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Securities Law Developments NEWSLETTER

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SEC Approves Rules for Consolidated Capital Treatment and Investment Bank Holding Company Supervision

On June 8, 2004 the Securities and Exchange Commission ("SEC" or "Commission") issued two sets of rules under the Securities Exchange Act of 1934 ("Exchange Act") relating to the supervision of a broker-dealer's parent holding company and the broker-dealer's affiliates.

The first set of rules, described in a release entitled "Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities," sets forth a *voluntary*, alternative method of computing net capital for broker-dealer subsidiaries of consolidated supervised entities ("CSEs") that utilize group-wide internal risk management control systems and consent to group-wide SEC supervision.[1] Under the rules, broker-dealers that participate in sophisticated internal risk management control systems designed by the broker-dealer and CSE may apply to the Commission for an exemption from the standard net capital rule. Such broker-dealers will be permitted to calculate their net capital requirements for market- and derivatives-related credit risk using mathematical models. A broker-dealer using this alternative method of computing net capital will be subject to enhanced net capital, early warning, recordkeeping, reporting, and certain other requirements, and must implement and document an internal risk management system.

The second set of rules, described in a release entitled "Supervised Investment Bank Holding Companies," establishes a framework for the Commission to supervise the parent holding company of a SEC-registered broker-dealer.[2] Under the rules, investment bank holding companies

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1 Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, Exchange Act Release No. 49,830 (June 8, 2004), 69 Fed. Reg. 34,428 (June 21, 2004) ("Alternative Net Capital Release"), *available at* http://www.sec.gov/rules/final/34-49830.htm

2 Supervised Investment Bank Holding Companies, Exchange Act Release No. 49,831 (June 8, 2004), 69 Fed. Reg. 34,472 (June 21, 2004) ("SIBHC Release"), *available at* http://www.sec.gov/rules/final/34-49831.htm.

This letter is for general informational purposes only and does not represent our legal advice as to any particular set of facts, nor does this letter represent any undertaking to keep recipients advised as to all relevant legal developments.

("IBHCs") may *voluntarily* apply to become supervised investment bank holding companies ("SIBHCs") under the supervision of the SEC as long as the holding companies have a broker-dealer subsidiary with a substantial presence in the securities markets. The new rules establish regulatory requirements for a SIBHC, including requirements regarding its group-wide internal risk management control system, recordkeeping, and periodic reporting. Under the rules, a SIBHC's reporting of consolidated computations of allowable capital and risk allowances will be consistent with the standards published by the Basel Committee on Banking Supervision ("the Basel Committee").

Compliance with the approved rules – which is voluntary, not mandatory – is intended to respond to an industry need to provide a basis for U.S. securities firms to demonstrate that they are subject to "consolidated supervision" at the holding company level. Without demonstration of such home country supervision, U.S. broker-dealers operating in the European Union ("EU") (and in other jurisdictions) may face the prospects of additional capital requirements and other duplicative regulatory burdens. The Commission expects that supervision under the rules as adopted will meet the EU's standard. *The effective date of the approved rules is August 20, 2004.* We discuss the final rule releases in turn.

I. Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities

The Commission's new alternative net capital rule responds to the interest of large broker-dealers, within holding company structures, in having their regulatory capital requirements better aligned with internal risk management control models already used by the holding company. The rule adopts a net capital calculation that is more consistent than previous U.S. requirements with the Basel Committee's standards and addresses the concerns of firms doing business in the EU that need to certify that their consolidated supervision at the holding company level is equivalent to EU consolidated supervision. Without a demonstration of "equivalent" supervision of U.S. securities firms with affiliates, such firms may be subject to additional capital charges in the EU or be required to form subholding companies in the EU for calculating net capital.

A broker-dealer that (1) maintains "tentative net capital" of at least $1 billion[3] and net capital of at least $500 million, (2) agrees to notify the Commission if *tentative net capital* falls below $5 billion, and (3) agrees to comply with Exchange Act Rule 15c3-4[4] as if it were an over-the-counter ("OTC") derivatives dealer may apply to the Commission for exemption from the standard method of calculating net capital.[5] Qualifying

3 Tentative net capital is defined by the rule to be net capital (before deducting the market and credit risk capital charges) plus the balance sheet value (including counterparty net exposure) resulting from transactions in derivative instruments. In adopting the final rule, the Commission amended the definition to allow a broker-dealer to include in net capital securities for which there is no ready market, as long as the Commission has approved the use of mathematical models for purposes of calculating deductions to net capital for those securities. 17 C.F.R. § 240.15c3-1(a)(15). This definition is effective August 20, 2004.

4 Rule 15c3-4 requires that each OTC derivatives dealer (a) "establish, document, and maintain a system of internal risk management controls to assist it in managing the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks"; (b) consider certain factors outlined in the rule when adopting its internal control system guidelines, policies, and procedures; (c) include specified elements in its internal management control system; and (d) have management periodically review, in accordance with written procedures, its business activities for consistency with certain risk management guidelines. 17 C.F.R. §240.15c3-4.

5 17 C.F.R. § 240.15c3-1(a)(7).

broker-dealers may, under the Commission's supervision, calculate market and credit risk charges using the firm's own internal mathematical models for risk measurement. To be eligible to use the alternative method, a broker-dealer's ultimate holding company and its affiliates – referred to as a "consolidated supervised entity" or "CSE" – also must maintain a group-wide risk management control system and consent to group-wide supervision by the Commission.[6] To safeguard against exposing a broker-dealer to the risk of its affiliates, broker-dealers that obtain an exemption from the standard net capital calculation requirements must submit additional financial information regarding the condition of the ultimate holding company and affiliates.

