

**SUPPORTING STATEMENT for the Paperwork Reduction Act Information Collection
Submission for Rule 18a-1 – Net capital requirements for security-based swap dealers for
which there is not a prudential regulator
3235-0701**

This submission is being made pursuant to the Paperwork Reduction Act of 1995, 44 U.S.C. Section 3501 *et seq.*

A. JUSTIFICATION

1. Information Collection Necessity

On June 21, 2019, in accordance with Section 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”),¹ which added section 15F to the Securities Exchange Act of 1934 (the “Exchange Act”),² the Securities and Exchange Commission (the “Commission”) adopted Rule 18a-1 (17 CFR 240.18a-1) to establish net capital requirements for nonbank security-based swap dealers that are not also broker-dealers registered with the Commission (“stand-alone SBSDs”).³ The rule establishes a number of new collection of information requirements.

First, under paragraphs (a)(2) and (d) of Rule 18a-1, a stand-alone SBSD may apply to the Commission to be authorized to use internal models to compute net capital. As part of the application process, a stand-alone SBSD is required to provide the Commission staff with, among other things: (1) a comprehensive description of the firm’s internal risk management control system; (2) a description of the value-at-risk (“VaR”) models the firm will use to price positions and compute deductions for market risk; (3) a description of the firm’s internal risk management controls over the VaR models, including a description of each category of person who may input data into the models; and (4) a description of the back-testing procedures that that firm will use to review the accuracy of the VaR models. In addition, under Rule 18a-1, a stand-alone SBSD authorized to use internal models must review and update the models it uses to compute market and credit risk, as well as back-test the models.

Second, under paragraph (f) of Rule 18a-1, a stand-alone SBSD is required to comply with certain requirements of Exchange Act Rule 15c3-4 (17 CFR 240.15c3-4). Rule 15c3-4 requires OTC derivatives dealers and firms subject to its provisions to establish, document, and maintain a system of internal risk management controls to assist the firm in managing the risks associated with business activities, including market, credit, leverage, liquidity, legal, and operational risks.

Third, for purposes of calculating “haircuts” on credit default swaps, paragraph (c)(1)(vi)(B)(1)(iii) of Rule 18a-1 requires stand-alone SBSDs that are not using internal models

¹ See *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, Public Law 111-203, 124 Stat. 1376 (2010).

² See 15 U.S.C. 78o-10(e)(2)(B).

³ See *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*, Exchange Act Release No. 86175.

to use an industry sector classification system that is documented and reasonable in terms of grouping types of companies with similar business activities and risk characteristics.

Fourth, under paragraph (h) of Rule 18a-1, stand-alone SBSBs are required to provide the Commission with certain written notices with respect to equity withdrawals.

Fifth, under paragraph (c)(5) of Appendix D to Rule 18a-1 (17 CFR 240.18a-1d), stand-alone SBSBs are required to file with the Commission two copies of any proposed subordinated loan agreement (including nonconforming subordinated loan agreements) at least 30 days prior to the proposed execution date of the agreement. The rule also requires an SBSB to file with the Commission a statement setting forth the name and address of the lender, the business relationship of the lender to the SBSB, and whether the SBSB carried an account for the lender effecting transactions in security-based swaps at or about the time the proposed agreement was filed.

Finally, under paragraph (c)(1)(ix)(C) of Rule 18a-1, a stand-alone SBSB may treat collateral held by a third-party custodian to meet an initial margin requirement of a security-based swap or swap customer as being held by the SBSB for purposes of the capital in lieu of margin charge provisions of the rule if certain conditions are met. The conditions include: (1) the execution of an account control agreement governing the terms under which the custodian holds and releases collateral pledged by the counterparty as initial margin that is a legal, valid, binding, and enforceable agreement under the laws of all relevant jurisdictions, including in the event of bankruptcy, insolvency, or a similar proceeding of any of the parties to the agreement, and that provides the security-based swap dealer with the right to access the collateral to satisfy the counterparty's obligations to the security-based swap dealer arising from transactions in the account of the counterparty; and (2) the SBSB maintains written documentation of its analysis that in the event of a legal challenge the relevant court or administrative authorities would find the account control agreement to be legal, valid, binding, and enforceable under the applicable law, including in the event of the receivership, conservatorship, insolvency, liquidation, or a similar proceeding of any of the parties to the agreement.

