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# Lehman Brothers Letter to the SEC

Joseph Polizzotto

David A. DeMuro

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Lehman Brothers Inc.

March 8, 2004

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

**Re: Proposed Rule: Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities (Release 34-48690; SEC File No. S7-21-03)**

Dear Mr. Katz:

Lehman Brothers Holdings Inc. ("LBHI") and Lehman Brothers Inc. ("LBI") (LBI and LBHI are together referred to as "Lehman Brothers") appreciate the opportunity to comment in response to the request by the Securities and Exchange Commission (the "Commission") in Securities Exchange Act Release No. 48690 entitled "Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities" (the "Proposing Release"). In addition to this letter, Lehman Brothers has actively participated in the drafting of and refers the Commission to the letter of the Securities Industry Association (the "SIA") dated February 27, 2004 relating to the Proposing Release. Lehman Brothers concurs with and supports the opinions expressed in the SIA letter and submits this letter to emphasize points that are of particular importance to Lehman Brothers or to elaborate or comment on positions raised in the SIA letter.

Lehman Brothers applauds and supports the Commission in establishing a voluntary alternative method for computing net capital for certain broker-dealers, which must also consent to group-wide Commission supervision, and in setting forth a regulatory regime (the "CSE Rules") to regulate the consolidated supervised entity (the "CSE"). This letter is organized under the following headings: (I) Key Principles and Issues; (II) Consolidated Supervision; (III) Risk Management Principles; (IV) Market Risk; (V) Credit Risk; and (VI) Operational Risk.

## I. Key Principles and Issues

**1. Equivalence** - It is of critical importance that the Commission implement the Proposing Release in such a way that the CSE Rules are deemed to be equivalent to the rules imposed by E.U. financial supervisors and that Basel-like standards will be equivalent.[1] The Commission and its CSE Rules may not be designated as equivalent if the Proposing Release establishes separate and distinct regulatory capital regimes for CSEs and U.S.-based broker-dealers within a CSE. We believe that the U.S. broker-dealer and the associated CSE should ultimately be subject to the same capital adequacy standards.

**2. Coordination and Consistency of Capital Requirements and Calculation Methodologies** - The U.S. broker-dealer and the associated CSE should use identical risk methodologies and capital charge calculations.

**3. Implementation of Standards** - At the time that U.S. firms will be required to report as a CSE, Basel II will not have been agreed to and implemented as a capital standard, leaving in flux the standard to which U.S. firms should be measured until Basel II is adopted in the United States. The Commission should adopt an approach that permits a migration toward regulatory capital minimums until a formalized risk-based framework is adopted. Since Basel II has not been finalized, this will present industry wide practical and logistical implementation issues.

**4. Phase in Approach** - In the Proposing Release, the Commission has set forth a product-based phase in approach to the implementation of a firm's Value at Risk ("VaR") models by product or on a security specific basis. This phase in approach is not appropriate. Broker-dealers do not manage risk on a product basis but rather on a portfolio of instruments, not all of which have identical risk characteristics. We do not consider that using a mixed approach of VaR models for "phased in" products and other standards for remaining products, as proposed by the Commission, would accurately capture the nature of the risk. Moreover, a phased in approach would require CSEs to significantly alter sound and established risk management practices in a costly and time-consuming effort that would later have to be reversed.

**5. Trading Book/Banking Book** - The Proposing Release would place unnecessarily high risk weights upon firms specializing in trading book activities. The resultant high corresponding capital requirements would therefore place these firms at a competitive disadvantage and could simultaneously place a potential strain upon market liquidity. Moreover, the current distinction between the treatment of trading books and banking books within Basel II does not correspond with either our firm's accounting treatment or the risk profile of our trading books.

**6. Inclusion of Long-Term Debt as Capital** - Broker-dealers, which have not been formally subject to consolidated capital adequacy minimums, have, in accordance with the Commission's rules, relied on both long-term and subordinated debt in the management of their capital structures. The exclusion of long-term debt as eligible capital instruments would have a significant detrimental impact on reported capital at the onset of the CSE Rules.

