Testimony of Robert L.D. Colby
Acting Director, Division of Market Regulation
U.S. Securities and Exchange Commission

"Prudential Supervision of U.S. Securities Firms"

Before the Subcommittee on Financial Institutions and Consumer Credit
U.S. House of Representatives

September 14, 2006

Chairman Bachus, Ranking Member Sanders, and Members of the Subcommittee:

As the Acting Director of the Division of Market Regulation of the Securities and Exchange Commission, I am very pleased to have the opportunity this morning to describe the Commission's program for monitoring capital at U.S. securities firms.

Generally, each broker-dealer registered with the Commission must comply with the Commission's net capital rule, Rule 15c3-1 under the Securities Exchange Act of 1934. The net capital rule is intended to be a conservative capital standard that requires broker-dealers to maintain liquid assets in excess of their liabilities. Illiquid assets, such as most unsecured receivables, are deducted in full when calculating a broker-dealer's net capital. Further, when calculating net capital, a broker-dealer is required to take additional deductions, known as haircuts, with regard to its proprietary securities positions. The net capital rule is designed to require that a broker-dealer have sufficient liquid assets to meet all of its obligations to customers and other market participants in an insolvency, without the need for a formal liquidation proceeding or the use of the Securities Investor Protection Corporation's fund.

Although the net capital rule has been an effective capital measure for registered broker-dealers, as securities business expanded and broker-dealers became part of international financial conglomerates, the Commission became increasingly concerned about the risk that a broker-dealer may fail due to the insolvency of its holding company or affiliates. This risk was exemplified by the bankruptcy of the Drexel Burnham Lambert Group in 1990 and the consequent liquidation of its broker-dealer affiliate. Post-Drexel, the Commission took a number of initiatives to conduct group-wide risk assessments of financial institutions that have significant broker-dealer subsidiaries. The initiatives included (1) Commission implementation of the Market Reform Act of 1990 to require that larger broker-dealers report certain risk assessment information to the Commission about their material affiliates, (2) encouraging the creation of the Derivatives Policy Group consisting of securities firms active in over-the-counter derivatives that agreed to voluntarily provide information to the Commission about their unregulated over-the-counter derivatives activities, and (3) the Commission's program for supervision of over-the-counter derivatives dealers that register as limited broker-dealers. These initiatives

assisted the Commission in understanding how investment banks with large broker-dealer subsidiaries manage risk globally at the group-wide level.

Building upon those initiatives, in 2004 the Commission amended its net capital rule to establish a voluntary, alternative method of computing net capital for well capitalized broker-dealers that have adopted strong risk management practices. This alternative method permits a broker-dealer to use mathematical models to calculate net capital requirements for market and derivatives-related credit risk. As a condition to that exemption, the broker-dealer's ultimate holding company must consent to group-wide Commission supervision, thus becoming consolidated supervised entities, or CSEs. Formally supervising the financial condition of the broker-dealer holding company and its affiliates on a consolidated basis allows the Commission to monitor better, and act more quickly in response to, any risks that affiliates and the ultimate holding company will pose to regulated entities within the group or the broader financial system.

The Commission's program to supervise the CSEs also responded to concerns of the U.S. investment banks regarding the application of the European Union's Financial Conglomerates Directive to their activities in Europe. The Directive requires that firms active in Europe be supervised at the group level under a regulatory approach equivalent to those applied in the European Union, or face significant restrictions on their activities. The European Union recognized that there is broad equivalence in the Commission supervisory approach with respect to the CSE oversight program.

Currently, five U.S. investment bank holding companies, The Bear Stearns Companies Inc.; Goldman Sachs Group, Inc.; Lehman Brothers Holdings Inc.; Merrill Lynch & Co., Inc.; and Morgan Stanley, are supervised as CSEs. In addition, Citigroup Global Markets Inc., a broker-dealer subsidiary of Citigroup Inc., has received an exemption to use the alternative method to compute its net capital. A broker-dealer whose holding company already has a principal regulator, such as Citigroup, can apply for the alternative method for computing net capital, and the CSE rules rely on supervision by that principal regulator as a basis for substantially less direct Commission supervision of the holding company than one that does not have a principal regulator.

