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SEC Regulation of Investment Banks

Testimony before the Financial Crisis Inquiry Commission
May 5, 2010
Washington, D.C.

by

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Chairman Angelides, Vice Chairman Thomas, and members of the Commission: thank you for the invitation to testify about the SEC's regulation of investment banks and the shadow banking system.

I am currently a Professor of Finance at Babson College in Wellesley, Massachusetts. From September 18, 2006 to April 25, 2009, I was the Director of the Division of Trading and Markets at the U.S. Securities and Exchange Commission. My testimony today is my own and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the staff.

Statutory regulation of broker-dealers and investment banks

The Securities and Exchange Commission is our country's statutory regulator of broker-dealers, the regulated entities that buy and sell securities. Since 1934, when the SEC was established, some of these broker-dealers grew into large non-bank holding companies offering a broad variety of financial services. For those large firms known as investment banks, the primary business has always been the securities business, and as such the SEC has traditionally been the firm's primary regulator.

The SEC's regulatory policy toward investment banks has two important parts. The first part is the regulation of the broker-dealer subsidiaries. A large investment bank will generally have one or more U.S. broker-dealers, for which the SEC is the functional regulator. The SEC has a long-standing regulatory regime for regulating broker-dealer finances that centers around two bodies of rules, each focused on the financial and operational condition of the entity: the net-capital rule and the customer protection rule. These rules, together with protections associated with SIPC (Securities Investor Protection Corporation), work to insure that in the event of the failure of a broker-dealer, customers obtain the return of their cash and securities on deposit at the firm. Note that this regulatory regime does not primarily seek to insure the safety or soundness of the broker-dealer. Rather it focuses on the return of customer property.

The second part of the SEC's regulatory policy toward investment banks relates to non-broker-dealer subsidiaries and the top-level holding company itself. These are entities over which the SEC has never had statutory authority. Investment banks are complex firms with hundreds of subsidiaries. Some of these, such as commodities dealers, bank affiliates, or foreign broker-dealers, may have a functional regulator. But the vast majority of the subsidiaries, as well as the holding company of the entire investment bank, lacks a statutory regulator under the U.S. financial regulatory regime. This is the regulatory system laid out in the 1999 Gramm-Leach-Bliley Act. The law provides for mandatory consolidated supervision by the Federal Reserve Board for commercial bank holding companies, including financial holding companies. For investment banks that do not have U.S. banks or bank affiliates within the consolidated group, it provides for a holding company supervision structure that is purely voluntary. Only one relatively small

investment bank opted into this supervision. When the law was passed, the largest investment bank holding companies in the United States were ineligible for even this voluntary statutory regime because they have specialized bank affiliates, such as industrial banks or savings banks.

Thus the U.S. regulatory system for large financial services firms, which was formalized by Gramm-Leach-Bliley Act in 1999, contains no statutory provision requiring investment bank holding companies to maintain any particular level of capital at the holding company or to adhere to the Basel II capital requirements. Nor does the statute provide any regulator the authority to impose liquidity standards or other requirements intended to guard the financial and operational condition of the holding company. Finally, the law does not provide for a consolidated supervisor that is knowledgeable in their core securities business and that would be recognized for this purpose by international regulators.

Following the failure of Drexel Burnham Lambert Group, Inc. in 1990, Congress enacted the Market Reform Act of 1990, which added a new section 17(h) to the Exchange Act. As noted on the SEC's website, "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." Section 17(h) gave the Commission, for the first time, authority to require broker-dealers to provide financial and risk-related information regarding their material affiliates. Although the new statutory authority was an improvement for the Commission's oversight program, the 17(h) authority did not allow the Commission to set

capital or liquidity requirements at the holding company level, and did not give the Commission the authority to examine material affiliates.

The SEC's Consolidated Supervised Entity (CSE) program

Because the existing statutory scheme did not address how and by whom investment bank holding companies with specialized bank affiliates should be supervised, and in part because of the implications of the European Union's Financial Conglomerates Directive, which required consolidated supervision either internationally or at a European level, the SEC adopted its Consolidated Supervised Entities ("CSE") program for U.S. investment banks in 2004. This program, which was terminated in September 2008, was a purely voluntary program. Nonetheless, in 2004 and 2005 the five largest investment banks elected to participate. The CSE program relied on the SEC's authority under the Securities Exchange Act of 1934 to determine net capital rules for regulated broker-dealer subsidiaries of investment banks. In essence, the entire CSE program was constructed around an alternative net capital regime for the broker-dealer subsidiary, which carried as a condition the affiliated holding company's consent to group-wide supervision by the Commission. This was a significant regulatory extrapolation that the Commission believed in 2004 was necessary to fill a significant statutory gap.

