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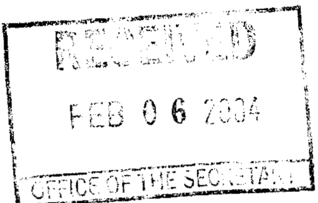

February 5, 2004

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

Re: Release No. 34-48690; File No. S7-21-03; Consolidated Supervised Entities

Dear Mr. Katz:

Merrill Lynch & Co., Inc. and its subsidiaries, including Merrill Lynch, Pierce, Fenner & Smith Incorporated ("MLPF&S"), appreciate this opportunity to comment on the rule amendments proposed under the Securities Exchange Act of 1934 by the Securities and Exchange Commission ("Commission"), as set forth in the above-referenced release (the "Release").

A. Introductory Comments

In brief, the proposed rule amendments would establish an alternative method for computing net capital charges for eligible broker-dealers. The alternative net capital calculation would be conditioned on: the broker-dealer and its holding company obtaining Commission approval; and consenting to group-wide supervision by the Commission as a consolidated supervised entity ("CSE"). To establish this alternative net capital/CSE framework, the Commission has, in the main, proposed to amend Exchange Act Rule 15c3-l by adding a new Appendix E - Market and Credit Risk Charges for Certain Brokers or Dealers, and a new Appendix G - Conditions for Holding Companies of Certain Brokers or Dealers.

More specifically, under Appendix E, a broker-dealer meeting its capital requirements could apply to the Commission for approval to calculate certain of its market and credit risk capital charges using the firm's own internal models for risk measurement. As part of its application, the broker-dealer would be required to submit undertakings on the part of its holding company to be subject to a series of requirements. For example, the holding company would undertake to: (1) permit the Commission to examine the books and records of the holding company and any affiliate that does not have a "principal regulator;" (2) compute allowable capital and allowances thereto; and (3) provide certain reports to the Commission pursuant to Appendix G.

The Release and the proposed rules reflect extensive and thoughtful work on the part of the Commission and its staff. We agree with the Commission's assessment that the proposal, if adopted, would: (1) improve the Commission's oversight of broker-dealers and their affiliate groups' internal risk management control systems; and, (2) also address international developments by implementing consolidated supervision at a broker-dealer's holding company

level that is equivalent to European Union consolidated supervision. More generally, we believe the proposed rules will have a fundamental and positive impact on the risk management practices and supervisory framework for globally active financial services companies.

We support the adoption of the CSE framework and alternative net capital treatment for broker-dealers. We do, however, have some specific comments on various aspects of the capital regimes and the requirements under the application process.

As a general matter, our comments are designed to ensure that the CSE framework can be adopted, while maintaining flexibility as to some specific requirements. Flexibility is, in our view, necessary and appropriate to: (1) ensure that the framework can accommodate global regulatory developments, particularly developments regarding the proposed New Basel Capital Accord ("Basel II"); and (2) ensure that global securities firms maintain their competitiveness with U.S. and non-U.S. banks and bank holding companies.

As the Commission is aware, there are a number of organizations involved in a dialogue on Basel II. We are pleased that the Commission staff will co-chair a joint Basel/IOSCO Working Group that has been recently created. We encourage the Commission and its staff to coordinate with other group efforts related to Basel II implementation across jurisdictions, such as the Accord Implementation Group ("AIG"). Participation by the Commission in these groups' dialogue on Basel II issues and developments will be critical to refining the CSE framework, over time. We welcome efforts of the Commission staff to represent investment firms in appropriate international forums. Such representation will afford the Commission and its staff the opportunity to address capital issues particular to investment firms and, to the extent practicable, minimize inconsistencies in cross-functional and cross-jurisdictional capital regimes.

We hope our comments below will serve to assist the Commission and its staff in refining the proposed rules and are responsive to some of the Commission's questions.

B. Capital Regime

We support the Commission's overall approach to an alternative net capital calculation for broker-dealers and a capital calculation for the CSE, subject to our comments below.

1. Some General Comments

We welcome the Commission's approach to permit modern risk management techniques using mathematical models for market and credit risk in the calculation of broker-dealer capital requirements. In general, this approach will significantly reduce capital requirements, without adversely impacting investor protection concerns.

