

debt are subject to additional limitations based on comparisons of the individual components of allowable capital.

We request comment on whether goodwill should be included in allowable capital or whether it is appropriate to include goodwill subject to a phase-out. If so, we request comment on how the phase-out should be structured and how long the phase-out should last.

An entity's debt is not ordinarily regarded as capital. Because subordinated debt can provide a long-term source of working capital to the entity and may have many of the characteristics of capital, however, the Basel Standards permit unrestricted long-term subordinated debt⁴¹ to count as capital. Under paragraph (a)(1)(iii)(B) of proposed Appendix G, and consistent with the Basel Standards, subordinated debt can be included in allowable capital if it meets four criteria, which generally are designed to assure that the subordinated debt will provide a long-term source of working capital to the holding company and that it has many of the characteristics of capital. First, the original weighted average maturity of the CSE's subordinated debt must be at least five years. Second, the subordinated debt instrument must state clearly on its face that repayment of the debt is not protected by the Securities Investor Protection Corporation ("SIPC") or any Federal agency. Third, the debt must be unsecured and subordinated in right of payment to all senior indebtedness of the CSE. Fourth, the terms of the subordinated debt agreement may permit acceleration only in the event of bankruptcy or reorganization of the CSE under Chapters 7 (liquidation) or 11 (reorganization) of the U.S. Bankruptcy Code. The intent of these four criteria is to provide for permanency of capital and to inform subordinated lenders of the risks associated with being a subordinated lender.

Funds lent under a subordinated debt agreement necessarily are subject to the risks of the CSE's business and must be available to pay other creditors if the holding company defaults on other obligations or fails. Although the customers of certain of the entities which are part of the CSE may be entitled to the protection of SIPC or a Federal agency under specific circumstances, such as the failure of a broker-dealer subsidiary, subordinated lenders of the holding company, as

subordinated lenders, would not be entitled to any such protection.

Under the proposal, to be included in allowable capital, subordinated debt must have characteristics that are consistent with capital. Therefore, the subordinated debt must be unsecured and subordinated in right of payment to all of the CSE's senior debt. Debt that, upon default, can be repaid by conversion of collateral or before other debt cannot be considered subordinated in right of repayment to all senior indebtedness of the CSE because the debt effectively would have priority over at least some other debt.

Subordinated debt instruments that permit acceleration of payment upon events other than bankruptcy or reorganization of the holding company would not qualify for inclusion in allowable capital under the proposed rules.⁴² Acceleration clauses raise significant supervisory concerns because repayment of the debt could be accelerated at a time when a CSE may be experiencing financial difficulties. Acceleration, therefore, could inhibit a CSE's ability to resolve its financial problems in the normal course of business and force the company into involuntary bankruptcy, thereby affecting the financial stability of the broker-dealer.

We request comment on the inclusion of subordinated debt in allowable capital generally and on the following questions in particular:

- Is five years the appropriate maturity for subordinated debt to be included in allowable capital? Would another term, whether longer or shorter, be more appropriate?
- To be included in allowable capital, could subordinated debt be subject to negative pledge provisions that, for example, would restrict a CSE's ability to pledge the equity securities of a subsidiary to secure the debt or to sell a subsidiary unless the buyer agreed to assume liability for some portion of the debt?
- Should subordinated debt that is subject to acceleration events other than bankruptcy or reorganization of the CSE under the Bankruptcy Code be included in allowable capital?

⁴² The prohibition on acceleration of payment also would prohibit inclusion of credit sensitive subordinated debt in allowable capital. Credit sensitive subordinated debt ties payments to the financial condition of a borrower/holding company or its affiliates. This feature of the debt forces a holding company to make increased payments as its financial condition deteriorates and, therefore, acts as a de facto acceleration clause that may deplete the CSE's resources and increase the likelihood of default on debt. Furthermore, the clause potentially would allow a subordinated lender to obtain payment before senior creditors.

• Should there be a maximum amount of subordinated debt that is includible in allowable capital? If so, what should be the amount?

• What are the additional costs of issuing subordinated debt versus long-term debt of the same maturity?

Some industry participants have suggested that certain long-term debt that cannot be accelerated should be included in allowable capital because, since at the holding company level there is no protected class of creditors, there is no significant difference between that type of long-term debt and subordinated debt. In addition, they assert that subordinated debt is more costly to an entity than long-term debt that cannot be accelerated because of the restrictive provisions associated with subordinated debt and the lack of an active trading market for subordinated debt. They see no other legitimate purpose behind the requirement that the debt be subordinated in order to count as capital.

We solicit comment on whether long-term debt, subject to appropriate limitations, should be included in allowable capital. Specifically, we request comment on the following issues:

- If long-term debt is included in allowable capital, what restrictions should apply?
- Does a holder of a CSE's subordinated debt have a greater incentive to monitor the financial condition of CSE than a holder of its long-term debt because its claim is more junior? Would trading in its subordinated debt provide a more reliable indication of the credit quality of the CSE than long-term debt and, if so, why?
- Are there debt instruments other than subordinated debt that provide an equivalent market signal about the credit quality of the issuer?
- Is there a material difference between the depth of the market for the long-term debt of a CSE and the depth of the market for its subordinated debt and, if so, how would any such difference impact the cost of financing for the CSE?
- Would there be any other adverse effects if the CSE was permitted to include long-term debt in allowable capital?
- If long-term debt could be included in allowable capital, what, if any, requirements should apply to the maturity date of the long-term debt? What should permissible events of acceleration be?
- Should long-term debt be subject to a negative pledge, that, for example, would restrict a holding company's

⁴¹ By contract, subordinated debt is debt that is subordinated in right of payment to all senior indebtedness of the company.