



February 27, 2004

Jonathan G. Katz
Secretary
U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Proposed Rule on Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities (Release No. 34-48690; File No. S7-21-03)

Dear Mr. Katz:

The Securities Industry Association¹ (“SIA”) welcomes the opportunity to comment on the above-referenced Securities and Exchange Commission (the “Commission”) proposal to adopt alternative, risk-based capital requirements for a broker-dealer that is part of a consolidated supervised entity (“CSE”).² The SIA working group that has prepared this comment letter comprises representatives of globally active financial institutions that are at the forefront of efforts to develop and implement group-wide internal risk management control systems and is drawn from two standing SIA committees³ and other SIA member firms.⁴ We commend the Commission for pursuing a new risk-based capital framework for broker-dealers that are part of CSEs.

The securities industry has changed dramatically since the mid-1970s when the Commission first adopted capital rules for broker-dealers.⁵ In the intervening period, advances

¹ The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker’s Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs more than 800,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated an estimated \$142 billion in domestic revenue and \$283 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

² SEC Release No. 34-48690 (Oct. 24, 2003), 68 Fed. Reg. 62871 (Nov. 6, 2003) (the “Proposing Release”).

³ These include SIA’s Risk Management and Capital Committees.

⁴ The firms who participated in the preparation of this letter are identified in the attached Appendix.

⁵ In 1975 the Commission adopted its net capital rule, Rule 15c3-1 under the Securities Exchange Act of 1934 (the “Exchange Act”), in substantially its current form.

in technology, financial theory and statistics have ushered in improved tools for the evaluation of the risks associated with the activities of broker-dealers and other financial services institutions. SIA has, for some time, advocated a fundamental review of the Commission's net capital rule⁶ and believes that the CSE proposal is an important step in the modernization of the Commission's approach to net capital. Implementation of risk-based capital and risk management requirements on a consolidated basis, as contemplated by the CSE proposal, would be fully consistent with investor protection and other objectives of the Exchange Act. While potentially reducing regulatory capital requirements, the CSE proposal would require group-wide adherence to rigorous risk management practices and introduce Commission supervision of such practices, thereby reinforcing the financial integrity of broker-dealers.

By providing economic incentives in the form of lower capital charges, the proposal would encourage firms to develop better measures of their exposures to risk and better techniques for managing such risk. In addition, by aligning the Commission's capital standards more closely with the international capital standards established by the Basel Committee on Banking Supervision,⁷ adoption of the proposal will help to ensure the continued global competitiveness of U.S. securities firms.

We appreciate the thoughtful approach that the Commission and its staff have taken in developing the CSE proposal and in beginning the process of harmonizing the Commission's capital rules with international capital standards. In our view, it is essential that broker-dealer capital rules reflect modern risk management practices and comport with recognized international standards. We therefore commend the Commission for its CSE proposal and look forward to working with the Commission on the finalization and implementation of the proposal.

In the following sections we have identified those issues raised by the CSE proposal that are, in our view, most significant. In the immediately following summary, we have highlighted principles that we believe to be fundamental to the efficacy of the proposed framework. In recommending certain alternative approaches, we have endeavored to ensure that our recommendations reinforce the "equivalence" of the CSE framework as a global supervisory standard.

⁶ See letter from Mark W. Holloway, Chairman, SIA Capital Committee, commenting on SEC Release No. 34-39455 (May 4, 1998).

⁷ In 1974 the Governors of the G-10 countries established what is now named the Basel Committee on Banking Supervision (the "Basel Committee") to provide a forum for ongoing cooperation among member countries on banking supervisory matters. In 1988, the Basel Committee established standards for a risk-based capital framework for internationally active banks ("Basel I"). Basel I has been adopted in various respects by most bank regulatory authorities around the world. Over the years it has been subject to considerable refinement and interpretation. In 1996, the Basel Committee adopted the Amendment to the Capital Accord to Incorporate Market Risks. In the late 1990s the Basel Committee commenced an international effort to update and revise Basel I to promote competitive equality and to take a more risk-sensitive approach. That effort has resulted in three successive drafts of a proposed new Basel Capital Accord ("Basel II"), the most recent being Consultative Paper 3 ("CP3"), which was issued in April 2003. Following further modification and calibration, final adoption by the Basel Committee of Basel II is expected some time in 2004. Basel II consists of three pillars: minimum capital requirements ("Pillar 1"), supervisory review of an institution's internal assessment process and capital adequacy ("Pillar 2") and effective use of disclosure to strengthen market discipline as a complement to supervisory efforts ("Pillar 3").

I. SUMMARY.

We have highlighted immediately below several issues, discussed in greater detail in the following sections, that we believe are critical to the success of the proposed CSE framework. We urge the Commission to focus in particular on these themes in the process of finalizing the CSE proposal.

- *Consistency at the Broker-Dealer and Holding Company Levels and with International Standards.* SIA shares the Commission's objective of assuring that broker-dealer capital be maintained at prudent levels. It is critical in achieving this objective, however, that the Commission adopt consistent approaches to capital computation at the broker-dealer and holding company levels and that these approaches be consistent with international standards as reflected in the Basel Accords.

We believe that the proposed hybrid capital regime at the broker-dealer level and its proposed phase-in of market risk modeling are inconsistent with these objectives and should be eliminated. Instead, market and credit risk charges should be computed, from inception, using "Value-at-Risk" (VaR) or other proprietary risk-based models in a manner that is consistent at the broker-dealer and the holding company levels and that comports with Basel standards.

Eliminating the proposed hybrid capital standard and phase-in approach at the broker-dealer level would avoid the operational expense and inefficiency of implementing different systems within the CSE for computing capital, would avoid the regulatory arbitrage that would undoubtedly result from the computation of different capital charges for similar activities within the CSE and, as important, would promote more consistent integration of capital computation, on the one hand, and effective group wide risk measurement and monitoring, on the other hand.

We recognize that broker-dealers face risks in addition to market and credit risk, such as operational risk, in the conduct of their businesses. As we note in Section IV below, we have significant reservations about aspects of each of the current approaches in CP3 of Basel II to operational risk. Nonetheless, to reflect the operational risks to which a broker-dealer may be subject and to promote greater consistency with Basel II, as well as between the broker-dealer and the holding company, we generally believe that broker-dealer capital requirements should include an allowance for operational risk, although certain firms believe that an operational risk allowance should not be allocated to the broker-dealer or its holding company prior to the implementation of operational risk allowances under Basel II. We emphasize in this context that the calculation of any such operational risk allowance should evolve over time to reflect future advances in operational risk theory, modeling and management that are incorporated into Basel II.

We also recognize that broker-dealers are subject to funding liquidity risks. Consistent with Basel II, however, we believe that Pillar 2 of Basel II provides a more appropriate framework than Pillar 1 within which to address funding risks. We note in this regard that Pillar 2 would provide the Commission a flexible framework within which to address concerns that may arise in relation to a firm's management of funding liquidity risk.