A. Otherwise Regulated Entities

To avoid duplicative regulation, the Commission determined to exclude from certain requirements any ultimate holding company or affiliate of the broker-dealer that has a principal regulator other than the Commission. Such ultimate holding companies and affiliates are not subject to either Commission examination or rules requiring internal risk management controls outside of the broker-dealer. An ultimate holding company or affiliate with a principal regulator other than the Commission also has reduced reporting, recordkeeping, and notification obligations.

The "ultimate holding company that has a principal regulator" category includes any financial holding company or company that is treated as a financial holding company under the Bank Holding Company Act of 1956.[7] Accordingly, any U.S. holding company or non-U.S. banking organization that has elected financial holding company status will be an ultimate holding company that has a principal regulator. In adopting this definition, the Commission aimed to recognize the comprehensive, consolidated supervision of both the Federal Reserve and non-domestic bank regulators.

The term "entity that has a principal regulator" includes insured depository institutions, futures commission merchants or introducing brokers registered with the CFTC, entities registered with or licensed by a state insurance regulator, and certain foreign banks. In adopting the final rule, the Commission also decided to include Edge Act and Agreement Corporations,[8] provided they are not primarily in the securities business, because these entities are subject to Federal Reserve supervision.[9]

B. Application to Use the Alternative Method of Net Capital Calculation

A broker-dealer that seeks to use the alternative method of calculating net capital must submit certain materials to the Commission in its application.[10]

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6 This supervision would impose reporting, recordkeeping, and notification requirements on the ultimate holding company. Supervision of an ultimate holding company and its affiliates would also include examination by the Commission, unless the ultimate holding company has a principal regulator other than the SEC.

7 17 C.F.R. § 240.15c3-1(c)(13)(ii)(A).

8 An "Edge Act Corporation" is a domestic subsidiary of a U.S. bank that is chartered by the Federal Reserve for the limited purpose of engaging in international banking and other financial transactions related to international business. *See* Section 25A of the Federal Reserve Act, 12 U.S.C. §§ 611-633. An "Agreement Corporation" is an equivalent state-chartered entity that enters into an "agreement" with The Federal Reserve to limit its activities to those permissible for an Edge Act Corporation. *See* Section 25 of the Federal Reserve Act, 12 U.S.C. §§ 601-604a.

9 17 C.F.R. § 240.15c3-1(c)(13)(i). In the final rule, the Commission also added a paragraph that permits the Commission to determine if other types of entities subject to comprehensive supervision by other regulators qualify as entities that have principal regulators. *Id.*

10 Recognizing the sensitivity of institutions' risk management systems and processes, the Commission stated that it will treat a broker-dealer's application to use the alternative method for computing net capital and all related submissions as confidential information to the extent permitted by law.

1. Information About the Broker-Dealer

A broker-dealer that meets the tentative net capital and capital standards described above also must meet certain application requirements in order to qualify for an exemption from the standard net capital charge calculations, as set forth in Appendix E to Rule 15c3-1.[11] These requirements include that the broker-dealer applicant provide the following categories of information in its application:

(1) An executive summary of all information included in its application and an identification of the broker-dealer's ultimate holding company;

(2) A comprehensive description of the broker-dealer's internal risk management control system;

(3) A list of the categories of positions the broker-dealer holds in its proprietary accounts and a brief description of how the broker-dealer will calculate market and credit risk deductions for those positions;

(4) Descriptions of the mathematical models used to price positions and calculate deductions for market and credit risk and how those models and the resulting calculations will be used, maintained, controlled, backtested, and reported to management;

(5) If applicable, a description of how scenario analysis will be used in calculating market risk deductions;

(6) A description of how the broker-dealer will calculate current exposure;

(7) A description of how the broker-dealer will determine internal credit ratings and internal credit risk weights of counterparties; and

(8) A written undertaking by the broker-dealer's ultimate holding company.[12]

Based on the information submitted, the Commission will determine if the broker-dealer has met the requirements described above. The Commission also will review whether the broker-dealer's ultimate holding company is complying with the terms of its undertaking, the requirements of which are described below.

2. Undertaking By and Information About the Ultimate Holding Company

In the adopting release, the Commission noted that ultimate holding companies that own large broker-dealers may also own many other entities. Depending upon the nature of its structure, broker-dealers may incur risks because of their affiliation with unregistered entities. A broker-dealer may use the alternative method of computing net capital only if its ultimate holding company complies with certain requirements. These requirements are substantially fewer if the ultimate holding company has a principal regulator.

a. Undertaking By the Ultimate Holding Company

As part of the broker-dealer's application, Appendix E to Rule 15c3-1 requires the ultimate holding company to file a written undertaking. The requirements for this undertaking by ultimate holding companies that have principal regulators differ substantially from those for ultimate holding companies that do not have principal regulators.

An ultimate holding company that does not have a principal regulator must agree, among other things, to:

(1) Comply with all Commission requirements for calculating net capital using the alternative method and all related recordkeeping, reporting, and notification requirements;

[11] Appendix E is found in 17 C.F.R. § 240.15c3-1e.

[12] 17 C.F.R. § 240.15c3-1e(a)(1).

