

## **J.P. Morgan Chase & Co.**

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February 12, 2004

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

Re: File No. S7-21-03 (Proposed Rule Regarding Alternative Net Capital Requirements for Broker-Dealers that are Part of Consolidated Supervised Entities)

Ladies and Gentlemen:

J.P. Morgan Chase & Co. ("JPMC") appreciates this opportunity to comment on the Commission's proposed alternative net capital rule (the "Proposed Rule") for broker-dealers that are part of consolidated supervised entities (each, a "CSE"), as set forth in Release No. 34-48690 (the "Release"). JPMC is a bank holding company that is registered with the Board of Governors of the Federal Reserve System (the "Federal Reserve") as a financial holding company. It has a broker-dealer subsidiary, J.P. Morgan Securities Inc., which would meet the proposed requirements for applying to use the alternative net capital computation under the Proposed Rule.

JPMC participated in the comment letters of the New York Clearing House Association L.L.C. (the "NY Clearing House") and the American Bankers Association Securities Association ("ABASA"), and fully supports these comments.

JPMC commends the Commission for its willingness to consider a new capital model for broker-dealers that takes into account the fact that broker-dealers and their holding companies have developed mathematical models for measuring market, credit and operational risks, including value-at-risk ("VaR") models and scenario analysis, as well as group-wide internal risk management control systems to control such risks. The Proposed Rule recognizes that the Commission's existing capital rule overstates the amount of capital a broker-dealer needs to cover its financial and operational risks, and that existing mathematical models, such as VaR, more closely approximate the risk of loss due to changes in market risk factors such as interest rates and security and foreign exchange prices. We hope to continue to work with the staff of the Commission to ensure that the Final Rule will not unfairly discriminate against broker-dealers that are subsidiaries of financial holding companies.

We believe the Proposed Rule contains many provisions that make sense in the context of establishing a system of consolidated supervision for a holding company group that is not already subject to consolidated supervision. However, they need further refinement as applied to a bank holding company or a financial holding company (hereinafter collectively referred to as "Financial Holding Companies"). As a result, many of the undertakings required of a holding company in Appendix E of the Proposed Rule (collectively, the

"Undertaking") are problematical for a Financial Holding Company. In many respects, the easiest way to eliminate this problem may be to bifurcate the Proposed Rule into two parts - one dealing with CSE's that seek consolidated supervision, and one dealing with the conditions for using a more risk-sensitive capital model. The consolidated supervision section would apply to traditional investment banks that seek consolidated supervision but do not qualify for the Commission's proposed rule for Supervised Investment Bank Holding Companies<sup>1</sup>. The capital relief section would apply to all broker-dealers applying for the capital relief, and would set forth the information about a consolidated group that the Commission needs in order to ensure that the financial health of the broker-dealer is not jeopardized by the business of its affiliates.

JPMC believes that that the final rule (the "Final Rule") should adhere to five general principles:

1. The Final Rule should avoid duplicative regulation of holding company groups that are already subject to consolidated supervision by a recognized consolidated company supervisor, in order to effectuate the policy of Congress as expressed in the Gramm-Leach Bliley Act ("GLBA"). In no event should the Commission require a Financial Holding Company or any of its affiliates (other than broker-dealers and investment advisers already subject to the jurisdiction of the Commission) to consent to group-wide or individual supervision, or subject themselves to examination, by the Commission. In addition, because a Financial Holding Company's consolidated group is already subject to capital regulation by the Federal Reserve, which is a recognized consolidated company supervisor, the Commission should not attempt to dictate the capital levels maintained by the holding company either initially or as a penalty for failure to comply with any provision of the Undertaking.<sup>2</sup> Instead, the Commission should rely on add-ons or multipliers at the broker-dealer level.
2. The Commission should follow the model established by Section 17(h) of the Securities and Exchange Act (the "Exchange Act") to ensure that the activities of the affiliates of the broker-dealer will not have an adverse affect on the liquidity or financial viability of the broker-dealer. Where a broker-dealer is a subsidiary of a Financial Holding Company, the Commission should rely on (a) information that the holding company has filed with its banking regulator, (b) other information that the holding company undertakes to make available<sup>3</sup> to the Commission, and (c) consultation with the banking agency.
3. The capital calculation at the broker-dealer level (including calculation of market and credit risk haircuts) should, to the greatest extent possible, be the same as that under the standards established by the Basel Committee on Banking Supervision (the "Basel Standards") for the consolidated holding company group. This will minimize the need for different and costly systems, and allow firms to make use of reports actually used by management in assessing risks and of methodologies that are well-understood by the business and its risk managers.
4. The information provided by and about the holding company and its direct and indirect subsidiaries other than the broker-dealer should be used only for prudential purposes to ensure that the broker-dealer is adequately capitalized, and will not be adversely affected by risks of the consolidated holding company group.
5. The classes of information that the Commission may require from a Financial Holding