- *Applicable Basel Standards.* Because U.S. broker-dealers, other than those that are part of an entity that is already subject to comprehensive consolidated supervision, have not been subject to Basel standards or have had only certain affiliates subject to Basel standards, we ask the Commission to be flexible as to which Basel standard applies to broker-dealers not currently subject to consolidated supervision, particularly during the period before Basel II is implemented.⁸ Such flexibility is necessary in order to avoid the undue expense and burden of requiring that broker-dealers and their CSEs comprehensively implement a standard that is destined to be superseded in the very near future. We recognize that any such flexibility must be exercised in a manner that maintains consistency with international supervisory standards and avoids competitive disparities.

We urge the Commission to continue to pursue an active role in the ongoing development of international standards for risk management and capital adequacy in order to ensure that those standards appropriately account for the risk characteristics of investment banking activities. The Commission should, in particular, continue its participation in the International Organization of Securities Commissions ("IOSCO") working group on trading book issues and should incorporate into the CSE framework future IOSCO recommendations that are consistent with Basel II.

- *Equivalence.* Consolidated supervision is an issue of particular urgency for firms doing business within the European Union ("EU") who do not currently have a comprehensive consolidated supervisor. Under the EU Financial Conglomerates Directive,⁹ financial markets regulators within the EU must determine whether an entity of non-EU parentage is subject to consolidated supervision that is "equivalent" to EU supervision. We believe that the CSE proposal fully meets the "equivalence" standard. We recognize the efforts that both the Commission and the U.S. Department of the Treasury have taken to ensure that the CSE proposal is recognized, in a timely fashion, as "equivalent" and urge the continuation of those efforts.

⁸ We refer in this letter to a CSE that is currently subject to comprehensive consolidated supervision by a recognized comprehensive consolidated supervisor ("RCCS") as an "independently supervised CSE."

⁹ Directive 2002/87/EC of the European Parliament and of the Council of the European Union of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate. The "Financial Conglomerates Directive" is also sometimes referred to as the "Financial Groups Directive."

- *Deference.* We urge that the Commission defer, to the maximum extent possible, to other RCCSs that supervise a CSE,¹⁰ as well as to any principal regulator who has primary responsibility for supervising an entity within a CSE. Doing so (1) would permit the Commission to leverage its resources, (2) would help to ensure that no entity within a CSE is subject to duplicative or inconsistent requirements, (3) would reinforce primary supervisory responsibility with the supervisor or regulator best situated to exercise such responsibility, (4) would promote efficient utilization of supervisory resources by the Commission and other RCCSs and (5) would promote reciprocity and effective home/host coordination within the international community of supervisors, including, in particular, deference to the Commission as an RCCS. We strongly suggest that the Commission provide as much clarity as possible as to those RCCSs and principal regulators to whom it will defer and the scope of its deference.

II. CAPITAL.

A. Broker-Dealer Capital.

SIA strongly supports the use of risk-based methodologies for the calculation of capital and commends the Commission for making risk modeling a core element of the CSE proposal. However, several key features of the proposal significantly undermine the benefits that might otherwise be derived through implementation of a risk-based capital framework. Specifically, under the proposed CSE framework, the capital standard applicable to broker-dealers is a hybrid one. It incorporates significant elements that are not risk-based and that do not comport with international standards or current best practices in the evaluation of capital adequacy.

Under the proposal, the use of risk models as a component of this hybrid approach would be phased-in at the broker-dealer level in three stages over a period of at least 18 months.¹¹ This proposed phase-in mechanism would present numerous difficult definitional issues and, more importantly, would result in significant operational costs, challenges and inefficiencies.

Integrated group-wide risk management is fundamental to the Commission's CSE proposal, as well as to Basel I and Pillar 1 of Basel II. The animating objective of risk management is to assure the preservation of adequate capital in the face of the risks incident to a firm's businesses. Thus, risk management is a core component in the maintenance and

¹⁰ We note that, although the Commission has defined the term CSE to encompass the broker-dealer's holding company and holding company group affiliates, certain other references to the term CSE in the Proposing Release imply that the term CSE refers specifically to the holding company. This ambiguity has given rise to some confusion both as to the scope of the Commission's framework as well as to the scope of the deference that the Commission intends to extend to other RCCSs vis-à-vis the examination and supervision of affiliates within a holding company group that is subject to consolidated supervision.

¹¹ See Paragraph (c)(3) of proposed Appendix E; Proposing Release at 62878.

evaluation of capital adequacy. As a result, the models used for risk measurement and risk monitoring must be consistent with those used to evaluate capital adequacy.¹²

Inconsistency between the computation of capital adequacy at the broker-dealer level, on the one hand, and risk measurement and monitoring at the holding company level, on the other hand, is not just conceptually flawed. The imposition of different capital frameworks at the broker-dealer and holding company levels would result in potentially significant systems costs and inefficiencies, as firms would be required to maintain two capital computation systems. We are not aware of any need or basis for measuring similar units of risk differently, for capital purposes, at the broker-dealer and the holding company levels. Accordingly, we believe that it is essential that firms be permitted to use a consistent approach to capital at both the broker-dealer and holding company levels.

Given the objectives of the CSE proposal, as well as relevant international standards and developments, we have summarized immediately below the core principles that we believe should guide the implementation of market-risk capital standards at the broker-dealer level.¹³

- *Market Risk Charges Should Not Be Distorted to Address Other Risks.* The Commission should not distort market risk charges, through the use of add-ons, cushions or multipliers, to compensate for risks that are not market risks. Risk model-based market risk capital charges have been widely and successfully used since the Basel Committee's adoption of the 1996 Amendment to the Capital Accord to Incorporate Market Risks and have gained widespread acceptance in the financial services industry and within the international supervisory community.
- *Flexibility Should Be Permitted in Use of Risk Models.* The Commission should afford firms as much flexibility as possible in utilizing proprietary VaR or other risk models.
- *Risk Modeling Should Be Permitted for All Trading Book Items.* The use of VaR or similar models should be permitted for any instrument that comes within the definition of "trading book," which is defined in CP3 to include positions in financial instruments and commodities that are (1) held either with trading intent or for purposes of hedging, (2) free of any restrictive covenants or able to be hedged completely, (3) frequently and accurately valued and (4) part of a

¹² See Section III.B.2(d) of the Amendment to the Capital Accord to Incorporate Market Risks (Jan. 1996, updated to Apr. 1998), which provides "The bank's internal risk measurement model must be closely integrated into the day-to-day risk management process of the bank. Its output should accordingly be an integral part of the process of planning, monitoring and controlling the bank's market risk profile."