As to the group-wide capital calculation, we strongly believe that a CSE, over time, should have the ability to manage its capital by using the same capital calculation methodology for each set of assets, wherever such assets are recorded or held within its affiliate group. Accordingly, the adopting release should affirmatively state that the overall goal of the CSE framework will be to permit CSEs and their broker-dealers to utilize the same capital calculation methodology. Towards this goal, we also request that the Commission amend proposed

Appendix E to permit the use of mathematical modeling for certain securities and assets described in Rule 15c3-1 (c)(2)(iv), as well as those described in Rule 15c3-1(c)(2)(vi). There are securities and other assets that fall into the category of "not readily convertible to cash" under Rule 15c3-1(c)(2)(iv), or under certain interpretations thereunder, that should be subject to VaR or scenario-based market risk charges. Otherwise, there will be an unnecessarily wide incompatibility gap between the capital calculation for the same assets at the broker-dealer versus the group-wide level.

Additionally, under the CSE proposal, the alternative net capital calculation would be available only to eligible broker-dealers within the CSE affiliate group that meet the minimum capital requirements. These minimum capital requirements are tentative net capital of $1 billion, and net capital of $500 million. We believe that the Commission should permit other broker-dealers within the CSE group-wide affiliate structure, particularly guaranteed subsidiaries of eligible broker-dealers, to utilize the alternative net capital rule.

2. Transitional and Certain Other Flexibility: We strongly believe the proposed capital regime should reflect a sufficiently flexible framework to anticipate and accommodate developments with respect to market trends, product developments and global regulatory changes and concerns. This is particularly important over the near term. During 2004, the Basel Committee will continue its work on Basel II. In concert, the European Commission is proposing to adopt the new Accord in an update to its Capital Adequacy Directive ("CAD3"). It is generally recognized that there are a number of open issues arising from the proposed application of Basel II to investment firms.[1] And, it is expected that Basel II will not be implemented until January 2007 (with parallel computations in 2006).

With the changes we suggest below, we believe that the CSE framework will remain consistent with both the first pillar (minimum regulatory capital requirements) and the second pillar (supervisory review) of Basel II. More importantly, however, this interim flexibility will afford the Commission the opportunity to engage in a dialogue about these specific requirements as part of its participation in IOSCO and other appropriate international groups.

More specifically, we request flexibility in respect of: (a) the proposed phase-in schedule for implementation of VaR or scenario analyses in the broker-dealer; (b) the calculation of credit risk capital charges; (c) any calculation of operational risk; (d) the definition of a holding company's allowable capital; (e) the specific methodology for the holding company capital calculation; and (f) the frequency and nature of group-wide reports required to be filed with the Commission.

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[1] We have been actively involved in commenting on these issues. See, for example, our November 3, 2003 letter on Docket No. R-1154, Advanced Notice of Proposed Rulemaking: Risk Based Capital Guidelines; Implementation of New Basel Capital Accord issued by the Board of Governors of the Federal Reserve System, and a December 2003 letter on the same and filed by an ad hoc group of U.S.-based global investment banking firms (in which we participated). See also, our July 2003 response to the Basel Committee on Banking Supervision on the Third Consultative Document on the New Basel Capital Accord, and our October 27, 2003 response on the European Commission on the Commission Services Third Consultation Paper. We have also been actively involved in the ISDA and TBMA working groups that have been fully engaged with the Basel Committee in exploring these issues.

(a) Phase-In of VaR Models: In brief, and as a first condition before permitting a broker-dealer to utilize value-at risk (VaR) models for market risk charges, the Commission will need to approve the broker-dealer's application under Appendix E, thereby requiring the holding company to comply with Appendix G. Proposed Appendix E, in paragraph (c)(3), would then permit a broker-dealer to use approved VaR models as part of the alternative net capital rules, only in accordance with a prescribed and lengthy phase-in schedule.

We respectfully request that this phase-in schedule be eliminated. We do so for two reasons. First, given the overall purpose of the alternative net capital calculation, a broker-dealer should be able to obtain its benefits on a more immediate basis, so long as the Commission agrees that the broker-dealer has adequate internal risk management controls. As stated in the Release, large broker-dealers have long expressed interest in having their regulatory capital requirements more closely aligned with mathematical risk management techniques. Such an approach is consistent with the Commission's own experience under its OTC Derivatives Dealer Rules, and under Basel I and II. Furthermore, the use of VaR in the broker-dealer would be consistent with the overall management approach to market risk, currently used by broker-dealer holding companies, on a group-wide basis.

Second, the phase-in schedule is designed to apply to all approved CSEs, permitting use by broker-dealers of the alternative net capital provisions for only specified asset classes, per each stage of the prescribed schedule. Such a strict and restrictive timetable, along with a "one-size-fits-all" approach, does not appear to be optimal or appropriate. A broker-dealer, as part of a CSE, should be able to apply for VaR modeling based on its own business needs and strategies. The demonstration by the broker-dealer of its internal control systems and liquidity levels, along with the Commission's review process, should address any concerns about managing an orderly transition to VaR-based capital calculations for the broker-dealer.