2. Information Collection Purpose and Use

The requirements in Rule 18a-1 are an integral part of the Commission's financial responsibility program for stand-alone SBSBs. The program is designed to ensure that stand-alone SBSBs maintain sufficient liquidity at all times to meet all unsubordinated obligations of their customers and counterparties and, should a nonbank SBSB fail, that there are sufficient resources for an orderly liquidation. These information collections facilitate the monitoring of the financial condition of nonbank SBSBs by the Commission.

Furthermore, the program is designed to protect the financial stability of the U.S. financial and banking system from the failure of a given stand-alone SBSB. The information collections under Rule 18a-1 provide the Commission with visibility into the liquidity and market risk profiles of stand-alone SBSBs, as well as meaningful plans on how stand-alone SBSBs intend to manage risks.

3. Consideration Given to Information Technology

The information collections do not require that respondents use any specific information technology system. The other information collections involve written notices, agreements, plans, and procedures, and do not benefit from specialized information technology.

4. Duplication

This information collection does not duplicate any existing information collection.

5. Effect on Small Entities

The information collections required under Rule 18a-1 do not place burdens on small entities. The stand-alone SBSs subject to the information collections under the rule are not expected to be small entities.

6. Consequences of Not Conducting Collection

If the required information collections are not conducted or are conducted less frequently, the protection afforded to investors and the U.S. financial system would be diminished.

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

There are no special circumstances. This collection is consistent with the guidelines in 5 CFR 1320.5(d)(2).

8. Consultations Outside the Agency

The required Federal Register notice with a 60-day comment period soliciting comments on this collection of information was published. No public comments were received.

9. Payment or Gift

No payment or gift is provided to respondents.

10. Confidentiality

The information collected by the Commission under Rule 18a-1, as adopted, is kept confidential to the extent permitted by the Freedom of Information Act (5 U.S.C. § 552 *et seq.*).

11. Sensitive Questions

The information collection does not collect personally identifiable information. The agency has determined that neither a PIA nor a SORN are required in connection with the collection of information.

12. Information Collection Burden

VaR Models (Rule 18a-1(a)(2) and (d))

There are 4 stand-alone SBSBs that use internal models to compute net capital under paragraphs (a)(2) and (d) of Rule 18a-1. The staff does not expect any new firms to apply to use external models in the next three years, but any new firm must first have an internal VaR model, and Rule 18a-1 requires that it submit information relating to the model along with its application to the Commission. Based on past experience with broker-dealers that applied to use internal models to compute net capital under Exchange Act Rule 15c3-1 and related Appendix E to that rule, the Commission staff estimates that a stand-alone SBSB will spend approximately 750 hours to create its model and risk control systems, as well as compiling its application for approval to use the model. The Commission initially estimated that 4 stand-alone SBSBs would apply to use internal models. As four firms now use internal models, there are no new respondents, and therefore at this time there is no industry-wide one-time burden associated with these provisions.

The staff estimates that these firms will then spend 4,200 hours per year reviewing and updating their VaR models, and also 480 hours per year backtesting those models against available data. **That results in a total annual industry-wide recordkeeping burden of 18,720 hours.**⁴

Risk Management Control System (Rule 18a-1(f))⁵

Paragraph (f) of Rule 18a-1 requires that firms subject to the rule comply with certain provisions of Exchange Act Rule 15c3-4. There are 5 firms that are subject to Rule 18a-1. (Certain other stand-alone SBSBs elect the alternative compliance mechanism under Exchange Act Rule 18a-10.) The Commission initially estimated that there would be 6 firms that would be subject to Rule 18a-1. The Commission does not expect that any new firms will be subject to Rule 18a-1 in the next three years, but any new firm would each bear a one-time burden of 2,000 hours to initially set up risk management control systems.⁶ As there are no new respondents, at this time there is no industry-wide one-time burden associated with this requirement.

⁴ (4,200 hours + 480 hours) x 4 stand-alone SBSBs = 18,720 hours.

⁵ In the prior PRA submission, this rule was mistakenly cited as “Rule 18a-1(g)”.

⁶ This amount will be annualized over three years, which results an annual burden of 666.67 recordkeeping hours, rounded to 667 hours.