¹³ We address in Section II.B below how the application of "Basel-equivalent" standards should be construed during the transition period preceding formal adoption of Basel II.

portfolio that is actively managed,¹⁴ without regard to other external limitations on the scope of the trading book.

- *“Ready Market” Concept Should Be Eliminated.* The Commission should eliminate the use of “haircuts” or categorizations that are based on the existence of a “ready market” for a particular security or on specific credit ratings.¹⁵ Firms should instead be required to demonstrate that their models adequately capture the material market risks associated with the categories of securities in which they transact business. Where uncertainty exists, any alternative approach (whether in the form of add-ons or increased multipliers) should be subject to a defined phase-out if and as backtesting results validate the adequacy of the firm’s model-based approach.
- *Scenario Analysis Should Be Permitted in Appropriate Circumstances.* If VaR or other proprietary models do not adequately reflect the scope of loss likely to be associated with a category of instruments in connection with the occurrence of an event of lower probability than the event probabilities captured by the confidence interval incorporated in the model (whether as the result of insufficient data or instrument characteristics), the firm and the Commission should agree on an appropriate scenario analysis designed for the purpose of capturing such risks.¹⁶ In determining whether to permit the use of scenario analysis and the composition of the scenario, the Commission should be sensitive to competitive disparities that could result from the calibration of the stresses utilized in defining the scenario analysis.
- *Newly Issued or Less Liquid Securities Should Be Eligible for Model Treatment.* SIA agrees with the Commission that robust data sets are critical to effective risk modeling. Nevertheless, there should be no minimum price history requirement for newly issued or less liquid securities whose risk attributes are sufficiently similar to securities with robust price histories that can serve as “proxies” in risk management models.

As noted earlier, we recognize that broker-dealers face risks in addition to market and credit risk, such as operational risk, in the conduct of their business. As we note in Section IV below, we have significant reservations about aspects of each of the approaches in CP3 of Basel II to operational risk, as well as a concern as to the difficulties in calculating operational

¹⁴ Paragraph 643 of CP3. For a full discussion of the concept of “trading book,” see Part 2 VI.A of CP3. Most firms’ asset-backed securitization programs would come within the definition of “trading book.”

¹⁵ See Exchange Act Rule 15c3-1.

¹⁶ In the Proposing Release, the Commission asks whether a multiplier or other charge should be used to adjust calculations based on scenario analysis. In using scenario analysis that is appropriately calibrated to capture extreme risk, a broker-dealer should not be required to use multipliers or other charges. Similarly, charges for specific risk should not be added to the results of a scenario analysis. The scope of potential loss associated with specific risk should be appropriately captured by the scenario being modeled.

risk capital allowances for discrete legal entities within a holding company group. Nonetheless, to reflect the operational risks to which a broker-dealer may be subject and to promote greater consistency with Basel II, as well as between the broker-dealer and the holding company, we generally believe that broker-dealer capital requirements should include an allowance for operational risk, although certain firms believe that an operational risk allowance should not be allocated to the broker-dealer or its holding company prior to the implementation of operational risk allowances under Basel II. We emphasize in this context that the calculation of any such operational risk allowance should evolve over time to reflect future advances in operational risk theory, modeling and management that are incorporated into Basel II.

We also recognize that broker-dealers are subject to funding liquidity risks. Consistent with Basel II, however, we believe that Pillar 2 of Basel II provides a more appropriate framework than Pillar 1 within which to address funding risks. We note in this regard that Pillar 2 would provide the Commission a flexible framework within which to address concerns that may arise in relation to a firm's management of funding liquidity risk.

Any supplemental charges or requirements that the Commission may impose to address the risks to which broker-dealers may be subject should be designed in a manner that does not create competitive disparities between firms subject to the charge or requirement and, together with the balance of the capital standard, should operate in a manner that eliminates any material discrepancy in the marginal capital charge associated with incremental transactions within the CSE, so as to minimize the influence of regulatory capital arbitrage in organizing trading books across CSE affiliates.

B. Basel Standards.

SIA is generally supportive of the efforts by the Basel Committee to establish global regulatory standards and of the Commission's proposal to adopt equivalent standards. However, for those broker-dealers that have not previously been subject to consolidated supervision requiring compliance with Basel standards, we urge the Commission to be flexible, consistent with equivalence, as to which Basel standards, and which interpretation of those standards, apply to CSEs, particularly during the period before implementation of Basel II. Having not previously been subject to Basel I, such U.S. broker-dealers and their affiliates generally have not structured their operations, control processes or balance sheets in accordance with Basel I. Requiring those firms to adopt Basel I and then to adopt Basel II shortly thereafter would not yield any benefit in terms of risk management and would be inefficient, costly, and burdensome. Doing so would also place broker-dealers that are not part of independently supervised CSEs at a competitive disadvantage to banks and broker-dealers that are part of independently supervised CSEs who have had years to come into compliance with Basel I and to plan their transition to Basel II. If Basel II is finalized (even if not yet universally adopted), firms should be permitted, but not required, to adopt those elements of Basel II that have been finalized.

In some instances, a U.S. broker-dealer that has not been subject to Basel standards may have a parent or certain affiliates that are already subject to Basel I. For such a firm, the Commission should work with the broker-dealer in the CSE application process to ensure a

firm-wide transition to Basel standards that maintains the financial integrity objectives of the Basel standards without being unduly burdensome to the broker-dealer. In this context, it may be appropriate for the CSE to use Basel I for certain activities and Basel II for other activities during the transition period prior to the adoption of Basel II. We recognize that any such approach would need to be defined by the firm and the Commission in the context of the CSE application process, based on the firm's particular circumstances, and that any such approach must maintain equivalence and must not undermine the financial integrity objectives of the Basel standards through opportunistic "cherry picking." We do not believe that any such hybrid approach would necessarily undermine the equivalence of the CSE framework with global supervisory standards. Indeed, we anticipate that, in connection with the transition to Basel II, there will be periods in which many institutions continue to comply with Basel I while others transition at an earlier time to Basel II.

We urge the Commission, on an ongoing basis, to pursue an active role in further efforts to establish global risk management and capital adequacy standards. The Commission should seek to ensure that those standards appropriately reflect the activities of securities firms and associated risks. The Commission should, in particular, continue its participation in the IOSCO working group on trading book issues and should incorporate within the CSE framework future recommendations of the IOSCO working group that are consistent with Basel II. We also encourage the Commission to promote consideration by IOSCO and other international forums of the credit risk work currently being conducted under the auspices of the International Swaps and Derivatives Association, Inc. ("ISDA"), with regard to the development of the concept of "expected positive exposure" and similar concepts for the quantification of counterparty credit exposure and to adopt any future refinements to Basel II in this area into the Commission's CSE requirements.