Company should be known at the time it makes an undertaking to provide information to the Commission.

In the opinion of JPMC, the Proposed Rule is a commendable first start, and a useful tool for aiding the Commission and the financial services industry to think about the issues raised by the alternative capital computation. However, it should be revised in order to address the foregoing principles.

### 1. Duplicative Regulation

As noted in the Release, the Proposed Rule is designed to help the monoline securities dealers avoid duplicate regulation under the EU Financial Groups Directive. However, a broker-dealer that is a subsidiary of a Financial Holding Company already has a home country regulator that applies group-wide supervision on a basis equivalent to the approach set out in the Financial Groups Directive. Consequently, the Proposed Rule is attractive to firms such as JPMC only because the alternative capital calculation results in significant capital relief at the broker-dealer level. Unfortunately, a number of aspects of the Proposed Rule involve duplicative regulation for Financial Holding Companies and their affiliates which outweigh the benefit of such capital relief.

The Undertaking provided for in Appendix E requires the holding company of a consolidated supervised entity (the "Holding Company") to agree to two types of regulation by the Commission: It must (1) file with the Commission certain specified financial, capital and risk reports (the "Information Requirement"); and (2) permit the Commission to examine the books and records of any affiliate of the broker or dealer, including the holding company, if the affiliate is not an entity that has a "principal regulator" as defined by the Commission (the "Examination Requirement"). JPMC does not generally object to the Information Requirement,<sup>4</sup> as long as the information required is information that is already filed with the Federal Reserve or prepared for the Holding Company's management. However, for the reasons set forth below and described more fully in the ABASA and NY Clearing House comment letters, we have serious objections to the Examination Requirements.

We feel that the definition of "entity that has a principal regulator" does not accurately reflect the degree to which a Financial Holding Company and all of its subsidiaries are subject to regulation and examination by the Federal Reserve. The Examination Requirement therefore represents unnecessarily duplicative regulation, which Congress, in GLBA, specifically prohibited. The Proposed Rule demands that Financial Holding Companies allow the Commission to examine hundreds of Holding Company affiliates already subject to regulation and examination by the Federal Reserve. The only exceptions are the Holding Company (assuming it meets the arbitrary and undefined term "primarily in the insured depository institutions business"), any insured bank subsidiaries, FCMs and regulated insurance companies.

GLBA clearly made the Federal Reserve the umbrella regulator for Financial Holding Companies, including all of their subsidiaries, and restricted the Commission to examining a broker or dealer registered under the Securities Act.<sup>5</sup> GLBA also gave the Federal Reserve the authority to gather, with respect to the holding company and all of its subsidiaries, the same type of information required by the Information Requirement -- information as to their financial condition, systems for monitoring and controlling financial and operating risks, and transactions with affiliates.<sup>6</sup> In addition, it authorized the Federal Reserve to conduct

examinations of a bank holding company and each of its subsidiaries to inform the Fed of the financial and operational risks that may pose a threat to the safety and soundness of any depository institution subsidiary of such holding company. Such examinations are comprehensive.<sup>7</sup>

The risks that are the focus of the Federal Reserve's examination are the same risks for which the Commission states it wishes to examine. This includes risks at affiliated companies that may pose a threat to the safety and soundness of an affiliated depository institution, and risks at the depository institution itself that may affect its safety and soundness or pose a risk to the insurance fund maintained by the Federal Deposit Insurance Corporation. Thus the examinations to which a Financial Holding Company must submit under the Proposed Rule will be duplicative and unnecessarily costly and time-consuming for the Financial Holding Company, and a waste of resources for the Commission. The fact that the Release states that "in most instances, the Commission's supervision on a group-wide basis would consist of analyzing records and reports provided by the holding company"<sup>8</sup> is not of sufficient comfort to a Holding Company that is already subject to a comprehensive regulatory scheme by another regulator.