(2) Comply with the provisions of Rule 15c3-4 with respect to a group-wide internal risk management control system as if it were an OTC derivatives dealer;

(3) Permit the Commission to examine the books and records of any affiliate that does not have a principal regulator; and

(4) Submit to the Commission for approval any material changes to mathematical models and other methods used to calculate allowances for market, credit, and operational risk, and any material changes to the internal risk management control system for the affiliate group.[13]

By contrast, a more limited undertaking is required for an ultimate holding company that has a principal regulator. The principal requirements for the undertaking by such ultimate holding companies are that they agree to:

(1) Comply with all Commission requirements for calculating net capital using the alternative method and all related recordkeeping, reporting, and notification requirements; and

(2) Make available to the Commission information about the ultimate holding company that the Commission finds necessary to evaluate its risks and its eligibility to use the alternative net capital method.[14]

b. Information About the Ultimate Holding Company

In connection with the broker-dealer's application to use the alternative method of computing net capital, the ultimate holding company also must supply certain information about its financial position, internal risk management system, and capital calculation methodology to the Commission. As elsewhere, the requirement is more streamlined for ultimate holding companies that have a principal regulator.

All ultimate holding companies of broker-dealers applying to use the alternative method of calculating net capital must submit the following, among other things, to the Commission:

(1) A description of the ultimate holding company's business and organization;

(2) An alphabetical list of affiliates of the broker-dealer and designation of which affiliates are material;[15]

(3) Consolidated and consolidating financial statements;

(4) A description of any differences between the models used by the ultimate holding company and those used by the broker-dealer to compute deductions for specified risks on the same instrument or counterparty;

(5) Sample risk reports that the ultimate holding company provides to senior management; and

(6) Any supplemental information that the Commission may request to complete its review of the application.[16]

[13] 17 C.F.R. §§ 240.15c3-1e(a)(1)(viii) and (a)(9).

[14] 17 C.F.R. § 240.15c3-1e(a)(1)(ix).

[15] The Commission does not establish criteria in the rule for deciding which affiliates are material, leaving it up to the broker-dealer to make that determination. The Commission will, however, review on a case-by-case basis the entities that have been so identified. Alternative Net Capital Release, 69 Fed. Reg. at 34,439 n.56.

[16] 17 C.F.R. § 240.15c3-1e(a)(2), (a)(3), and (a)(4).

An ultimate holding company that does not have a principal regulator must provide the Commission with the following additional information:

(1) Certain sample capital calculations;[17]

(2) A description of the categories of positions held by the ultimate holding company and affiliates;

(3) A description of the methods the ultimate holding company intends to use for computing allowances for market, credit, and operational risk; and

(4) A description of the risk management control system the ultimate holding company uses to manage group-wide risk and how that system satisfies the requirements of Rule 15c3-4.[18]

C. Broker-Dealer Net Capital Calculations

The Commission revised the proposed rule's provisions related to the broker-dealer's computation of net capital.[19] The final rule requires deductions for market risk and credit risk to be calculated in compliance with the following rules:

1. Market Risk Capital Charge

The rule sets forth certain qualitative, quantitative and other requirements for Value at Risk ("VaR") models to be approved.[20] A broker-dealer approved to use the alternative net capital computation must compute monthly a market risk capital charge using the VaR mathematical model, scenario analysis, and the standard haircut method.[21]

A broker-dealer's deduction for market risk is an amount equal to the sum of the following deductions:

- VaR. For positions for which a market risk capital charge may be calculated using a VaR model, the deduction would be computed by using the VaR position multiplied by the appropriate multiplication factor determined according to Table 1 of Appendix E.

- Specific risk deduction. For positions for which the VaR model does not incorporate specific risk, a deduction must be made for specific risk as determined on a case-by-case basis by the Commission based on a review of the broker-dealer's application and the positions involved.

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[17] An ultimate holding company that has a principal regulator is required instead to submit the capital measurement report it provided to its principal regulator.

[18] 17 C.F.R. § 240.15c3-1e(a)(4).

[19] For an overview of the proposed requirements for broker-dealer net capital computation, *see* Exchange Act Release No. 48,690 (Oct. 24, 2003), 68 Fed. Reg. 62,872 (Nov. 6, 2003) ("Proposing Release").

[20] 17 C.F.R. § 240.15c3-1e(d). The Commission also proposed to phase in the use of the VaR models over a period of at least 18 months beginning with positions of lower risk and ending with those with higher risk levels, but ultimately removed this provision from the final rule based on comments that the phase-in would impose unnecessary operational costs and inefficiencies.

[21] The proposed rule would have required a daily computation of the deduction for market risk. In response to comments that such a requirement would be unduly burdensome, this requirement was revised to require only a monthly calculation of the capital deduction for market risk. The Commission did note, however, that a broker-dealer must be in compliance with net capital requirements at all times.

- Scenario analysis. For positions for which the Commission has approved the use of scenario analysis to calculate a capital charge, the deduction will be the greatest loss resulting from a range of adverse movements in relevant risk factors, prices, or spreads designed to represent a negative movement greater than, or equal to, the worst ten-day movement over the four years preceding calculation of the loss, or some multiple of that movement based on liquidity. The rule also provides that the broker-dealer be required to take a minimum charge for positions using the scenario analysis.