C. Allowable Capital.

The definition of holding company "allowable capital" in Paragraph (a) of proposed Appendix G would exclude, among other items, deferred tax assets and certain types of preferred stock. In addition, the definition would not include long-term debt. We believe that the proposed definition of allowable capital is too limited.

We recommend that the Commission permit long-term debt to be included in allowable capital during a five-year phase-out period. Long-term debt currently represents a significant portion of the capital of broker-dealer holding companies that have not previously been subject to consolidated supervision. These firms should be allowed sufficient time to adjust their capital structures without undue market impact. As capital standards have changed over the years, regulators have given banking organizations time to adjust their balance sheets accordingly.¹⁷ The Commission should adopt a similar approach with respect to broker-dealers whose holding

¹⁷ See e.g., 12 C.F.R. 225, Appendix A, footnote 12, in which the Board of Governors of the Federal Reserve System ("Federal Reserve Board") provided that unsecured term debt issued by bank holding companies prior to March 12, 1988 that qualified as secondary capital at the time of issuance would continue to qualify as an element of supplementary capital under the risk-based capital framework adopted in 1989.

companies have not previously been subject to consolidated supervision. Given the amount of long-term debt that will need to be refinanced and the potential capital market impact and increased funding costs that could be associated with a more accelerated time frame, we believe that five years is an appropriate time period for the phase-out of long-term debt.

We also urge that the Commission conform its treatment of deferred taxes to the Federal Reserve Board's treatment of deferred tax assets under its capital rules.¹⁸ In addition, hybrid capital instruments, including trust preferred securities should be treated in a manner consistent with current Federal Reserve Board guidance.¹⁹ Hybrid capital instruments provide firms with significant economic and liquidity protection. Various regulators and certain major rating agencies recognize and include these instruments (up to certain limits) in their computation of a firm's "core capital." It is estimated that in excess of \$90 billion of such hybrid capital instruments are currently outstanding. Accordingly, CSEs would be at a significant competitive disadvantage if, unlike certain other regulated institutions, they are unable to use this lower cost alternative to meet a portion of their capital requirements.

D. Frequency of Required Calculations.

Proposed Appendix G would require a holding company to compute allowances for market and credit risk on a daily basis.²⁰ We believe that daily calculation of holding company market and credit risk allowances would constitute a material cost and burden and would represent a significant change in current practice, without materially enhancing CSE supervision. Holding companies not subject to supervision by an RCCS should be permitted to calculate market and credit risk allowances as part of their monthly group-wide capital computations, provided firm risk managers run and review daily risk management reports and conduct daily backtesting. Holding companies subject to supervision by an RCCS should be required to calculate market and credit risk allowances on the schedules required by their RCCSs.

III. CREDIT RISK CAPITAL CHARGES.

A. Credit Concentration.

Under the CSE proposal, a broker-dealer would be subject to counterparty and portfolio credit concentration charges. Paragraph (d)(8) of proposed Appendix E would impose a concentration charge where the current exposure of the broker-dealer to counterparty exceeds 5% of the tentative net capital of the broker-dealer. The amount of the charge would depend on the

¹⁸ See 12 C.F.R. 225, Appendix A, Part II.B.4, in which the Federal Reserve Board limits the exclusion of deferred tax assets from a bank holding company's capital.

¹⁹ See 12 C.F.R. 225, Appendix A, Part II.A.1.iv.

²⁰ Paragraph (a)(2) of proposed Appendix G would require daily calculation of an allowance for market risk; paragraph (a)(3) would require daily calculation of an allowance for credit risk. Under paragraph (a)(1) of proposed Appendix G, a holding company would be required to calculate allowable capital monthly.

credit risk weight of the counterparty. Paragraph (d)(9) would impose a concentration charge across all counterparties for unsecured receivables of 100% of the amount of the broker-dealer's aggregate current exposure arising from the broker-dealer's transactions in derivatives instruments across all counterparties in excess of 15% of the tentative net capital of the broker-dealer.

We note preliminarily that comparable charges are not required at the holding company level or under either Basel I or Basel II. The proposed concentration charges would be so onerous and attach at such low thresholds that they would impose limitations on the scope of the derivatives activities that could be booked in a broker-dealer in a capital-efficient manner and thus effectively would deter such activity in the broker-dealer. Moreover, we believe that the proposed charges additionally overstate credit risk because they fail to take into account certain risk-mitigating portfolio effects.

The Commission should therefore eliminate concentration charges at the broker-dealer level for derivatives. We recommend that the Commission approach concerns about credit concentration from a risk management perspective, under a Pillar 2 approach, rather than through a capital charge. In reviewing the adequacy of CSE internal risk management controls, the Commission should consider whether these controls adequately address counterparty and portfolio credit concentration risk.

B. Potential Credit Exposure.

The CSE proposal would permit broker-dealers and holding companies to use a "maximum potential exposure" methodology to compute credit risk charges for derivatives counterparty risk.²¹ We believe that the "maximum potential exposure" methodology is an improvement upon the "add-on" methodology contained in CP3 of Basel II. We believe, however, that "maximum potential exposure" should more appropriately account for the future value of collateral that would be collected through calls for collateral. In our view, the appropriate time horizon for computing "maximum potential exposure" should be ten business days, rather than one year as provided in Paragraph (e)(2)(ii) of proposed Appendix E, in circumstances where the position is marked-to-market daily and the firm has the ability to call for additional collateral daily.²²

²¹ Paragraph (d)(4) of Proposed Appendix E provides that the "maximum potential exposure" of the broker-dealer to a counterparty is the increase in the replacement value of the counterparty's positions with the broker-dealer, after applying netting agreements with the counterparty and taking into account the value of collateral from the counterparty held by the broker-dealer. Paragraph (a)(3)(i)(d) of Proposed Appendix G provides that the "maximum potential exposure" of a member of the affiliate group to a counterparty is the increase in the net replacement value of the counterparty's positions with the member of the affiliate group, after applying netting agreements with the counterparty and taking into account the value of collateral from the counterparty held by any member of the affiliate group and subtracting the fair market value of any credit derivatives that specifically change the exposure to the counterparty.

²² Where the timing of collateral calls is less frequent than daily, appropriate adjustments should be made to the time horizon for computing "maximum potential exposure."

As noted above, a considerable amount of work has been done by ISDA in connection with the development of an “expected positive exposure” approach to future credit exposure. We endorse the work that is being done on this approach and support the views expressed on this issue in the comment letter filed by ISDA with respect to the CSE proposal.²³ We are hopeful that the current work in this area will result in future changes to Basel II with respect to derivatives and securities financing charges and recommend that the Commission adopt any such methodological improvements as they are incorporated into Basel II.

