PWG Working Group on Supervision
Questionnaire
July 16, 2009

1. Regulation and guidance

- **Overview**

  a. **What weaknesses have we discovered in our regulations and guidance during the crisis? What changes have been made to address these weaknesses? What further changes to regulations or guidance in these areas should be considered?**

The turmoil in the global financial system during the recent crisis was unprecedented and has tested not only the resiliency of financial institutions, but also the assumptions underpinning many financial regulatory programs. The deterioration in mortgages spread to the capital markets through securitization, and to related derivative and insurance products. The knock-on effects broadened and deepened beyond those entities that deal in mortgages and mortgage-related financial products, including investment and commercial banks, insurance companies, and government sponsored enterprises, and finally to operating companies.

Market participants relied on the thriving securitization process to disperse risk and provide more private capital raising and investing opportunities for investors, but we have learned that process did not eliminate or, in many cases, even reduce risk. The building blocks of many of the securitized products, mortgages, were approved as mortgage underwriting standards deteriorated—thus the mortgage terms did not ultimately correspond to the creditworthiness of the borrower. Other safeguards in the securitization process, such as geographic diversification of the pooled mortgage assets, did not account for the occurrence of a national decline in house values. While low interest rate policies and weak underwriting standards were significant contributors to the credit crisis, investors, including financial institutions', reliance on credit rating agencies (NRSROs) proved problematic—since the NRSROs evaluation did not account for certain risks. These same investors and institutions relying on NRSROs, in turn, did not perform adequate due diligence of their own on structured products.

The movement of credit derivatives from corporate bond underliers to asset-based security underliers (ABS), while offering a means for institutions to hedge risks associated with mortgage loan exposures, amplified the benefits and risks related to securitizations. Specifically, with the advent of CDS on ABS, the creation of the ABX index, and eventually other credit derivatives referencing ABS underliers, banks could source protection to hedge their securitization pipelines and grow their businesses further while staying within their risk limits (VaR and Scenario/Stress Tests). However, it also allowed firms to increase their securitization activities by enabling them to do securitizations and re-securitizations with synthetic collateral (i.e. CDS on ABS) as well as with cash securities. While CDS on ABS was potentially very positive from the standpoint of reducing risk at a given institution that was long mortgage credit, it had unintended consequences. On a net basis it did not increase mortgage exposure for the institution; on a gross basis it greatly increased the long mortgage credit exposure.

During 2006 and 2007, certain market participants, e.g. hedge funds, started moving against housing by shorting CDS on ABS and the ABX index. This pressure led to mark to market losses for those entities that sold the protection via CDS. Among these were the monoline insurers, certain credit derivative product groups ("CDPC"s) and others such as AIG which were much too concentrated in the mortgage market and not sufficiently capitalized. In addition, monolines and CDPCs did not post initial margin or variation margin on these transactions due to their very high ratings (most had AAA ratings). However, buying protection from institutions, like the monoline financial guarantor subsidiaries, that were unregulated and which did not post collateral eventually led to huge concentrations of counterparty credit risk, and large losses for those institutions that relied on them for hedging their risk. The weakening of institutions such as monolines caused a major disruption in the municipal markets.

Also, as delinquency and foreclosure rates for subprime mortgage loans (and later Alt-A and commercial real estate loans) dramatically increased over time, NRSROs issued unprecedented numbers of downgrades to the ratings of securities collateralized by such loans, including subprime Residential Mortgage Backed Securities ("RMBS") and Collateralized Debt Obligations ("CDOs") backed by or referencing subprime RMBS. The NRSROs' performance in rating these structured credit products called into question their credit ratings generally as well as the integrity of the ratings process as a whole. In an era of interconnected worldwide financial markets, the impact of the turmoil in subprime RMBS and CDOs was widespread, adversely affecting the strength and stability of credit markets on a global scale.

The lack of confidence in the accuracy of NRSRO ratings that has resulted from the scope and magnitude of downgrades issued to structured finance ratings has been a factor in the broader dislocation in the credit markets. For example, the complexity of assessing the risk of structured finance products and the lack of commonly accepted methods for measuring the risk has caused investors to leave the market, including the market for AAA instruments, particularly investors that had relied primarily on NRSRO credit ratings in assessing whether to purchase these instruments. This has had a significant impact on the liquidity of the market for these instruments and the illiquidity in turn presented serious challenges in valuing the assets.

Accordingly, we offer the following supervisory observations:

- <u>Regulations and guidance need to adequately address liquidity risk</u>.

The SEC's supervision of investment banks long recognized that capital is not synonymous with liquidity — that a firm could be highly capitalized — that is, it can have far more assets than liabilities — while also having liquidity problems. While the ability of a securities firm to withstand market, credit, and other types of stress events is linked to the amount of its capital, the firm also needs sufficient liquid assets — cash, and high-quality instruments such as U.S. Treasury securities that can be used as collateral — to meet its financial obligations as they arise. The CSE program built on this concept and required stress testing and substantial liquidity pools at the holding company to allow firms to continue to operate normally in stressed market environments envisioned at the time. The liquidity pool at each CSE firm was sized for the loss of unsecured funding for a year.

But what neither the CSE regulatory approach nor most existing regulatory models had taken into account was the possibility that secured funding, even that backed by high-quality collateral, could become unavailable. The existing models for both commercial and investment banks had been premised on the expectation that secured funding, would be available in any market environment, albeit perhaps on less favorable terms than normal. Supervisors simply did not anticipate that a run-on-the-bank was a real possibility for a well-capitalized securities firm with high quality assets to fund. Thus, one lesson from the SEC's oversight of CSEs — Bear Stearns in particular — is that no parent company liquidity pool can withstand a "run on the bank." Subsequently, regulators, including the SEC, took the lessons learned from the Bear Stearns experience and ensured that the institutions they supervised applied much more severe assumptions in their liquidity stress tests, incorporating the loss of secured funding as well as other liquidity drains.

Another lesson learned is that these liquidity constraints are exacerbated when clearing agencies seize sizable amounts of collateral or clearing deposits to protect themselves against intraday exposures to the firm.

An independent investment banking model may remain viable for firms that have robust risk management and internal control systems in place, and which are funded with sufficient long term debt that provides the liquidity necessary to withstand an extreme crisis and a market operating under severe stress (e.g., where counterparties refuse to lend against high quality collateral). However, where an investment bank firm relies excessively on short term funding to meet liquidity needs, no matter how good its risk management and internal controls, it may not be capable of surviving a crisis event where markets no longer function rationally. For such a firm, the investment bank model may be unsustainable in the presence of a crisis of confidence by secured lenders, including clearing banks, and unsecured lenders. In other words, it may not be able to survive a “run on the bank,” whether of its own cause or contributed to by others, without access to emergency liquidity support facilities. Of course, the role of the government in providing, in certain circumstances, any such backstop liquidity should be carefully circumscribed, the effects on incentives considered, and the risk of moral hazard carefully minimized.

