

## **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 rule generally defines “net capital” as a broker-dealer’s net worth (assets minus liabilities), plus certain subordinated liabilities, less certain assets that are not readily convertible into cash (e.g., fixed assets), and less a percentage (haircut) of certain other liquid assets (e.g., securities).<sup>1</sup> Broker-dealers are required to calculate net worth using generally accepted accounting principles. The net capital rule requires that brokers or dealers registered with the Securities and Exchange Commission (“Commission”) maintain a minimum amount of net capital. A firm’s minimum net capital requirement is the greater of (1) a fixed minimum amount set forth in Rule 15c3-1 based on the types of business that the broker-dealer conducts and on whether it holds customer funds or securities, or (2) a financial ratio. If a firm’s net capital falls below this minimum level, that firm must cease doing a securities business.

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 Rule 15c3-1’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 Rule 15c3-1 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 Rule 15c3-1 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 Rule 15c3-1 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.

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<sup>1</sup>

See 17 CFR 240.15c3-1(c)(2).

Appendix E to Rule 15c3-1 provides an alternative method for determining certain net capital charges for certain broker-dealers that manage risk on a group-wide basis and that submit to group-wide Commission supervision. Such broker-dealers are referred to as alternative net capital firms, or ANCs. Appendix G to Rule 15c3-1 requires the holding company of an ANC, 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 Rule 15c3-1 is embodied in Sections 15(c)(3) and 23(a) of the Securities Exchange Act, 15 USC 78o(c)(3), 78w (the “Exchange Act”). 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 Rule 15c3-1 is to ensure that brokers and dealers have on hand at all times sufficient liquid resources to meet all 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 Rule 15c3-1 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 Rule 15c3-1. Most of these entities are not affected by the information collection provisions of 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 Rule 15c3-1 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**

The Commission staff estimates that broker-dealers annually file approximately 950 notices. Based on the Commission staff's experience with the industry, it would take a broker-dealer approximately 30 minutes to file these notices. Therefore, the Commission staff estimates that under the present Rule 15c3-1 broker-dealers spend approximately 475 hours each year to comply with the reporting burden in this rule.

The Commission staff estimates that the approximate cost to broker-dealers to comply with this requirement would be \$265 per hour<sup>2</sup> resulting in an annual cost of \$125,875 (\$265 per hour x 475 burden hours).

In addition, approximately 225 broker-dealers file consolidated financial reports some of which, under Appendix C, require an opinion of counsel. The Commission staff believes that over the course of a year, certain of these broker-dealers may require such an opinion. The Commission staff estimates that broker-dealers spend approximately one hour of Commission staff time to obtain the opinion of counsel. Therefore, the hour burden associated with Appendix C is approximately 225 hours (225 broker-dealers x 1 hour).

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 Rule 15c3-1 would be \$212 per hour,<sup>3</sup> resulting in an annual cost of \$47,700 (\$212 per hour x 225 burden hours). In addition, the Commission staff estimates that an opinion of counsel would cost a broker-dealer approximately \$2,500, resulting in an approximate cost of \$562,500 (225 x \$2,500).

In summary, under Rule 15c3-1,<sup>4</sup> the total annual burden hours is 700 (475 + 225 = 700 hours), with a total annual hour burden cost of \$736,075 (\$125,875 + \$47,700 + \$562,500 = \$736,075).

## **B. Summary of Reporting Burden Under Appendixes E and G to Rule 15c3-1<sup>5</sup>**

The Paperwork Reduction Act (“PRA”) estimates are based on the assumption that 10 broker-dealers will ultimately apply to compute deductions for market risk under Appendix E to Rule 15c3-1. There are currently 4 ANC firms; therefore, the Commission expects that 6 additional firms will apply to compute deductions for market risk under Appendix E to the net capital rule. 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 holding company, including the 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

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<sup>2</sup>Based on the average annual salary for a Financial Reporting Manager, as reflected in SIFMA’s Management and Professional Earnings in the Securities Industry 2008, modified by Commission staff 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> Based on the average annual salary for a Senior Compliance Examiner, as reflected in SIFMA’s Management and Professional Earnings in the Securities Industry 2008, modified by Commission staff 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>4</sup> The reporting burdens for Appendix E and G of Rule 15c3-1 are described in Section 12.B. below.

<sup>5</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.

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.

We estimate that an ANC 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 10 broker-dealers we expect to become ANC firms will be approximately 62,400 hours per year  $((5,600 + 640) \times 10)$ . The Commission staff estimates that the hourly salary of a senior accountant is \$178 per hour,<sup>6</sup> for a total cost of approximately \$11.1 million per year  $(\$178 \times 62,400 = \$11,107,200)$ .