Under the Commission's CSE program, the ultimate holding company must provide the Commission with information at the group level covering its global businesses, whether or not these activities are conducted in functionally regulated entities such as banks or broker-dealers. Those affiliates that do not have a principal financial regulator, as well as the holding company itself, are subject to examination by the Commission. The CSE rule also requires monthly calculation at the holding company level of a capital adequacy measure that is designed to be consistent with the standards adopted by the Basel Committee on Banking Supervision. This should allow for greater comparability of a CSE firm's financial position to other international securities firms and banking institutions.

In requiring a holding company calculation of capital in accordance with the Basel standard, the CSE rules do not specify that capital adequacy be calculated using the

original framework, Basel I, or the revised framework, Basel II. Likewise, the rule does not prescribe the use of the "advanced" approaches contained in Basel II that make extensive use of internal models in the computation of credit risk capital charges. Nonetheless, four of the five CSE firms elected to satisfy the CSE capital calculation requirement by applying Basel II and its advanced approach to credit risk exposure, and the Commission agreed to that approach. These firms were concerned that if they used the standardized approach for calculating credit risk capital requirements, they would be viewed as being less sophisticated than other internationally active institutions. The fifth firm, who because of its fiscal year was confronted with a period of only six months between publication of Basel II by the Basel Committee and the effective deadline imposed under the EU Financial Conglomerates Directive, opted to apply Basel I. This firm is now in the process of preparing to implement Basel II.

When the CSE firms began in earnest to implement Basel II during the latter part of 2004, the only complete description of the standard was the "midyear text," published by the Basel Committee in June 2004. Thus this text served as the basis for implementation of Basel II by the CSE firms.

This is not to say that the implementation of Basel II by the CSE firms has been simple. Commission staff has worked collaboratively with our banking colleagues to address issues that are central to the CSE firms. The staff believes that the CSE firms have implemented Basel II in a manner that is conservative while also reflective of the fundamental nature of securities firms and their business model.

Looking ahead, when the US banking regulators formally issue the draft Notice of Proposed Rulemaking regarding the implementation of Basel II, Commission staff will review the document carefully to apply the proposed approaches to securities firms in the context of their history, risk profile, and business mix. Areas that will be reviewed during this process undoubtedly will include the treatment of private equity positions, the allowed methodology for computing the exposure at default for over-the-counter derivatives and similar transactions, and conditions for the recognition of collateral for capital purposes. Where further modifications to the calculation methodologies used by CSE firms are warranted, the Commission has authority to require their adoption. The CSE firms understood, when they elected to apply the Basel II standard during 2005, that the standard was still very much a work in progress, and that they were likely to have to make various adjustments as the broader US implementation process moved forward.

One final note: in addition to the Basel capital calculation required of CSE firms, the Commission also requires CSE firms to meet certain liquidity risk standards. Securities firms rely on a wide range of funding sources, notably repurchase and repurchase-like secured financing of assets. In the face of any crisis – whether real or only perceived – secured lenders are likely to require significantly more collateral, while unsecured lenders may disappear altogether. Because the CSE firms do not have a lender of last resort, they must conscientiously manage this liquidity risk through their own resources. There are a number of instances where securities firms that were adequately capitalized by the measures of the day collapsed because the asset side of the balance sheet proved

insufficiently liquid to withstand a stress event. Thus, under the CSE program, the Commission looks not just at capital adequacy, but also at the liquidity of the assets being supported by that capital through an additional set of standards. Generally, each CSE firm must have sufficient stand-alone liquidity and sufficient financial resources to meet its expected cash outflows in a stressed liquidity environment for a period of at least one year. To meet these standards, each CSE firm holds a substantial amount of liquid assets that are available to the ultimate holding company and its subsidiaries to deal with a crisis or perceived crises anywhere within the organization.

In summary, we are confident that the CSE firms are currently calculating a capital adequacy measure consistent with Basel II in a manner appropriately sensitive to the risks assumed by the firms. To the extent that further modifications of the calculations become necessary in order to continue to achieve this primary goal, while maintaining to the maximum extent possible consistency with national and international regulatory authorities, the Commission has both the commitment and the regulatory authority under the CSE rules to ensure that the appropriate changes are made.

Thank you again for inviting me to appear before you today and I am happy to answer any questions you may have.