

Commission and, if so, how they should be modified.

C. Proposed Amendments to Rule 15c3-4

The proposed amendments to Exchange Act Rule 15c3-4 would expand its coverage to include broker-dealers that use Appendix E to calculate their capital charges, requiring them to establish a system of internal controls for monitoring and managing the risks associated with their business activities.⁶² Rule 15c3-4 is designed to improve 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.

In addition, as a condition for the broker-dealer to use Appendix E to compute certain of its capital charges, the CSE would agree to establish such a system to manage group-wide risk for the affiliate group of the broker-dealer.

Participants in the securities markets are exposed to various risks, including market risk, credit risk, funding risk, legal risk, and operational risk. These risks are due, in part, to the diverse range of financial instruments now traded by broker-dealers. Risk management controls within a broker-dealer promote the stability of the firm and, consequently, the stability of the general marketplace. A firm that has adopted and follows appropriate risk management controls reduces its risk of significant loss, which also reduces the risk of spreading the losses to other market participants or throughout the financial markets as a whole. Further, as a general prudent business practice, most securities firms have developed risk management systems to manage risk on a consolidated basis at the holding company level. To have a complete understanding of how risks are managed at the broker-dealer, regulators need to understand how risks are managed at the holding company.

The specific elements of a risk management system will vary depending on the size, complexity, and organization of a firm. As a result, the design and implementation of a system of internal controls for a particular CSE may differ from other firms. However, well-developed risk management systems generally share certain core principles such as establishing clear responsibilities at each level of management, separation of certain key responsibilities, and effective monitoring and reporting.

Individual firms must have the flexibility to implement specific policies and procedures unique to its circumstances. As a result, Rule 15c3-4 establishes only basic elements for the design, implementation, and review of a risk management control system. We previously found these elements to be the appropriate ones for an entity to use when developing such a system.

Rule 15c3-4 requires a firm to consider a number of aspects of its business when adopting its risk management control system. Although each firm must develop controls appropriate to its specific circumstances, the rule requires certain elements to be included in the firm's internal risk management control system. For example, the system must include a risk control unit that reports directly to senior management and is independent from business trading units. In addition, there must be separation of duties between personnel who enter into transactions and personnel who record the transactions.

Finally, the firm's management must periodically review the firm's business activities for consistency with established risk management guidelines to check whether firm personnel are operating within the scope of permissible activity and whether the risk management system continues to be adequate.

We request comment on the proposed amendments to Rule 15c3-4. We request comment on whether the holding company undertakings should incorporate Rule 15c3-4 or whether the requirement to establish a group-wide internal risk management control system should be a stand-alone rule. We request comment on whether any aspect of Rule 15c3-4 could be better tailored to reflect unique aspects of group-wide risk management or risk management of broker-dealers using proposed Appendix E to calculate certain capital charges. We request comment on whether Rule 15c3-4 should be amended to require that results of periodic reviews conducted by an internal auditor or annual reviews conducted by a registered public accounting firm should be reported in writing to the Board of Directors. Should we amend Rule 15c3-4 to require all broker-dealers to do so?

D. Proposed Amendments to Rule 17a-5; Broker-Dealer Reporting Requirements

The proposed amendments to Exchange Act Rule 17a-5 would require a broker-dealer that uses proposed Appendix E to file certain reports with the Commission in addition to the

reports that all broker-dealers must file under the rule. These reports would provide current detailed information regarding the financial position of the firm, which would assist us in understanding the risk profile of the firm. The Commission would use the information collected under the proposed amendment to monitor the financial condition, internal risk management control system, and activities of broker-dealers that elect the alternative capital computation.

These additional reports would include a monthly report detailing, among other things, its derivatives revenues, certain market and credit risk information, backtesting results of its mathematical models, and regular risk reports it supplies to its management, quarterly reports on, among other things, how well its daily VaR and maximum potential exposure correspond to the daily net trading loss, and certain supplemental reports concerning management controls and inventory pricing and modeling prepared by a registered public accounting firm.⁶³ We request comment on the proposed additional reporting requirements for a broker-dealer that uses Appendix E. In particular, we request comment on whether the supplemental reports should be prepared by a registered public accounting firm.

E. Proposed Amendments to Rule 17a-11; Broker-Dealer Notification Requirements

Exchange Act Rule 17a-11 requires that a broker-dealer provide notification of certain net capital levels and certain operational problems to the Commission and its designated examining authority within specified time periods. Currently, Exchange Act Rule 17a-11 also imposes certain additional notification requirements on an OTC derivatives dealer.⁶⁴ The Commission proposes to amend Rule 17a-11 to provide for additional notification requirements for a broker-dealer that uses proposed Appendix E to calculate certain of its capital charges. The events that would require Commission notification would indicate that the broker-dealer or its holding company may be experiencing financial or operational difficulty.

The proposed amendments would expand the additional notification requirements that apply to an OTC derivatives dealer to include a broker-dealer that uses Appendix E to calculate certain of its capital charges. For

⁶³ See *supra*, note 32.

⁶⁴ 17 CFR 240.17a-11(b)(2).

⁶² 17 CFR 240.15c3-4.