Firms currently subject to Rule 18a-1 would bear an annual burden of 250 hours per year.⁷ **This will result in an estimated industry-wide annual internal hour burden of approximately 1,250 recordkeeping hours per year.**⁸

Industry Sector Classification

Paragraph (c)(1)(vi)(B)(1)(iii) of Rule 18a-1 requires stand-alone SBSBs that are not using internal models to use an industry sector classification system that is documented and reasonable in terms of grouping types of companies with similar business activities and risk characteristics.

The Commission staff estimates that 1 stand-alone SBSB would not use internal models and therefore will be subject to this requirement. The Commission expects that it will use external classifications systems because of reduced costs and ease of use as a result of the common usage of several of these classification systems in the financial services industry. The Commission staff estimates that the firm will spend approximately 1 hour per year documenting the industry sectors. **This results in an estimated industry-wide annual internal hour burden of approximately 1 recordkeeping hour per year.**⁹

Commission Notices (Rule 18a-1(h))

Paragraph (h)(1) of Rule 18a-1 requires that stand-alone SBSBs file written notices with the Commission when certain amounts of equity are withdrawn from the firm. Based on the staff's experience with similar withdrawal notices filed by broker-dealers under Rule 15c3-1, the staff estimates that the 5 stand-alone SBSBs will file an average of 2 notices per year. It requires an estimated 30 minutes to file these notices, **for an annual industry-wide reporting burden of 3 hours.**¹⁰

Subordinated Loan Agreements

Under paragraph (c)(5) of Appendix D to Rule 18a-1, stand-alone SBSBs are required to file with the Commission two copies of any proposed subordinated loan agreement (including nonconforming subordinated loan agreements) at least 30 days prior to the proposed execution date of the agreement. The rule also requires an SBSB to file with the Commission a statement setting forth the name and address of the lender, the business relationship of the lender to the SBSB, and whether the SBSB carried an account for the lender effecting transactions in security-based swaps at or about the time the proposed agreement was filed. There are 5 stand-alone SBSBs. The Commission initially estimated that there would be 6 stand-alone SBSBs. The Commission does not expect that there will be any new stand-alone SBSBs in the next three years, but any new firm would spend 20 hours of internal employee resources drafting or

⁷ The one-time estimate of 2,000 hours and the annual estimate of 250 hours are based on the estimates for OTC derivatives dealer burdens to implement the same controls under Rule 15c3-1. *See OTC Derivatives Dealers*, 62 FR 67940.

⁸ 5 stand-alone SBSBs x 250 hours/year = 1,250 hours/year.

⁹ 1 non-model stand-alone SBSBs x 1 hour/year = 1 hour/year.

¹⁰ 5 stand-alone SBSBs x 30 minutes/year = 2.5 hours/year, rounded to 3 hours/year.

updating its agreement templates. As there are no new respondents, at this time there is no industry-wide one-time burden associated with this requirement.

Based on its experience with broker-dealers submitting such loan agreements under a similar requirement under Rule 15c3-1, the staff estimates **that each firm will file 1 subordinated loan agreement per year and that it will take approximately 10 hours to prepare and file the agreement, resulting in an annual industry-wide hour burden of 50 reporting hours.**¹¹

Account Control Agreements

Under paragraph (c)(1)(ix)(C) of Rule 18a-1, a nonbank SBSB may treat collateral held by a third-party custodian to meet an initial margin requirement of a security-based swap or swap customer as being held by the nonbank SBSB if certain conditions are met. In particular, the rule requires the execution of an account control agreement governing the terms under which the custodian holds and releases collateral pledged by the counterparty as initial margin. Based on staff experience with the net capital and customer protection rules, the Commission estimates that the 5 stand-alone SBSBs will enter into approximately 100 account control agreements per year with security-based swap customers and that it will take approximately 2 hours to execute each account control agreement, **resulting in an annual industry-wide third-party hour burden of 1,000 hours.**¹²

The rule also requires SBSBs to maintain written documentation of their legal analysis of the account control agreement. Based on staff experience, the Commission estimates that stand-alone SBSBs will meet this requirement either by obtaining a written opinion of outside legal counsel or through the firm's own "in house" analysis. The Commission estimates that 3 of the firms will elect to conduct an in house analysis. The Commission initially estimated that 3 firms would do so. The Commission does not expect that there will be any new stand-alone SBSBs in the next three years, but any new firm that would conduct a written "in house" analysis will take approximately 20 hours to do so.¹³ As there are no new respondents, at this time there is no industry-wide one-time burden associated with this requirement.