- Haircut method. For all remaining positions, a deduction using the haircut method as laid out in Rule 15c3-1(c)(2)(vi) and (c)(2)(vii) is required.[22]

2. Credit Risk Capital Charge

An eligible broker-dealer must compute its credit risk capital charge on credit exposures to all counterparties arising from the broker-dealer's positions in derivative instruments.[23] The charge is the sum of counterparty exposure charges for each counterparty, concentration charges by counterparty, and a portfolio concentration charge across all counterparties.[24]

D. Other Broker-Dealer Requirements

The Commission has also amended rules regarding record retention, reporting, and notification requirements for broker-dealers using the alternative net capital calculation method.

- Recordkeeping. Rule 17a-4 has been amended to require a broker-dealer that uses the alternative method of computing net capital to preserve certain records in connection with its use of that method.

- Reporting. Under amendments to Rule 17a-5, the broker-dealer must file a monthly report with the Commission detailing, among other things, the broker-dealer's derivatives revenues, certain market and credit risk information, and the regular risk reports it provides to management. It must also file quarterly reports on, among other things, how well the firm's daily VaR and maximum potential exposure calculations correspond to the daily net trading loss and backtesting results of mathematical models. The broker-dealer must also file concurrently with its annual audit report a supplemental report on management controls.

- Notification. Rule 17a-11 has been amended to require a broker-dealer using the alternative method of calculating net capital to notify the Commission of certain events indicating that the broker-dealer may be experiencing financial or operational difficulty. Rule 15c3-1(a)(7) also separately requires Commission notification if the tentative net capital of broker-dealer applying the alternative method of net capital calculation falls below $5 billion.

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22 17 C.F.R. § 240.15c3-1e(b).

23 The rule does not specifically define "derivative instruments."

24 17 C.F.R. § 240.15c3-1e(c)(1)-(3).

E. Additional Regulatory Conditions

The Commission may impose additional regulatory requirements on an eligible broker-dealer or ultimate holding company that does not have a principal regulator upon the occurrence of certain events.[25] If one of the specified events occurs, the Commission may, among other things, restrict the broker-dealer's business on a product-specific, category-specific, or general basis, or require the broker-dealer to submit to the Commission a plan to increase the broker-dealer's net capital or tentative net capital.[26]

F. Ultimate Holding Company Net Capital Calculations

The rule also prescribes the method under which an ultimate holding company that does not have a principal regulator must measure its allowable capital and risk allowances.[27] This measurement must be submitted to the Commission on a monthly basis, including calculations for market, credit and operational risks on a consolidated basis for the affiliated group.[28] An ultimate holding company that has a principal regulator may instead submit its most recent quarterly measurements, in accordance with the standards published by the Basel Committee, as reported to its principal regulator.[29]

1. Allowable Capital

Paragraph (a)(1) of Appendix G to Rule 15c3-1 sets forth the calculations for allowable capital, which under the proposed rule would have included common shareholders' equity, certain preferred stock, and certain properly subordinated debt. To be more consistent with both Basel and Federal Reserve standards, the final rule expands the definition of allowable capital to include hybrid capital instruments and certain deferred tax assets. The Commission also determined that long-term debt must be excluded from allowable capital. To avoid imposing significant costs or causing market disruptions, the Commission will permit an ultimate holding company to request in its application that it be allowed to phase-out the inclusion of long-term debt as allowable capital over a period of up to three years, if the long-term debt meets the criteria specified in paragraph (a)(1)(iii)(C) of Appendix G.

In the alternative, a broker-dealer may request in its application that its ultimate holding company use the "building block" approach to computing allowable capital rather than a calculation on a consolidated basis. A broker-dealer making such a request must demonstrate that the proposed "building block" calculation is consistent with the methods described in the Joint Forum's 2001 "Capital Adequacy Principles."

2. Allowance for Market, Credit, and Operational Risk

The required risk allowances for an ultimate holding company that does not have a principal regulator are as follows:

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25 These events include the following: (1) the broker-dealer's tentative net capital falls below $5 billion; (2) the broker-dealer or ultimate holding company fails to comply with reporting requirements; (3) there is a material deficiency or change in the internal risk management control system or mathematical models used by the broker-dealer or ultimate holding company; (4) the ultimate holding company fails to comply with its undertakings; or (5) the Commission finds that imposing an additional regulatory condition is necessary and appropriate in the public interest or to protect investors. 17 CFR § 240.15c3-1e(e).

26 17 CFR § 240.15c3-1e(e).

27 17 C.F.R. § 240.15c3-1g(a).

28 17 C.F.R. § 240.15c3-1g(b).

29 17 C.F.R. § 240.15c3-1g(b)(2)(i)(B).

- Market Risk. The rule requires the ultimate holding company to calculate a group-wide allowance for market risk.[30] The allowance must be made for all proprietary positions (including positions in debt instruments, equity instruments, commodity instruments, foreign exchange contracts, and derivative contracts), and must be the aggregate of the VaR of its positions multiplied by the appropriate multiplier from Table 1 of Appendix E to Rule 15c3-1 and, for positions for which there is not enough historical data to support a VaR model, an alternative method, to be proposed by the ultimate holding company, that produces a suitable allowance for those positions.[31]

- Credit Risk. The ultimate holding company must also calculate a group-wide allowance for credit risk. The allowance must account for credit risk for certain assets on the consolidated balance sheet and certain off-balance sheet items, including loans and loan commitments, exposures due to derivative contracts, structured financial products, and other extensions of credit and credit substitutes. The allowance is to be 8% of the credit equivalent amount of the ultimate holding company's exposure multiplied by the appropriate risk weight. The "credit equivalent amount" and "appropriate risk weight" are defined by the rule. Alternatively, the ultimate holding company may request to use another method that is consistent with Basel Committee standards.[32]

- Operational Risk. The ultimate holding company must also make an allowance for operational risk calculated in accordance with Basel Committee standards.[33] The Basel Committee has adopted three methods for calculating an allowance for operational risk: the basic approach, the standardized approach, and the advanced measurement approach. The basic and standardized approaches are not risk-based and, instead, are calculated based on a fixed percentage of revenues. Under the basic approach, the allowance is 15% of consolidated annual revenues, net of interest expense, averaged over the past three years. The standardized approach uses a similar calculation, except the fixed percentage ranges from 12% to 18% for each of eight business lines. The advanced measurement approach requires institutions to use internal systems to calculate an allowance that is the largest operational loss that might be expected over a one-year period with 99.9% confidence.

