TESTIMONY OF
MARC E. LACKRITZ
PRESIDENT
SECURITIES INDUSTRY ASSOCIATION

BEFORE THE
HOUSE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

UNITED STATES HOUSE OF REPRESENTATIVES

"A REVIEW OF REGULATORY PROPOSALS ON BASEL CAPITAL AND COMMERCIAL REAL ESTATE"

September 14, 2006

CSE: A Framework for Prudential Supervision

Mr. Chairman and Members of the Subcommittee:

My name is Marc Lackritz, and I am President of the Securities Industry Association (SIA).[1] I appreciate the opportunity to testify today on Basel II as incorporated into the Securities and Exchange Commission's ("SEC") framework for Consolidated Supervised Entities ("CSE"). Capital adequacy and prudential supervision are absolutely fundamental to the regulation of the financial services industry, and we commend the subcommittee for holding this timely hearing.

---

[1] The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2005, the industry generated an estimated $322.4 billion in domestic revenue and an estimated $474 billion in global revenues. (More information about SIA is available at: www.sia.com.)

My testimony will focus on three key points: 1) the origin of CSE; 2) how the CSE structure operates; and 3) a brief discussion of how well the framework has worked in practice.

Evolution of Framework

In response to global competition and customer demand for new products and services over the last several decades, the number of large financial conglomerates has grown significantly. These financial intermediaries – banks, brokers, and insurers – no longer engage solely in activities that have traditionally been regulated on a purely functional basis. As a result, both regulators and market participants recognized the need to obtain a comprehensive view of *all* of a firm's activities, as distinct from an individual line of business. The risk of potential systemic problems in the capital markets led to the conclusion that a form of *consolidated* supervision of such conglomerates was necessary.

In early 1996, the Joint Forum on Financial Conglomerates ("Joint Forum") was established under the sponsorship of the Basel Committee on Banking Supervision (the group responsible for the various Basel Capital Accords), the International Organization of Securities Commissions, and the International Association of Insurance Supervisors to deal with issues common to the banking, securities and insurance sectors, focusing especially upon oversight of financial conglomerates. In early 1999, the Joint Forum published a collection of papers on this subject under the title of "Supervision of Financial Conglomerates."[2] That document proved to be very influential in Europe, particularly in the context of the European Union's ("EU") Financial Services Action Plan ("FSAP")[3] that was developed to create a single market in financial services throughout the EU.

---

[2] *Supervision of Financial Conglomerates*" Papers prepared by the Joint Forum on Financial Conglomerates, February 1999.
[3] The FSAP is a set of 42 separate legislative and non-legislative measures in banking, insurance and securities, which collectively provides a plan for European financial services market integration. It groups the various proposals into three broad categories: 1) the development of a single EU institutional market; 2) open and secure retail markets; and 3) developing state-of-the-art prudential rules and supervision.

One of the top FSAP priorities was the development of legislation for the prudential supervision of financial conglomerates, which ultimately resulted in a document entitled the Financial Conglomerates Directive ("FCD").[4] The FCD mandates that any financial firm with significant operations in the EU demonstrate that it is subject to and in compliance with a regime of consolidated supervision. Under the terms of the FCD, any non-EU firm must prove that it is subject to consolidated supervision by its home regulator that is "equivalent" to that required of EU firms. A failure to demonstrate equivalency would require that the firm's EU operations be "ring fenced" from the remainder of its global activities, and that it have an EU regulator undertake supervision of its EU-based operations. Although London is the most significant location for the EU-based transactions of U. S. securities firms, the United Kingdom's lead financial regulator, the Financial Services Authority, expressed doubts about its ability to adequately supervise a non-EU-based financial conglomerate.[5]

Similarly, EU representatives – after discussions with the SEC in 2001 and 2002 – expressed doubt that the SEC's existing supervisory regime applicable to the material affiliates of broker-dealers would be judged "equivalent" to the EU requirements. Consequently, the SEC undertook to craft a new regulatory framework for consolidated supervision of major independent investment banks not otherwise subject to consolidated supervision. The agency published the initial CSE proposal in October 2003[6] and received more than 20 responses from private and public commentators, both foreign and domestic. The SEC then made a number of amendments to the proposal and finalized the CSE framework in June 2004.[7]

---

[4] The FCD was finalized in December 2002, and made applicable to firms with financial years beginning on or after January 1, 2005. Directive 2002/87/EC of the European Parliament and of the Council, 16 December 2002.

[5] "We do not believe that it will generally be feasible for the EU coordinator to achieve the oversight of major third country [i.e., non-EU] banking and investment groups and conglomerates necessary to assess whether they have adequate capital and adequate systems and controls and management at the top of the financial group. . . . . It is not likely, therefore, that we will apply worldwide group supervision to [such] banking and investment or financial conglomerate groups." "Financial groups," Consultation Paper 204, p. 45, FSA and HM Treasury, October 2003.

[6] Rel. No. 34-48690 (Oct. 24, 2003), 68 Fed. Reg. 62872 (Nov. 6, 2003).

[7] Rel. No. 34-49830 (June 8, 2004), 69 Fed. Reg. 34428 (June 21, 2004).