- Regulations and guidance should give due attention to illiquid assets.

Another lesson relates to the need for supervisory focus on the concentration of illiquid assets held by financial firms, particularly in entities other than a U.S. registered broker-dealer. Such monitoring is relatively straightforward with U.S. registered broker-dealers, which must disclose illiquid assets on a monthly basis in financial reports filed with their regulators. Also, registered U.S. broker-dealers must take capital charges on illiquid assets when computing net capital. As a result, illiquid assets often are held outside the registered U.S. broker-dealer in other legal entities within the consolidated entity. So, for the consolidated entity, supervisors must be well acquainted with the quality of assets on a group wide basis, monitor the amount of illiquid assets, and drill down on the relative quality of such illiquid assets.

The SEC currently inquires about the amount of Level 3 assets at broker-dealers, but such information must be known with specificity about affiliates in the group as well. A thorough understanding of illiquid assets would be a more useful measure of financial health than a leverage metric that is broadly applied across a complex financial institution. Moreover, regulators should be wary that the liquidity of any asset class can change rapidly based on market conditions. For example, loans intended for syndication or mortgages intended for securitization can rapidly become illiquid and thus linger on a firm's balance sheet. The complete shut-down of syndication and securitization markets in this crisis resulted in unprecedented drop in asset prices, was not foreseen, and was far more severe than in firms' stress tests. Again, it wasn't that the firms or regulators weren't aware that the markets could become stressed and or that a significant spread widening or price drop could result, but that their magnitude was far greater than anticipated based on recent experience.

A review of an institution's illiquid assets must also consider off-balance sheet vehicles. Off-balance sheet vehicles such as Structured Investment Vehicles ("SIVs"), used by many commercial banks to move risk off balance sheet, were essentially taken back by the banks onto their balance sheets when the assets deteriorated and funding of these vehicles failed. This, of course, led to financial and liquidity issues at these commercial banks. Similarly, sales to CDO structures by commercial and investment banks that essentially had liquidity put back provisions also negatively impacted bank liquidity.

Furthermore, firms and regulators should ensure that they view the financing of similar illiquid positions together with firms own proprietary positions, to get the complete understanding of the risk. Many commercial and investment banks were saddled with additional illiquid positions that they had been financing for clients or that they had previously financed through off-balance sheet vehicles.

- <u>Regulations and guidance should not encourage over-reliance on statistical measures. As an example, concentration risk should be assessed using an appropriate variety of metrics</u>.

Recent events have proven the limitations of certain risk metrics such as Value-at-Risk (VaR) and the necessity of rigorous stress testing of financial models. VaR, among other things, assumes certain historical correlations, which may be inapplicable during times of extreme stress. In addition, VaR may not measure liquidity or concentration risk well. Therefore, a lesson learned is while VaR and other risk metrics may be useful during normal market conditions, risk managers and supervisors must recognize their imbedded limitations and assumptions and plan accordingly. That is, supervisors and risk managers must supplement their usage with stress testing that incorporates not only likely economic scenarios, but also low probability, extreme events.

Even when VaR is supplemented with other tools such as scenario analysis and stress testing, firms and their regulators should supplement these risk metrics with other non-statistically based tools to assess and manage concentration risk.

In connection with concentration risk, regulations should give due regard to basic, non-statistical concentration measures such as notional values, jump-to-default metrics, etc. and incorporate them as part of analyzing concentration risk. While regulations should not completely disregard VaR, stress tests, and other statistically based measures, they should incorporate a healthy skepticism of their uses and limitations.

- Regulations and guidance should encourage the use of mark-to-market practices.

While the SEC knew the importance of supervisory focus on illiquid assets, no regulator truly understood that market perception of the integrity of the financial statements, which involves both the amount of illiquid assets and the valuation of such assets, could erode so precipitously and ignite a run on a financial institution.

A knowledge of illiquid assets requires managers, auditors, investors, and supervisors to review valuation thoroughly, and understand how mark-to-market (MTM) is executed within the firm — with a particular focus on the strength of control processes, and the independence of the price verification function. The challenges of valuing illiquid or complex structured products should not cast doubt on the process of marking-to-market, however. In fact, marking-to-market is part of the solution. Those firms that had the best governance over valuation performed better generally. Not having to recognize losses can lead to the continuing addition of problem assets. Of course the incentive structure is important here as well. This is another lesson from the events of 2008.

MTM informs investment bank senior managers of trading performance and asset price and risk factor volatilities, supports profit and loss (p/l) processes and hedge performance analyses, facilitates the generation and validation of risk metrics, and enables a controlled environment for risk-taking. In short, the MTM process helps ensure consistency between p/l reporting, hedging, and risk measurement. Without this, discipline across these activities would be more difficult to maintain and risk management would be significantly weaker. The act of marking-to-market provides necessary information and can impose discipline on risk-taking and risk management.

At securities firms and elsewhere, to protect the accuracy and integrity of the financial institution's books and records and to support the CFO's attestation concerning the fair value of the firm's inventory as of a certain date, an independent group of financial controllers verifies monthly that traders' marks are accurate and unbiased. Once the price verification is completed, summary mark review reports are provided to senior managers at investment banks which provides insight into the composition of the portfolio, as different methods signal different degrees of liquidity, complexity or model risk. Internally, one of the primary aims of the control function performed by price verification is to reduce the risk of a position or portfolio being mis-marked. Obviously, this risk rises with the degree of subjectivity that may be applied to a given mark or position (and gets multiplied by the exposure). Given its critical contribution to the integrity of valuation and books and records, managers, auditors, investors, and supervisors must engage fully in understanding the price verification controls at financial institutions, ensure that it is well-resourced, has independent authority to push back on the business line valuations, and is in ready communication with and has the active support and involvement of firm senior management.

Further, while there is much discussion of the effects of mark-to-market or fair value accounting on pro-cyclicality, changes that would weaken accounting standards is not the right approach to address these concerns and would only reduce investor confidence and risk management standards generally. In that regard, it is important to point out that the over-reliance on VaR for capital and risk management purposes reinforces pro-cyclicality. A better approach would be through regulatory capital standards, supervision and improved disclosure. One practical constraint would be to supplement this approach with additional concentration charges, possibly based on more basic measures of concentration, such as notional values. Additionally, graduated limits and capital charges could be imposed on institutions as they grow, spreading risk, encouraging a diversity of risk management approaches, and minimizing the "systemic risk" of any individual institution.

- Regulations and guidance should give due skepticism to the role of credit ratings in internal risk management.