13. Costs to Respondents

VaR Models (Rule 18a-1(a)(2) and (d))¹⁴

There are 4 stand-alone SBSBs that use internal models to compute net capital under paragraphs (a)(2) and (d) of Rule 18a-1. The staff does not expect any new firms to apply to use external models in the next three years, but any new firm will incur external costs associated with developing VaR models and applying to the Commission for approval to use them to

¹¹ 5 stand-alone SBSBs x 10 hours/year = 50 hours/year.

¹² 5 stand-alone SBSBs x 100 account control agreements x 2 hours = 1,000 hours.

¹³ See cost burden below for SBSBs that elect to hire outside counsel.

¹⁴ Note that the two cost burdens for VaR Models (Rule 18a-1(a) and Rule 18a-1(d)) were previously contained in one cost burden in ROCIS but have been separated for clarity.

calculate net capital. The staff estimates that, based upon previous experience with broker-dealers that developed internal models, 25% of these tasks will be handled by outside consultants. This results in 250 hours per respondent. The outside consultants are estimated to charge \$400 per hour. The Commission initially estimated that 4 stand-alone SBSBs would apply to use internal models. As four firms now use internal models, there are no new respondents, and therefore at this time there is no industry-wide one-time burden associated with these provisions.

With respect to the external costs associated with annually reviewing, backtesting, and updating VaR models, the staff estimates that, based on previous experience with broker-dealers that developed internal models, 25% of these tasks will be handled by outside consultants. The outside consultants are estimated to charge \$400 per hour resulting in an annual recordkeeping cost of \$624,000 per respondent. **This will result in an annual industry-wide external cost of \$2,496,000.**¹⁵

As stated above, there are 4 stand-alone SBSBs that use internal models to compute net capital under paragraphs (a)(2) and (d) of Rule 18a-1. The staff does not expect any new firms to apply to use external models in the next three years, but any new firm will incur electing to file an application with the Commission to use a VaR model will incur start-up costs, including information technology costs, to comply with Rule 18a-1. Based on past experience with broker-dealers that applied to use internal models under Rule 15c3-1 and related Appendix E, it is expected that a stand-alone SBSB will incur an average of approximately \$8.0 million to modify its information technology systems to meet the VaR requirements of Rule 18a-1. The Commission previously initially that 4 stand-alone SBSBs would apply to use internal models. As four firms now use internal models, there are no new respondents, and therefore at this time there is no industry-wide one-time burden associated with these provisions.

Risk Control Management System (Rule 18a-1(f))¹⁶

There are 5 stand-alone SBSBs. The Commission initially estimated that there would be 6 stand-alone SBSBs. The Commission does not expect that there will be any new stand-alone SBSBs in the next three years, but any new firm would incur start-up information technology external costs with respect to setting up a risk control management system. Based on the estimates for similar collections of information, it is expected that a stand-alone SBSB will incur an average cost of approximately \$16,000 for initial hardware and software expenses. As there are no new respondents, at this time there is no industry-wide one-time burden associated with this requirement.

However, the Commission estimates that the average ongoing cost will be approximately \$20,500 per stand-alone SBSB per year. **This will result in an ongoing industry-wide external cost of \$102,500 per year.**¹⁷

¹⁵ The total industry-wide recordkeeping cost is \$2,496,000 (4 stand-alone SBSBs x \$624,000).

¹⁶ This burden was mistakenly attributed to paragraph (g) of Rule 18a-1 in the previous PRA submission.

¹⁷ 5 SBSBs x \$20,500/year = \$102,500.

Account Control Agreement

Under paragraph (c)(1)(ix)(C) of Rule 18a-1, a nonbank SBSB may treat collateral held by a third-party custodian to meet an initial margin requirement of a security-based swap or swap customer as being held by the nonbank SBSB if certain conditions are met. In particular, the rule requires the execution of an account control agreement governing the terms under which the custodian holds and releases collateral pledged by the counterparty as initial margin that is a legal, valid, binding, and enforceable agreement under the laws of all relevant jurisdictions. In addition, the SBSB must maintain written documentation of its analysis that in the event of a legal challenge the relevant court or administrative authorities would find the account control agreement to be legal, valid, binding, and enforceable under the applicable law.