In connection with this discussion, we note that the Commission may approve the broker-dealer's use of "scenario analysis" to compute a market risk capital charge to its capital calculation. This is an appropriate way to measure market risk for those assets that may not be VaR eligible, but that nonetheless should be afforded capital treatment more aligned with modern risk management techniques.

(b) Credit Risk Capital Charges: We recognize that the CSE proposal serves to refine the Commission's approach to credit risk as reflected in its OTC Derivatives Dealer rules. The proposed capital risk credit charge calculation for both the broker-dealer and the CSE appear to be based on Basel II. As described in the Release, the charge is based upon the use of a qualifying VaR model to compute "maximum potential exposure".

As we have noted above, however, Basel II is still under discussion and the EU recognizes that issues have arisen in the application of the credit risk calculation for investment firms, among other issues. We are concerned about the CSE/Basel II credit risk calculation for OTC derivatives in particular. Indeed, we have raised these concerns in our various comment letters mentioned previously in this letter. Accordingly, while we appreciate the forward-looking approach of the Commission and its staff, we believe the proposed rules should be amended to provide for short-term flexibility to permit CSEs to use interim approaches, including Basel I calculations, until such time as Basel II is implemented.

Separately, proposed Appendix E, in paragraph (d)(8), requires a concentration charge by counterparty, where a counterparty current exposure exceeds 5% of the tentative net capital. Paragraph (d)(9) states that a concentration charge across all counterparties for unsecured receivables is 100% of the current exposure in derivatives across all counterparties in excess of 15% of tentative net capital. We believe these charges should be eliminated or set at a higher threshold level, especially in the context of governmental and quasi-governmental agency counterparties. Furthermore, portfolio charges should be grouped by counterparty type and subjected to credit risk weightings, as opposed to 100% charges.

(c) Operational Risk: Under Appendix E, an eligible broker-dealer must describe in its application the method by which its holding company will calculate its allowance for operational risk. As part of Appendix G, the holding company is required to calculate a capital allowance for operational risk consistent with Basel standards as modified from time to time.

The Commission has asked how best to measure operational risk and when such a calculation would be required. In the Release, there is a description of the three Basel II approaches to operational risk calculations. The Commission has asked which method is preferable, and whether any changes should be made to the Basel approaches that would be more appropriate for "broker-dealer business."

We note that the Basel II operational risk calculation is one of the significant areas of concern of investment firms in applying Basel II. We have conveyed a number of our concerns to the Basel Committee and the U.S. banking authorities relating to operational risk capital calculations that have been described in various published proposals. For example, the so-called Basic Approach and the Standardized Approach are not risk-based. Industry studies have shown that revenues have little correlation with operational risk event losses. We continue to have strong reservations regarding the Standardized Approach. The Standardized Approach appears to be based on the view that, from an operational risk perspective, a "trading book" is riskier than a "banking book". We strongly disagree with this view.

As to the Advanced Measurement Approach, it is too subjective for a capital calculation charge. This is due to the scarcity of data relative to a specific 99.9% confidence level interval. This may turn out to be an unfair or unattainable standard. And, we note that certain operational risk events, particularly low-frequency, high-impact ones are unsuited to measurement or evaluation.

At this stage in the evolution of operational risk methodologies, we respectfully request that the Commission delete any references in the proposed rules for an operational risk charge allowance. Alternatively, the Commission should amend the rules to make clear that operational risk need not be calculated until the Basel II implementation date. We believe that there should be a separate effort, after the CSE framework is adopted, to fully vet the questions of operational risk. We would be pleased to work with the Commission towards a reasonable and agreed upon definition of operational risk prior to requiring any artificial or inappropriate measurement as a capital charge allowance.

Finally, we take this opportunity to state that, in our view, the general category of "operational risk" should not be used in a way to require more capital at the holding company level (or in the broker-dealer), due to a broker-dealer's *customer* business. The Commission has ample regulatory tools to address this concern directly, such as through any necessary or appropriate amendments to Rule 15c3-3, its Customer Protection Rule.

(d) Definition of Holding Company's Allowable Capital: At the current time, we do not have any specific changes to the proposed computation of a holding company's "allowable capital" in Appendix G. We do, however, suggest adding a provision that states: "The holding company may, upon approval by the Commission of a request by the broker-dealer in its initial or amended application, compute allowable capital using an approach different from that required under paragraph (a)(1) of this Appendix G." This suggested provision is designed to permit the Commission to account for differences in the businesses as between bank and broker-dealer holding companies, as may be necessary or appropriate, in computing allowable capital, especially during the stage prior to implementation of Basel II to investment firms.

