

## **RULE 15c3-1**

### **SUPPORTING STATEMENT**

#### **A. Justification**

##### **1. Necessity of the Collection of Information**

The purpose of Rule 15c3-1, the net capital rule, is to ensure that a broker-dealer at all times has sufficient liquid assets to promptly satisfy the claims of customers if the broker-dealer goes out of business. The term “net capital” is defined in paragraph (c)(2) of the net capital rule to be the net worth of a broker-dealer with various upwards and downwards adjustments, which are intended to give a conservative estimate of the financial soundness of a broker-dealer. These adjustments include deductions to take account of various risks associated with the broker-dealer’s proprietary securities positions. The net capital rule requires that brokers or dealers registered with the Commission maintain a minimum amount of net capital. The amount of the net capital requirement depends primarily on the types of business that the broker-dealer conducts and on whether it holds customer funds or securities. Finally, the net capital rule prohibits rapid withdrawals of funds from a broker-dealer by its parent or other affiliated company.

Various provisions of Rule 15c3-1 require that brokers and dealers give notice to the Commission and/or the designated examining authority (“DEA”). For example, a broker-dealer carrying the account of an options market maker must file a notice with the Commission and the DEA of both the carrying firm and the market maker. In addition, the carrying firm must notify the Commission and the appropriate DEA if a market maker fails to deposit any required equity with the carrying broker-dealer relating to his market maker account within the prescribed time period or if certain deductions and other amounts relating to the carrying firm’s market maker accounts computed in accordance with the rule’s provisions exceeds 1,000% of the carrying broker’s or dealer’s net capital. In addition, a broker-dealer electing to compute its net capital using the alternative method under paragraph (a)(1)(ii) of the rule must notify its DEA in writing. A broker-dealer must continue to operate under this paragraph unless a change is approved upon application to the Commission.

Moreover, Appendix C to the rule requires each broker and dealer that consolidates its financial statements with a subsidiary or affiliate, under certain circumstances, to submit to their DEA an opinion of counsel. The opinion of counsel must state, in essence, that the broker-dealer may cause that portion of the net assets of a subsidiary or affiliate related to its ownership interest in the entity to be distributed to the broker-dealer within 30 calendar days.

Appendix D to the rule requires brokers and dealers to file copies of subordinated loan agreements with the Commission and their DEA before those liabilities can be added back to the broker’s or dealer’s net worth when computing net capital.

Appendix E to the rule provides an alternative method for determining certain net capital charges for certain broker-dealers (referred to as consolidated supervised entities or CSEs) that manage risk on a group-wide basis and that submit to group-wide Commission supervision. Appendix G to Rule 15c3-1 requires a CSE firm to calculate allowable capital and allowances for market, credit, and operational risk monthly on a consolidated basis, file certain monthly, quarterly, and annual reports with the Commission, make, keep current, and preserve certain records, and notify the Commission of certain events.

The statutory authority for the rule is embodied in Sections 15(c)(3) and 23(a) of the Exchange Act, 15 USC 78o(c)(3), 78w (copies attached). Rule 15c3-1 was promulgated under Section 15(c)(3) of the Exchange Act, which directed the Commission to adopt minimum financial responsibility requirements for all brokers and dealers.

**2. Purpose of, and Consequences of Not Requiring, the Information Collection**

Rule 15c3-1 is an integral part of the Commission’s financial responsibility program for brokers and dealers. The purpose of the rule is to ensure that brokers and dealers have on hand at all times sufficient liquid resources to meet their current liabilities, particularly the claims of customers. The rule facilitates monitoring the financial condition of brokers and dealers by the Commission and the various self-regulatory organizations (“SROs”). The ultimate purpose of the rule is the protection of investors. If the information were not required to be collected, the Commission and the SROs would not be able to monitor the financial condition of broker-dealers, exposing their customers to increased risk.