After the program was launched in 2004, the Commission supervised the following five U.S. securities firms on a group-wide basis: The Bear Stearns Companies, the Goldman Sachs Group, Lehman Brothers Holdings, Merrill Lynch & Co., and the Morgan Stanley Group. For these CSE firms, the Commission oversaw not only the U.S.-registered broker-dealer, but also supervised the holding company and all affiliates on a consolidated basis.

All of the CSEs were internationally active, traded a wide range of financial products, were connected through counterparty relationships to other large institutions, and provided services to a variety of market participants. The CSE program was approved by the EU as equivalent to the EU oversight program for investment banks.

When a CSE firm had a regulated entity in the consolidated group that was subject to oversight by another functional regulator, the Commission deferred to that functional regulator as the supervisor of the regulated affiliate. We also shared relevant information concerning the CSE holding company with our fellow regulators, both domestically and internationally.

While maintaining broad consistency with established holding company supervision regimes (discussed in more detail below), the CSE program was tailored to reflect two fundamental differences between investment bank and commercial bank holding companies. First, the CSE regime reflected the reliance of securities firms on daily mark-to-market accounting as a critical risk and governance control. Second, the design of the CSE regime reflected the critical importance of maintaining adequate liquidity for holding companies that did not have access to an external liquidity provider. The SEC, unlike the Federal Reserve, did not have a balance sheet available to support the firms in times of stress.

The CSE rule was designed to provide consolidated oversight only to those holding companies affiliated with a large and well-capitalized broker-dealer. The Commission believed that it should only supervise on a consolidated basis those firms engaged primarily in the securities business, and not holding companies affiliated with a broker-dealer that was only incidental to the firm's primary business activity. To this end, the CSE

rules limited the program to firms whose principal broker-dealer met certain minimum requirements for tentative net capital (defined as regulatory capital less deductions of illiquid assets), and subjected these to a tentative net capital early warning requirement of $5 billion.

The CSE program had five principal components: First, CSE holding companies were required to maintain and document a system of internal controls subject to approval by the Commission at the time of initial application. Second, before approval and on an ongoing basis, the Commission staff examined the implementation of these controls. Third, CSEs were monitored for financial and operational weakness that might place regulated entities within the group at risk. Fourth, CSEs were required to compute a capital adequacy measure at the holding company that was consistent with the Basel II Standard. Finally, CSEs were required to maintain significant pools of liquid assets at the holding company for use in any regulated or unregulated entity within the group without regulatory restriction. This liquidity pool was sized to ensure that the holding company had sufficient stand-alone liquidity to meet its expected cash outflows without access to unsecured financing for a period of at least one year. At all times, the CSE program was focused on fulfilling the SEC's explicit statutory responsibility to protect funds and securities of the customers of the investment bank's regulated broker-dealer affiliates.

It is important to note that the CSE program was not the only oversight regime applicable to the CSE firms. The regulated broker-dealers within CSE holding companies were supervised by an extensive staff both at the SEC and at the primary self-regulatory organization, FINRA, which devoted a large amount of resources to overseeing the broker-dealers that are the key regulated entities within the CSE groups. The oversight of the

registered broker-dealer is based on regulation at the SEC and SRO (such as FINRA) level, backed by examinations and enforcement. The oversight of the CSEs at the holding company level is similarly based on rules that incorporate principles of prudential oversight, backed by ongoing monitoring and examinations.

Capital and liquidity at investment banks

The SEC required that, in electing to operate under the CSE program, the holding company had to, among other things, compute and report on a monthly basis its group-wide capital in accordance with the Basel II standards. Like commercial banks, CSEs were required to compute regulatory capital measures at the consolidated level. Further, the holding company had to provide the Commission on an ongoing basis with extensive information regarding its capital and risk exposures, including market and credit risk exposures, as well as an analysis of the holding company's liquidity risk.

