

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

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

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

We are proposing what we believe are prudent parameters for measuring a broker-dealer's net capital charges and allowances for risk for its holding company, although in some cases these parameters may be more conservative than some firms may believe are necessary to account for risk. For example, the proposal contains the requirements that the VaR model used to calculate market risk for the broker-dealer and for the holding company be based on a ten business-day movement in rates and prices and that a 99% confidence level be used, and that the VaR measure be multiplied by a factor of at least three. These parameters are

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

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

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

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

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

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

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

#### *A. Proposed Appendix E to Rule 15c3-1*

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

#### *1. Application*

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

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

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

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

<sup>25</sup> 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