

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).¹ 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.

¹

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.

In March 2007, the Commission proposed for comment amendments² to its net capital, customer protection, books and records, and notification rules for broker-dealers under the Exchange Act. More specifically, the changes to Rule 15c3-1 would amend subparagraph (c)(2)(iv)(B) to clarify that broker-dealers providing securities lending and borrowing settlement services are assumed, for purposes of the rule, to be acting as principals and are subject to applicable capital deductions. Under the proposed amendment, these deductions could be avoided if a broker-dealer takes certain steps to disclaim principal liability. Namely, the broker-dealer would be required to disclose the identities of the borrower and lender to each other and obtain written agreements from the borrower and lender stating that the broker-dealer is acting exclusively as agent and assumes no principal liability in connection with the transaction.³

This supporting statement describes the impact of these proposed amendments on the currently approved inventory for this collection of information.⁴

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

² Exchange Act Release No. 55341 (Feb. 23, 2007), 72 FR 12862 (Mar. 19, 2007).

³ Standard master securities loan agreements (including the annexes thereto) commonly used by the parties to a securities lending transaction contain similar provisions for establishing agent (as opposed to principal) status in a securities lending and borrowing transaction. *See, e.g.*, 2000 Master Securities Loan Agreement, Annex I, published by The Bond Market Association.

⁴ *See supra* note 2.

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. The comment period for the 2007 proposing release that discusses the proposed amendments to Rule 15c3-1 was 60 days.⁵ This comment period afforded the public an opportunity to respond to the proposal. No PRA comments were received in response to this request.

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

⁵ Exchange Act Release No. 55341 (Feb. 23, 2007), 72 FR 12862 (Mar. 19, 2007).

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.

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).

B. Summary of Reporting Burden Under Current Appendixes E and G to Rule 15c3-1⁶

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 one-time 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.

⁶ 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.

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 $((5,600 + 640) \times 10)$.

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 $(120 \text{ hours} \times 10 \text{ broker-dealers})$.

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 $((96 + 64 + 200) \times 10)$.

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 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 $(40 \text{ hours} \times 10 \text{ broker-dealers})$ on a one-time basis and approximately 2,900 hours on an annual basis $(290 \text{ hours} \times 10 \text{ broker-dealers})$.

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.

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.

In summary, the total annual hour burden for Appendix E and G to Rule 15c3-1 is 72,601 hours $(62,400 + 1,200 + 3,600 + 2,900 + 1 + 2,500 = 72,601 \text{ hours})$ and the total one-time burden is 6,400 hours $(6,000 + 400)$.

C. Summary of Reporting Burden Under 2007 Proposed Amendments to Rule 15c3-1⁷

Under the 2007 proposing release, the proposed amendment to Rule 15c3-1 would require a broker-dealer to make disclosures to, and obtain certain agreements from, securities lending principals in situations where the firm participates in the settlement of a securities lending transaction but wants to be deemed an agent for purposes of Rule 15c3-1. The staff estimates that approximately 170 broker-dealers would be affected by this proposed requirement.⁸ The Commission understands that most existing standard securities lending master agreements in use today already contain language requiring agent lenders to disclose principals and principals to agree not to hold the agents liable for a counterparty default and, consequently, the proposed amendment would be codifying industry practice. Thus, the standard agreement used by the vast majority of broker-dealers should contain the representations and disclosures required by the proposed amendment. However, a small percentage of broker-dealers may need to modify their standard agreements.

The Commission estimates that 5% of the approximately 170 firms engaged in this business, or 9 firms, may not presently use the standard agreements. The Commission further estimates each of these firms would spend approximately 20 hours of employee resources updating their standard agreement template. Therefore, the Commission estimates that the total one-time burden to the industry as a result of this proposed requirement would be approximately 180 hours.⁹

13. Estimate of Total Annualized Cost Burden

Under Appendix C to current Rule 15c3-1, the Commission staff estimates that an opinion of outside counsel would cost a broker-dealer approximately \$2,500, resulting in an approximate cost of \$562,500 (225 x \$2,500).

The Commission does not expect that respondents will have to incur capital or start-up costs to comply with the amendments proposed to Rule 15c3-1 in the proposing release.¹⁰

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.

⁷ See *supra* note 2.

⁸ This estimate is derived from FOCUS Reports filed by broker-dealers pursuant to Section 17 of the Exchange Act and Rule 17a-5 (17 CFR 240.17a-5).

⁹ 9 broker-dealers x 20 hours per firm = 180 hours.

¹⁰ See *supra* note 2.

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

15. Explanation of Changes in Burden

The Commission is revising the annual cost burdens previously report for Rule 15c3-1. The annualized cost of internal hour burdens of \$13,181,587 has been deleted from this supporting statement because these costs relate to the internal costs of the annual hour burden for Rule 15c3-1. We note that the \$13,181,587 decrease includes a decrease in the annual costs for Appendix C to Rule 15c3-1 of \$47,700 from \$610,200 to \$562,500.

The number of respondents has decreased by 10. The annual hour burdens for Appendixes E and G to the rule were reported separately, resulting in 20 respondents. The estimated number of firms using these two appendixes would be the same 10 firms. Therefore, these numbers have been combined to result in 10 respondents.

Finally, the changes in the one-time reporting burden are a result of the proposed amendments to paragraph (c)(2)(iv)(B) of Rule 15c3-1 as discussed in the 2007 proposing release.¹¹

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.

¹¹ See *supra* note 2.