With respect to regulatory capital measures, CSEs were expected to maintain an overall Basel II capital ratio at the consolidated level of not less than 10%, consistent with the Federal Reserve's "well-capitalized" standard for bank holding companies. CSEs provided monthly capital computations to the SEC, applying the same Basel II standard used by European financial institutions and then in the process of being adopted by U.S. commercial banks. CSEs were also required to file an "early warning" notice with the SEC in the event that certain minimum thresholds, including some specified with respect to capital measures, were breached or were likely to be breached.

There has been much confusion surrounding the Commission's alternative net capital rule for CSE firms, including the mistaken belief that the rule allowed investment

bank holding companies to increase their leverage. For a complete discussion of this topic, please see my April 9, 2009 speech, a copy of which is attached as an Appendix.

In addition to capital adequacy, the SEC viewed liquidity and liquidity risk management to be of critical importance to the investment bank holding companies. The SEC required each CSE to adopt funding procedures designed to ensure that the holding company had sufficient stand-alone liquidity and sufficient financial resources to meet its expected cash outflows in a stressed liquidity environment where access to unsecured funding was not available for a period of at least one year. Another premise of this liquidity planning was that any assets held in a regulated entity were unavailable for use outside of the entity to deal with weakness elsewhere in the holding company structure. This premise was based on the assumption that during the stress event, including a tightening of market liquidity, regulators in the U.S. and relevant foreign jurisdictions would not permit a withdrawal of capital. Following the credit events in early 2008, this long-standing scenario-based requirement was augmented to reflect the potential impact of other more severe but shorter duration events that contemplate a significant decline in secured funding capacity.

The SEC viewed applying such a "liquidity standard" alongside a capital standard to be critical to the effective supervision of a CSE and, as noted earlier, was a critical distinction between the supervisory regime for commercial and investment banks. Before 2008, liquidity standards were not incorporated into Basel II or other requirements applicable to internationally active firms. In the aftermath of the crisis, requirements have been adopted globally that bear a significant resemblance to those developed under the

CSE program, but which incorporate a variety of lessons learned during 2008 including those relating to the vulnerabilities of secured funding.

The shadow banking system and the SEC

The term "shadow banking" is a reference to those financial institutions that perform economic functions traditionally associated with banks, but that either are not regulated as banks or not substantively regulated at all. These include, but are not limited to, certain hedge funds, structured investment vehicles, money market mutual funds, investment banks, and non-bank mortgage lenders.

A notable feature of the shadow banking system is that these institutions operate without the benefit of a federal safety net or lender of last resort to guarantee the liabilities that they issue. As opaque financial intermediaries, they can be subject to crises of confidence. Most of these firms made extensive use of overnight or short-term financing while simultaneously holding assets of considerably greater duration and lesser liquidity. In the case of investment banks, this secured funding mechanism had been in place for decades, and the fact that short-term financing was transparently secured by marketable assets was regarded by regulators and practitioners as ameliorating the problems inherent in such a funding structure. These assumptions were overturned beginning in the fall of 2007 as the asset-backed commercial paper market began to freeze up. The degree to which maturity transformation – the funding of longer-term assets with secured or unsecured shorter-term liabilities -- should be permitted, and under what terms, outside of the formal banking system and without explicit government-guaranteed backstops, remains an open policy question at this time.

Conclusion

The CSE program adopted by the Commission was developed to fill a serious gap left after the Gramm-Leach-Bliley Act broadly restructured the regulation of financial institutions. Although the investment bank holding companies elected to be supervised by the Commission under the CSE program, thereby complying with applicable capital or capital reporting standards at the holding company and regulated entity level, a number of these firms ultimately were overwhelmed by unprecedented demands for liquidity in a crisis of confidence. Despite these extraordinary occurrences, it is important to note that the cash and securities of customers of the broker-dealer were never imperiled, and remained protected by the Commission's financial responsibility requirements. These experiences challenged a number of assumptions, held by the SEC and by other regulators in the U.S. and around the world, relating to the supervision of large and complex securities firms. A resulting imperative is the need to address explicitly how and by whom large financial firms with a primary securities business should be regulated and supervised, and in the case of financial distress, unwound.

Thank you again for the opportunity to testify about these issues. I am happy to answer any questions you may have.