C. Collateral Limitations.

The CSE proposal would permit broker-dealers and holding companies, when calculating current exposure and maximum potential exposure, to take into account the fair market value of pledged and held collateral only if such collateral meets certain requirements, including a requirement that the collateral have a ready market.²⁴ SIA believes that the Commission should not exclude the collateral value of securities that do not have a “ready market” as defined in Exchange Act Rule 15c3-1. Consistent with our comments in Section II.A above regarding market risk charges, we urge the Commission to recognize all classes of securities as eligible collateral and, instead, incorporate appropriate adjustments for specific risk and liquidity, in accord with the firm’s approved proprietary model for computing market risk charges, in determining the credit risk mitigation value to be accorded such collateral.

D. Margin Charges.

Paragraph (a)(3)(i)(A)(2) of proposed Appendix G would impose, for purposes of calculating a holding company’s allowance for credit risk, a 5% conversion factor for margin loans extended by members of the affiliate group of the broker-dealer in compliance with applicable self-regulatory organization rules. We believe that the imposition of the proposed conversion factor is unwarranted and would result in an excessive charge. The proposed factor also has no corollary under Basel II standards. We therefore urge the Commission to eliminate it.

²³ See letter from David L. Mengle, Head of Research, ISDA, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Feb. 4, 2004).

²⁴ Paragraph (d)(6) of Proposed Appendix E provides that when calculating current exposure and maximum potential exposure, the fair market value of collateral pledged and held may be taken into account provided: (i) the collateral is marked to market each day and is subject to a daily margin maintenance requirement; (ii) the collateral has a ready market or consists of major market foreign currency; (iii) the collateral agreement is legally enforceable by the broker-dealer against the counterparty and any other parties to the agreement; (iv) the collateral does not consist of securities issued by the counterparty or a party related to the broker-dealer or to the counterparty; (v) the Commission has approved the broker-dealer’s use of a VaR model to calculate market risk capital charges for the type of security used as collateral; and (vi) the collateral is not used in determining the credit rating of the counterparty. Paragraphs (a)(3)(i)(C) and (D) of Proposed Appendix G incorporate the collateral requirements of Paragraph (d)(6) of Proposed Appendix E into holding company calculations of current exposure and maximum potential exposure.

IV. OPERATIONAL RISK CAPITAL CHARGES.

We welcome the introduction in the CSE proposal of a specific focus on operational risk and support the objective of encouraging greater discipline in this area. Operational risk management has long been a core competency for well-managed firms, although the development of risk-sensitive metrics for quantifying operational risk is in its infancy. A risk-sensitive capital charge would be an efficient and effective way to encourage sound management of operational risk. We believe that the CP3 distinctions between operational, market and credit risks are appropriate.

A. Definition of Operational Risk.

Paragraph (a)(4) of proposed Appendix G would require a holding company to compute an allowance for operational risk determined consistent with appropriate standards published by the Basel Committee, as modified from time to time. For purposes of consistency, we would recommend that the Commission define “operational risk” as it is defined in CP3 of Basel II. Paragraph 607 of CP3 defines “operational risk” as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The definition includes legal risk, but excludes strategic and reputational risk.

B. Calculation of Operational Risk Charges.

As noted by the Commission, Basel II provides three methods for calculating operational risk: the basic approach, the standardized approach, and the advanced measurement approach (“AMA”). Under the basic approach, the allowance for operational risk is 15% of consolidated annual revenues, net of interest expense, averaged over the past three years. For the standardized approach, the allowance for operational risk is a percentage of revenues net of interest expense, ranging from 12% to 18%, for each of eight business lines. The AMA approach requires a system for tracking and controlling operational risk and provides that the allowance for operational risk is the largest operational risk that might be expected over a one-year period with 99.9% confidence level.

We agree with the Commission’s proposal to permit firms to choose which of the three Basel II approaches to use to calculate an allowance for operational risk. Although firms generally prefer the AMA, that approach is still evolving. We would appreciate the opportunity to work with the Commission to develop AMAs that result in meaningful capital requirements for CSEs conducting substantial investment banking activities.

In addition, we note that the basic and standardized approaches are insensitive to risk and risk management practices. In the case of the latter, the beta coefficients assigned to a broker-dealer’s main business lines have not been fully supported by industry data. Firms with significant sales, trading, and corporate finance businesses were under-represented in the process of establishing betas. The Commission should indicate a willingness to change the alpha and beta factors as new empirical information becomes available.

C. Home/Host Issues and Allocation Methodology.

The home/host capital allocation issue has not been directly addressed in the CSE context. The development of an appropriate allocation methodology raises a number of issues. For example, the limited number of losses and resulting lack of loss data prevent a meaningful independent calculation of AMA capital for subsidiary entities. An apportionment mechanism will be particularly important if, as we advocate, operational risk charges are imposed at the broker-dealer level. It is important that any proposed solution be acceptable both to home and host regulators.

D. Applicable Confidence Interval.

We firmly support the development of an effective AMA that is consistent with evolving Basel Standards. The Basel Committee made clear its intention to establish a soundness standard that is “comparable” to that for credit and market risk.²⁵ However, we believe that it is premature to prescribe a capital requirement determined at a 99.9% confidence interval. A 99.9% confidence interval is unworkable in the short term given the limited history of data, the potential risk-weighting attributed to low-frequency high-impact loss events and the likelihood that firms would use different approaches to computing statistical distribution. We suggest removing the 99.9% confidence interval requirement and urge the Commission, consistent with Paragraph 628 of CP3, to work with the Basel Committee and other regulators to ensure that operational risk models are appropriate and relevant for supervised entities.

V. CONSOLIDATED SUPERVISION ISSUES.

A. EU Equivalence.

SIA concurs with the Commission’s view that the CSE framework should be recognized as equivalent to the global supervisory standard established by the EU Financial Conglomerates Directive. In the absence of such recognition, US-based firms doing business within the EU that are not independently supervised CSEs may be subject to higher capital requirements or may be required to establish an EU-wide holding company for their European businesses. Any such requirement could force firms to manage their businesses inefficiently and would have significant ramifications for existing risk management and organization. Accordingly, we urge the Commission, as well as the U.S. Department of the Treasury, to continue consultations with their counterparts within the EU community with a view to obtaining the earliest possible recognition that the Commission’s CSE framework, as adopted, qualifies as “equivalent” under the EU Financial Conglomerates Directive.

²⁵ See Paragraph 627 of CP3 of Basel II.

B. Home/Host Supervision.

Under the CSE proposal, the Commission has retained significant flexibility as to the circumstances in which it will extend deference, and the scope of deference it will extend, to other home/host supervisors and regulators.²⁶ The CSE proposal, as a result, offers little guidance to potential applicants or to other home/host supervisors and regulators regarding the Commission's approach to deference. Although SIA acknowledges the need for some flexibility on these issues, we believe that the lack of clarity in the current proposal may undermine the efficacy of the CSE framework (particularly for independently supervised CSEs) and may deter development of an effectively functioning international framework based on reciprocity and principled deference.