(e) Methodology for Holding Company Capital Calculation: The proposed CSE rules require a capital calculation approach on a "consolidated" basis.[2] The question of how to address group-wide capital adequacy for a diversified financial services firms is a challenging one, and various principled approaches exist. It has been advocated that the consolidated approach may be the desirable, long-term solution for demonstrating capital adequacy for financial services firms. On the other hand, it is also recognized that it may be undesirable or burdensome for a diversified firm to consolidate, for capital purposes, business sectors with different risk profiles, subject to different regulatory regimes.

Accordingly, we suggest that the SEC expand proposed Appendix G so that, until Basel II is implemented, either a consolidated or an "aggregated" approach may be used by the holding company. Under an aggregated approach, CSE would have sufficient capital if available capital exceeds the sum of its subsidiaries' functional regulatory requirements.[3] Such an approach does require, for comparability to the consolidated approach, that capital requirements for inter-company exposures are eliminated and any concentration charges are adjusted to reflect total available capital. For the interim, until the Basel II regime is implemented, we believe the aggregated approach offers a sound, determinant and fairly straightforward measure of capital adequacy. Accordingly, it is important that this approach be one of the available computation methodologies for CSEs. Both the consolidated and aggregated approaches are currently permissible in the EU.[4]

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[2] A consolidated (or "line-by-line") approach determines capital adequacy by comparing the consolidated capital resources to the capital requirements, using one regulatory method, based on the consolidated balance sheet. Under this method, capital computations for assets are performed at least twice, once at the subsidiary level and again at the parent company level as well as potentially at intermediate holding company levels.

[3] More specifically, an aggregated (or "building block") approach uses the existing regulatory capital adequacy calculations prepared for each entity and sums these capital requirements for an aggregate capital requirement to compare to total capital resources. Unregulated entities require a proxy capital requirement. Under this method, capital computations for assets are performed once, at the subsidiary level.

[4] Combinations of consolidated and aggregation approaches are also viable. These two core approaches underpin the four methods set out in the Joint Forums' July 2001 Paper "Capital Adequacy Principles."

In summary, with regard to demonstrating a CSE holding company's capital adequacy, we request that the above-described flexibility be built into the CSE proposals.

(f) Group-Wide/Holding Company Reports to the Commission: Proposed Appendix G would, among other things, require the holding company to submit on a monthly basis, not later than 17 business days after the end of each month that does not end a quarter, a report showing computations of allowable capital and allowances for market, credit and operational risk, computed pursuant to Appendix G. While we support the other monthly report requirements, we would suggest that the capital calculation reports be submitted quarterly.[5] By way of comparison, the U.S. federal banking supervisors (through the FFIEC) require banks to submit call reports (the FFIEC 031), which include consolidated capital and other financial information, on a quarterly basis. Similarly, the Federal Reserve Board requires bank holding companies to file similar reports (the FR Y-9C) on a quarterly basis. The FSA in the U.K. requires a six-month capital calculation report (although, in practice, this may be supplied on a quarterly basis).

As to quarterly reports, Appendix G establishes quarterly reporting deadlines that may conflict with Securities Exchange Act filing deadlines, particularly at year-end. We suggest that the quarterly deadlines be five days after the applicable Securities Exchange Act filing deadlines. This avoids potential issues regarding filing preliminary data at year-end and allows the CSE appropriate time to prepare the required reports.

Proposed Appendix G would also require the holding company to provide a supplemental report by a registered public accounting firm indicating the results of the accounting firms review of its internal risk controls as required by Exchange Rule 15c3-4. The supplemental report must indicate the results of the accounting firm's review of the holding company's inventory pricing and modeling procedures. These reviews must be conducted in accordance with procedures agreed to by the holding company and the accounting firm. The purpose is to confirm that the holding company (presumably through its affiliate group) complies with the qualitative and quantitative standards for models as required under Appendix E.

We are concerned about the requirement relating to an accounting report on "inventory pricing". Similar to our comments in Section C.2 below, an audit review of "inventory pricing" for purposes of the CSE rules would be extremely costly and burdensome without a corresponding benefit. Moreover, the proposal does not set forth sufficiently clear standards for an audit review of models. Accordingly, these proposed requirements should be further clarified.[6]

Finally, we note our understanding that the new reports required under the proposed CSE rules (as well as the application-related information) would be filed with the Commission on

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Basel II also suggests that a combination of consolidation and aggregation is acceptable for determining capital adequacy for diversified firms.