The Commission recognized that the New Capital Accord, which sets forth methods for calculating operation risk, had not yet been adopted by the Basel Committee at the time the alternative net capital rule was released, but explained that the operational risk allowance requirement is intended to be flexible.[34] The Commission also recognized that it may need to revisit this requirement as Basel standards continue to evolve.

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[30] 17 C.F.R. § 240.15c3-1g(a)(2).

[31] *Id.*

[32] 17 C.F.R. § 240.15c3-1g(a)(3).

[33] 17 C.F.R. § 240.15c3-1g(a)(4).

[34] The Basel Committee approved the final version of its New Capital Accord on June 26, 2004. The final version did not differ substantively from the previous draft approved by negotiators in May 2004. In a statement accompanying the New Capital Accord's release, the Basel Committee noted that it plans to continue monitoring market developments and advances in risk management practices, and make revisions as future developments may make appropriate. *See* Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework, *available at* http://www.bis.org/publ/bcbs107.htm.

G. Other Ultimate Holding Company Requirements

Appendix G of Rule 15c3-1 also requires ultimate holding companies of broker-dealers electing to use the alternative method of net capital calculation to meet certain reporting, recordkeeping, and notification requirements. As elsewhere, there are fewer requirements if the ultimate holding company has a principal regulator.

- Reporting requirements. An ultimate holding company that does not have a principal regulator must file with the Commission monthly and quarterly reports containing consolidated financial and credit risk information along with a selection of other reports on risk management and the mathematical models used to calculate the risk charges. It also must file an annual audit report.[35] An ultimate holding company that has a principal regulator is subject to a more limited quarterly reporting requirement and must submit an annual audit report, but is not required to make monthly filings.[36]

- Recordkeeping. All ultimate holding companies are required to keep for three years any application, documents, reports, and notices filed with the Commission, as well as any written responses received from the Commission regarding their applications.[37] In addition, an ultimate holding company that does not have a principal regulator must maintain for three years the following records: the results of quarterly and funding stress tests; the bases for determinations of credit risk weights and internal credit ratings for each counterparty; monthly calculations of allowable capital and allowance for market, credit, and operational risks; and all written policies and procedures concerning its group-wide internal risk management control system.[38]

- Notification requirements. Each type of ultimate holding company must comply with certain notification requirements. All ultimate holding companies must notify the Commission within 24 hours if certain early warning indicators of low capital occur, if it files a Form 8-K with the Commission, or if a material affiliate declares bankruptcy or otherwise becomes insolvent. In addition, an ultimate holding company that does not have a principal regulator also must notify the Commission if: a nationally recognized statistical rating organization materially reduces its assessment of the creditworthiness of a material affiliate; a financial regulator or SRO takes significant enforcement or regulatory action against a material affiliate; or any backtesting exception occurs that increases its multiplier for calculating allowance for market or credit risk.[39]

II. Supervised Investment Bank Holding Companies

The SEC's second set of approved rules elaborates on the new framework created in §17(i) of the Exchange Act for supervising IBHCs that meet specified criteria and elect to become subject to group-wide supervision by the Commission. The rules set forth the following: (1) the definitions relevant to understanding the statutory framework; (2) the election criteria that establish which IBHCs

[35] 17 C.F.R. § 240.15c3-1g(b)(1).

[36] 17 C.F.R. § 240.15c3-1g(b)(2)(iii).

[37] 17 C.F.R. § 240.15c3-1g(d).

[38] 17 C.F.R. § 240.15c3-1g(c).

[39] 17 C.F.R. § 240.15c3-1g(e).

are eligible to file with the Commission a written "Notice of Intention" to become a SIBHC, what the Notice of Intention must include, when the Notice of Intention is required to be amended, and the Commission's process for review of the Notice of Intention; (3) the requirements for the internal risk management control system that all SIBHCs are required to develop or implement; (4) the records, along with the access requirements, that must be created and maintained by the SIBHC; (5) the periodic reporting requirements; (6) calculation of allowable capital and risk allowances or alternative capital assessment by the SIBHC; (7) notification to the SEC of certain specific events; and (8) withdrawal from Commission supervision. The requirements of each rule are summarized below.

A. Election Criteria and Notice of Intention (Rule 17i-2)

Under new Rule 17i-2, an IBHC may elect to become supervised by the Commission as a SIBHC if the IBHC demonstrates that it meets certain statutory election criteria outlined in §17(i) of the Exchange Act and files a written Notice of Intention.