SIA urges the Commission to provide greater clarity as to those RCCSs and principal regulators to whom it will defer, particularly with respect to holding company capital, examination, reporting and model review, at the holding company and affiliate levels, as well as to the scope of such deference.²⁷ We believe that the Commission should, at a minimum, defer in these areas to those RCCSs that are generally recognized by supervisory authorities within G-10 countries. The Commission could alternatively adopt the approach included in the Commission's proposal to exempt foreign banks from the insider lending prohibition of Exchange Act Section 13(k). In defining the banks that would qualify for the proposed exemption, the Commission included foreign banks that the Federal Reserve Board has determined are subject to comprehensive supervision or regulation on a consolidated basis by the bank supervisor in the foreign bank's home jurisdiction under 12 CFR 211.24(c).²⁸

The Commission should defer to an RCCS with respect to all entities, other than entities required to register with the Commission, within the group supervised by the RCCS. In our view, the Commission should similarly defer, in the case of a functionally regulated affiliate within a CSE (including CSEs that are not independently supervised), to the affiliate's principal regulator. We recommend that, for these purposes, the term "principal regulator" include any regulator within the G-10, or another major financial center, that is responsible for the functional regulation of the securities, banking, commodities or insurance activities of the relevant affiliate. We see no basis for the more limited definition of "entity that has a principal regulator" that is included in the CSE proposal.

As noted above, the Commission should also provide greater clarity as to the scope of the deference it will extend to RCCSs and principal regulators in administering the proposed supervisory framework. In particular, we strongly recommend that the Commission adopt a clear and unambiguous standard defining the circumstances in which it will seek additional information from a holding company about matters subject to oversight by an RCCS or principal regulator.

²⁶ See, e.g., Proposing Release at 62873.

²⁷ Under the Gramm-Leach-Bliley Act, the Commission does not have authority to examine insured depository institutions.

²⁸ SEC Release No. 34-48481, 68 Fed. Reg. 54590 at 54598 (Sept. 17, 2003).

The Commission's standard should take into account the objectives of equivalence and consistency, the avoidance of the undue burdens of duplicative regulation and potential implications for reciprocity. In this regard, the Commission should refrain from seeking additional information from, or pursuing other action with respect to, a CSE or CSE affiliate supervised by an RCCS, except in circumstances in which the Commission finds a clear need to address a material risk to the capital of the broker-dealer. Similarly, the Commission should refrain from seeking additional information from, or pursuing other action with respect to, a CSE or CSE affiliate that has a principal regulator, but is not supervised by an RCCS, except in circumstances in which the Commission finds a clear need to address a material risk to the capital of the holding company or the broker-dealer or to understand group-wide risk management processes.²⁹ The standard adopted by the Commission should also take into account each of the different contexts in which deference issues arise (e.g., model approval, examinations, reports, enforcement and holding company capital versus broker-dealer capital).

Expressing a clear and strong presumption in favor of deference would permit the Commission to focus its resources on the areas of greatest risk and would place oversight responsibility with the RCCS or principal regulator best situated to exercise such responsibility. Such an approach would also avoid unnecessary duplication of effort and the promulgation of inconsistent requirements. Moreover, in our view, it would promote more efficient use of international supervisory resources and foster more effective international cooperation.

C. Level at Which Consolidated Supervision Applies.

The Commission should clarify the level at which consolidated supervision applies. It should provide that CSE supervision applies either at the level of the ultimate holding company or, if a CSE has another RCCS, at an intermediate level that the CSE and the Commission agree is appropriate given the holding company group's structure and organization and the nature of the business activities conducted by the relevant affiliate group.

VI. GENERAL/LEGAL ISSUES.

A. CSE Application Process.

The CSE application process, as set forth in Paragraph (a) of proposed Appendix E, is too open-ended. For example, the application process does not incorporate any specific time frames for Commission review and approval of an application or for the identification of material deficiencies. We recommend that the Commission incorporate appropriate time frames and more specific standards for approval (or non-approval). We believe that risk management systems and controls documentation and models previously reviewed or approved by the

²⁹ The requirement in Paragraph (a)(1)(viii)(F) of proposed Appendix E that a broker-dealer must make available to the Commission for an entity that has a principal regulator such information as the Commission finds necessary to evaluate any risks that may affect the reputation of the holding company or the broker-dealer is an example of a requirement that is overly broad and should be eliminated.

Commission³⁰ or by an RCCS or principal regulator³¹ should be presumptively valid, at least for initial approval purposes. To the maximum extent possible, applicants should be permitted to provide information they have prepared for public company or other reporting purposes such as the Sarbanes-Oxley Act requirement for reports on internal controls over financial reporting.

Expeditious approval is, as noted above, particularly important to those firms who are not part of an independently supervised CSE. In this regard, we note that the Commission has significant familiarity with the global risk management policies and procedures of a number of broker-dealers through its oversight of the broker-dealer, its over-the-counter (“OTC”) derivatives dealer affiliate, and/or through information shared pursuant to the voluntary supervisory framework adopted by the Derivatives Policy Group. We believe that this familiarity should enable the Commission to expedite the application process with regard to such materials and should enable the Commission to specify a more abbreviated time frame for its review and approval of such materials.³²

In the event that the Commission has concerns about a particular model, SIA recommends that the Commission resolve any such concerns by provisionally approving the model, subject to appropriately calibrated add-ons, cushions or multipliers (that would phase out over time if and as backtesting results validate the model), rather than by a protracted delay in approving the affected firm’s CSE application.

SIA recommends the Commission also streamline the process for amending a CSE application. A broker-dealer should not be required to amend and refile its entire application in the event of a material change to a mathematical model used to calculate market or credit risk or to its internal risk management system.³³ Imposing an onerous process for amendments would be burdensome and could serve to deter or delay firms in making changes to improve their models and risk management systems.

B. Confidentiality.

As the Commission recognizes in the CSE proposal, it is essential that any information related to CSE supervision, including any changes in models, calculations or procedures made in response to Commission comments, be accorded confidential treatment. We note in this regard that Paragraph (a)(4) of proposed Appendix E would provide confidential treatment for all information or documents submitted in connection with an application filed under Appendix E. Paragraph (b)(7) of proposed Appendix G similarly states that statements filed by the holding

³⁰ For example, the Commission may have given approval, at least implicitly, in connection with the Commission’s capital framework for OTC derivatives dealers.

³¹ We strongly encourage the Commission to develop, in consultation with its EU and other foreign counterparts, a common framework and criteria for the review and approval of models used for the computation of risk-based capital charges.

³² If the Commission deemed it necessary, such approval could be provided on a provisional basis, subject to timely correction of deficiencies subsequently identified by the Commission.