**3. Role of Improved Information Technology and Obstacles to Reducing Burden**

The method of computing net capital varies by size and complexity of a firm. Most larger firms subject to the net capital rule utilize automated systems for computing their capital requirements. Smaller firms with simple balance sheets may compute their net capital on a manual basis.

**4. Efforts to Identify Duplication**

Not applicable.

**5. Effects on Small Entities**

Small entities may be affected to the extent they are required to maintain a minimum amount of net capital. However, there are different requirements for small entities subject to the rule. Most of these entities are not affected by the information collection provisions of the Rule 15c3-1.

**6. Consequences of Less Frequent Collection**

If the required activities were to be conducted less frequently, the protection afforded to the public would be lessened.

**7. Inconsistencies With Guidelines in 5 CFR 1320.5(d)(2)**

Not applicable.

**8. Consultations Outside the Agency**

All Commission rule proposals are published in the Federal Register for public comment. This comment period is generally 21 days, which affords the public and the industry an opportunity to respond to and comment on any such proposals.

**9. Payment or Gift to Respondents**

Not applicable.

**10. Assurance of Confidentiality**

The Commission regards the information obtained pursuant to the filings and notices required by the rule to be confidential. Such information is of a financial nature and generally is not disclosed to the public. The statutory basis for the Commission's refusal to disclose such information to the public is the exemption contained in Section (b)(4) of the Freedom of Information Act, 5 USC 552, which essentially provides that the requirement of public dissemination does not apply to commercial or financial information which is privileged or confidential.

**11. Sensitive Questions**

No questions of a sensitive nature are asked.

**12. Estimate of Respondent Reporting Burden**

**A. Summary of Reporting Burden Under Rule 15c3-1**

Under the current rule, the Commission staff estimates that broker-dealers annually file approximately 1,100 notices and subordinated loan agreements. Based on the staff's experience with the industry, it would take a broker-dealer approximately 30 minutes to file these notices. Therefore, the staff estimates that under the present Rule 15c3-1 broker-dealers spend approximately 550 hours each year to comply with the reporting burden in this rule.

Under the current rule, the Commission staff estimates that the approximate cost to broker-dealers to comply with this requirement would be \$278 per hour<sup>1</sup> resulting in an annual cost of \$152,900 (\$278 per hour x 550 burden hours).

In addition, under the current rule, approximately 400 broker-dealers file consolidated financial reports which, under Appendix C, require an opinion of counsel. The staff estimates that broker-dealers spend approximately one hour of staff time to obtain the opinion of counsel. Therefore, the hour burden associated with Appendix C is approximately 400 hours (400 broker-dealers x 1 hour).

Under the current rule, the Commission staff estimates that the approximate cost to broker-dealers to comply with the requirement to obtain an opinion of counsel as required under Appendix C of the rule would be \$223 per hour,<sup>2</sup> resulting in an annual cost of \$89,200 (\$223 per hour x 400 burden hours). In addition, the staff estimates that an opinion of counsel would cost a broker-dealer approximately \$2,500, resulting in an approximate cost of \$1.0 million (400 x \$2,500).

In summary, under Rule 15c3-1,<sup>3</sup> the total annual burden hours is 950 (550 + 400 = 950 hours), with a total annual hour burden cost of \$1,050,487 (\$27,847 + \$22,640 + \$1,000,000 = \$1,050,487).

## **B. Summary of Reporting Burden Under Appendixes E and G to Rule 15c3-1<sup>4</sup>**

The Paperwork Reduction Act (“PRA”) estimates are based on the assumption that 11 broker-dealers will apply to compute deductions for market risk under Appendix E to Rule 15c3-1.<sup>5</sup> A broker-dealer that applies to use Appendix E and its affiliates have discretion in allocating the paperwork burden associated with the proposal among the entities in the CSE, including the

<sup>1</sup>Based on the average annual salary for a Financial Reporting Manager based inside New York City, as reflected in SIA Management and Professional Earnings for 2005, modified to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. The SIA recently spoke with the Commission’s Office of Economic Analysis to inform the Commission that the multiplier of 1.35 that the Commission has historically used was too low. The SIA informed the Commission that, with increasing health care costs, the fact that the largest firms that pay higher salaries generally fail to respond to the SIA’s salary survey, and other factors, the Commission should increase its multipliers. Consequently, the Commission and the SIA worked together to determine the level at which the multipliers should be set.