1. Election Criteria

To be eligible to file a Notice of Intention with the Commission, an IBHC must show that it is not: (i) an affiliate of an insured bank (with certain exceptions) or a savings association; (ii) a foreign bank, foreign company, or a company that is described in §8(a) of the International Banking Act of 1978; or (iii) a foreign bank that controls, directly or indirectly, a corporation charted under §25A of the Federal Reserve Act.[40] Where the election criteria are met, an IBHC has the option of filing a Notice of Intention to be supervised as a SIBHC.

2. Notice of Intention

The Notice of Intention is a statement and compilation of other documents "designed to provide the Commission with a basis for evaluating the IBHC's activities, financial condition, internal risk management control systems, and the relationships among its associated persons" in order to determine whether it is necessary or appropriate in the furtherance of the purposes of §17(i) of the Exchange Act for the IBHC to become a SIBHC.[41] The Notice of Intention must include:

(i) A request to become supervised by the Commission as a SIBHC;

(ii) A statement certifying that the IBHC meets the election criteria outlined in §17(i)(1)(A)(i)-(iii) of the Exchange Act;

(iii) Documentation demonstrating that the IBHC owns or controls a broker-dealer that maintains a substantial presence in the securities business as evidenced either by its holding $100 million or more in tentative net capital as calculated pursuant to §240.15c3-1 or by any other information that the Commission determines is appropriate; and

(iv) Other supplemental information.[42]

[40] 17 C.F.R. § 240.17i-2(a).

[41] 69 Fed. Reg. at 34,475. All Notices of Intention, amendments thereto, and other documentation and information filed with the Commission in conjunction with the Notice of Intention must be retained for three years in an easily accessible place. 17 C.F.R. § 240.17i-5(b).

[42] For example: a description of the business and organization of the IBHC; a list of affiliate group members naming by whom the affiliate is regulated and whether the affiliate is a material affiliate; an organizational chart; consolidated and consolidating financial statements; sample computations for the SIBHC of allowable capital and allowances for market risk, credit risk, and operational risk; a list of categories of positions held in proprietary accounts and a description of how the IBHC proposes to calculate allowances for market and credit risk on those categories; or a description of the mathematical models the IBHC proposes to use to price positions and compute allowances for market and credit risk. *See* 17 C.F.R. § 240.17i-2(b).

Once the Notice of Intention is complete, an IBHC effectively comes under Commission supervision 45 calendar days after the filing unless the Commission issues an order determining either that (A) the Commission will begin to supervise the IBHC prior to 45 calendar days after the Commission receives the completed Notice of Intention; or (B) "the Commission will not supervise the [IBHC] because supervision of the [IBHC] as a [SIBHC] is not necessary or appropriate in furtherance of the purposes of [§17(i)] of the [Exchange] Act."[43] To determine whether such supervision is either necessary or appropriate, the Commission will review the complete Notice of Intention and make a case-by-case determination regarding the IBHC's suitability for supervision. If, however, the IBHC is unable to demonstrate that it owns or controls a broker-dealer that has a substantial presence in the securities business, the rule explicitly provides that supervision is unnecessary and inappropriate.[44] Accordingly, the Commission will decline to supervise the IBHC.

Beyond the initial filing of the Notice of Intention, SIBHCs have a continuing obligation to amend their Notices of Intention if any of the information or documentation filed with the Commission is found to be, or becomes, inaccurate. Prior to the SEC's determination as to whether an IBHC is eligible to be supervised as a SIBHC, the IBHC "must promptly notify the Commission and provide the Commission with a description of the circumstances in which the information was found to be or has become inaccurate along with updated, accurate information."[45] Additionally, once the IBHC comes under the SEC's supervision as a SIBHC, it must amend and resubmit its Notice of Intention and obtain the Commission's approval of the amendment, *before* making a material change to a "mathematical model or other method used to compute allowable capital or allowance for market, credit, or operational risk, or its internal risk management control systems."[46]

B. Internal Risk Management Control System Requirements (Rule 17i-4)

Rule 17i-4 requires the SIBHC to substantially comply with Rule 15c3-4 under the Exchange Act, as if it were an OTC derivatives dealer,[47] and "establish, document, and maintain procedures for the detection and prevention of money laundering and terrorist financing."[48]

C. Record Creation, Maintenance, and Access Requirements (Rule 17i-5)

Section 17(i)(3)(A) of the Exchange Act authorizes the Commission to require by rule (Rule 17i-5) that a SIBHC maintain appropriate records for prescribed periods.[49] Specifically, Rule 17i-5(a) requires the SIBHC to maintain the following categories of records:

(1) A record reflecting the results of stress tests, conducted by the SIBHC at least once each quarter, of the affiliate group's funding and liquidity with respect to the following events: (i) a credit rating downgrade of the SIBHC; (ii) an inability to access capital markets for unsecured short-term funding; (iii) an inability to move liquid assets across international borders when the events described in (i) or

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43 17 C.F.R. § 240.17i-2(d)(2)(i)(B).

44 17 C.F.R. § 240.17i-2(d)(2)(i)(B).

45 17 C.F.R. § 240.17i-2(c)(1).

46 *See* 17 C.F.R. § 240.17i-2(c)(2).

47 Under Rule 17i-4(a), paragraphs (c)(5)(xiii), (c)(5)(xiv), (d)(8), and (d)(9) of Rule 15c3-4 do not apply to SIBHCs.

48 *See* 17 C. F.R. § 240.17i-4. The SIBHC's procedures should include adequate controls at the holding company level to prevent money laundering through affiliates. 69 Fed. Reg. at 34,477.