**7. Legal Certainty** - The Commission should articulate objective standards pursuant to which the Commission can take action under rules in the Proposing Release. In particular, the Proposing Release should be more specific about the application process and under what conditions exemptions from Rule 15c3-1 will be granted or revoked.

**8. Approval of Models** - The Commission should presumptively approve VaR models that have been previously approved by the Commission or by another recognized G-10 or equivalent regulatory agency.

**9. Application Review Process and On-site Reviewing Process** - The Commission should specify the details of the application process, including the necessary documents to be filed, and the areas where the Commission will concentrate its review. The Proposing Release should clarify the scope of the Commission's on-site review processes as it relates to Appendix E of the Proposing Release.

**10. Dialogue with Other Regulators and Elimination of Duplicative Filings and other**

**Redundancies** - The Commission should aim to minimize the burden on CSEs by not requiring the consolidated entity to file reports with the Commission that are already publicly available elsewhere. The Commission should specify the format and content of the periodic filings in greater detail. Lehman Brothers urges the Commission to coordinate regulatory oversight with other regulators to ensure that a CSE is subject to transparent regulation and a unified supervisory framework.

## II. CONSOLIDATED SUPERVISION

Our comments below generally follow the order in which the questions are raised in the Proposing Release.

### A. Equivalence

The Proposing Release must impose a regulatory regime that is "functionally equivalent" to the consolidated regulation imposed by the FSA or any other regulator in the European Union that oversees consolidated financial groups. A primary reason for a broker-dealer to elect to be part of a CSE is to have the Commission as its consolidated regulator and to ensure that the CSE or any part of it is not subject to adverse and penalizing treatment by an E.U. regulator. As noted above, it appears that a Basel-like regulatory regime will be deemed to be equivalent to European consolidated supervision, and that the Basel-like methodologies should be imposed at the U.S. broker-dealer as well as the holding company levels. If the regulatory regime that is implemented is deemed not to be functionally equivalent to E.U. consolidated supervision, it will be a factor of greatest importance to a broker-dealer that is considering applying for the alternative capital regime of the Proposing Release.

If consolidated supervision is implemented in a way that is deemed not equivalent to European consolidated supervision, U.S. broker-dealers will be at a tremendous disadvantage in their global operations and would be forced to function in a radically different way. For these reasons, it is very important that the Commission secure a determination of equivalency as soon as practicable. We would also urge the Commission to maintain a dialogue with the E.U. and other regulators so that any changes to the CSE Rules would not be unanticipated by the foreign regulators.

### B. Application Review Process

The Commission should list the documents that are required for application for CSE status, and also, when possible, where the Commission will concentrate its review of the application. The Proposing Release is too vague in specifying the details of the application process, including the documents required, the time in which applications will be reviewed and the standards that the Commission will be using in its review of the application process.

In addition to the requirements of the application process specified in Appendix E, we request that the Commission further specify the basic procedures it will undertake during its on-site examinations. Highlighting the areas of focus will enhance the effectiveness and efficiency of the Commission's examinations, which we understand is a concern, as many examinations will have to be completed within the aggressive time frame established by the E.U. Financial Conglomerates Directive. We believe that the experience gained in the staff's OTC Derivatives Dealer examinations could provide a basis for modifications to this

section of the Proposing Release.

C. Dialogue and Coordination with Other Regulators

We urge the Commission to solicit comments from and meet with other regulatory bodies to ensure that the implementation of the Proposing Release will not unduly or adversely affect the capital or regulatory regimes of other regulatory bodies.

We would also encourage the Commission to collaborate on the industry specific issues that remain outstanding in Basel II, including trading book/banking book, repos, stock borrows and allowable capital definitions.

D. Broker-Dealer and CSE Capital Consistency and Implementation

The U.S. broker-dealer and the associated CSE should operate under the same capital framework, and the same models should be utilized in each entity for the same asset. This will eliminate inconsistent charges across legal entities for the same securities.

Further, we consider that the Proposing Release's ready market provisions should be eliminated. We believe each model will incorporate the appropriate methodology to capture liquidity risk.

It would be difficult for the Commission to implement CSE Rules before Basel II is finalized given the underlying methodology of the CSE Rules is derived from Basel II. Further, as Basel II will not be adopted as a final eligible capital framework by the date of the implementation of the E.U. Financial Conglomerates Directive, the Commission should be flexible in implementing standards and methodologies for calculating regulatory capital.