As noted above, while low interest rate policies and weak underwriting standards were significant contributors to the credit crisis, the over-reliance on credit rating agencies (NRSROs) by investors, including financial institutions, may also have contributed to the problem. In relying on NRSROs, many of these investors failed to perform adequate independent due diligence of products purchased.

In addition, firms built up risks with highly rated hedge counterparties based on the belief that the counterparties were creditworthy and financially stable institutions. Moreover, relevant capital rules imposed minimum charges for these hedging activities, further encouraging the build-up in risk positions. Many commercial and investment banks sourced protection from monolines, AIG, and other entities such as Credit Derivative Product Groups, not realizing that these entities would not be in a position to deliver on their CDS contracts if the event they were insuring against were to actually occur.

The primary difference between these entities and other entities to which firms would have turned to buy protection (i.e., short CDS) is that these counterparties did not generally post collateral to the banks. In limited cases, contracts did include ratings-based collateral triggers. Nonetheless, as the credit markets deteriorated, uncollateralized receivables and consequently current and potential exposures to these entities grew. As another lesson learned in connection with reliance on credit ratings, regulators and firms should encourage the posting of collateral even when counterparties are highly rated by credit rating agencies.

2. Execution of supervision

- **Consolidated supervision of large, complex firms**

  Critics have argued that supervisors failed to identify key risks developing at large, complex financial institutions. In some cases, they argue, where supervisors did identify key risk areas, they failed to react with timely and appropriate measures.

  a. **What processes does your agency have in place to identify and continuously monitor emerging risks at major financial institutions?**

The Broker Dealer Risk Office (BDRO) conducts ongoing supervision of broker-dealers registered with the Commission that calculate net capital under the alternative method in Appendix E of Rule 15c3-1 under the Securities Exchange Act of 1934 (Exchange Act) – known as alternative net capital, or "ANC" firms-- as well as those owned by a holding company supervised by the Commission pursuant to Section 17(i) of the Exchange Act. The Commission has learned through its longstanding experience that even broker-dealers that are well-capitalized and in compliance with applicable financial responsibility and customer protection rules are affected by the financial difficulties of affiliate entities and may thus be placed at risk in several ways. The financial distress of an affiliate, including the holding company, may affect the U.S. registered broker-dealer either directly, if affiliates seek to withdraw capital from or effectively transfer liabilities to the registered broker-dealer, or indirectly, if the registered broker-dealer receives financing from an affiliate or relies on the affiliate in order to access the capital markets. Notably, the use of derivatives and highly structured and securitized products typically occurs outside the registered broker-dealer, sometimes in unregulated entities, and add to the risk inherent in complex holding companies.

Accordingly, BDRO centers its supervision of ANC firms on potential affiliate risks to the broker-dealer and adequate risk management controls within the holding company. In addition, the BDRO Inspections Group augments BDRO's supervisory efforts with inspections of the ANC firms. Based on its technical expertise in market developments and risk management, BDRO also assists the Commission in interagency regulatory efforts.

Broker-dealers that wish to use the ANC computation must file an application with and obtain authorization from the Commission, as well as maintain an "early warning" level of at least $5 billion in tentative net capital[1] and minimum levels of at least $1 billion in tentative net capital and at least $500 million in net capital.

- Initial Application

In their initial applications to the Commission, broker-dealers that wish to use the ANC computation must file an application that, among other things, describe their Value-at-Risk (VaR) models, including the manner in which the models meet the requirements specified in Appendix E, and the broker-dealer's internal risk management control system and how that system satisfies the requirements set forth in Exchange Act Rule 15c3-4. Without being prescriptive, Rule 15c3-4 sets forth criteria that a firm must meet in adopting its internal control system guidelines, policies, procedures, and risk management systems. The application must also include sample risk reports that are provided to the persons at the ultimate holding company who are responsible for managing group-wide risk.

As part of the application review process and on an ongoing basis, the Commission staff assesses the firm's financial position, the adequacy of the firm's internal risk management controls, and the mathematical models the firm would use for internal risk management and regulatory capital purposes. The staff also conducts on-site reviews to verify the accuracy of the information included in the application, and to assess the adequacy of the implementation of the firm's internal risk management policies and procedures.

- Ongoing monitoring

[1] "Tentative net capital" is defined in the rules as net capital before deductions for market and credit risk.

Once its application is approved, the ANC firm and its ultimate holding company continue to provide the Commission with monthly, quarterly, and annual reports. The reports include specified financial, market and credit risk information, including a consolidated and consolidating balance sheet and income statement audited by a registered public accounting firm; the capital adequacy measurement (statements of allowable capital and allowances for market, credit, and operational risk); regular back testing results; and certain reports that the ultimate holding company regularly provided to its senior management to assist in monitoring and managing risk.

To monitor the implementation of firms' internal controls, the ANC program leverages the firms' internal audit functions, among other things. To monitor the financial and operational condition of the holding company, a multi-disciplinary team of Commission staff, including economists, financial analysts, and accountants, meet regularly with senior risk managers, financial controllers, treasury personnel, and internal auditors of the ANCs. A key theme throughout these discussions is risk concentration, and how the control functions collectively manage concentrated exposures of various types. Another key objective is to monitor for whether, within the firm, senior management engages with firm risk managers and supports them as an independent function. Commission staff also note whether the firms' boards of directors participate actively in setting the risk appetite of the firm, hold senior management accountable for following the board's direction on risk taking, and force management to take action, as appropriate. For instance, risk managers should have some degree of authority over trading decisions, and any decision by senior management to deviate from their recommendations should be documented and reviewed by the board.

Commission staff meets at least monthly with senior market and credit risk managers of the ANC firms, who are charged with managing a bidirectional flow of risk information between the trading businesses which take market and credit risk, and the senior management. In one direction, value-at-risk and other techniques are used to aggregate exposures across diverse businesses with different underlying risk factors both for internal risk management and regulatory capital computations. In the other direction, a granular system of limits articulates to each division, business or desk the risk appetite of senior management. During the monthly meetings, the performance of the models and aggregation tools are assessed, by comparing ex ante measures of risk with ex post realizations of gain and loss. The monthly discussion is structured around a review of risk reporting and analytics prepared for the internal use of the firm's management. SEC staff monitor for whether risk tolerances are properly communicated downstream from senior management to individual trading desks and exposure information properly measured, aggregated, and communicated upstream.

At a minimum, on a quarterly basis, Commission staff meets with treasury personnel at each firm. The focus of the discussion is the liquidity position of the holding company and, in particular, the amount and nature of liquid assets that are held at the parent, and thus available for use anywhere within the group. Of equal importance, however, are the less liquid assets held by the firm, and how they are funded. During the quarterly discussion, material changes in the liquidity requirements generated by this analysis are discussed. This entails reviewing several liquidity metrics including the firm's contingency funding plans or liquidity stress tests and challenging the assumptions built into these models. The staff's knowledge of the markets through the ANC program's cross-firm approach provides them with an informed and independent view on how market factors may impact the individual firm's liquidity plans.