³³ See Paragraph (a)(7) of proposed Appendix E.

company under Paragraph (b) of Appendix G would be accorded confidential treatment. We urge the Commission to further clarify that it would afford confidential treatment to any non-public information that is submitted to the Commission by the broker-dealer or the CSE and that the Commission will not share any such information with another U.S. or non-U.S. regulator except pursuant to statutory or other binding provisions ensuring the confidential treatment of such information by such other regulator.

We urge that the Commission exercise vigilance, in the issuance of orders and other administrative actions, in ensuring that orders and other publicly available Commission documents do not directly or indirectly reveal confidential information including, by way of example, any conditions or representations that may be made by an applicant or CSE under the CSE framework.³⁴

We also believe that it would be helpful, in confirming the confidential treatment of the information to be provided to the Commission, if the Commission would explicitly confirm in the adopting release its implicit determinations that: (1) the scope of the information it will obtain from CSEs under the proposed framework is, by its nature, competitively sensitive; (2) CSEs have a commercial interest both in their risk models and risk management systems and processes and in the data they obtain through use of these models, systems and processes; and (3) the Commission's inability to afford confidential protection to information obtained under the CSE proposal would fundamentally undermine the willingness of firms to apply for and maintain CSE status and would thereby jeopardize the viability of the CSE framework.³⁵

C. Scope of Commission Authority to Impose Limitations or to Revoke a Firm's CSE Status.

The CSE proposal provides the Commission with broad authority to impose limits and additional regulatory conditions on an applicant for an exemption permitting it to use proposed Appendix E.³⁶ In addition, the proposal provides the Commission with broad authority to revoke

³⁴ We note that Federal Reserve Board approvals sometimes refer to information contained in separate communications.

³⁵ The Commission may wish to consider pursuing appropriate statutory amendments, consistent with Exchange Act Section 17(j), in order to eliminate any risk of the expense, distraction and burden that would result from the need to respond to meritless requests under the Freedom of Information Act by third parties for access to CSE submissions and reports.

³⁶ See Paragraphs (a)(6) and (f) of proposed Appendix E. Paragraph (a)(6) provides that the Commission may approve an application, in whole or in part, subject to any conditions or limitations the Commission may require if the Commission finds it to be necessary or appropriate in the public interest and consistent with the protection of investors. Paragraph (f) provides that, in certain circumstances, the Commission may impose additional regulatory conditions including restricting a firm's business, increasing its net capital or tentative net capital requirements, requiring it to file more frequent reports with the Commission, modifying its internal risk management control procedures, or requiring it to compute its market and credit risk capital charges in accordance with provisions of Exchange Act Rule 15c3-1. The circumstances in which the Commission may impose additional regulatory conditions on a broker-dealer under Paragraph (f) include failure to meet certain reporting requirements, an event specified in Exchange Act Rule 17a-11 or Rule 15c3-1g(e), a material deficiency in its internal risk management control systems or risk models, failure of its holding company to comply with certain undertakings, a material

a broker-dealer's exemption permitting it to use proposed Appendix E.³⁷ The Commission's authority to impose limitations or to revoke a firm's exemption should be more narrowly calibrated and should clarify that any limitations or remedial action must be narrowly circumscribed to address the relevant deficiency. Any Commission action to revoke a firm's CSE status or impose other limitations or sanctions should be limited to instances in which the Commission finds a material capital deficiency or a substantial pattern of material non-compliance. In addition, firms whose applications are denied or who face remedial actions should be afforded administrative due process protections, including the opportunity to correct a deficiency.³⁸

D. Additional Relief.

SIA believes that the Commission should provide additional relief to remove certain regulatory obstacles that currently limit the expansion of certain business activities within U.S. broker-dealers and could continue to do so even for broker-dealers subject to the CSE framework. In particular, we believe that the additional relief summarized below would be critical to an expansion of OTC derivatives business within a registered broker-dealer. Facilitating an expanded range of activity within the U.S. broker-dealer could reduce the number of different entities through which firms conduct various activities. This would result in a number of potential benefits and efficiencies for affected firms as well as for the counterparties with whom they transact. We would be pleased to provide greater detail or work with the Commission on implementing these recommendations.

1. Rule 15c3-3 Relief.

Given the Commission's substantial proposed amendments to the methodologies under Exchange Act Rule 15c3-1 for computing capital requirements for market risk, and particularly with respect to OTC derivatives, we urge the Commission to amend the custody, control and hypothecation limitations within Exchange Act Rules 15c3-3, 8c-1 and 15c2-1 for collateral pledged to a broker-dealer by an OTC derivatives counterparty to allow for the consistent application of those rules to full service broker-dealers and OTC derivatives dealers. SIA's objective in making this recommendation is to remove what would otherwise remain as a barrier prohibiting full-service broker-dealers from developing OTC derivatives businesses. If the Commission does not provide such relief under Rule 15c3-3, full-service broker-dealers would continue to have an incentive to conduct and develop OTC derivatives businesses outside the

amendment to its risk models or internal risk management control systems or corporate structure, or the Commission finds that imposing other regulatory conditions are necessary or appropriate in the public interest and for the protection of investors.

³⁷ See Paragraph (a)(10) of proposed Appendix E, which provides that the Commission may revoke an exemption if it finds that the exemption is no longer necessary or appropriate in the public interest or is no longer consistent with the protection of investors.

³⁸ Furthermore, we believe that the Commission should make clear that any examinations conducted by self-regulatory organizations, such as the New York Stock Exchange, Inc. ("NYSE"), for compliance with CSE requirements must be conducted, in coordination with Commission staff, in accordance with Commission rules and consistent with the Commission's interpretation of the CSE framework.

broker-dealer and would therefore leave full-service broker-dealers at a competitive disadvantage to other competitors not subject to similar restrictions. Additionally, by granting the requested relief, the Commission would provide opportunities for full-service broker-dealers to establish cross-product netting arrangements with counterparties and allow credit risk exposures to be managed within a single legal entity, thereby reducing aggregate credit risk to the holding company and such counterparties.

2. Margin Relief.

We urge the Commission to work with the industry, the Federal Reserve Board and self-regulatory organizations to exempt from or otherwise reduce margin requirements applicable to certain activities pursuant to Federal Reserve Board Regulation T and self-regulatory organization margin rules. In particular, the Commission should ensure that a portfolio margining regime is adopted under NYSE Rule 431 and National Association of Securities Dealers, Inc. ("NASD") Rule 2520 that would qualify for exemption from the margin requirements of Federal Reserve Board Regulation T and that would permit the margin charges applicable to any securities position to reflect the full spectrum of off-setting and risk-reducing transactions or positions in the counterparty's portfolio.

In addition, the Commission should ensure that OTC derivatives transactions conducted by a broker-dealer are exempt from NYSE Rule 431 and NASD Rule 2520.