To assist the Commission in applying various capital regimes, the U.S. broker-dealer and the associated CSE should be required to prepare and submit to the Commission a plan outlining the migration of its current regulatory capital calculation program to a Basel II based regime.

E. Approval of Models

If the Commission or any other equivalent regulator has previously approved a model, the Commission should not require the submission of models for re-approval. Such a model should be presumptively approved.

In addition, the Commission should not delay approval of an application to review models that have been approved by another G-10 regulator or any other regulator recognized as equivalent by a G-10 regulator.

We encourage the Commission to set up a fast track model approval process for new businesses.

F. Inclusion of Long-Term Debt as Eligible Capital

Broker-dealers, which have not been formally subject to consolidated capital adequacy minimums, have, in accordance with the Commission's rules, relied on both long-term and

subordinated debt in the management of their capital structures. As a result, the type of debt issued was primarily driven by economic considerations, including the term, structure and cost of borrowing. Lehman Brothers recommends that long-term debt or a percentage of long-term debt be accepted as eligible capital. If long-term debt is not deemed an acceptable form of capital, Lehman Brothers recommends that the Commission adopt a phase out period for long-term debt as eligible capital. We believe a phase out period would allow firms to modify their capital structure in a more orderly manner.

G. Time frame for Commission Responses

The Commission should be required to respond to an application or a request for approval within a certain time that is specified in the CSE Rules. This time frame should be measured from the date that a completed application is received by the Commission.

In the event that the European Union makes a determination that the CSE Rules are equivalent for purposes of the Financial Conglomerates Directive, it will continue to be of primary importance to many applicants for CSE status that consolidated supervision by the Commission is implemented by the time the Financial Conglomerates Directive is in effect for that firm. CSE status is of such importance to applying firms that have a regulated financial entity located in the European Union, it is necessary that the Commission state in the CSE Rules that the Commission will by the date of implementation of the E.U. Financial Conglomerates Directive in the relevant European jurisdiction either (1) make a final determination regarding approval of a firm's CSE status; or (2) obtain an extension from the European Union so that U.S. firms are not subjected to penalties in Europe because of a lack of equivalent consolidated supervision in the United States.

H. Amendment of Application

Firms should not be required to resubmit its entire application each time an amendment is required. The Commission should confirm that only the discreet changes to applications need to be submitted where necessary.

I. Revocation of License

The Commission should clearly state under what conditions it can revoke a broker-dealer's exemption from the standard haircut method of calculating capital charges. The Commission should exercise such power only in the instance of an intentional misstatement of a material fact by an applicant or material non-compliance with the CSE Rules. The standard articulated in the Proposing Release, "no longer necessary or appropriate in the public interest or is no longer consistent with the protection of investors" is unclear and promotes regulatory uncertainty. A firm should always be given a reasonable time to cure a deficiency. Such cure period should be negotiated by the Commission and the firm.

J. Pillar 3 Disclosures

Lehman Brothers supports Pillar 3 disclosure requirements insofar as they allow for strengthened market discipline. The qualitative and quantitative disclosure requirements outlined in Pillar 3, however, would place an extremely onerous and expensive burden on the financial services industry. Moreover, given that some or all of the information required by supervisors can be made publicly available, the resultant disclosure could involve the

release of proprietary and confidential information.

The Commission should also be mindful of the fact that the level of disclosure required will inundate the marketplace with highly technical and complicated information that may not be fully understood and may be misinterpreted.

K. Dual Registrants

Under the Proposing Release and with limited exceptions, the Commission has authority to regulate all activities undertaken by any entity in the corporate group to which the broker-dealer belongs. At a minimum, the Commission would have inspection rights over all entities in the consolidated group, unless such affiliate is a functionally regulated broker-dealer. We would encourage the Commission to coordinate its regulation of dually registered entities as well as the consolidated entity with other regulators in order to ensure the most efficient use of both regulatory and firm resources.