[5] We do note, however, that monthly reports that go beyond public reporting requirements should be required 35 calendar days after month end.

[6] We recognize that this public accounting report requirement is the same as for OTC Derivatives Dealers, but we nonetheless have the above concerns.

a confidential basis. We recognize that the Commission asks in the Release whether there should be any additional disclosures required to meet the third pillar of Basel II relating to enhanced public disclosure practices. In our view, any new public disclosures should not be required until the Basel II implementation date.

C. Application Requirements

Set forth below are some comments designed to streamline the CSE application process, and to assist the Commission in its intended focus on material, unregulated CSE affiliates. We believe that the Commission can streamline the process, while meeting its objective of obtaining sufficient information so as to properly perform its supervision of a CSE.

1. Requirement to Provide Affiliate List and Related Information: Proposed Appendix E, in paragraph (a)(2)(ii), requires the broker-dealer to submit an alphabetical list of the affiliates of the broker-dealer, with an identification of the financial regulator, if any, with whom the affiliate is "registered," and a designation of those affiliates that are material to the holding company.[7] Paragraph (a)(2)(iii) requires an organizational chart that identifies the holding company, the broker-dealer and the material affiliates of the broker or dealer.

While we can provide this information, the Commission may wish to only require broker-dealers to submit an organizational chart that identifies the holding company, the broker-dealer, and the material, unregulated affiliates of the broker-dealer (and maybe also the listing of the affiliates that are otherwise regulated and by whom) and such other affiliate organizational information as it may request from time to time. As large financial service holding companies can have many hundreds of affiliates, including many intermediary holding companies, the Commission may wish to focus on material affiliate information at the application stage, with an opportunity to request more information. Furthermore, existing rules 17h-1T and 17h-2T, already require broker-dealers to maintain and provide certain reports concerning its holding companies and material affiliates. As a result, the Commission should be comfortable with more streamlined information at the CSE application stage, with the opportunity to request more information.

2. Requirement to Describe and Provide All Models Across Affiliate Group: In addition, proposed Appendix E, in paragraph (a)(2)(vii), requires the submission of a great deal of information across the entire affiliate group. More specifically, it requires a "description of all mathematical models used to price positions and to compute market and credit risk capital charges," among other information. This information submission requirement is overly broad. First, the Commission staff may be presented with an overload of information that may be unnecessary for purposes of an initial approval of the application. Second, while the provision of documentation on the market and credit risk calculation models is appropriate, the apparent requirement to provide all *pricing* models across a large affiliate group seems excessive and unnecessary.

[7] As to the use of the word "registered," we recommend that the Commission refer to affiliates in this context as those that are "registered or licensed under a regulatory system that imposes financial responsibility rules, including rules on capital."

We would alternatively suggest that the Commission only require "market and credit risk models used to compute market and credit risk capital charges" for the broker-dealer applying to use VaR or scenario analyses for its alternative net capital calculation, and for the holding company and material, unregulated affiliates using such models, and such other model information as the Commission may request from time to time. This would permit the Commission and its staff with an opportunity to focus on the most salient information for purposes of approving the application permitting the broker-dealer to perform the alternative net capital calculation, and for permitting the CSE to calculate its capital, on a group-wide basis. Furthermore, there should be no need for the Commission to require the submission of descriptive information of any models previously approved for an OTC Derivatives Dealer or utilized by an affiliate that has another principal regulator.

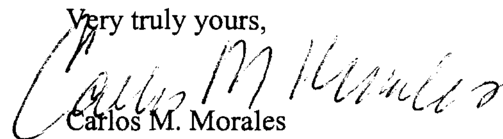
D. Other Comments

Before closing, we refer to a particular statement in the Release concerning the risk management control system required by Rule 15c3-4. The Release suggests that there must be separation of duties between personnel who enter into transactions and personnel who record the transactions. In this regard, we wish to highlight that personnel who enter into transactions (traders) are the very individuals responsible for recording transactions on the books and records of firms. Other personnel, such as risk management, finance and operational professionals, maintain a series of controls regarding such transactions. But, the individual trader, authorized by the firm to enter into the transaction, is truly the only appropriate individual to record the transaction on a firm's books and records.

* * *

We appreciate this opportunity to comment on the proposed CSE rules. We hope our comments are helpful to the Commission and its staff. If you have any questions on this letter or would like to discuss our comments, please do not hesitate to call me at (212) 449-4367 or Peggy Willenbucher, First Vice President and Senior Counsel at (212) 449-4378.

Very truly yours,



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