Appendix

Speech by SEC Staff:
Securities Markets and Regulatory Reform

by

Erik R. Sirri
Director, Division of Trading and Markets

U.S. Securities and Exchange Commission
Washington, D.C.
April 9, 2009

http://www.sec.gov/news/speech/2009/spch040909ers.htm

U.S. Securities and Exchange Commission

Speech by SEC Staff: Remarks at the National Economists Club: Securities Markets and Regulatory Reform

by

Erik R. Sirri[1]

Director, Division of Trading and Markets
U.S. Securities and Exchange Commission

Washington, D.C.
April 9, 2009

Thank you for the kind introduction. It is a pleasure to be here with you today. Before I begin, it is my obligation to remind you that my remarks represent my own views and not necessarily the views of the Commission, the individual Commissioners or my colleagues on the Commission staff.

We are in the midst of one of the most serious financial crises since the 1930s. Systemically important institutions across all three financial sectors — banking, insurance and securities — have either collapsed into bankruptcy or required massive government support to stay afloat. The survivors and newcomers must instill within their firms a culture that promotes long-term stability through prudent risk-taking and rejects the inclination to "bet the company" for short-term and ultimately unsustainable returns. Financial supervisors also bear a responsibility to learn from these events and improve their practices and, where necessary, strengthen oversight of activities that can put a firm at risk of failure.

To this end, we supervisors must seek to identify the core reasons why firms such as Bear Stearns, Lehman Brothers, Wachovia, Washington Mutual, AIG, and Citigroup experienced significant stress or collapsed. In this regard, the Commission is working closely with the other financial supervisors through the President's Working Group on Financial Markets, the Financial Stability Forum and other initiatives to gain an understanding of what went wrong and develop coordinated and targeted regulatory responses.

Today, I want to discuss a Commission action that I believe has been unfairly characterized as being a major contributor to the current crisis. I am referring to the Commission's 2004 rule amendments to the broker-dealer net capital rule that established the consolidated supervised entity (CSE) program. Since August 2008, commenters in the press and elsewhere have suggested that the 2004 amendments removed a leverage restriction that had prevented the firms from taking on debt that exceeded more than

twelve times their capital and, as a consequence, the Commission allowed these firms to increase their debt-to-capital ratios to unsafe levels well-above 12-to-1, indeed to 33-to-1 as some have suggested. These commenters point to the 2004 amendments as a significant factor leading to the demise of Bear Stearns. While this theme has been repeated often in the press and elsewhere, it lacks foundation in fact.

The 2004 Amendments Did Not Undo Leverage Restrictions

First, and most importantly, the Commission did not undo any leverage restrictions in 2004. Rather, I believe that the Commission sought to fill a gap in the statutory system of supervision by offering to the US investment banks, for the first time, a regime of comprehensive consolidated oversight by virtue of its conditions on the broker-dealers. Given pressures from Europe, it was expected that the five largest US investment banks would make the necessary one-time election to be supervised under this regime. Thus the Commission effectively added an additional layer of supervision at the holding company where none had existed previously. While certain changes were made in 2004 to the net capital rule to conform more closely with the methods of computing capital adequacy that would be applied at the holding company, the changes were unrelated to the "12-to-1" restriction.

New Requirements for the Investment Bank Holding Company

Through conditions on broker-dealers, the 2004 amendments provided for information on the CSE investment bank holding companies to be reported in a manner consistent with the capital adequacy standards for US (and international) bank holding companies. The capital adequacy standard is known as the "Basel Accord." Specifically, under these amendments, a CSE investment bank holding company would report allowable capital and charges for market, credit, and operational risk using standards in the Basel Accord. In addition, for the first time, the Commission had the ability to examine the activities of the investment bank holding companies taking place outside the U.S. broker-dealer subsidiary. This allowed Commission staff to get a direct view of the risk taking (and corresponding risk management controls) of the entire enterprise.

Thus, the Commission did not eliminate or relax any requirements at the holding company level because previously there had been no requirements. In fact, the Commission increased its supervisory access to the CSE investment bank holding companies.

Changes to the Broker-dealer Net Capital Rule

The net capital rule requires a broker-dealer to undertake two calculations: (1) a computation of the minimum amount of net capital the broker-dealer must maintain; and (2) a computation of the actual amount of net capital held by the broker-dealer. The "12-to-1" restriction is part of the first computation and it was not changed by the 2004 amendments. The greatest changes effected by the 2004 amendments were to the second computation of actual net capital.