L. Confidentiality of Application and Filings

The Proposing Release states that the filings will be kept confidential. All information, not merely filings, submitted to the Commission as part of a firm's application for CSE status should be kept confidential by the Commission. It is anticipated also that this requirement would apply to all information, whether oral, written or otherwise, obtained before the formal CSE application is filed with the Commission.

The Commission should take steps to ensure that filings are not provided to the public either directly or indirectly. We also urge the Commission to seek assurance from other regulators that any provision of information by the Commission to those regulators will remain confidential.

CSE applicants would gain greater comfort if the Commission were to formally state that broker-dealers and holding companies are submitting applications and information to the Commission based on the presumption of confidentiality.

III. RISK MANAGEMENT PRINCIPLES

Lehman Brothers appreciates and fully supports the Commission's efforts to develop a capital framework designed to align capital adequacy assessment with an organization's risk profile and risk management framework. Lehman Brothers has highlighted a number of general risk management principles as well as specific issues related to Market, Credit, and Operational Risk in the sections that follow.

A. Trading Book/Banking Book

As the Commission has pointed out in the Proposing Release, there are certain accounting differences between securities firms and banking firms that may require modifications to the manner in which certain Basel standards are applied to investment banking firms. The predominant difference in these accounting rules is that Lehman Brothers, like many other securities firms, marks-to-market its trading book positions on a daily basis. The firm's VaR or other risk management models account for the market risks inherent in its trading book positions.

The Proposing Release would require CSEs to inaccurately categorize some trading book positions as banking book positions thereby placing unnecessarily high risk weights upon positions that are already marked-to-market. The resultant high corresponding capital requirements would therefore place these firms at a competitive disadvantage and could simultaneously place a potential strain upon market liquidity. Moreover, the current distinction between the treatment of trading books and banking books within Basel II does not correspond with either our firm's accounting treatment or the risk profile of our trading books. Moreover, since the hedges associated with some portfolios could be themselves considered trading book positions, even though the underlying asset being hedged has not been deemed as such, capital treatment of the hedge separately could be unduly punitive.

We urge the Commission to join the Basel Committee in its commitment to review and deliver alternative solutions to the current proposal. The Commission's review is of critical importance when considering the treatment of such transactions as OTC credit derivatives, repurchase and reverse repurchase agreements, stock borrowing and lending transactions, other similar collateralized lending transactions, securitizations and prime brokerage activities.

It should be noted that in most if not all of the above areas the Basel Committee has committed to working with industry groups to modify the existing approach and develop solutions more representative of firms' business models and therefore, risk management frameworks.

We would like to draw the Commission's attention to the fact that the collaborative efforts on the part of the Basel Committee and industry participants are not expected to result in solutions by the time Basel II is finalized but rather in time for its implementation, which is planned for 2007.

B. Ready Market Concept

As previously mentioned, Lehman Brothers believes that the concept of a ready market test for a particular asset class should be eliminated from the Proposing Release. Instead, the Commission should review a firm's models to ensure that they incorporate the underlying risks of the particular security or trade covered. Moreover, the model and corresponding backtesting results will provide validation that all potential risks have been captured.

C. Material Change

Lehman Brothers believes, as with the OTC Derivatives Dealer approval process, that changes to models that do not affect valuations of positions or the risk measures, do not constitute materiality. Similarly, if the firm introduces an enhancement or variation to an approved model that does not significantly alter the model, the Commission should not require notification or review. Furthermore, CSEs should have discretion in determining when a material change to VaR and/or maximum potential exposure ("MPE") models takes place. Lehman Brothers expects that the Commission's issues concerning materiality will be addressed through its periodic reviews.

IV. MARKET RISK

Lehman Brothers supports the Commission's efforts to move towards a VaR mathematical

model to calculate market risk. Market risk management is an essential component of Lehman Brothers' overall risk management culture. The Market Risk Management ("MRM") department has responsibility for developing and implementing Lehman Brothers' overall market risk management framework and for the preparation and dissemination of risk reports, developing and implementing the firm-wide risk management guidelines and evaluating adherence to these guidelines. These guidelines provide a clear framework for risk management decision-making. The identification of material market risks inherent in positions includes, but is not limited to, interest rate, equity, and foreign exchange risk exposures.