Similar duplication exists as a result of the requirement of the Undertaking<sup>9</sup> that the Holding Company make available to the Commission with respect to the operations of entities that have a principal regulator (e.g., the holding company, a bank or an insurance company) such information as "the Commission finds is necessary to evaluate the financial and operational risk within the affiliate group . . . (including any risks that may affect the reputation of the holding company or the broker or dealer)". This open-ended invitation to obtain information about heavily regulated and supervised banks, bank holding companies and insurance companies is completely unwarranted.

Another example of the duplicative nature of the Proposed Rule are the requirements that the Holding Company undertake to obtain prior approval of the Commission for (i) all material changes to its mathematical models for calculating allowances for market, credit and operational risk, and (ii) all material changes to the internal risk management control system for the affiliate group,<sup>10</sup> even where the change has been approved (or submitted for approval) by the Federal Reserve. This requirement has the effect of placing the Commission in the role of dictating the models and risk management system that a Financial Holding Company may use. We believe that, where the Federal Reserve has accepted or approved the use of a model or risk management system, the Commission should defer to the Federal Reserve for consolidated holding company purposes. If the Commission disagrees with the Federal Reserve over the methodology of the model, and reasonably believes the broker-dealer is exposed to heightened risk, it should clearly express the reason for its disagreement, and address the risk at the broker-dealer level, for example, by imposing a higher multiple on VaR or an operational charge at the broker-dealer level.

## 2. Reliance on Information Provided to Banking Regulators.

Both the GLBA and Section 17(h) of the Exchange Act already provide operational models we believe the Commission should follow. Section 111 of GLBA, which is called "Streamlining Supervision of Bank Holding Companies", gives jurisdiction over examinations of bank holding companies and all of their subsidiaries (other than functionally regulated subsidiaries) to the Federal Reserve. The Conference Committee Report<sup>11</sup> sets forth the regulatory framework conceived by Congress:

"Both the House and Senate bills generally adhere to the principle of functional regulation, which holds that similar activities should be regulated by the same regulator. Different regulators have expertise at supervising different activities. It is inefficient and impractical to expect a regulator to have or develop expertise in regulating all aspects of financial services. Accordingly, the legislation intends to ensure that banking activities are regulated by bank regulators, securities activities are regulated by securities regulators, and insurance activities are regulated by insurance regulators."

Congress left no doubt in Section 111 that the Federal Reserve is the umbrella supervisor for banking and financial holding companies.

Section 17(h) was added to the Exchange Act for the specific purpose of informing the Commission about risks posed by affiliates of broker-dealers. Section 17(h)(3) contains special provisions with respect to associated persons subject to federal banking agency regulation. It provides that a broker-dealer complies with any recordkeeping or reporting requirements adopted under Section 17(h)(1) if it utilizes copies of reports filed by the associated person with the appropriate Federal banking agency. As noted in the Senate Report on the Market Reform Act of 1990:

"The SEC is also provided with exemptive authority to avoid the imposition of duplicative or otherwise unnecessary reporting obligations on regulated affiliates of broker-dealers. Consequently, the Committee expects that the SEC will provide exemptions which permit comparable risk assessment information that is filed with another financial regulator, such as the Federal Reserve Board or the CFTC, to be provided by the broker-dealer to the SEC without reformatting."