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 an ANC holding company under Appendix G to Rule 15c3-1 would require approximately 10 hours per month, or approximately 120 hours per year. Thus, the aggregate annual burden for the 10 broker-dealers we expect to become ANC firms would be approximately 1,200 hours  $(120 \text{ hours} \times 10 \text{ broker-dealers})$ . The Commission staff believes that a senior accountant would do the work. The Commission staff estimates that the hourly salary of a senior accountant is \$178 per hour.<sup>7</sup> The total annual cost would be approximately \$213,600  $(\$178 \times 1,200 = \$213,600)$ .

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 10 broker-dealers we expect to become ANC firms would be approximately 3,600 hours  $((96 + 64 + 200) \times 10)$ . The Commission staff expects that a senior accountant would do the work. The Commission staff estimates that the hourly salary of a senior accountant is \$178 per hour,<sup>8</sup> for a total annual cost of approximately \$640,800  $(\$178 \times 3,600 = \$640,800)$ .

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

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<sup>6</sup> Based on the average annual salary for a Senior Accountant, as reflected in SIFMA's Management and Professional Earnings in the Securities Industry 2008, modified by Commission staff 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>7</sup> Based on the average annual salary for a Senior Accountant, as reflected in SIFMA's Management and Professional Earnings in the Securities Industry 2008, modified by Commission staff 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>8</sup> Id.

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 approximately 290 hours. Consequently, we estimate that the total burden for the 10 broker-dealers we expect will become ANC firms would be approximately 400 hours (40 hours x 10 broker-dealers) on a one-time basis and approximately 2,900 hours on an annual basis (290 hours x 10 broker-dealers). The Commission staff expects that a senior accountant would do the work. The Commission staff estimates that the hourly salary of a senior accountant is \$178 per hour,<sup>9</sup> for a total annual cost of approximately \$516,200 ( $\$178 \times 2,900 = \$516,200$ ).

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 its holding company. 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 10 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 Commission staff estimates that the hourly salary of a senior compliance staff person is \$212 per hour,<sup>10</sup> for a total cost for the 10 firms of approximately \$212.

Finally, we estimate that each of the 10 broker-dealers would spend approximately 250 hours per year reviewing and updating its risk management control system, for an aggregate annual burden of 2,500 hours and that a senior compliance staff person would do the work. The Commission staff estimates that the hourly salary of a senior compliance examiner is \$212 per hour,<sup>11</sup> for a total cost for the 10 firms of approximately \$530,000 ( $\$212 \times 2,500 = \$530,000$ ).

In summary, the total annual hour burden for Appendix E and G to Rule 15c3-1 is 73,301 hours ( $62,400 + 1,200 + 3,600 + 2,900 + 1 + 2,500 = 72,601$  hours). In addition, we estimate that the total cost of the annual hour burden would be approximately \$13 million under Appendix E and G to Rule 15c3-1 ( $\$11,107,200 + \$213,600 + \$640,800 + \$516,200 + \$212 + \$530,000 = \$13,008,012$ ).

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

In summary, we estimate that the total annual hour burden for Rule 15c3-1 is 73,301 ( $700 + 72,601 = 73,301$ ). Finally, the estimated cost for the annual hour burden for Rule 15c3-1 is approximately \$13.7 million ( $\$736,075 + \$13,008,012 = \$13,744,087$ ).

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

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<sup>9</sup> Id.

<sup>10</sup> Based on the average annual salary for a Senior Compliance Examiner, as reflected in SIFMA's Management and Professional Earnings in the Securities Industry 2008, modified by Commission staff 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>11</sup> Based on the average annual salary for a Senior Compliance Examiner, as reflected in SIFMA's Management and Professional Earnings in the Securities Industry 2008, modified by Commission staff to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

Not applicable. The Commission does not expect that respondents will have to incur capital or start-up costs to comply with the Rule.

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

The Commission staff estimates that the operational costs of reviewing the notices and reports required by Rule 15c3-1 are approximately \$5,520 (\$30 hour x 184 hours (10 minutes x 1,100 notices)) based on our computation of the value of Commission staff time devoted to this activity and the related overhead, valued at 35% of Commission 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**

Since the last submission there has been a decrease in the number of notices filed by broker-dealers, the number of broker-dealers that file consolidated financial reports, and the number of broker-dealers that the Commission staff estimates will compute deductions for market risk under Appendix E. Therefore, the hours burden has decreased from 84,616 to 73,301.

**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.