3. Relief from NASD Position Limits.

The Commission should ensure that the NASD adopts amendments to its position and exercise limit, reporting and related rules that would provide an exemption for OTC options positions, including positions that are hedged on a delta neutral basis. The exemption should apply to registered broker-dealers. The failure to provide such relief to registered broker-dealers would pose a substantial impediment to the expansion of OTC derivatives activities within a registered broker-dealer.

4. SIPA Relief.

In order to promote greater legal certainty, the Commission should provide or obtain clarification regarding the following issues related to the Securities Investor Protection Act of 1970 ("SIPA"):

- Confirmation that the Securities Investor Protection Corporation ("SIPC") will not seek to stay a qualifying counterparty (i.e., "financial institution," "stockbroker," "repo participant," etc., under the U.S. Bankruptcy Code safe harbors for financial contracts) from exercising close-out and setoff rights, including foreclosure-on-collateral rights, in cases where the remedies do not involve a sale of securities pledged, lent or otherwise transferred by the failed broker-dealer to the counterparty and returnable to the broker-dealer upon performance by the broker-dealer.
- Confirmation that, if a counterparty submits an affidavit that it knows of no fraud in a transaction and has a perfected interest in securities pledged, lent or otherwise

transferred by the failed broker-dealer to the counterparty and returnable to the broker-dealer upon performance by the broker-dealer, SIPC would not seek to either obtain the securities from the counterparty (through payment or performance) or prevent the counterparty from liquidating the securities within 4-5 days after the appointment of SIPC (or sooner in periods of market volatility).

- Clarification by SIPC of the circumstances in which securities or other assets pledged or otherwise transferred to a SIPC member would constitute customer property in a liquidation proceeding.

5. Relief for OTC Derivatives Dealers.

The Commission should permit registered OTC derivatives dealers the option of complying with proposed Appendix E in lieu of Appendix F.

6. Coordination with Other Regulators.

SIA recommends that the Commission, at an early stage, coordinate with the U.S. Department of the Treasury and the Commodity Futures Trading Commission ("CFTC") to ensure that compliance with the CSE framework by dual registrants will satisfy corollary regulatory obligations under U.S. Department of Treasury rules and CFTC rules.

E. Additional Issues.

1. Definition of "Material Affiliate."

We recommend that the Commission adopt a definition of "material affiliate" that is consistent with the determination of "material associated person" of a broker-dealer under Exchange Act Section 17(h), recognizing that risks to the broker-dealer may flow through the broker-dealer's holding company. We believe that this approach has worked well under the Commission's existing framework for risk assessment to the broker-dealer.

2. Concept of Primarily in the Insured Depository Institutions Business.

The requirement in the proposed definition of "entity that has a principal regulator," in Paragraph (a)(13)(ii) of Rule 15c3-1, that an entity be "primarily in the insured depository institutions business" should be eliminated. The proposed requirement would make the definition of "entity that has a principal regulator" too narrow for certain U.S. entities and, particularly, for foreign banks whose deposits would not qualify under the proposed standard. We note that if the Commission adopts our recommendation in Section V.B above regarding principal regulator, our recommendation to eliminate the "primarily in the insured depository institutions business" would be moot.

VII. REPORTING REQUIREMENTS.

A. Timing and Content of Reports.

Broker-dealers, their holding companies, and certain of their affiliates are already subject to extensive Commission reporting requirements. The CSE proposal would impose substantial additional reporting requirements.³⁹ As a general matter, we recommend that the Commission conform, to the maximum extent possible, the content and timing of reporting requirements under the CSE proposal to other Commission reporting requirements as well as to reporting requirements of other principal regulators and RCCSs. For example, requirements related to reports on management controls should be aligned with Sarbanes-Oxley Act requirements for management's report on internal control over financial reporting. Reporting requirements that go beyond published reporting requirements, such as transactional, counterparty and risk management information, should be required to be provided 35 calendar days after month end or as otherwise required by a firm's RCCS.⁴⁰

B. Affiliate Reporting.

We believe that the reporting requirements proposed by the Commission with respect to affiliates are overly broad. For example, Paragraph (b)(2)(ii) of proposed Appendix G would require the provision of a consolidating balance sheet that provides information regarding each material affiliate of the holding company in a separate column (information regarding members of the affiliate group that are not material affiliates could be aggregated into one column). For many firms, preparing such reports would be extremely burdensome. The Commission should instead require reporting solely at the broker-dealer level, on a consolidated basis and with respect to material affiliates only. It should also specify that reports for foreign affiliates of holding companies that are not normally subject to U.S. generally accepted accounting principles ("GAAP") would not be required to use U.S. GAAP. Reporting requirements under Rule 17a-11 related to affiliates should be limited to events that have a significant impact on broker-dealer capital and should be part of monthly/quarterly reporting.

C. Audit Reports.

SIA supports the use of agreed upon procedures in the accountant's reports that would be required under Paragraph (b)(i) of proposed Appendix G. We believe that audit reports should be required on an annual cycle agreed upon by an applicant and the Commission in the CSE application process. In the case of a firm that is subject to consolidated supervision by another RCCS, audit reports should be required in accordance with the requirements of, and on the schedule required by, such RCCS.

³⁹ See Paragraph (b) of proposed Appendix G.

⁴⁰ The Commission should also clarify that the notes referred to in Rule 15c3-1(g)(b)(1)(i) and Rule 15c3-1(g)(b)(2)(ii) are not footnotes in the financial statement sense but rather management notes or highlights.

VIII. PILLAR 3 DISCLOSURES.

SIA generally supports the goal of Pillar 3 of Basel II, which is to use disclosure to strengthen market discipline as a complement to supervisory efforts. We do not believe, however, that disclosure standards should be established as part of the proposed CSE supervisory framework. Any disclosure standards would have potentially broad ramifications and competitive implications. SIA believes that Pillar 3 disclosures should, as a result, be addressed in the context of a broader dialogue between the financial industry and regulators regarding the appropriate scope of public disclosure.

* * * * *

SIA appreciates the opportunity to comment on this important proposal and looks forward to working with the Commission on the successful implementation of consolidated supervision of broker-dealers. If you have any questions concerning our comments, please do not hesitate to contact Michael J. Alix at (212) 272-7597, Mark W. Holloway at (212) 902-1360 or outside counsel to SIA, Edward J. Rosen of Cleary, Gottlieb, Steen & Hamilton at (212) 225-2820.

Sincerely,

s/ Michael J. Alix; Mark W. Holloway

Michael J. Alix and Mark W. Holloway, Co-Chairs
CSE Steering Committee

Appendix

cc: The Honorable William H. Donaldson, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner
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APPENDIX

The following firms participated in the preparation of this letter:

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Morgan Stanley
UBS Securities LLC