S. Rep. 101-300 (May 22, 1990) at 50.

Under the rules adopted by the Commission to effect the purposes of Section 17(h), the Commission carefully attempted to avoid duplicative regulation of entities subject to regulation and examination by banking authorities. For example, under Rule 17h-1T, broker-dealers are required to maintain specified information, including consolidated and consolidating balance sheets and income statements. However, a broker-dealer affiliated with a banking institution subject to examination by a Federal banking agency is deemed to be in compliance with those recordkeeping requirements if it maintains copies of all reports submitted by its affiliates with the appropriate Federal banking agency. Similarly, Rule 17h-2T requires broker-dealers to file Form 17-H with the Commission. However, a broker-dealer affiliated with a banking institution subject to examination by a Federal banking agency is deemed to be in compliance if the broker-dealer or its affiliate furnishes the Commission with copies of its reports filed on Form FR Y-9C, Form FR Y-6, Form FR Y-7 and Form FR 2068.

We believe the Commission should continue to follow the model established in these contexts, and attempt to reduce duplicative reporting and recordkeeping requirements, by relying as much as possible on information filed by the Holding Company with the Federal Reserve.

### 3. Same Standards to Calculate Capital Adequacy at Broker-Dealer and Holding Company

To the greatest extent possible, the capital calculations at the holding company and broker-

dealer levels should be the same. This will allow the Holding Company and the broker-dealer to use the same models at both entities. The Proposed Rule contains some very significant divergences between the calculations for the Holding Company and the broker-dealer. For example, the use of VaR models for the broker-dealer has a 3-tier phase-in period.<sup>12</sup> In addition, there are certain assets for which the broker-dealer capital calculation does not allow mathematical models, even where such models are allowed under the Basel Standards.<sup>13</sup> Finally, the risk measurement for derivatives is not the Basel Standard, but more like the "BD Lite" version. These divergences will require the maintenance of two completely different systems by a Holding Company. Such a requirement is not only more costly, but it also results in producing capital usage and risk estimates that are different from those used by management in measuring and managing risk. In addition, because risk managers and business persons are required to use methodologies that are different from the ones they normally use, they introduce an opportunity for confusion and error.

If the Commission believes there are substantive differences between broker-dealers and consolidated holding company groups that warrant separate treatment at the broker-dealer level, we believe it should demonstrate the reasons for such belief. The assumption of the Basel Standard is that the same types of assets should receive the same capital treatment no matter what entity they are booked in. In the case of universal banks, banking and securities assets are booked in a single entity. If the Commission needs further time to be convinced of this principle, then we would urge it to address these differences through an add-on or multiplier, and not through differences in the underlying risk calculations. We assume that such an add-on could be phased out as the Commission became more comfortable with the efficacy of firms' mathematical models. If the Commission is concerned about possible liquidity risk at the broker-dealer level, we believe it should address such concerns by requiring the broker-dealer to adopt contingency plans to address a liquidity crisis. In JPMC's opinion, a capital charge is not well suited to address a liquidity crisis.

4. Information provided by and about a Financial Holding Company and its direct and indirect subsidiaries (other than functionally regulated entities) should be used only for prudential purposes.

As the Commission is aware, substantial work has been done to ensure cooperation between different regulators of international financial conglomerates. See, e.g. "Exchanges of Information Between Banking and Securities Supervisors (April 1990), which appears in Chapter II to the Basel II Standards. One of the most important principles governing the exchange of information between banking and securities regulators is that it be used solely for prudential purposes.<sup>14</sup> A corollary of this principle is that the receiving supervisor "should be free from any statutory obligation to divulge information received from other supervisory authorities in the course of its prudential supervision. For example, the law should not oblige such information to be disclosed in court unless the foreign supervisory authority which supplied it has given its consent."

Paragraph (b)(7) of Appendix G states that the statements filed by the holding company with the Commission under paragraph (b)<sup>15</sup> "will be accorded confidential treatment". Similarly, Paragraph (e)(3) of Appendix G states that notices and reports filed pursuant to that paragraph "will be accorded confidential treatment". We believe the Commission should do more to ensure that such materials are entitled to confidential treatment under applicable law. Information a Financial Holding Company supplies to the Federal Reserve, and the additional information requested by the Commission in Paragraphs (b) and (e) are

extremely sensitive from a customer, business, reputational and competitive standpoint. Consequently, the Commission should take steps to ensure that it is free from disclosure to third parties.