49 15 U.S.C. §78q(i)(3)(A); 17 C.F.R. § 240.17i-5(a).

(ii) occur; and (iv) an inability to access credit or assets held at a particular institution when the events described in (i) or (ii) occur;

(2) A contingency plan to respond to the events outlined in (1) above;

(3) A record of the basis for the determination of the credit risk weight and internal credit rating, if applicable, for each counterparty; and

(4) A record of the calculations of allowable capital and allowances for market, credit, and operational risk computed currently at least once each month on a consolidated basis.[50]

All of the foreign records must be retained for three years in an easily accessible place.

Records are not required to be kept in a standard form; rather, a SIBHC may use records it has created for its own use to meet recordkeeping obligations as long as the records contain all the required information.[51] Further, records may be kept either at the SIBHC, an affiliate, or a records storage facility, provided the records are located within the U.S.[52] If the records are maintained by an entity other than the SIBHC, the SIBHC must file with the Commission a written agreement between the entity maintaining the records and the SIBHC demonstrating that the records will be treated as if the SIBHC were maintaining them and that the entity will permit examination of the records by representatives of the Commission and that it will promptly furnish copies of such records to the Commission upon request.[53]

D. Reporting Requirements (Rule 17i-6)

Rule 17i-6 requires that a SIBHC file with the Commission certain monthly and quarterly reports. In addition, the SIBHC must file its organizational chart, certain other reports requested by the SEC, and an annual audit report as of the SIBHC's fiscal year-end. These records must be retained for three years in an easily accessible place.

1. Monthly and Quarterly Reports

Monthly, an SIBHC must file a risk report with the Commission, within 30 calendar days after the end of each month that does not end a calendar quarter, that includes: (i) a consolidated balance sheet and income statement (including notes to the financial statements) and statements of allowable capital and allowances for market, credit, and operational risk computed pursuant to Rule 17i-7 (as discussed below) for the affiliate group;[54] (ii) a graph reflecting, for each business line, the daily intra-month VaR; (iii) consolidated credit risk information; and (iv) certain other risk reports that the SIBHC regularly provides to the persons responsible for managing risk for the affiliate group that the Commission may request from time to time.[55] The SIBHC is not required to submit a separate monthly report when the month-end coincides with a quarter-end.[56]

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[50] 17 C.F.R. § 240.17i-5(a). Rule 17a-4(f) of the Act allows a broker or dealer to maintain records in hard copy micrographic media (microfilm, microfiche or similar media) or electronic storage media (any digital storage medium) or system that meets certain requirements outlined in the rule. *See* 17 C.F.R. § 240.17a-4(f); *see also* 69 Fed. Reg. at 34,478 n.39.

[51] 69 Fed. Reg. at 34,478 n.39.

[52] 17 C.F.R. § 240.17i-5(c).

[53] *See* 17 C.F.R. § 240.17i-5(c); *see also* 69 Fed. Reg. at 34,478 n.39.

[54] The consolidated financial statements for the first month of the fiscal year, however, may be filed with the SEC at a time approved by the Commission.

[55] 17 C.F.R. § 240.17i-6(a)(1).

[56] 17 C.F.R. § 240.17i-6(a)(1).

Quarterly reports must be filed no later than 35 calendar days after the end of the quarter and must include: (i) the information contained in the monthly report; (ii) a consolidating balance sheet and income statement for the affiliate group;[57] (iii) the results of backtesting of all models used to compute allowable capital and allowances for market and credit risks indicating, for each model, the number of backtesting exceptions; (iv) a description of all material pending legal or arbitration proceedings involving the SIBHC or any member of the affiliate group that are required to be disclosed under generally accepted accounting principles ("GAAP"); and (v) the aggregate amount of unsecured borrowings and lines of credit.[58] Note that a SIBHC need not include consolidated and consolidating balance sheets and income statements with its quarterly report on the quarter-end that coincides with the SIBHC's fiscal year-end. A publicly traded company is not required to file its financial statements prior to the date it would otherwise be required to file them with the Commission.[59]

2. Annual Audit Report

As of the same date of the SIBHC's broker-dealer affiliate and not later than 65 calendar days after the end of the fiscal year, a SIBHC must file an annual audit report with respect to an audit conducted by a registered public accounting firm.[60] The audit report must include: (i) consolidated financial statements (including notes to the financial statements) along with a supporting schedule containing statements of allowable capital and allowances for market, credit, and operational risks and (ii) a supplemental report, entitled "Accountant's Report on Internal Risk Management Control System," prepared by the registered accounting firm, that indicates whether the SIBHC's internal risk management control system complies with the requirements of Rule 17i-4 and that the SIBHC and its affiliates are adhering to the requirements of the internal risk management control system.[61]

The accountant's review must use procedures that are in compliance with the rules promulgated by the Public Company Accounting Oversight Board and agreed upon by the accountant and the SIBHC. The procedures must be filed with the Commission prior to the accountant's initial review and, before any subsequent review, the SIBHC must file a notice of any changes to the agreed upon procedures.[62]

3. Organizational Chart and Other Reports

A SIBHC is required to file an organization chart with the Commission at least once each year as of its fiscal year-end and file quarterly updates where a material change in the organization has occurred.[63] A SIBHC also may be required, on receiving written notice from the Commission, to provide additional financial or operational information "to monitor the SIBHC's activities, financial condition, policies, systems for monitoring and controlling financial and operational risks, transactions and relationships among members of the affiliate group, and the extent to which the SIBHC has complied with the provisions of the Exchange Act and regulations thereunder."[64]

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[57] The consolidating balance sheet and income statement should "break out information regarding each material affiliate into separate columns, but may consolidate information regarding affiliate group entities that are not material affiliates into one column." 17 C.F.R. § 240.17i-6(a)(2)(ii).