While the program calls for a formal meeting at least on a quarterly basis, the reality is that during times of stress, whether market-based or firm-specific, the discussions occur frequently -- daily in many situations. These discussions are also complemented with regular liquidity reporting.

Commission staff also meets quarterly with the financial controllers to review the financial results including significant profit or losses at the desk level. Financial results are compared with the risk exposures theoretically associated with those gains or losses as a means of validating that the risk measurement systems are functioning properly. The results of the firm's internal price testing processes, intended to validate the marking-to-market of complex and illiquid products, are also reviewed.

Also on a quarterly basis, Commission staff meets with each firm's internal auditors. The Commission's rules for ANC firms require internal auditors to review the functioning of major governance committees and all internal risk control functions and represent in writing to the SEC annually that this review has been done, with the results presented to the external auditor and the audit committee of the Board of Directors. In addition, Commission staff review with internal audit staff significant audit findings and the evolution of the audit plan throughout the year. Commission staff monitors the resolution of findings, or their escalation to the firm's audit committee, and discuss selected audit reports with audit staff, particularly those related to risk governance. As circumstances require, or as risk management issues arise, senior officers of the SEC meet with CEOs, CFOs, and other members of the firm's senior management to raise issues for focus and resolution.

The on-site work described above is augmented by the Commission staff's review of monthly holding company capital adequacy measures computed in accordance with the Basel standard, which are required to be filed under the ANC rule, as reported to the ultimate holding company's principal regulator.

- Assessing risk management practices

The BDRO Risk Management Practices Group (RMPG) functions as an "in-house" inspections group dedicated to the supervision of the ANC firms. RMPG focuses on the financial and operational condition of the ANC Firms, subjecting their relevant controls to on-site testing. The RMPG is tightly integrated, conceptually and operationally, with BDRO monitoring activities. This integration ensures the most effective utilization of Commission resources. Moreover, it ensures continuous information flows across components of the program: ongoing monitoring activities are informed and enhanced by the results of focused testing of controls, and inspections are precisely targeted using information from ongoing monitoring.

RMPG conducts timely inspections that respond to identified risks. The ANC firms are dynamic and rapidly grow, contract, and transform their business activities, and related risk control systems, as market conditions evolve. RMPG reflect this dynamic character to provide timely feedback to the BDRO monitoring teams and to the ANC firms. Projects focus on the portfolio of controls around a particular business, for example credit or equity trading, encompassing the marking of positions, computation of risk exposure measures, transaction flow, permissioning, and computation of regulatory capital.

Almost all projects are implemented across multiple firms. Conducting similar work at multiple firms within a short time interval enables the staff to develop a comprehensive understanding of the relevant business and control issues, and allows for more useful feedback to the firms. While not defining best practices, the feedback provides a sense of whether a firm is an outlier, which is sought by firms as a management tool.

b. What processes does your agency have in place to make sure that risks and vulnerabilities at individual firms that have been identified are escalated within the supervisory function?

The monitoring staff will circulate notes of the various firm meetings internally to keep the group informed. Firm specific and cross-firm reporting is completed and circulated internally at various levels of management within the Commission. Escalations to senior management may occur through this reporting or, if a time-sensitive matter, in a more rapid, but less formal approach.

c. What were the strengths and weaknesses in the processes described above in 2a, 2b, and 2c? Did they identify key risks and result in timely and appropriate actions in the run-up to the current financial crisis – particularly with respect to risks posed by complex structured products, securitization, and nontraditional mortgage lending? Which important emerging risks were identified early but did not get appropriately addressed? Are there other examples where these processes worked well or broke down? What changes has your agency made or is it considering to these processes?

The BDRO monitoring group conducted cross-firm studies specifically on the subjects of Event-Driven Lending, Securitization, Private Equity, and Hedge Fund-Linked Derivatives. These particular areas were chosen either because the represented material (and/or) growing businesses at the CSE firms or were complex in nature. The reports documenting these cross-firm studies were distributed to senior management within the Division of Trading and Markets, Commissioners, and, in appropriate cases, shared with the Federal Reserve Board of New York. These studies focused on the details of the business, the risk management practices, and regulatory capital treatment of the positions. While these cross firm studies documented the build-up in exposures to certain asset classes or products, they also noted that the firms generally understood the risks that were involved and attempted to capture the tail risks in their firm-wide stress tests or scenario analysis. For example, for many of the businesses, the risk that the syndication and securitization markets would suffer a shock was contemplated. The firms generally would have modeled a stress test or scenario that would capture the resulting spread widening or price drop that would occur in such event. Staff routinely monitored these exposures and the firm's measurement of the risks involved. However, the event that actually occurred in this crisis was unprecedented in these markets, and as a result, the actual losses suffered were much greater than the stress tests and scenario analysis suggested. Of course, there were many lessons learned in this process which we have previously highlighted, relating to the over-reliance on credit ratings, the over-reliance on statistical measures and historical measures, the need to factor in simple concentration metrics, and the ineffectiveness of hedges, particularly when placed on with non-posting counterparties such as the monolines.

d. How does your agency identify large, complex firms? What factors are considered or should be considered in the future?

As noted earlier, any broker-dealer seeking to calculate net capital using model-based market and credit risk charges under Appendix E of the Net Capital Rule must comply with an "early warning" rule that essentially requires them to maintain $5 billion in tentative net capital. Additionally, they must comply with minimum levels of at least $1 billion in tentative net capital and at least $500 million in net capital. By these terms, only the largest broker dealers, generally belonging to large, complex holding companies as a matter of course, qualify for supervision under the ANC program.

e. What is your agency's process for setting and implementing supervisory priorities for individual institutions? What are your lessons learned from the current crisis? What changes has your agency made or is it considering?

See 2(h) below.

f. How does your agency conduct supervision of non-depository subsidiaries of banks, bank holding companies, and financial holding companies? What are your lessons learned? What changes has your agency made or is it considering? Are sufficient resources available and allocated to this task?