Under Section 17(j) of the Exchange Act, the Commission has authority to prevent public disclosure of information supplied to the Commission "by any domestic or foreign regulatory agency that relates to the financial or operational condition of any associated person of a broker or dealer". The Commission should take maximum advantage of this provision by obtaining as much information as possible about a Financial Holding Company from the Federal Reserve. Of course, the Commission may also be exempt from disclosure under certain statutory exceptions under the Freedom of Information Act, particularly the exemptions for information related to examination, operating or condition reports prepared for use of an agency responsible for the regulation or supervision of financial institutions. Since the Commission has statutory jurisdiction to act in a supervisory capacity with respect to broker-dealers, and no statutory jurisdiction to act in a supervisory capacity with respect to a Financial Holding Company and its subsidiaries (other than functionally regulated subsidiaries), and since all information about the risks posed by the broker-dealer's affiliates would be requested in furtherance of the Commission's authority to regulate the broker-dealer, we believe the Commission should request that such information be provided by the broker-dealer.

#### 5. The classes of information to be provided by a Financial Holding Company Should be Known at the Time it Makes an Undertaking

Paragraph (b)(3) of Appendix G requires the Holding Company, upon receiving written notice from the Commission, to provide "such other financial or operational information as the Commission may request in order to monitor the holding company's financial condition or risk exposures". This requirement may make sense for a company that is seeking consolidated holding company supervision to comply with EU requirements. In the case of Financial Holding Companies, however, it is far too open-ended. The Commission should rely to the greatest extent possible on reports the company already generates for internal risk management and capital allocation systems.

#### 6. Miscellaneous Comments.

The following comments address miscellaneous issues that arise in connection with the Proposed Rule, but which do not fall within one of the broad categories above.

- a. The Proposed rule provides that, if the disclosure to the Commission of any information required as a condition for the broker-dealer to use Appendix E would be prohibited by law or otherwise, the holding company must cooperate with the Commission and provide the Commission with adequate access to information. It is not clear what the Commission intends with respect to Financial Holding Companies. The Commission should clarify that this provision applies to local privacy statutes, and not to statutes or regulations protecting examination materials of other regulators from disclosure. Regulations of the Federal Reserve prohibit banking organizations from disclosing certain types of information relating to their supervision.<sup>16</sup> Similarly, under Section 17(h)(3)(D) of the Exchange Act, the Commission is not permitted to require a broker or dealer that is affiliated with a bank to obtain or furnish "any examination report of any federal banking agency or any supervisory recommendations or analysis contained therein." However, the Federal Reserve may

provide such information in certain circumstances.<sup>17</sup>

- b. In connection with the application process, the Holding Company must supply an organization chart depicting the holding company and all its subsidiaries and affiliates, an alphabetical list of the affiliates, as well as a designation of which affiliates are material to the Holding Company. A large Financial Holding Company has many hundreds of subsidiaries in multiple countries, but large numbers of those subsidiaries are not material to the holding company and a listing or chart containing all of them would not materially assist the Commission in understanding the risks to the broker-dealer. This requirement should be limited to subsidiaries that are material to an understanding of the business of the holding company group.
- c. Under paragraph (a)(9) of Appendix E, a broker-dealer must agree to provide 45 days' written notice to the Commission if it chooses to end its reliance on the exemption. (The Commission may lengthen this period indefinitely if it determines that a longer period of time "is necessary or appropriate in the public interest and consistent with the protection of investors". We believe that, as long as the broker-dealer is capable of computing its capital in accordance with the net capital rule without reliance on the alternative methodology, it should be permitted to do so with 10 days' notice.
- d. Under paragraph (a)(10) of Appendix E, the Commission may, by order, revoke the broker-dealer's exemption to use the alternative methodology, with no minimum notice period. The broker-dealer should be given a 90-day notice period to terminate reliance on Appendix E. In order to return to a "haircut" mode after a significant period of using the alternative capital methodology, a broker-dealer would need to re-create procedures for calculating haircuts, a process which will require new programming and testing of haircut methodologies, as well as determining that regulatory reporting personnel are trained in the new procedures. During such period, a reasonable add-on to the minimum capital requirement under Appendix E might be appropriate.
- e. Under paragraph (e) of Appendix E, the VaR models for the broker-dealer and Holding Company must be reviewed periodically by the firm and annually by a registered public accounting firm. We note that outside model verification is not required by the Federal Reserve;<sup>18</sup> consequently, it will represent an added cost for Financial Holding Companies. We do not believe such outside verification is necessary where internal model verification procedures are robust. For example, under our Model Review Procedures, new models, whether prepared by a business unit or purchased commercially, and all changes to existing models are reviewed and approved for reasonableness by the Model Review Group in Market Risk Management, a staff unit that is independent of the business. Market Risk Management also conducts re-reviews of previously approved model at least annually. The operational performance of VaR models is reviewed by backtesting. Backtesting results are monitored monthly by Market Risk Management and reported to the Risk Management Committee of the Holding Company and the Risk Policy Committee of the Board.

