

control systems and its compliance with those systems.

#### *G. Exemption From Risk Assessment Rules for Broker-Dealer Affiliates of SIBHCs*

The Commission presently receives 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 pursuant to the risk assessment rules (Rules 17h-1T and 17h-2T) and through meetings with and reports from members of the Derivatives Policy Group.<sup>63</sup> These supervisory tools generally have performed well by assisting the Commission in identifying, at an early stage, firms that are experiencing financial problems.

As part of this rulemaking, the Commission is proposing to amend Rules 17h-1T and 17h-2T<sup>64</sup> to exempt broker-dealers that are affiliated with an SIBHC from those rules. Rule 17h-1T requires that a broker-dealer maintain and preserve records and other information concerning the broker-dealer's holding companies, affiliates, or subsidiaries that are likely to have a material impact on the financial or operational condition of the broker-dealer. Rule 17h-2T requires that broker-dealers file quarterly reports with the Commission concerning the information required to be maintained and preserved under Rule 17h-1T. We believe that exempting a broker-dealer that is affiliated with an SIBHC is appropriate because, pursuant to proposed Rule 17i-5, the SIBHC would be required to make and retain documents substantially similar to those the broker-dealer is required to make and retain pursuant to Rule 17h-1T. Further, pursuant to proposed Rule 17i-6, the SIBHC would be required to make reports that are substantially similar to those the broker-dealer is required to make pursuant to 17h-2T. We request comment on the proposed exemptions

<sup>63</sup> Pursuant to the "risk-assessment rules," adopted under Exchange Act Section 17(h), broker-dealers also submit consolidated and consolidating financial statements, organizational charts of the holding company, descriptions of material legal exposures, and risk management policies and procedures to the Commission. [17 CFR 240.17h-1T and 17 CFR 240.17h-2T]. Member firms of the Derivatives Policy Group ("DPG") also voluntarily supply us with additional information regarding derivative financial instruments, off balance sheet obligations, and the concentration of credit risk. The DPG was formed in March 1995 by the industry and the Commission to provide a voluntary oversight framework for monitoring derivatives activities of broker-dealer affiliates.

<sup>64</sup> 17 CFR 240.17h-1T and 240.17h-2T.

from Rules 17h-1T and 17h-2T for broker-dealers affiliated with an SIBHC.

#### *H. Proposed Rule 17i-7: Calculations of Allowable Capital and Risk Allowances or Alternative Capital Assessment*

Proposed Rule 17i-7 would require an SIBHC to calculate the affiliate group's allowable capital and allowances for certain types of risk. Proposed Rule 17i-7 would not set minimum group-wide capital levels for SIBHCs; rather, it would require the SIBHC to perform certain calculations that the Commission could review to gain an understanding of the financial position of the affiliate group and identify any risks it poses to the broker-dealer.

The Basel Committee on Banking Supervision<sup>65</sup> ("Basel Committee") has developed international regulatory standards that aim to align economic capital calculations with regulatory capital requirements for large internationally active banking institutions ("Basel Standards").<sup>66</sup> The Basel Committee has proposed to modify the Basel Standards.<sup>67</sup> Our proposal incorporates a capital computation for the SIBHC that is

<sup>65</sup> 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.

<sup>66</sup> The basic consultative papers developed by the Basel Committee 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. It is intended to increase the transparency and consistency of the supervision of financial companies across borders. 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).

<sup>67</sup> In April 2003, the Basel Committee released for public comment a document entitled "The New Basel Capital Accord" (the "New Basel Capital Accord") to modify the Basel Standards. This paper can presently be found at: <http://www.bis.org/bcbs/cp3full.pdf>. Comments were accepted through July 31, 2003. On October 11, 2003, the Committee announced that it had received over 200 comment letters, that there is continued broad support for the structure of the new 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. 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.

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.

We are proposing what we believe are prudent parameters for measuring allowable capital and allowances for risk for the SIBHC that are consistent with the Basel Standards. In some cases these parameters may be more conservative than some firms believe are necessary to account for risk. For example, the proposal would place limits on the amount of subordinated debt that may be included in allowable capital, require that the VaR model used to calculate the allowance market risk be based on a ten business-day movement in rates and prices and that a 99% confidence level be used, and require that the VaR measure be multiplied by a factor of at least three. Requiring that an SIBHC calculate its allowable capital and allowances for market, credit and operational risk based on the Basel Standards would provide the Commission with a useful measure of the SIBHC's financial position and allow for greater comparability of an SIBHC's financial condition to that of other international securities firms and banking institutions.

#### *1. Calculation of Consolidated Allowable Capital*

Consistent with the Basel Standards,<sup>68</sup> proposed Rule 17i-7 would require that an SIBHC calculate "allowable capital" for the affiliate group that would include common shareholders' equity (less goodwill, deferred tax assets, other intangible assets, and certain other deductions), certain cumulative and non-cumulative preferred stock,<sup>69</sup> and certain properly subordinated debt. As set forth in

<sup>68</sup> Proposed Rule 17i-7 is generally consistent with U.S. banking regulators' interpretations of the Basel Standards and incorporates the quantitative and qualitative conditions imposed on banking institutions. However, one difference is our proposal to use maximum potential exposure as opposed to notional add-ons to calculate credit risk for OTC derivatives instruments, and our interpretation as to what instruments should be subject to market risk, as opposed to credit risk, treatment. These differences, and the reasons for them, are described more specifically in the sections relating to the calculations of allowance for market and credit risk.

<sup>69</sup> The cumulative and non-cumulative preferred stock could not (i) have a maturity date, (ii) be redeemed at the option of the holder, or (iii) 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. Finally, the cumulative and non-cumulative preferred stock would be subject to certain limits (see paragraphs (a)(2) and (a)(3)(i) of proposed Rule 17i-7).