Lehman Brothers uses a VaR-based approach as one of its main market risk measures. The VaR measure has been firmly integrated into the daily risk management process for several years and covers the full range of products traded at Lehman Brothers. Furthermore, the VaR measure is one of several inputs into Lehman Brothers' Risk Appetite framework as well as the Risk Equity and EVA framework. The amount of equity capital needed to absorb unanticipated losses is determined at a 99.5% confidence level with a holding period of 1 year. For certain products, Lehman Brothers measures potential losses over a longer time horizon.

Lehman Brothers would like to raise the following points regarding sections of the Proposing Release relating to market risk: (1) phase in by product class should be eliminated; (2) the application of multipliers to VaR models; and (3) scenario analysis and other market risk modeling alternatives.

A. Phase in by Product Class should be Eliminated

Given the level of integration into Lehman Brothers' risk management and measurement framework, a phase in approach for different product classes would be inappropriate as complying with the proposed phase in approach would require additional systems modifications and the creation of a parallel process for capital reporting purposes. Additionally, this would very likely distort true risk estimation not least due to the fact that the phase in would require position segregations and a resultant loss of the diversification benefits inherent in large portfolios. In conjunction with the application for OTC Derivatives Dealer status, Lehman Brothers has already provided extensive material demonstrating the robustness of the risk management approach that we apply. As such, we consider that VaR risk management should be used wherever possible and not according to a predetermined phase in schedule.

B. Multiplier for VaR Would Distort Market Risk

The Proposing Release requires the VaR results to be multiplied by a factor of at least three. The need for a multiplier is unclear and seems to be arbitrary rather than based upon statistical models or empirical evidence. The Commission will review and approve each model as well as the backtesting results of said model. If the Commission is attempting to incorporate other risk elements, then these should be identified separately and reflected accurately rather than arbitrarily applying a multiplier to market risk models.

C. Scenario Analysis and Alternative Proxy Risk Modeling are Appropriate

Scenario analysis or other statistical techniques to measure event risk should be used for

those products whose risk is not adequately captured by a VaR model. The Commission should carefully develop uniform procedures for both identifying and evaluating such instruments so as to avoid inconsistent treatment across the CSE community. Also, while lack of market data or the complexity of certain instruments might at first suggest an inability to use a VaR model for assessing risk, we wish to highlight possible alternative solution to these problems.

In many cases, it will be possible to demonstrate that there is an existing instrument already captured by the VaR model that could serve as a proxy for a given new product. The test for acceptance of such proxy would be the theoretical proof that under all relevant market conditions the risk of the proxy would conservatively estimate the risk profile of the new candidate. Generally speaking, this would mean that the proxy is always riskier than the actual instrument. Applying this alternative method would not only be practical by virtue of avoiding the need for bespoke modeling, but would also be more accurate and fair since it would still allow the capture of some portion of portfolio diversification effects. The assumption with regard to the latter point is that scenario analysis results would necessarily stand apart from VaR calculations and therefore would be simply added to the VaR results.

V. CREDIT RISK

Lehman Brothers strongly agrees that employing models for measuring and managing potential exposure is a much more precise and prudent basis upon which to calculate credit risk and associated capital charges than using a "notional add-on" approach. Lehman Brothers' MPE system is the primary analytical tool for estimating and monitoring counterparty potential exposure, management and regulatory reporting of the exposure, and calculating credit risk-based and reserves. Our aggregate MPE measure is another component of our Risk Appetite and Risk Equity framework.

The proposed guidelines surrounding the use of MPE models for calculating capital charges attributable to credit risk contain several points requiring additional clarification and also raise a number of issues requiring further examination and potentially, revision. In their present form, the guidelines may have unintended consequences of over/under-charging in various instances or charging unequally across CSEs for similar risks. At the extreme, they may lead to an adverse concentration of risk. We have highlighted several key themes in the section which follows.

A. Data Requirements

We recommend that the Commission allow CSEs to determine the appropriate time interval of data on a product by product basis for the purposes of modeling credit risk instead of requiring a rigid one-year minimum. To the extent that there is insufficient historical data, CSEs should be permitted to use proxy instruments that have similar price characteristics. For example, in the new issue market a proxy instrument's historical data could be employed. This allows for consideration of marketability where appropriate, a factor that is already incorporated even under the existing net capital rules. In the absence of either of the above, the Commission could allow a CSE to use scenario analysis.