The Commission's mandate is to protect investors, ensure orderly securities markets, and promote capital formation. With regard to large, complex financial institutions, the agency's charge is to protect investors and, therefore, the customers of the broker-dealer. It is important to observe that the SEC's statutory and regulatory regime, including not only the broker-dealer net capital regime, but also the protection provided by the Securities Investor Protection Corporation and the requirement that SEC-regulated broker-dealers segregate customer funds and fully-paid securities from those of the firm — worked in this case to achieve the purpose for which it was designed. For example, despite the run on the bank to which Bear Stearns was subjected, its customers were fully protected. At no time during the week of March 10th — 17th, up to and including the date of the agreement with JP Morgan, were any of the customers of the Bear Stearns's broker-dealers at risk of losing their cash or their securities. (See also 1 and 2(a) above)

g. How does your agency identify and evaluate the risks of new products to individual institutions? To what extent does your agency rely on examiner evaluations of banks' internal risk management processes for evaluating new products? What are your lessons learned, particularly with respect to complex structured products and nontraditional mortgages? What changes has your agency made or is it considering, to your approach to new products?

Commission staff vet new product processes as part of the ANC application process and monitor the development of new products during their monthly risk meetings, as well as during their meetings with and internal audit. We seek to understand how new products are being risk managed, whether there are outsized exposures, and if internal audit is monitoring compliance with the firms internal policies and procedures with regard to new products.

h. To what extent does the supervisory process incorporate an explicit focus on factors such as "tail risks," inherent limitations of quantitative risk management, and forecasting uncertainties? What specific "tail risks" are considered (e.g., credit, liquidity, asset prices) and how are co-movements in tail risk incorporated into the analysis? What recent changes has your agency made or is it considering?

The BDRO continually monitors the ANC firms' use of firm-wide stress tests and scenario analyses for quantifying tail risk for both market and liquidity risk. In its monitoring function, the BDRO reviews and analyzes the assumptions and results of these stress tests and scenario analyses to ensure that the lessons learned during this recent crisis are appropriately incorporated. As noted above, however, risk management and capital standards must not place over-reliance on such tools, as this crisis has pointed out the difficulties in quantifying "tail risk." As such additional measures of concentration should be reviewed both for risk management and capital standards.

i. How does the supervisory process address the risk of prolonged periods of market illiquidity? How is such risk measured? What changes has your agency made or is it considering in its approach to such risk?

As the nature, timing, and duration of market illiquidity in this most recent crisis were not anticipated, supervisors should acknowledge that causes of future periods of market illiquidity will be likewise difficult to anticipate. Accordingly, regulatory measures that discourage financial institutions from over-concentration in a particular asset class or product are appropriate, and may consider not only concentration of a product held within a firm, but also as a percentage of the market for those products. While supervisors should be wary of substituting their own business judgment, they can ensure that firms are incorporating appropriate assumptions into stress testing, risk limits, etc.

j. How much of supervision is currently "audit" related (i.e., checking assertions of the firms themselves) vs. independent analysis? Is this the right balance?

Please see above description of RMPG under Question 2(c).

k. What does your agency do to assure that supervisors continue to enforce strong risk management practices – for example, underwriting standards – during long periods of market stability and limited credit losses? What lessons has your agency learned?

Although the SEC has authority over disclosure in connection with securitized products and other securities, it has no direct authority to regulate the underwriting standards themselves. The lack of strong national underwriting standards was particularly problematic during this crisis. With regard to enforcing strong risk management practices, the SEC continues to monitor and inspect large broker-dealers as described above.

l. Any other comments?

One observation relates to the challenges any single regulator has in overseeing an entity — in the SEC's case, sizable broker-dealers — that reside within a complex institution with multiple material affiliates, regulated or not, in numerous countries. Any regulator must have an ability to get information about the holding company and other affiliates, particularly about issues and transactions that could impact capital and liquidity. For instance, whether directed by a holding company supervisor here or abroad, a poorly capitalized and not very liquid affiliate could require infusions from the parent and become the source of financial weakness for the entire organization. This could occur while the registered U.S. broker-dealer is well-capitalized and liquid. As was true in the case of Lehman Brothers, the bankruptcy filing of a material affiliate has a cascading effect that can bring down the other entities in the group. Also, in some instances, affiliates try to involve the well-capitalized broker-dealer in their business in a manner that is not prudent.

For these reasons, and to protect the broker-dealer and its customer assets, the SEC would want, not only to be consulted before any such liquidity drain occurs at the parent, but to have a say, likely in coordination with other interested regulators, in the capital and liquidity standards the holding company must maintain. Our experience last year with the failure of Lehman's UK broker-dealer, and the fact that the U.S. registered broker-dealers were well-capitalized and liquid throughout the turmoil, has redoubled our belief that we must rely on and protect going forward the soundness of the regulatory regime of the principal subsidiaries. Nothing in any future regulatory regime, or systemic regulator, should operate to weaken the regulatory standards of these subsidiaries.

- **Supervision of smaller institutions**

  In many ways, smaller institutions face different challenges from larger institutions.

  a. What lessons has your agency learned from the crisis with respect to the supervision of smaller institutions?

In general the SEC’s supervision of smaller broker-dealers has not been affected by the crisis.

b. What processes does your agency have in place to make sure that concentration risks and vulnerabilities at individual firms are identified and escalated for attention within the supervision function?

In general, broker-dealers that belong to holding companies and are not part of the ANC regime are supervised through the SEC’s Risk Assessment Program. The Risk Assessment

Program was established under the Market Reform Act of 1990 following the collapse of Drexel Burnham Lambert Group, Inc. (Drexel), the holding company parent of Drexel Burnham Lambert, Inc. (DBL), a registered broker-dealer. Drexel's collapse demonstrated that broker-dealers could encounter serious financial difficulty due to the loss of market confidence, loss of access to the capital markets, or failure of the registered broker-dealer's affiliates or the holding company itself.

Broker-dealers and municipal securities dealers belonging to holding companies generally are subject to the Risk Assessment rules unless they meet an exemption.[2] These firms must keep records and file with the Commission information including the holding company organizational chart, risk management policy information, consolidating and consolidated financial statements, securities and other financial product position data of material associated persons, and other categories of financial and securities related information.

BDRO staff review filings under the Risk Assessment Program and public disclosures relating to reporting broker-dealers or their holding companies to analyze the activities and relationships of the broker-dealer and associated entities. Staff analyze financial dependencies and unregulated business activities which could potentially affect the net capital, liquidity, financing or profitability of the broker-dealer, as well as sources of funding for the broker-dealer and the parent. After evaluation of the filings, staff may request additional information from the firm to elaborate on developments or trends noted. As warranted, or at least once yearly, reviews are supplemented by phone calls or on-site visits. Data are tracked to note trends over time in business activities, liquidity, profitability or asset quality.

c. How should the supervision of smaller, simpler firms differ from supervision of larger, more complex firms?

The same principles apply in monitoring smaller broker-dealers – that is, due attention to the concentration of assets and exposures, illiquid assets, and a focus not only on the broker-dealer, but also the business activities of and interdependencies among affiliates.

d. How does your agency allocate resources between large and small banks and other financial firms? For example, does your agency allocate resources based on charter, assets, or some measure of complexity? If your agency charges examination fees, do assessments on large firms subsidize small firms or vice versa?