Under the net capital rule, a broker-dealer calculates its actual net capital amount by starting with net worth computed according to generally

accepted accounting principles and then adding to that amount qualifying subordinated loans. Next the broker-dealer deducts from that amount illiquid assets such as fixed assets, goodwill, real estate and unsecured receivables. This leaves the broker-dealer with what is known as tentative net capital, which, generally consists of liquid securities positions and cash. The final step is to take percentage deductions (haircuts) from the securities positions. The percentage deductions are prescribed in the rule and based on, among other things, the type of security (e.g., debt or equity), the type of issuer (e.g., US government, public company), the availability of a ready market to trade the security and, if a debt security, the time to maturity and credit rating. The amount of the deduction is based on the inherent risk in the type of security. For example, a US government security with a maturity of between 9 and 12 months has a haircut of 1% whereas one with a maturity of 25 years or more has a haircut of 6%. An exchange traded equity security has a haircut of 15%. The amount left after deducting the haircuts from the securities positions is the broker-dealer's net capital. This actual amount of net capital needs to equal to or greater than the required minimum amount that is calculated using a different process.

The 2004 amendments changed two elements of the process for computing actual net capital. The more significant change permitted the CSE broker-dealers to reduce the value of the securities positions (the last step in computing actual net capital) using statistical value-at-risk (VaR) models rather than the prescribed percentage haircuts in the net capital rule. This is how commercial banks — under the Basel Accord — had been computing market risk charges for trading positions since 1997. In addition, a special class of SEC-registered broker-dealers that limited their business solely to dealing in over-the-counter derivatives had been permitted to use VaR models to compute haircuts since 1998.[2]

Because the CSE broker-dealers were permitted to use modeling techniques to compute market and credit risk deductions, the Commission imposed a requirement that they file an early warning notice if their tentative net capital fell below $5 billion. This became their effective minimum tentative net capital requirement — under the previous requirement the minimum was $250,000 in net capital (which could be increased to no more than $1,000,000 for market making activity). The $5 billion minimum amount was comparative to the amount of tentative net capital they maintained prior to the 2004 amendments. It was designed to ensure that the use of models to compute haircuts would not substantially change the amount of capital maintained by the broker-dealers. Some commenters have suggested in the press and elsewhere that the use of VaR models allowed the broker-dealer subsidiaries to significantly reduce their capital levels by paying large dividends to their holding company parents. This simply is not the case. The levels of capital in the broker-dealer subsidiaries remained relatively stable after they began operating under the 2004 amendments, and, in some cases, increased significantly.

The "12-to-1" Restriction Was Not Addressed by the 2004 Amendments

The second fatal flaw to the theory about the 2004 amendments is that, as noted above, the "12-to-1" restriction was not even effected by the 2004 amendments. Moreover, even if it had been eliminated, the CSE broker-

dealers would not have been impacted because they had been using a different financial ratio since the late 1970s.

As discussed above, the net capital rule requires a broker-dealer to undertake two computations: one to determine required net capital and one to determine actual net capital. The first computation — required net capital — requires the broker-dealer to use one of two financial ratios prescribed in the rule. The first ratio prohibits a broker-dealer from having aggregate indebtedness that exceeds fifteen times its net capital. There is a corresponding "early warning" rule that requires the broker-dealer to file a notice with the Commission if its aggregate indebtedness exceeds twelve times its net capital. This effectively makes the requirement a 12-to-1 aggregate indebtedness-to-net capital requirement. This financial ratio generally is used by smaller broker-dealers with simpler balance sheets and that do not carry customer accounts.

The second financial ratio requires a broker-dealer to maintain a minimum level of net capital equal to 2% of its customer debit items. This ratio is used by broker-dealers that carry customer accounts — generally the largest broker-dealers — because it relates their net capital requirement to the amount of customer obligations ("debit items") they originate. Customer debit items are obligations of customers to the broker-dealer arising from, for example, margin loans. The "early warning" rule requires notice when net capital falls below 5% of customer debits making that ratio the effective minimum requirement. The broker-dealer subsidiaries of the investment banks used the 2% of customer debit items ratio to compute their minimum net capital since the 1970s.

Moreover, the 2004 amendments did not eliminate these ratios from the net capital rule, nor exempt any broker-dealers from adhering to them. As discussed above, the changes to the net capital rule primarily impacted the computation of actual net capital. Thus, the broker-dealers subject to the 2004 amendments continued to compute their minimum net capital requirement using one of the two financial ratios prescribed in the rule and, as noted above, they used 2% of customer debits ratio (not the "12-to-1" restriction).