In addition, our VaR system is reviewed in a 2 year cycle by our internal audit department, with a view to determining the adequacy of the system of internal controls over the VaR processing environment. The scope of this audit includes (1)

application controls (including edit and validation checks), (2) logical security over the application (program files) and databases, (3) security administration over access to the system, (4) production control over the system, (5) change management over program files, and (6) market data management. Finally, the risk management process is examined by the Federal Reserve. See Bank Holding Company Supervision Manual at § 2125 (Trading Activities of Banking Organizations - Risk Management and Internal Controls). The Federal Reserve also reviews models if the Holding Company wishes to use them in determining regulatory capital.

- f. Under Paragraph (b)(5)(i)(A) of Appendix G, at the time the Holding Company provides its audited financial statements, it must provide an accountant's supplemental report confirming that the Holding Company's pricing and modeling procedures conform to the procedures submitted to the Commission as part of the broker-dealer's application to use the alternative capital calculation. We note that outside pricing and modeling verification is not required by the Federal Reserve; consequently, it will represent an added cost for Financial Holding Companies. We do not believe such outside verification is necessary where internal pricing verification procedures are robust. For example, JPMC has an independent Valuation Control Group, whose responsibilities include independent price testing and substantiation of market risk reserves.
- g. Paragraph (b) of Appendix G requires the Holding Company to undertake to provide the Commission monthly, by the 17<sup>th</sup> business day after the end of each month that does not end a quarter) consolidated balance sheet and income statement (including notes to the financial statements), as well as capital computations. Financial Holding Companies are not required to file monthly financial statements and capital reports, and the Commission should not require them to file reports more frequently than does the Federal Reserve.
- h. Paragraph (b) of Appendix G also requires the Holding Company to file, on a quarterly basis within 35 days after the end of each calendar quarter, a consolidating balance sheet and income statement that provides information regarding each "material affiliate" of the Holding Company in a separate column, and aggregate information regarding non-material affiliates in one column. Such consolidating financial statements are not required by the Federal Reserve and are not prepared for management information purposes. Consequently, we do not believe the Commission should require them. As noted above in Section 3, broker-dealers affiliated with banking institutions are not required to file consolidating financing statements under Rule 17h-1T.
- i. Paragraph (e)(1)(iii) of Appendix G requires a notification to the Commission if an affiliate declares bankruptcy or otherwise "goes into default". This requirement needs substantial clarification and the addition of a materiality standard. For example, a fail on a securities transaction should not be considered a default. We recommend that the default be limited to failure to pay indebtedness for borrowed money above a certain threshold amount (other than failure to pay deposits as a result of applicable laws or regulations).
- j. Paragraph (e)(2) of Appendix G requires the holding company to file a report if there is a material change in certain items, including the corporate structure of the holding company and the major business functions of a material affiliate. Similarly, under

Paragraph (a)(8) of Appendix E, the broker-dealer is required to notify the Commission of any material change to the corporate structure of the broker-dealer or the holding company. The Commission should describe the types of change in structure it believes are material. For example, would a merger of the broker-dealer with or into another broker-dealer recently acquired by the Holding Company be considered material? A change in the form of the broker-dealer from a corporation to an LLC? The Commission should also quantify what it believes is a material change in a major business function. Developing a new products that is expected to produce substantial revenues? Selling a line of business in which the firm has less than a specified market share? Finally, the Commission should clarify that these sections do not require prior notice.