[2] There are currently seven provisions exempting categories of broker-dealers from the Risk Assessment rules. They are found under Rules 17h-1T(d) and 17h-2T(b) under the Exchange Act. The exemptions cover, for example, (1) broker-dealers that do not carry or clear customer assets, including limited purpose mutual fund broker-dealers; 2) introducing broker-dealers that clear all transactions with and for customers on a fully disclosed basis with a clearing broker; 3) broker-dealers that clear customer trades but do not hold funds or securities for customers except to facilitate transactions and only for the time necessary to complete the transaction; 4) broker-dealers maintaining capital, including subordinated debt, of less than $20 million and who do not clear or carry customer accounts; and 5) broker-dealers that maintain less than $250,000 in capital.

Given that the frequency and types of information that the SEC may obtain through the Risk Assessment Program is by statute somewhat limited, a fewer number of staff are able to monitor a greater number of firms under the Risk Assessment Program.

e. Any other comments?

Outside of the ANC and Risk Assessment programs, the SEC, through its Office of Compliance, Inspections, and Examination ("OCIE"), and SROs examine broker-dealers periodically to assess compliance with securities laws, regulations and rules. The SEC may inspect a broker-dealer based on a random selection of that broker-dealer, or based upon some specific perceived risk. SROs generally inspect broker-dealer members periodically, depending on the types of business the broker-dealer engages in and the perceived relative risk of those types of business. For instance, SROs inspect broker-dealers that hold customer funds and securities once each year. Other broker-dealers are also subject to on-site examinations by SROs, however they may be examined less frequently.

During examinations of broker-dealers the SEC staff reviews a broker-dealer's operational risk management to obtain a level of comfort that the firm's systems for trade capture, confirmation, valuation, reconciliation and risk monitoring reporting are functioning adequately and are correctly feeding the books and records of the firm, including the general ledger, stock record and risk reporting systems. The review generally focuses on the broker-dealer's controls in and between the front office, middle office and back office, and the level of segregation of duties within these areas. In addition, during examinations of broker-dealers the SEC staff reviews a broker-dealer's risk management procedures and systems to obtain a level of comfort that the broker-dealer's senior management is appropriately reviewing and monitoring risk controls at the firm, and that the firm has appropriately assessed operational risk and implemented risk control measures.

- **Examination programs**

  Critics have argued that supervisors in the run-up to the current crisis failed at the basic tasks of a bank examiner: for instance, testing credits and monitoring liquidity.

c. Any other comments?

The alternative to relying on a firm's internal models to start with company risk management assumptions and based on staff's expertise and cross-firm knowledge, critiquing and challenging the assumptions. This can lead to both the firm changing its previous assumptions as well as in some cases the regulator advising or requiring the firm to change certain assumptions.

Also see above Question 2(c) concerning the RMPG.

- **Systemic risk and the Financial Services Oversight Council**

  Supervisors are tasked to protect the safety and soundness of individual financial institutions. The Treasury recommended in its white paper the creation of a Financial Services Oversight Council to take a broader view, considering risks to the financial stability of the system as a whole. The Council would have a staff at the Treasury. Its

mandate would be to facilitate information sharing and coordination among agencies, identify emerging risks, advise the Federal Reserve on the identification of firms whose failure could pose a threat to financial stability due to their combination of size, leverage, and interconnectedness, and provide a forum to discuss cross-cutting issues among regulators. An analogy could be the National Intelligence Council, which reports to the Director of National Intelligence, is staffed by expert National Intelligence Officers, works closely with staff at the intelligence agencies, and reports on emerging issues and broad trends.

a. What are your suggestions for how the Council should implement these responsibilities?

While traditional oversight, regulation, enforcement and market transparency play a critical role in reducing systemic risk, they alone are not sufficient. Chairman Mary Schapiro has testified regarding her support of the Administration's plan to establish a regulatory framework for macro-prudential oversight. Within that framework, a single systemic risk regulator (SRR) would work with a powerful council of various governmental agencies to ensure clear accountability for systemic risk, enable a strong, nimble response should circumstances arise, and maintain the broad and differing perspectives needed to best identify developing risks and minimize unintended consequences.

The SSR should have access to information across the financial markets and, in addition to the individual functional regulators, serve as a second set of eyes upon those institutions whose failure might put the system at risk. It should have ready access to information about institutions that might pose a risk to the system, including holding company liquidity and risk exposures; monitor whether institutions are maintaining capital levels required by the Council; and have clear delegated authority to respond quickly in extraordinary circumstances.

In addition, an SSR should be required to report to the Council on its supervisory programs and the risks and trends it identifies at the institutions it supervises.

b. How would your agency view its role in helping to implement the Council?

This Council should have the tools needed to identify emerging risks, be able to establish rules for leverage and risk-based capital for systemically-important institutions; and be empowered to serve as a ready mechanism for identifying emerging risks and minimizing the regulatory arbitrage that can lead to a regulatory race to the bottom.

To balance the weakness of monitoring systemic risk through the lens of any single regulator, the Council would permit us to assess emerging risks from the vantage of a multi-disciplinary group of financial experts with responsibilities that extend to different types of financial institutions, both large and small. Members could include representatives of the Department of the Treasury, SEC, CFTC, FRB, OCC, and FDIC.

The Council should have authority to identify institutions, practices, and markets that create potential systemic risks and set standards for liquidity, capital and other risk management practices at systemically important institutions. The SRR would then be responsible for implementing these standards.

The Council also should provide a forum for discussing and recommending regulatory standards across markets, helping to identify gaps in the regulatory framework before they morph into larger problems. This hybrid approach can help minimize systemic risk in a number of ways:

* First, a Council would ensure different perspectives to help identify risks that an individual regulator might miss or consider too small to warrant attention. These perspectives would also improve the quality of systemic risk requirements by increasing the likelihood that second-order consequences are considered and flushed out;

* Second, the financial regulators on the Council would have experience regulating different types of institutions (including smaller institutions) so that the Council would be more likely to ensure that risk-based capital and leverage requirements do not unintentionally foster systemic risk. Such a result could occur by giving large, systemically important institutions a competitive advantage over smaller institutions that would permit them to grow even larger and more risky; and

* Third, the Council would include multiple agencies, thereby significantly reducing potential conflicts of interest (e.g., conflicts with other regulatory missions).

