

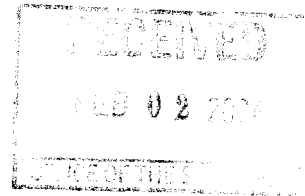
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January 22, 2004

S7-21-03



Jonathan G. Katz, Secretary,
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: **File number [S7-21-03]:** Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities

Mr. Katz:

I question the efficacy of utilizing Value at Risk (VAR) to compute capital requirements for U.S. broker dealers and the necessity to simultaneously lower their capital requirements given the Commission's mandate to protect ALL market participants.

The proposal referenced above establishes Consolidated Supervised Entities (CSE). In return for granting the Commission increased oversight of broker dealers and their affiliates within a CSE, firms opting for this structure may use Value at Risk to compute capital requirements, demonstrate that they have consolidated supervision at the holding company level that is "equivalent" to EU consolidated supervision and enjoy lower capital requirements.

Although VAR is an accepted tool for risk management, I question its use to compute capital requirements for U.S. broker dealers and I encourage the Commission to avoid a revision of the capital rules for U.S. broker dealers that may undermine the protection they afford U.S. customers and market participants.

The FDIC, along with the Comptroller of the Currency, has expressed concern about reduced bank capital requirements proposed by the Federal Reserve. They voiced the notion that the methods used to compute the requirements and the reduced requirements themselves might prove inadequate in safeguarding depositors, investors and the financial industry since "No one knows how to measure the 100-year flood plain..." I believe the same concerns relate to the application of VAR to broker dealer capital requirements and the proposed lowering of those same requirements.

According to Roger Lowenstein in *When Genius Failed: The Rise and Fall of Long-Term Capital Management*, LTCM utilized a VAR model that obviously proved to be inadequate. Had LTCM been a broker dealer utilizing the proposed methodology and capital multipliers proposed, would the near implosion have been avoided? Would the methodology have done a better or worse job protecting the system and its participants?

How would VAR have fared on Black Monday in 1987 when nearly 1068 NYSE securities reached new 52 week lowsⁱⁱ, declines outnumbered advances 1973:52ⁱⁱⁱ and the implied volatility of at the money S&P 100 options increased from under 40% to over 150%? ^{iv}

Market risk VAR is based on historical data and the computation of volatilities and covariance. Lowenstein cites Mark Twain as commenting that history rhymes, but does not repeat. ^v As such, VAR is only as good as the data it is fed and the applicability of the time period being examined. Firms will assess their risk using the tools available to them, but the Commission need not adopt those same tools to define capital requirements for U.S. broker dealers.

In the proposal, the Commission writes "The principal purposes of the net capital rule are to protect customers and other market participants from broker-dealer failures and to enable those firms that fall below the minimum net capital requirements to liquidate in an orderly fashion without the need for a formal proceeding or financial assistance from the Securities Investor Protection Corporation."^{vi} The CSE proposal increases the oversight capabilities of the Commission and may provide a more level playing field for U.S. firms in Europe, but it does little to enhance or ensure the protection mentioned above.

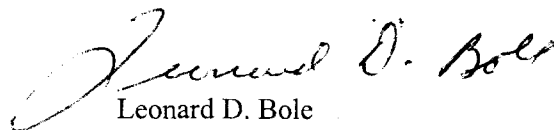
Currently, a broker dealer would be charged 5% or 7.5% of the value of stock basket hedged by an index product such as a future or exchange traded fund. This requirement applies even if the stocks in the basket are in the exact proportion of the underlying index and, as such, represent a basket that perfectly matches the index. A VAR approach to this same position should generate little if any risk since the underlying index product cannot move unless its components stocks, represented in the stock basket, move accordingly. With the stroke of a pen, capital requirements are removed! Has the trading environment changed sufficiently since 1997, when the current requirements were enacted, that the Commission is confident that current requirements in examples such as these can be disregarded?

I suggest that the Commission, in the interests of following its mandate to protect customers, require that U.S. broker dealers that are part of a CSE continue to compute capital requirements in a manner that does NOT dramatically lower those requirements and thus remove a safety net below the investing public. The Commission can expand its purview and a CSE can compete more effectively in Europe if this proposal is adopted even WITHOUT the lowering of U.S. broker dealer capital requirements. Just as multinational corporations in other industries deal with a myriad of tax, environmental and security laws in the various jurisdictions in which they operate, so, too, can a CSE deal with a more conservative calculation of net capital in the U.S. while utilizing a more lenient VAR approach for its overall risk assessment.

The proposal offers a trade off: the Commission obtains greater oversight and the firms who opt for this structure are in compliance with the European mandate for consolidated supervision at the holding company level. This quid pro quo should provide adequate incentive to those firms seeking recognition as a CSE WITHOUT the added inducement of lowered capital requirements for U.S. broker dealers. If the Commission decides that the lower VAR requirements are adequate, they should resist any industry pressure to provisionally approve CSE applications or to fast track the entire process.

Lowering capital charges for US broker dealers in return for greater regulatory control could erode the system that has safeguarded US investors. By all means, work with the large firms to facilitate a level playing field in Europe, but at the same time continue to protect market participants in this country by preserving the safety net afforded by the current capital requirements.

Yours truly,



Leonard D. Bole

ⁱ Wall Street Journal, *Rules on Bank Capital Draw Fire*, December 8, 2003.

ⁱⁱ New York Times, October 20, 1987.

ⁱⁱⁱ Ibid.

^{iv} <http://www.sniper.at/stock-market-crash-of-1987.htm>

^v Roger Lowenstein, *When Genius Failed* (Random House, 2000), 75.

^{vi} Securities and Exchange Commission, *Proposed Rule: Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities* (Federal Register, November 6, 2003), 2.