B. Credit Equivalent Amount

MPE simulation models including those used by Lehman Brothers incorporate the current

exposure ("CE") as the starting value for a portfolio and then project future additional potential exposure over time. Thus, the MPE figure includes, as a basis, the current exposure. The proposed Credit Equivalent Amount requires that the MPE be multiplied by an additional factor and the resulting product be added to the current exposure. Given the MPE already incorporates current exposure, it would be excessive to subsequently multiply the entire MPE result by an additional factor as proposed.

C. Impact of Concentration Charges

In the absence of MPE models and supervisory review, it could certainly be argued that some formulaic charge ought to be levied in order to insure against adverse concentrations of risk. Even under such conditions, however, the current exposure is not a reliable basis for judging the amount of credit risk represented by a particular client portfolio. Among other reasons, it is possible for the current exposure to be *de minimis* while the future potential exposure could be very large. Thus, measures of concentration risk should more appropriately incorporate MPE. Under the Proposing Release, the use of advanced risk quantification tools such as MPE models will capture such concentrations in the form of higher potential exposures and, consequently, via the application of risk weights, higher resulting capital requirements. We advocate these tools plus the supervisory review process of Pillar 2 for the management of concentration risk. There is no justification or need for additional charging.

D. Risk Mitigating Effects of Diversification

Capital requirements for credit risk should reflect the non-cumulative risk properties of diversified portfolios of counterparties. One simple example of where diversification arises is from the random occurrence of opposing positions among differing counterparties whose risk of loss depends on mutually exclusive market conditions. For example, if one counterparty portfolio contains positions that are exposed to rising rate scenarios while the other counterparty's positions are exposed to falling rate scenarios, then the CSE could not be at risk of loss to the simultaneous default of both counterparties. Thus the appropriate capital charge for this two-counterparty scenario would be less than the sum of the capital charges for each counterparty calculated separately. As an additional example, counterparties are generally not perfectly correlated to one another and therefore will not simultaneously default. Thus, even were they to have similar trades, the likelihood of loss would not equal the sum of there individual risks.

In general, the appropriate capital charge should be based upon the CSE's model of diversified credit risk that incorporates both potential exposures and default probabilities across counterparty portfolios.

E. Exposure at Default

The Proposing Release bases its calculations for credit risk capital charges on maximum potential exposures measured at 99% confidence levels. Lehman Brothers wishes to point out that counterparty defaults/deteriorations are not necessarily correlated with maximum potential exposures or even rising exposures and may in fact occur, for example, at average or even negative exposures. The extent to which a counterparty default and its level of exposure are correlated depends on a number of factors such as the counterparty's industry, the economic conditions at the time, the types of transactions, etc. Measuring the joint

events of counterparty default and potential exposure is typically carried out by complex simulations. We understand and support the Commission's practical objective of prescribing discrete formulae for determining capital charges for credit risk. However, in order to ensure that the capital charges not become punitive, care needs to be taken to account for this condition.

F. Credit Risk Time Horizons

The appropriate time horizon for measuring the credit risk may not always be one year. For example, collateralized accounts, such as hedge funds, post variance margin as frequently as daily and may exhibit high rates of portfolio turnover such that their positions are significantly changed over the course of a year. For these accounts, a much shorter time horizon may be more appropriate. Alternatively, non-margined accounts may be concentrated in long-dated derivatives such that the peak exposures are heavily back-loaded. For example, currency swaps very commonly exhibit their highest MPE at or near maturity. To limit the credit risk calculation to a one-year horizon for these trades might not only miss a significant portion of the risk but could also adversely incentivize market participants to concentrate in these positions. Consequently, Lehman Brothers recommends that the time horizons that are adopted be tailored to the particular product's risk profile.

G. Credit Risk Weights

Lehman Brothers believes that Credit Risk Weights should be based upon a firm's internal estimates of annual default probabilities. Default probabilities themselves could be derived from either actual historical experience (e.g. NRSRO data) or forward-looking market implied figures or some combination of the two.