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Once again, we commend the Commission for the thoughtful work evidenced in the new supervisory and capital paradigm described in the Proposed Rule. We hope to continue to work with the staff of the Commission to ensure that the Final Rule appropriately refines that paradigm and does not unfairly discriminate against broker-dealers that are subsidiaries of Financial Holding Companies. If you have any questions on these comments, please do not hesitate to contact the undersigned at (212) 270-2097 or James M. Collins, the Chief Financial Officer or J.P. Morgan Securities Inc., at (201) 595-5734.

Very truly yours,

Marjorie E. Gross

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  
Annette L. Nazareth, Director, Division of Market Regulation  
Robert L.D. Colby, Deputy Director, Division of Market Regulation  
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<sup>1</sup> Release No. 34-48694, 68 Fed. Reg. 62910 (November 6, 2003).

<sup>2</sup> For example, Paragraph (f) of Appendix E currently provides that, in certain circumstances, the Commission may condition further use of the exemption on the holding company filing more frequent reports, modifying its internal risk management control procedures or on imposing "such other appropriate additional regulatory conditions that the Commission finds are necessary or appropriate in the public interest and consistent with the protection of investors". We believe it is inappropriate for the

Commission to require a financial holding company to modify internal risk management control procedures approved by the Federal Reserve.

- [3](#) Or to cause the broker-dealer to make available. See Section IV below.
- [4](#) Our specific comments on these requirements are set forth below.
- [5](#) See Senate Banking Committee, Conference Report on S. 900/H.R. 10 at 1 ("Reflected in the legislation is the determination made by both Houses to preserve the role of the Board of Governors of the Federal Reserve System . . . as the umbrella supervisor for holding companies, but to incorporate a system of functional regulation designed to utilize the strengths of the various Federal and State financial supervisors.") Although GLBA prohibited the Federal Reserve from examining a "functionally regulated subsidiary" in most circumstances, consistent with its umbrella regulatory authority, it is allowed to examine such a subsidiary in certain circumstances. See Section 5(c)(2)(B).
- [6](#) Bank Holding Company Act Section 5(c)(1), as amended by GLBA Section 111 (The Federal Reserve may require a bank holding company and any subsidiary of such company to submit reports to keep the Fed informed as to its financial condition, systems for monitoring and controlling financial and operating risks, and transactions with depository institution subsidiaries of the bank holding company, as well as compliance by the company or subsidiary with applicable Federal law.)
- [7](#) See, e.g. Board of Governors of the Federal Reserve System, Bank Holding Company Supervision Manual (hereinafter, "Bank Holding Company Supervision Manual"), which may be found at <http://www.federalreserve.gov/boarddocs/supmanual/bhc/bhc1203.pdf>.
- [8](#) Release at 62873.
- [9](#) Paragraph (a)(1)(viii)(F).
- [10](#) Paragraph (a)(1)(viii)(I) and (J).
- [11](#) Conference Report on S. 900/H.R. 10.
- [12](#) Appendix E, paragraph (c)(3). The phase-in period is designed to allow the Commission to determine whether an applicant has management controls that can adequately assess increasing risk levels and whether the models have flaws or other defects. However, these models are already being used and have been approved by another regulator.
- [13](#) For example, a broker-dealer is not permitted to use VaR models to calculate capital charges on securities recently sold in an initial public offering or securities without a ready market as defined under the net capital rule. It would have to apply to use scenario analysis or continue to use the standard haircut method.
- [14](#) "Since the purpose of the information exchanges envisaged in this paper is to enhance the effectiveness of prudential supervision, it is understood that information received under these arrangements would be used for purposes related to the prudential supervision of financial institutions only. There should, in particular, be no possibility of government departments or public sector officials not responsible for, or involved in, prudential supervision having access to the information."

- [15](#) This includes the capital assessment calculated in accordance with Paragraph (a) of Appendix G.
- [16](#) *See* 12 C.F.R. § 261.20(g), (h).
- [17](#) *See* 12 U.S.C. § 326.
- [18](#) *See* Appendix E to Regulation Y, 12 CFR Pt. 225, App. E, Section 4(b)(4)(The organization must conduct independent reviews of its risk measurement and risk management systems at least annually.)