Operation of Framework

Overview -- Under the CSE framework, the SEC supervises certain broker-dealers, their holding companies, and affiliates on a consolidated basis, focusing on the financial and operational status of the entity as a whole. The goal is two-fold: first, to reduce the possibility that some problem within the holding company and/or an unregulated affiliate could endanger regulated entities; and second, to reduce any potential systemic threat to the capital markets as a whole.

Parallel with the requirements of other global consolidated supervisors, the CSE framework incorporates significant elements of Basel II.[8] Although Basel II was not yet in effect when the first CSE applications were approved, it is an element of the new framework. Partly this was due to its status as an internationally agreed capital standard, and partly based upon practical considerations. Otherwise, the CSE applicants would have had to bear the cost of implementing Basel I on a firm-wide basis only to replace it with Basel II shortly thereafter. The CSE framework permits the broker-dealer of a CSE registrant that is judged as having strong internal risk management practices to utilize their own mathematical modeling methods, such as value-at-risk ("VaR") models and scenario analysis, to compute their capital requirements. The SEC must be notified if the broker-dealer's capital falls below $5 billion.

Application process -- In reviewing a CSE application, the SEC staff assesses the firm's financial position, the adequacy of the firm's internal risk management controls, and the mathematical models the firm will 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.

[8] Facing severe time constraints, the first SEC approved CSE applicant utilized Basel I, but subsequent applicants implemented Basel II.

Additionally, a firm's ultimate holding company must consent to group-wide consolidated supervision by the SEC. Among other things, the firm's holding company must agree to:

- Maintain and document an internal risk management control system for the affiliate group;
- Calculate a group-wide capital adequacy measure consistent with Basel Standards;
- Agree to SEC examination of the books and records of itself and its affiliates, where those affiliates do not have a principal regulator;
- Regularly report its financial and operational condition, and make available to the SEC information about itself or any of its material affiliates; and
- For those affiliates that are not subject to SEC examination, make available examination reports of their principal regulators.

Continuing oversight -- Following approval, the SEC staff reviews monthly, quarterly, and annual filings containing financial, risk management, and operations data on the CSE registrant. These reports include consolidating financials (which show inter-company transactions not included in the preparation of consolidated financial statements) and risk reports substantially similar to those provided to the firm's senior managers. At least monthly, the holding company files a capital calculation made on a consolidated, group-wide basis consistent with Basel standards.

Additionally, the SEC staff meets at least monthly with senior risk managers and financial controllers at the holding company level to review the packages of risk analytics prepared at the ultimate holding company level for the firm's senior management. The focus is on the performance of the risk measurement infrastructure, including statistical models; risk governance issues, including modifications to and violations of risk limits; and the management of outsized risk exposures. There are also quarterly meetings to review financial results, the management of the firm's balance sheet, and, in particular, balance sheet liquidity. Also on a quarterly basis, SEC staff meets with the internal audit department to discuss audit findings and reports that may bear on financial, operational, and risk controls. These regular discussions are augmented with focused work on risk management, regulatory capital, and financial reporting issues.

In conjunction with the staff of relevant self-regulatory organizations, SEC staff also conducts examinations of the books and records of the registered broker-dealer and material affiliates that are not subject to supervision by a principal regulator. The examinations focus on the capital calculation and on the adequacy of implementation of the firm's documented internal risk management controls.

Perception of the Framework

The first CSE applicant was approved on December 23, 2004 with four additional applicants gaining approval between March and November 2005.[9] Shortly after publication of the final CSE framework by the SEC in July 2004, the EU provided general guidance indicating that the framework is "equivalent" to the form of consolidated supervision required under the FCD. And with the U.K.'s FSA acting on behalf of the EU, that finding has been subsequently affirmed in its having made equivalence decisions for each of the individual CSE registrants.

There are at least two dimensions to these equivalency determinations. The CSE framework itself had to demonstrate that it established a high standard for a registrant's internal controls, risk management infrastructure, and capital resources, and that it would be applied in a rigorous fashion by regulators. But it was also necessary to show that cooperation of supervisors across borders would be a central feature of the framework. Each of the CSE firms has large and important affiliates that are functionally regulated in other jurisdictions, in large measure by the FSA in London. While the SEC – as the home regulator – must take the lead in overseeing these firms, foreign regulators have an understandable and perfectly legitimate interest in knowing the overall financial

[9] On August 11, 2006, the SEC approved an application that will permit the broker-dealer of a bank holding company already subject to consolidated supervision to utilize the alternative method of computing net capital set forth in CSE. But as the SEC does not purport to provide consolidated supervision of the entity as a whole, strictly speaking it is not a CSE firm *per se*.

condition of the holding company, and obtaining some comfort that the local entity will not be imperiled by events elsewhere in the group. A structure had to be created that facilitates a high level of cooperation between U.S. and foreign regulators. The EU decision on CSE equivalency is a clear statement that the framework is a solid success.

Conclusion

While all five CSE firms found the examination and implementation of the CSE framework challenging and rigorous, they also found it to be flexible and practicable. We wish to congratulate the SEC for the implementation of a new framework for consolidated supervision in a very timely fashion. It required a great deal of work by the Commission and its staff in a relatively short period of time, and we regard it as an excellent example of prudential supervision.

The CSE firms also wish to thank this Committee – and members of the Administration, particularly Treasury – for their interest in learning about the CSE framework, and most importantly in ensuring that the process of finding of “equivalency” by the EU was both fair and timely.

Thank you.