In addition if the suggested table of default probabilities and associated credit risk weights is incorporated into the Proposing Release, then it should ideally be updated periodically as new default experience is accumulated. This would be consistent with using dynamic historical data for VaR and MPE calculations.

In addition, the proposed 75% Loss Given Default ("LGD") assumption should ideally become a function of the issuer, industry type and the particular debt class. There is wide variability of LGDs among these combinations. Lehman Brothers recommends incorporating all of these factor combinations, rather than using a presumed average LGD. Employing an average could produce unintentionally biased results, whether detrimental or beneficial, for a given CSE.

H. Accounting for Credit Derivatives

The assumption for this discussion is that a CSE purchases a credit derivative from a Writing Counterparty ("WC") to protect some portion of its portfolio of trades executed with an Underlying Counterparty ("UC"). We would suggest that the current exposure of the Underlying Portfolio could reasonably be adjusted by the current value of the credit derivative. However, the MPE of the Underlying Portfolio should be adjusted by the forecast value of the credit derivative at the time when the MPE is measured. This value will depend on the credit quality of the UC and may be as high as the notional amount (less any recovery). The actual determination of the value would require complex probability calculations or a Monte Carlo simulation.

In the context of measuring risk at one time horizon, e.g. one year, it could be argued that the appropriate offset to the MPE of the Underlying Portfolio would be the notional value of the credit derivative, adjusted for the cumulative default probability of the WC.

I. Backtesting Issues and Timeframes

Quarterly backtesting will require storing static copies of the 40 or more counterparty portfolios over the 3-month timeframes. The Commission should clarify for backtesting purposes that the MPE be calculated once at the beginning of the quarter, then for the static portfolio's current exposures to be monitored over the quarter in relation to the forecast MPE. Otherwise, since the portfolio's composition, and therefore its MPE, is changing each day, the test would only be relevant over a one-day period.

Assuming this is the intention, we wish to remind the Commission of both the Proposing Release's specification that MPE be calculated over a one-year time horizon and our observations above regarding the proprietary nature of setting risk timeframes according to the different margining frequencies among counterparts. We believe that the Proposing Release and our own views on timeframes support the sampling of current exposures for backtesting, every two weeks during the quarter. This will capture the most frequent MPE scenario and likely conforms to industry standards regarding the frequency of MPE estimation on a forward-looking basis.

J. Notification and Reporting Requirements

Under the Conditions Regarding Notification, the 24-hour notification period for backtesting exceptions is insufficient insofar as the CSE would need to first rule out data errors and other system-related issues as the cause for the exception(s).

Generally, the proposed reporting requirements are onerous. Lehman Brothers strongly urges the Commission to avoid duplicative or substantially similar filings where regulatory and/or publicly available risk documents already exist.

VI. OPERATIONAL RISK

Lehman Brothers welcomes the Commission's focus upon and adoption of policies regarding Operational Risk. Lehman Brothers believes that formalizing an operational risk management framework is good business practice and protects the firm, the capital markets and shareholder value. Lehman Brothers supports the development of an approach to Operational Risk that will enable the industry to continue to move towards a more risk sensitive framework.

Operational Risk has become a critical aspect of risk management and has gained focus, as firms deal with issues surrounding the increasing complexity of internal processes and increased exposure to external events. Lehman Brothers believes that risk sensitive approaches and methodologies for Operational Risk are still in early development. Moreover, the development of risk sensitive modeling methodologies and the collection of sufficient operational loss data on which to base a capital charge will not be available for some time, and while applicable to one firm may not necessarily be applicable to another.

A. Preferred Operational Risk Methodology

Ultimately, Lehman Brothers prefers to use an Advanced Measurement Approach ("AMA") to measure operational risk. AMA's afford firms a risk sensitive approach towards measuring and monitoring operational risk. Since operational risk is still in the early stages of development, there is not sufficient data to support a full AMA approach for firms within the timeframe dictated by the Proposing Release. Consequently, the Commission will need to adopt a flexible approach toward evolving methodologies.

The Basic and Standardized Approaches are based purely upon a firm's revenues and do not afford firms an approach that is sensitive to risk management and the control environment. Moreover, the alpha and beta levels employed in these methods are not based upon sufficient empirical evidence. Investment firms in particular have been underrepresented in any prior data surveys.