[58] *See* 17 C.F.R. § 240.17i-6(a)(2). The unsecured borrowings and lines of credit should be segregated into categories, scheduled to mature within twelve months from the most recent quarter by each material affiliate. 17 C.F.R. § 240.17i-6(a)(2)(v).

[59] 69 Fed. Reg. at 34,479.

[60] 17 C.F.R. § 240.17i-6(d)(2), (3).

[61] 17 C.F.R. § 240.17i-6(d)(1)(ii).

[62] *See* 17 C.F.R. § 240.17i-6(d)(1)(ii).

[63] 17 C.F.R. § 240.17i-6(b).

[64] *See* 17 C.F.R. § 240.17i-6(c); *see also* 69 Fed. Reg. at 34,479.

E. Calculations of Allowable Capital and Risk Allowances or Alternative Capital Assessment (Rule 17i-7)

Consistent with the alternative net capital rules discussed above,[65] Rule 17i-7 requires that a SIBHC calculate allowable capital and allowances for market, credit, and operational risks.

1. Allowable Capital

On a consolidated basis, SIBHCs must calculate allowable capital by taking the aggregate of common shareholder's equity (less goodwill, certain deferred tax assets, other intangible assets, and certain other deductions), certain cumulative and non-cumulative preferred stock, certain properly subordinated debt, certain long-term debt (for a period of three years and with the Commission's approval), and certain hybrid capital instruments.[66]

2. Allowances for Market, Credit, and Operational Risks

On a consolidated basis, a SIBHC must compute, as outlined in the alternative net capital release discussed above, an allowance for market risk for all proprietary positions,[67] credit risk for certain assets on the consolidated balance sheet and off-balance sheet items,[68] and operational risk.[69]

F. Notification Provisions (Rule 17i-8)

In addition to requiring a SIBHC to continuously update its Notice of Intention, the Commission provides in Rule 17i-8 that, on the occurrence of certain events, a SIBHC is required to immediately notify the Commission. The events that trigger such notification are the following:

(1) The occurrence of any backtesting exception, determined in accordance with §240.15c3-1e(d)(1)(iii) or (iv), that would require that the SIBHC use a higher multiplication factor in the calculation of its allowances for market or credit risk;

(2) The early warning indications of low capital as the Commission may agree;[70]

(3) A material affiliate declares bankruptcy or otherwise becomes insolvent;

(4) The SIBHC becomes aware that a nationally recognized statistical rating organization has determined to reduce materially its assessment of the creditworthiness of a material affiliate or the credit rating(s) assigned to one or more outstanding short or long-term obligations of a material affiliate;

(5) The SIBHC files a Form 8-K with the Commission;[71]

(6) The SIBHC becomes aware that any financial regulatory agency or self-regulatory organization has taken significant enforcement or regulatory action against a material affiliate; or

[65] *See infra* pp. 8-9.

[66] *See* 17 C.F.R. § 240.17i-7(a).

[67] 17 C.F.R. § 240.17i-7(b).

[68] *See* 17 C.F.R. § 240.17i-7(c).

[69] *See* 17 C.F.R. § 240.17i-7(d).

[70] The Commission and the ultimate holding company will determine what the appropriate indicators of low capital are as part of the application process. 69 Fed. Reg. at 34,448 n.81.

[71] The Commission believes that "filing a Form 8-K may indicate that a major change has occurred at the SIBHC or material affiliate, and that the Commission may want to monitor the SIBHC more closely to determine, for instance, that internal risk management controls remain robust despite the change." 69 Fed. Reg. at 34,485.

(7) The SIBHC becomes ineligible to be supervised by the Commission as a SIBHC.[72]

Note, if the SIBHC files a notification regarding these events, the Commission may request additional reports and begin to monitor the SIBHC's condition more closely and, where the SIBHC filed a notification indicating that it is no longer eligible for SEC supervision, the Commission would review whether it should continue supervising the IBHC as a SIBHC.[73] All notices filed under this rule must be retained for three years in an easily accessible place.

G. Withdrawal from Supervision as a SIBHC (Rule 17i-3)

A SIBHC may withdraw from Commission supervision by filing a "Notice of Withdrawal" with the Commission that includes a statement indicating the SIBHC's compliance with its Notice of Intention amendment obligations.[74] Once filed, the Notice of Withdrawal will automatically take effect after one year unless the Commission issues an order determining that it is necessary or appropriate for the Commission to terminate its supervision within a shorter or longer period to help ensure effective supervision of the material risks to the SIBHC and any affiliated broker-dealer or to prevent evasion of the statutory purposes of §17 of the Exchange Act.[75] Additionally, by order, the Commission may discontinue supervision of the SIBHC if the Commission finds that (i) the SIBHC is no longer in existence; (ii) the SIBHC has ceased to be an IBHC; or (iii) continued supervision by the Commission of the SIBHC is not necessary or appropriate.[76]

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72 17 C.F.R. § 240.17i-8(a).

73 *See* 69 Fed. Reg. at 34,485.

74 17 C.F.R. § 240.17i-3(a).

75 *See* 17 C.F.R. § 240.17i-3(b).

76 17 C.F.R. § 240.17i-3(c).