

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

II. Alternative Capital Computation for Eligible Broker-Dealers

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

¹⁴ The central bank governors of the Group of Ten countries ("G-10 countries") established the Basel Committee in 1974 to provide a forum for ongoing cooperation among member countries on banking supervisory matters. Its basic consultative papers are: the Basel Capital Accord (1988), the Core Principles for Effective Banking Supervision (1997), and the Core Principles Methodology (1999). The Basel Standards establish a common measurement system, a framework for supervision, and a minimum standard for capital adequacy for international banks in the G-10 countries. In April 2003, the Basel Committee released for public comment a document entitled "The New Basel Capital Accord." Comments were accepted through July 31, 2003. On October 11, 2003, the Basel Committee announced that it had received over 200 comment letters and that there is continued broad support for the structure of the proposed New Basel Capital Accord and agreement on the need to adopt a more risk-sensitive capital framework. The Committee requested comment by December 31, 2003 on an amendment to its proposed treatment of expected and unexpected losses. The Basel Committee expects to issue a final revision of the proposed New Basel Capital Accord by the middle of 2004, with an effective date for implementation of December 31, 2006.

The Basel Standards generally have been implemented for internationally active, large banking institutions by U.S. bank regulators. See Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, "Risk Based Capital Standards; Market Risk," 61 FR 47358 (Sept. 6, 1996). Currently, U.S. banking regulators have released an Advanced Notice of Proposed Rulemaking to seek comment on their preliminary views regarding the implementation of the proposed New Basel Capital Accord (68 FR 45900 (August 4, 2003)). Comments are due by November 3, 2003.

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

¹⁵ 15 U.S.C. 78o(c)(3).

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

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

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

¹⁹ 17 CFR 240.17a-3 and 240.17a-4.

²⁰ 17 CFR 240.17a-5.

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

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

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