The Council also would monitor the development of financial institutions to prevent the creation of institutions that are either "too-big-to-fail" or "too-big-to-succeed" -- whose businesses are so large and diverse that they have become, for all intents and purposes, unmanageable. Given the potential daily oversight role of the SRR, it would likely be less capable of identifying and avoiding these risks impartially. Accordingly, the Council framework is vital to ensure that the desire to minimize short-term systemic risk does not inadvertently undermine our system's long-term health.

c. The intent is that the Council would offer an independent view on emerging systemic risks. This goal may not be achievable if the work of the Council must represent a consensus of its members. How can the structure and mandate of the Council be designed so that there is a proper balance between independence and originality, on the one hand, and serving many masters, on the other?

In most times, Council and SRR would work with and through primary regulators of systemically important institutions. The primary regulators understand the markets, products and activities of their regulated entities. The SRR, however, can provide a second layer of review over the activities, capital and risk management procedures of systemically important institutions as a backstop to ensure that no red flags are missed.

If differences arise between the SRR and the primary regulator regarding the capital or risk management standards of systemically important institutions, the higher (more conservative) standard should govern. The systemic risk regulatory structure should serve as a "brake" on a systemically important institution's riskiness; it should never be an "accelerator."

In emergency situations, the SRR may need to overrule a primary regulator (for example, to impose higher standards or to stop or limit potentially risky activities). However, to ensure that authority is checked and decisions are not arbitrary, the Council should be where general policy is set, and only then to implement a more rigorous policy than that of a primary regulator. This will reduce the ability of any single regulator to "compete" with other regulators by lowering standards, driving a race to the bottom.

- **Shadow banking system**

  Critics have said that supervisors did not understand or appropriately address the risks posed to supervised institutions and to the system as a whole by their interactions with the shadow banking system.

  c. How did your agency evaluate asset quality in the area of structured products? Did examiners rely on credit quality assessments of ratings agencies and the supervised institutions themselves? What changes has your agency made or is it considering?

  d. Any other comments on the shadow banking system?

We believe that disclosure prepared in connection with structured products generally was available and revealed asset quality and underwriting standards. As noted above in our response to Question 1 however, the risk mitigating properties of securitization did not materialize as expected, particularly in light of a broad decline in real estate asset prices. Assumptions based on historical data were insufficient for modeling in connection with the assignment of credit ratings and the forecasting of expected cash returns and asset values. Statistical measures again revealed their limitations through unreliable credit ratings and as the tranching of cash flows failed to protect the values of particular products as expected.

While on one hand securitization and syndication can provide significant benefits to the economy by providing for more private capital raising and investing opportunities, they also exacerbate the moral hazard problem by lowering underwriting standards. Moreover, economic recovery is complicated by the difficulty faced by borrowers who wish to renegotiate the terms of mortgages or commercial loans owned by countless investors. This in turn contributes to the vicious cycle of an illiquid market resulting from and contributing to the difficulty in valuing and monetizing SFPs.

Of note, the FASB has sought to address the issue of valuing illiquid SFPs. Prior to 2008, external prices (or observable inputs used in valuation models) for certain asset categories were more readily available and observable. Therefore, estimating fair value for certain SFPs simply required identification and use of to observable pricing information for identical or similar assets. However, beginning in 2008, liquidity in certain markets significantly decreased, or in some cases, those markets completely froze. As a result, external pricing information was not available or observable; and if they were available, they were not necessarily reliable given that trading was sporadic and not in close proximity to the measurement date.

The reduction in market liquidity for certain SFPs significantly increased the amount of work and judgment required by financial statement preparers to estimate the fair value. Specifically, preparers needed to determine if observable pricing information reflected fair value as defined by FAS 157, or if observable transactions were the result of “fire sales” or distressed transactions. However, determining if a transaction is orderly or forced is a difficult task and requires significant judgment. To address the concerns of marketplace participants, the FASB issued FSP FAS 157-4 in April 2009, which provided additional guidance on how to estimate fair value in markets that have become illiquid and identifying transactions that are not orderly.

- **Peer comparisons and stress tests**

  Supervisors conduct stress tests and use a number of other tools to encourage examiners and analysts to compare the financial soundness and risk management of peer institutions. The stress test conducted in the first half of 2009 on 19 large firms took a more comprehensive approach to peer or "horizontal" analysis of individual firms.

  d. Any other comments?

While the SEC did not participate in the Supervisory Capital Assessment Program conducted jointly by the Federal Reserve, OCC, and Treasury of the 19 largest banking institutions – aka the "stress tests" -- we have found horizontal, or "cross-firm," studies to be invaluable. Our program is built on a "cross-firm" approach, one implemented even under the CSE program. Under that CSE Program, Commission staff conducted several cross-firm studies, including those focused on Securitization, Private Equity, Hedge Fund Derivatives, and Event-Driven Lending. SEC staff also discussed the findings of many of these studies with other regulators.

The cross-firm monitoring approach is reflected in the staffing of the program. Each staff member is assigned to monitor 2 or 3 firms. In addition, one staff member each month is assigned to attend all of the risk meetings of all the ANC firms.

Similarly, with regard to inspections of the ANC firms, almost all projects are implemented across multiple firms. Conducting similar work at multiple firms within a short time interval enables the staff to develop a comprehensive understanding of the relevant business and control issues, and allows for more useful feedback to the firms. While not defining best practices, the feedback provides a sense of whether a firm is an outlier, which is sought by firms as a management tool.

- **Information-gathering**

  A great deal of information about individual institutions is available to bank supervisors, some through mandatory filing of regulatory reports and public disclosures, and some through the provision of internal reports such as risk reports to company boards of directors.

  a. What lessons did your agency learn from the current crisis with respect to the information supervisors had and should have had about individual institutions?

  d. Any other comments?

We discuss the reporting obtained in connection with ANC firms in Question 2[__] above. Reporting obtained in connection with the former CSE program was more extensive. In addition to the general reporting requirements, staff requested and received information on an ad-hoc basis based on the occurrence of an unusual or significant transaction, risk exposure, market event, or study conducted by Commission staff. In general we are able to obtain adequate information concerning the firms' risk exposures, positions, liquidity, and capital, including that provided to each firm's senior management and board of directors. In our view, the crisis was not one that could have been averted by additional reporting from the firms, notwithstanding our previous comments about the need to look at additional concentration measures. Rather, in the case of Bear Stearns, for example, the market's dramatic loss of confidence in a well-capitalized institution was unexpected and the rapidity with which secured funding evaporated was unprecedented.

- **Market discipline and transparency**

  Some observers have argued that the capital markets, through shareholders, creditors, and counterparties, can play a positive role in the governance of bank behavior.

  a. **What role should market indicators such as bond and equity prices and credit default swap spreads play in the supervisory process?**

Supervisors should be aware of and understand market indicators and their impact on the financial institutions regulated. To advise or set standards based on market indicators, however, draws close to the substitution of a supervisor's business judgment for that of the firm's management.