Lehman Brothers would suggest that the Commission consider implementing a framework whereby the beta coefficients are correlated to a firm's core and non-core businesses. If the Commission takes this approach, a firm's core businesses for which it has more extensive operational risk monitoring, measuring and control systems in place, would be assigned lower beta coefficients. Accordingly, a firm's non-core businesses would be assigned beta coefficients at the higher end of the range. Furthermore, it would be advisable to consider adjusting these beta coefficients in the future as more empirical data is collected.

B. Applicable Confidence Interval

The proposal suggests that a 99.9% confidence interval be applied to any AMA that a firm adopts. Imposing such a confidence interval would be somewhat premature, particularly one this stringent, given the state of development of Operational Risk models and the lack of statistically significant data. We do agree with and fully support establishing a soundness standard for Operational Risk confidence intervals over the long term.

C. Home/Host Allocation for Operational Risk

The Commission should be aware that although not specifically addressed in the Proposing Release, there are a number of unresolved issues around meaningful calculations of AMA capital at the subsidiary level. In order to resolve these issues, an apportionment methodology needs to be developed that will allow for the allocation of subsidiary level capital from the group calculation. In addition, any such methodology will have to be deemed acceptable to both home and host regulators. The Basel Committee has solicited industry advice on this topic and is continuing to work toward an agreeable solution. We would encourage the Commission to engage in this process.

* * *

Lehman Brothers appreciates the opportunity to make our views regarding the Proposing Release known to the Commission and the staff and hope that our letter is helpful. If the Commission or the staff has any questions or think that we might be of further assistance, please contact us (Joe Polizzotto 212 526-2726, jpolizz@lehman.com ; David DeMuro 212 526-0616, ddemuro@lehman.com). We look forward to collaborating with you on this matter.

Sincerely,

______/s/________
Joseph Polizzotto
General Counsel
Lehman Brothers Inc.

______/s/________
David A. DeMuro
Global Head of Compliance and Regulation
Lehman Brothers Inc.

cc: The Honorable William H. Donaldson, Chairman
The Honorable Paul S. Atkins, Commissioner

The Honorable Roel C. Campos, Commissioner

The Honorable Cynthia A. Glassman, Commissioner

The Honorable Harvey J. Goldschmid, Commissioner

Annette L. Nazareth, Director, Division of Market Regulation

Robert L.D. Colby, Deputy Director, Division of Market Regulation

Catherine McGuire, Associate Director and Chief Counsel, Division of Market Regulation

Michael A. Macchiaroli, Associate Director, Division of Market Regulation

Lourdes Gonzales, Assistant Chief Counsel, Division of Market Regulation

Matthew J. Eichner, Assistant Director, Division of Market Regulation

Thomas K. McGowan, Assistant Director, Division of Market Regulation

Linda Stamp Sundberg, Attorney Fellow, Division of Market Regulation

Bonnie L. Gauch, Attorney, Division of Market Regulation

Rose Russo Wells, Attorney, Division of Market Regulation

David Lynch, Financial Economist, Division of Market Regulation

Ethiopis Tafara, Director, Office of International Affairs

# Endnotes

[1] John Tiner, the Chief Executive of the U.K. Financial Services Authority (the "FSA"),

recently noted regarding equivalency, "SEC standards that are `consistent' with Basel rules does not of course mean that they need to be in all respects identical." Speech by John Tiner, "The Practical Implications of SEC Regulation outside the United States," delivered at the Marriott Hotel, London on February 17, 2004.

Governors of the central banks of the G-10 countries established what is now called the Basel Committee on Banking Supervision (the "Basel Committee"), which meets on an ongoing basis to coordinate banking supervision. In 1988 the Basel Committee agreed to the text of the Basel Capital Accord ("Basel I"), which was to be implemented by 1992 and outlined minimum capital standards for internationally active banks. Basel I has been adopted by most banking authorities. Basel I is currently being revised, and the Basel Committee in 2003 proposed a draft of the New Basel Capital Accord ("Basel II"), which currently is anticipated in a best case scenario to be finalized in mid-2004 and implemented in 2007.