There are 5 stand-alone SBSBs. The Commission initially estimated that there would be 6 stand-alone SBSBs. The Commission does not expect that there will be any new stand-alone SBSBs in the next three years, but any new firm would engage outside counsel to draft and review the account control agreement at a cost of \$400 per hour for an average of 20 hours per respondent. As there are no new respondents, at this time there is no industry-wide one-time burden associated with this requirement.

As discussed above, the Commission estimates that 2 SBSBs will obtain a written opinion of outside legal counsel instead of conducting the firm's own "in-house" analysis. The Commission initially estimated that 3 SBSBs would do so. The Commission does not expect that there will be any new stand-alone SBSBs in the next three years, but the Commission estimates that any new firm that would use outside legal counsel would incur a cost of approximately \$8,000. As there are no new respondents, at this time there is no industry-wide one-time burden associated with this requirement.

This chart summarizes the hour and cost burdens associated with Rule 18a-1:

Title of Collection	Responses	Hours	Dollars
Rule 18a-1(a) VaR Models Initial Burden	0	0	\$0
Rule 18a-1(a) VaR Models Ongoing Burden	4	18,720	\$2,496,000
18a-1(f) Risk Management Control System ¹⁸ Initial Burden	0	0	\$0
18a-1(f) Risk Management Control System Ongoing Burden	5	1,250	\$102,500

¹⁸ This burden was mistakenly attributed to paragraph (g) of Rule 18a-1 in the previous PRA submission.

18a(c) Industry Sector Classification Ongoing Burden	1	1	
Rule 18a-1(h) Commission Notices Ongoing Burden	5	3	
Rule 18a-1 Subordinated Loan Agreements Initial Burden	0	0	
Rule 18a-1 Subordinated Loan Agreements Ongoing Burden	5	50	
Rule 18a-1(c) Account Control Agreement Opinion of Counsel Ongoing Burden	500	1,000	
Rule 18a-1(c) Account Control Agreement Legal Analysis (In-house counsel) Initial Burden	0	0	
Rule 18a-1(c) Account Control Agreement Opinion of Counsel Initial Burden	0		0
Rule 18a-1(c) Account Control Agreement Legal Analysis (outside counsel) Initial Burden	0		\$0
Rule 18a-1(d) (VaR Models)	0		\$0

Initial Burden			
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14. Cost to Federal Government

The staff does not anticipate this information collection to impose additional costs to the Federal Government.

15. Changes in Burden

The changes in ongoing burden are due to a change in the estimate of stand-alone SBSBs that are subject to Rule 18a-1 from the Commission’s initial estimate of 6 respondents to the current number of 5 respondents and a change in the estimate of the number of stand-alone SBSBs that are subject to Rule 18a-1 but do not use models from the Commission’s initial estimate of 2 respondents to the current number of 1 respondent.

With respect to the initial burdens, the Commission initially estimated that 4 stand-alone SBSBs would apply to use internal models. As four firms now use internal models, there are no new respondents and the Commission does not expect that there will be any new respondents in the next three years. Therefore at this time there are no industry-wide one-time hour or cost burdens associated with these provisions.

With respect to Paragraph (f) of Rule 18a-1, there are currently 5 firms that are subject to those provisions, and the Commission initially estimated that there would be 6 such firms. The Commission does not expect that any new firms will be subject to Rule 18a-1 in the next three years, so as there are no new respondents, at this time there are no industry-wide one-time hour or cost burdens associated with those provisions.

With respect to subordinated loan agreements, there are currently 5 stand-alone SBSBs. The Commission initially estimated that there would be 6 stand-alone SBSBs. The Commission does not expect that there will be any new stand-alone SBSBs in the next three years, so as there are no new respondents, at this time there are no industry-wide one-time hour or cost burdens associated with subordinated loan agreements.

In addition, the risk management control system requirements are in paragraph (f) of Rule 18a-1. These requirements were mistakenly attributed to paragraph (g) of Rule 18a-1 in the 2019 PRA submission, and this error has been corrected.

16. Information Collected Planned for Statistical Purposes

Not applicable. The information collection would is not used for statistical purposes.

17. OMB Expiration Date Display Approval

The Commission is not seeking approval to not display the OMB approval expiration date.

18. Exceptions to Certification for Paperwork Reduction Act Submissions

This collection complies with the requirements in 5 CFR 1320.9.

B. COLLECTIONS OF INFORMATION EMPLOYING STATISTICAL METHODS

This collection does not involve statistical methods.