3. Structure of supervision

- **Cooperation and collaboration among supervisors**

  With more than one federal financial supervisor, it is critical that they share information and collaborate closely, particularly in order to effectively supervise large institutions.

  a. **What lessons did your agency learn from the current crisis with respect to cooperation, coordination, and collaboration among supervisors, for example, between consolidated supervisors and functional and bank supervisors?**
  b. **How do functional and bank supervisors interact with consolidated holding company supervisors to ensure strong and thorough consolidated supervision? What works and what doesn't work?**

Consolidated supervision of holding companies generally would benefit from more information sharing and collaboration among consolidated and functional regulators. Traditionally there has been reluctance among consolidated supervisors to share information or collaborate with functional regulators. Without adequate information sharing, however, functional regulators may take measures that are counterproductive to the holding company overall. Conversely, consolidated supervisors may take action without duly considering potentially disastrous consequences to individual regulated entities. Rather than exacerbating the problem, improved information sharing and communication regarding the distribution of responsibilities can be a way to address concerns regarding duplicative or overlapping regulation. Alternatively, regulatory gaps may remain.

d. How do federal and state supervisors coordinate with foreign supervisors in the supervision of multi-national financial firms? What works and what doesn't work? Are there specific instances in which it would have been helpful to have more information from the home supervisor to understand a troubled foreign-owned institution during the current crisis?

The SEC's experience with the bankruptcy filing of a foreign affiliate of Lehman Brothers has demonstrated the innate difficulties of any multi-jurisdictional approach to regulation. While cross border coordination and dialogue is important, jurisdictions nonetheless have unique bankruptcy and financial regulatory regimes-and creditors wherever they are located shall always act in their own interest during a crisis. Thus, a U.S. liquidity provider might be faced with the difficult choice of guaranteeing the assets of the holding company globally, or else risk creditors exercising their rights against foreign affiliates or foreign supervisors acting to protect the regulated subsidiaries in their jurisdictions, either of which could trigger bankruptcy of the holding company. These are thorny issues that Congress should consider carefully.

- **Regulatory arbitrage**

  Critics have noted that the existence of competing charters creates the opportunity for regulatory arbitrage or charter-swapping among agencies. In some cases, financial institutions have been able to avoid serious regulation by finding loopholes in the supervisory structure.

a. How does your agency define its mission, and how does its mission differ from the other federal agencies?

The mission of the SEC is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. Accordingly, rigorous financial responsibility requirements apply to all US broker-dealers, including ANC firms, that are designed to ensure that broker-dealers operate in a manner that permits them to meet all obligations to customers and counterparties. The first prong of these requirements is the net capital rule, which requires the broker-dealer to maintain a level of liquid capital in excess of all liabilities to enable the firm to absorb business losses and, if necessary, finance an orderly self-liquidation. The second prong is the customer protection rule, which requires the firm to safeguard customer cash and securities by segregating these assets from its proprietary business activities. In short, the broker-dealer is prohibited from using customer cash or securities to raise funds to trade for its own account. The third prong is comprised of recordkeeping and financial reporting requirements that require the broker-dealer to make and maintain records and file reports that detail its net capital positions and document the segregation of customer assets.

Taken together, these requirements are designed to ensure that a broker-dealer operates in a prudent manner and, if it fails financially, is able to promptly wind down its affairs in an orderly manner, return all cash and securities to customers, and meet obligations to counterparties. Finally, the Securities Investor Protection Act serves as a backstop to the financial responsibility rules by providing protection to customers in the event a broker-dealer fails and is unable to meet all obligations to customers.

g. Critics also have noted that an uneven approach to supervision across types of financial services firms (e.g., commercial banks and thrifts, investment banks, insurance companies, unregulated finance companies, investment companies and others) may complicate the ability of bank regulators to impose prudential requirements that are not readily avoided. How important is this concern and what should be done about it?

The SEC notes that while there are no competing securities activities charters, comprehensive securities regulations – including the net capital, customer protection, and sales practice rules, as well as the overlay of FINRA regulations – have driven securities activities into entities with capital and sales practice standards that are less rigorous. Any efforts to close regulatory loopholes should consider and harmonize these differences with regard to securities activities across all legal entities.

- **Oversight of the supervision function**

  Supervisory agencies, like the institutions they regulate, rely on policies and procedures, internal controls, and management information systems to elevate issues to senior management or Board members, ensure quality of the supervisory product, and assure appropriate checks and balances.

- **Regulatory independence**

  Critics argue that supervisors may get too close to the institutions they supervise, impeding the appropriate skeptical and independent approach.

a. Other national supervisors have chosen not to exercise supervision through on-site examiners, preferring instead roving teams of examiners or reliance on outside auditors. The UK FSA recently considered, and again rejected, the on-site examination model. Similarly, within the US, other types of government supervisors follow varied models. What are the costs and benefits of relying on on-site examiners? What would be the benefits and risks of enlisting the expertise of outside experts?

As noted above, the SEC's ANC program is one of continuous, though generally not on-site, supervision. We note, as events of the past year have confirmed, that the stability of financial institutions is unrelated to whether their examiners remain on-site or off-site or how many examiners are dedicated to a particular institution. Moreover, regulators may be on-site but may be physically isolated from the activities that they are charged with monitoring. More important is access to information from knowledgeable personnel who are competent and authorized to speak to relevant subject matter at the supervised firms.

e. How does your agency monitor the skepticism and independence exhibited by examiners and program managers in the exercise of their supervisory

judgments? What checks and balances does your agency have in place? What further steps is your agency contemplating?

The BDRO's cross-firm approach requiring staff to monitor multiple firms at once encourages staff to maintain skepticism and independence in the review and analysis of information provided by the firms and thus the exercise of supervisory judgments. Similar institutions generally encounter similar challenges or successes in the same market environment, so outliers in terms of information provided/results reported stand out.

- **Resources**

Insufficient examiner resources and expertise may have been a significant cause of supervisory failure during the financial crisis.

a. What are your agency's lessons learned about staffing, resources, and expertise?

An important lesson is that critical financial and risk management controls cannot just exist on paper. They must be staffed appropriately and well-resourced. Whether a supervisory program maintains staff on-site at regulated entities, or engages in frequent in- person meetings, the quality of the program must combine an ability to focus and follow up on risk management issues as they develop with an ability to gain the attention of senior management of the firm.

We feel it is important that the competencies of monitoring and inspection staff are equal to that of the firm's personnel regarding the relevant topic. Having a multi-discipline staff is key. Generalists with substantial experience across the breadth of issues and firm relationships should complement their skills with those of experts in relevant quantitative specialties. This is an approach that BDRO uses, which is similar to the model employed by bank regulators (e.g., the Federal Reserve Banks' CPC teams along with specialized exam teams as well as other regulators such as the UK FSA.