<sup>2</sup> Based on the average annual salary for a Senior Compliance Examiner based inside New York City, as reflected in SIA Management and Professional Earnings for 2005, modified to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

<sup>3</sup> The reporting burdens for Appendix E and G of Rule 15c3-1 are described in Section 12.B. below.

<sup>4</sup> This discussion includes a discussion of the hour burden to prepare the application to receive approval from the Commission to use Appendix E to Rule 15c3-1.

broker-dealer. We estimate that each broker-dealer that applies would spend approximately 1,000 hours to create and compile the various documents to be included with the application and to work with the Commission staff through the application process. This includes approximately 100 hours for an in-house attorney to complete a review of the application. Consequently, the Commission estimates the total burden associated with the application process for the 6 additional broker-dealers we expect to apply to compute deductions for market risk under Appendix E to the net capital rule to be 6,000 hours.<sup>6</sup>

We estimate that a CSE firm using Appendixes E and G to Rule 15c3-1 would spend approximately 5,600 hours per year to review and update the models it uses to compute market and credit risk and approximately 160 hours each quarter, or approximately 640 hours per year, to backtest the models. Consequently, we estimate that the total burden associated with reviewing and backtesting mathematical models for the 11 broker-dealers we expect to apply will be approximately 68,640 hours per year  $((5,600 + 640) * 11)$ . The staff estimates that the hourly salary of a senior accountant is \$240 per hour,<sup>7</sup> for a total cost of approximately \$16.5 million per year  $(\$240 * 68,640 = \$16,473,600)$ .

Based on Commission experience and discussions with industry participants, we estimate that the calculation of allowable capital and allowances for market, credit, and operational risk for a CSE firm would require approximately 90 hours per month, or approximately 1,080 hours per year. Thus, the aggregate annual burden for the 11 broker-dealers we expect to apply would be approximately 11,880 hours.

We estimate that the average amount of time necessary to prepare and file the monthly reports required by Appendix G would be approximately 8 hours per month, or approximately 96 hours per year, that the average amount of time necessary to prepare and file the quarterly reports would be about 16 hours per quarter, or approximately 64 hours per year, and that the average amount of time necessary to prepare and file the annual audit reports would be approximately 200 hours per year. Consequently, we estimate that the total annual reporting burden of Appendix G for the 11 broker-dealers we expect to apply would be approximately 3,960 hours.

We expect that any additional burden associated with the requirements of Appendix G relating to making, keeping, and preserving records would be minimal because a prudent firm that manages risk on a group-wide basis would make and preserve these records in the ordinary course of its business. We estimate that the average one-time burden of making and preserving these records would be approximately 40 hours and that the average annual burden would be

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<sup>5</sup> Based on comments received when the CSE rules were adopted in 2004. There are currently 5 CSE; therefore, the Commission expects that 6 additional broker-dealers will apply to compute deductions for market risk under Appendix E to the net capital rule.

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<sup>7</sup> Based on the average annual salary for a Senior Accountant based inside New York City, as reflected in SIA Management and Professional Earnings for 2005, modified to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. See *also* note 1.

approximately 290 hours. Consequently, we estimate that the total burden for the 11 broker-dealers we expect will apply under this proposal would be approximately 440 hours on a one-time basis and approximately 3,190 hours per year.

The notification provisions of Appendix G are designed to give the Commission advance warning of situations that may pose material financial and operational risks to the broker-dealer and the CSE. These provisions are integral to Commission supervision of broker-dealers that use Appendix E. We estimate that it would require a total of approximately one hour per year for all 11 of the broker-dealers to comply with the notification provisions of Appendix G.

