

context. Credit derivatives can enter into the calculation of credit risk in two ways. The first would be to substitute the credit risk weight of the writer of the credit derivative for the credit risk weight of the counterparty. This is the treatment included in proposed Appendix E. The second would be to adjust the current exposure and the maximum potential exposure by the value of the credit derivative. We request comment on these methods of including credit derivatives in the calculation of credit risk capital charges. We also request comment on whether any special treatment should be accorded guaranteed obligations or other obligations that may have double default effects.

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

Paragraph (f) of proposed Appendix E provides that as a condition for the broker-dealer to be permitted to use proposed Appendix E to calculate certain of its capital charges, the Commission may impose additional regulatory conditions on the broker-dealer or may condition further use of the exemption on the holding company of the broker-dealer filing more frequent reports, modifying its internal risk management control procedures or on imposing such other appropriate additional regulatory conditions that the Commission finds are necessary or appropriate in the public interest and consistent with the protection of investors. The Commission may impose these additional regulatory conditions if: the broker-dealer or the CSE fails to comply with reporting requirements under the proposal; if there is a material deficiency in the internal risk management control system or certain mathematical models of the broker-dealer or the CSE; if the CSE fails to comply with its undertakings; if the broker-dealer or the CSE notifies the Commission of the occurrence of certain events; if there is a material change in a mathematical model, internal risk management control system, or corporate structure as described in the application; or if the Commission finds that imposing an additional regulatory condition is necessary or appropriate in the public interest, and is consistent with the protection of investors. The events that require notification are specified in paragraph (e) of proposed Appendix G (for the CSE) and in the proposed amendments to Rule 17a-11 (for the broker-dealer), which are described in detail below. The proposed additional regulatory conditions include requiring the broker-dealer to restrict its

business, to provide a plan for increasing its net capital or tentative net capital, or to calculate its capital charges using the haircut method of Rule 15c3-1.

This provision is intended to identify situations where the broker-dealer may be exposed to increased levels of risk. We could respond to that increased risk level by, for example, requiring increased capital charges or requiring that we be provided more information concerning the operational or financial condition of the broker-dealer, its holding company, and its affiliates.

We seek comment on the additional conditions that would be available to the Commission under paragraph (f) of Appendix E. Are the events pursuant to which the Commission may impose additional conditions appropriate? Should any other events be added to this list? Should we specify in the rule other conditions that could be imposed if the broker-dealer or CSE did not comply with applicable requirements? What should these conditions be?

B. Proposed Appendix G to Rule 15c3-1

As a condition of Commission approval, the holding company of a broker-dealer applying for authorization to compute certain of its capital charges in accordance with proposed Appendix E would undertake to comply with the requirements listed in proposed Appendix G to Rule 15c3-1, in addition to those listed in paragraph (a)(1)(viii) of proposed Appendix E. Under Appendix G, the CSE would be required to compute allowable capital and allowances for market, credit, and operational risk on a consolidated basis for the CSE; provide the Commission with certain monthly, quarterly, and annual reports; maintain certain books and records relating to the CSE's consolidated 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 holding company and the potential impact on the risk exposure of the broker-dealer.

We are proposing what we believe are prudent parameters for measuring allowable capital and risk allowances for the CSE and that are consistent with the Basel Standards, which are used by many other financial regulators as a method to assess capital adequacy at the holding company level. For example, the proposal contains requirements placing limits on the amount of subordinated debt that may be included in allowable capital, that the VaR model

used to calculate the allowance for market risk be based on a ten business-day movement in rates and prices, and that the VaR measure be multiplied by a factor of at least three. Requiring that a 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 an CSE's financial condition to that of other international securities firms and banking institutions.

1. Calculation of Allowable Capital and Allowances for Market, Credit, and Operational Risk by the CSE

Pursuant to proposed paragraph (a) of Appendix G, the CSE would be required to calculate allowable capital and allowances for market, credit, and operational risk on a consolidated basis for the affiliate group on a monthly basis, which is designed to be consistent with the Basel Standards, which will allow for greater comparability of CSEs to international securities firms and banking institutions. This requirement is necessary to monitor the financial condition of the affiliate group, which may impact the financial stability of the broker-dealer. A CSE that makes a capital calculation consistent with the Basel Standards that it is required to submit to another regulator can request in the original exemption application or in an amendment to substitute that calculation for the calculations required by paragraph (a) of proposed Appendix G. If the Commission finds that the calculation gives the Commission sufficient information about the financial health of the holding company, it will approve that request.

e. Group-Wide Allowable Capital Calculation

Under proposed paragraph (a)(1) of Appendix G, the CSE would calculate "allowable capital" on a consolidated basis for the affiliate group. Consistent with the Basel Standards, allowable capital would include common shareholders' equity (less goodwill, deferred tax assets, and certain other intangible assets), certain cumulative and non-cumulative preferred stock,⁴⁰ and certain properly subordinated debt. As set forth in detail in the rule, the cumulative and non-cumulative preferred stock and the subordinated

⁴⁰ To qualify, the cumulative and noncumulative preferred stock could not have a maturity date, could not be redeemed at the option of the holder, and could not contain any other provisions that would require future redemption of the issue. In addition, the issuer would have to be able to defer or eliminate dividends. Preferred stock meeting these conditions would have characteristics consistent with capital, as opposed to debt.