The "12-to-1" Restriction was not an Absolute Constraint on Leverage

The third fatal flaw in the leverage theory is that the "12-to-1" restriction — incorrectly characterized as a victim of the amendments — was not an absolute constraint on leverage (i.e., it would not have accomplished the results the author suggests). As discussed above, broker-dealers using the "12-to-1" financial ratio are prohibited from allowing their aggregate indebtedness to exceed 15 times their net capital (actually 12 times given the early warning requirement). Viewed another way, they must maintain a minimum amount of net capital equal to at least 1/15 (6.67%) of their total aggregate indebtedness. The net capital rule defines "aggregate indebtedness" and, in doing so, specifies the types of obligations that are and are not included in the calculation. Significantly, the definition excludes obligations that are fully collateralized by a liquid proprietary security. Thus, securities financing transactions are not included in a broker-dealer's aggregate indebtedness for purposes of calculating the minimum

requirement. This means that the aggregate indebtedness standard does not limit the amount of assets the broker-dealer could take on through financing transactions. Substantial portions of the balance sheets of the CSE broker-dealers were comprised of these types of financing transactions.

A Limit on the Broker-dealer Cannot Constrain the Parent

The fourth fatal flaw to the theory is the notion that a requirement applicable to an investment bank's broker-dealer subsidiary could somehow constrain the leverage of the parent.

The investment banks within the CSE program were global financial institutions with operating subsidiaries located around the world. The net capital rule only applied to the US broker-dealer subsidiary of the investment banks. Many of the investment banks' activities — including those with the highest levels of inherent risk — such as OTC derivatives dealing and the originating and warehousing of real estate and corporate loans occurred outside the US broker-dealer subsidiary. The net capital rule alone could not limit the ability of the investment banks to undertake these activities outside the US broker-dealer subsidiary.

Leverage Restrictions can Provide False Comfort

Finally, given the all the discussion about the "utility" of leverage ratios, I believe a little perspective is in order. While the attraction of leverage tests is clear, their implementation is anything but, and can easily provide false comfort. For example, two firms with identical 33-to-1 leverage ratios (assets-to-net worth) may have very different risk profiles. The degree of risk arising from leverage is dependent on the type of assets and liabilities making up the balance sheet. Assets that are highly liquid can be sold quickly to close out financing and, thereby, reduce leverage. The risk arises from assets that cannot be quickly sold or whose sale will cause markets to drop and that are financed with short-term loans.

While some of the investment banks had leverage ratios on the order of 33-to-1, substantial portions of their balance sheets were comprised of secured financing transactions that could be closed out fairly quickly allowing them to de-lever without incurring large losses. For example, they had large matched book repo businesses where the assets were government securities and the liabilities obligations secured by government securities. These transactions can be liquidated or closed out without much difficulty. In addition, the investment banks maintained large stock borrow/stock loan books, which also can be liquidated or closed out in a relatively short time. Similarly, substantial portions of their balance sheets were allocated to customer margin lending, which — because of over-collateralization — were highly liquid assets. Viewing the balance sheets on a risk-adjusted basis to account for the relative safety of these positions would reduce the leverage ratios substantially.

Conclusion

In the coming months, I anticipate that debate over the proper regulation of financial institutions will rage on. The various proposals will provide all of us with an opportunity to evaluate aspects that require improvement and to reflect on that which has worked. I look forward to hearing your views on

these important issues. Thank you.

Endnotes

[1]The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. This speech expresses the author's views and does not necessarily reflect those of the Commission, the Commissioners, or other members of the staff.

[2]The second change related to the treatment of unsecured receivables. As described above, a broker-dealer computes net capital by starting with net worth, adding qualified subordinated loans and then deducting illiquid assets such as fixed assets, goodwill, real estate and unsecured receivables. CSE broker-dealers continued to compute net capital by deducting illiquid assets in full except for one type of unsecured receivable: receivables from OTC derivative counterparties. In the case of OTC derivative receivables, the amendments permitted the CSE broker-dealers to take a deduction based on the creditworthiness of the counterparty using credit-modeling techniques approved for commercial banks in the Basel Accord. The amount of receivables subject to this new provision was relatively small as compared with the amount of securities positions subject to the VaR model treatment.

http://www.sec.gov/news/speech/2008/spch040909ers.htm