We estimate that the holding company's calculation of allowable capital and allowances for market, credit, and operational risk under Appendix G to Rule 15c3-1 would require approximately 90 hours per month, or approximately 1,080 hours per year, for a total of approximately 11,880 hours per year for the 11 broker-dealers, and that a senior accountant would do the work. The staff estimates that the hourly salary of a senior accountant is \$240 per hour.<sup>8</sup> The total annual cost would be approximately \$2,851,200 ( $\$240 * 11,880 = \$2,851,200$ ).

We estimate that the average amount of time necessary to prepare and file the monthly reports required by Appendix G would be approximately 8 hours per month, or approximately 96 hours per year, that the average amount of time necessary to prepare and file the quarterly reports would be about 16 hours per quarter, or approximately 64 hours per year, and that the average amount of time necessary to prepare and file the annual audit reports would be approximately 200 hours per year. Consequently, we estimate that the total for the 11 broker-dealers we expect to apply would be approximately 3,960 hours ( $(96 + 64 + 200) * 11$ ) per year, and we expect that a senior accountant would do the work. The staff estimates that the hourly salary of a senior accountant is \$240 per hour,<sup>9</sup> for a total of approximately \$950,400 ( $\$240 * 3,960 = \$950,400$ ).

Any additional costs associated with the requirements of Appendix G relating to making, keeping, and preserving records would be minimal because a prudent firm that manages risk on a group-wide basis would make and preserve these records in the ordinary course of its business. We estimate that the average annual time spent would be approximately 290 hours. Consequently, we estimate that the 11 broker-dealers we expect will apply under this proposal would spend approximately 3,190 hours per year, and we expect that a senior accountant would do the work. The staff estimates that the hourly salary of a senior accountant is \$240 per hour,<sup>10</sup> for a total annual cost of approximately \$765,600 ( $\$240 * 3,190 = \$765,600$ ).

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<sup>8</sup> Based on the average annual salary for a Senior Accountant based inside New York City, as reflected in SIA Management and Professional Earnings for 2005, modified to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. See also note 1.

<sup>9</sup> Id.

<sup>10</sup> Id.

We estimate that it would require a total of approximately one hour per year for all 11 of the broker-dealers to comply with the notification provisions of Appendix G, and that a senior compliance staff person would do the work. The staff estimates that the hourly salary of a senior compliance staff person is \$223 per hour,<sup>11</sup> for a total cost for the 11 firms of approximately \$223. Finally, we estimate that each of the eleven broker-dealers would spend approximately 250 hours per year reviewing and updating its risk management control system, for an aggregate annual burden of 2,750 hours and that a senior compliance staff person would do the work. The staff estimates that the hourly salary of a senior compliance staff person is \$223 per hour,<sup>12</sup> for a total cost for the 11 firms of approximately \$613,250.

In summary, the total annual hour burden for Appendix E and G to Rule 15c3-1 is 87,231 hours (68,640 + 11,880 + 3,960 + 1 + 2,750 = 87,231 hours). In addition, we estimate that the total cost of the annual hour burden would be approximately \$4.7 million under Appendix E and G to Rule 15c3-1 (\$16,473,600 + \$2,851,200 + \$950,400 + \$765,600 + \$223 + \$613,250 = \$21,654,273).

### **C. Total Annual Reporting Burden**

In summary, we estimate that the total annual hour burden for Rule 15c3-1 is 88,181. Finally, the estimated cost for the annual hour burden for Rule 15c3-1 is approximately \$22.7 million.

### **13. Estimate of Total Annualized Cost Burden**

The staff does not believe that broker-dealers will incur any capital and start-up or operation and maintenance expenses.

As discussed in Item 12 above, we estimate that each broker-dealer that applies to use Appendix E to Rule 15c3-1 would spend approximately 1,000 hours to create and compile the various documents to be included with the application and to work with the Commission staff through the application process. The staff anticipates that this would include approximately 100 hours for an in-house attorney and 900 hours for a senior compliance staff member. The staff estimates that the hourly salary of an attorney is \$327 per hour,<sup>13</sup> for a total cost of

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<sup>11</sup> Based on the average annual salary for a Senior Compliance Examiner based inside New York City, as reflected in SIA Management and Professional Earnings for 2005, modified to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. See *also* note 1.

<sup>12</sup> Based on the average annual salary for a Senior Compliance Examiner based inside New York City, as reflected in SIA Management and Professional Earnings for 2005, modified to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. See *also* note 1.

<sup>13</sup> Based on the average annual salary for an Attorney based inside New York City, as reflected in SIA Management and Professional Earnings for 2005, modified to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. See *also* note 1.

approximately \$196,200 ( $\$327 * 100 * 6 = \$196,200$ ). The staff estimates that the hourly salary of a senior compliance staff person is \$223 per hour,<sup>14</sup> for a total cost of approximately \$2.2 million ( $\$223 * 900 * 11 = \$2,207,700$ ).

We estimate that the 6 additional broker-dealers we expect will apply to use Appendix E to Rule 15c3-1 would spend approximately 240 hours on a one-time basis incurring additional costs associated with the requirements of Appendix G relating to making, keeping, and preserving records would be minimal because a prudent firm that manages risk on a group-wide basis would make and preserve these records in the ordinary course of its business, and we expect that a senior accountant would do the work. The staff estimates that the hourly salary of a senior accountant is \$240 per hour,<sup>15</sup> for a total one-time cost of approximately \$57,600 ( $\$240 * 240 = \$57,600$ ).

In summary, the Commission estimates that the total annualized cost burden for Rule 15c3-1 is approximately \$2,461,500 ( $\$2,403,900 + \$57,600 = \$2,461,500$ ).

#### **14. Estimate of Cost to Federal Government**

The staff estimates that the operational costs of reviewing the notices and reports required by the rule are approximately \$5,520 ( $\$30 \text{ hour} \times 184 \text{ hours (10 minutes} \times 1,100 \text{ notices)}$ ) based on our computation of the value of staff time devoted to this activity and the related overhead, valued at 35% of staff time.

These estimates have been computed on the basis of the GSA, Guide to Estimating Reporting Costs (1973).

#### **15. Explanation of Changes in Burden**

The number of hours related to the review and backtesting of mathematical models in Appendix E and G were reduced to more accurately reflect the fact that tasks performed under Appendix G with respect to the holding company of a CSE firm would fulfill certain requirements of Appendix E with respect to the broker-dealer without requiring further work.

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<sup>14</sup> Based on the average annual salary for a Senior Compliance Examiner based inside New York City, as reflected in SIA Management and Professional Earnings for 2005, modified to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. See also note 1.

<sup>15</sup> Based on the average annual salary for a Senior Accountant based inside New York City, as reflected in SIA Management and Professional Earnings for 2005, modified to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. See also note 1.



In addition, the cost of the hour burden under the current Rule 15c3-1 was revised to reflect new compensation and earnings information based on 2005 year end numbers, based on comparable positions in the updated SIA Reporting Management & Professional Earnings in the Securities Industry (2005).

**16. Information Collection Planned for Statistical Purposes**

This provision is not applicable because compliance with Rule 15c3-1 will not require the employment of statistical methods. There is no intention to publish the information for any purpose.

**17. Explanation as to Why Expiration Date Will Not Be Displayed**

Not applicable.

**18. Exceptions to Certification**

Not applicable.

**B. Collection of Information Employing Statistical Methods**

Not applicable.

Brokers or dealers in the ordinary course of their businesses maintain certain books and records reflecting, among other things, income and expenses, assets and liabilities, daily trading activity, and the status of customer and firm accounts. Most of these books and records would be kept by any prudent individual engaging in a securities business.