

**SUPPORTING STATEMENT  
for the Paperwork Reduction Act Information Collection Submission**

**Rule 18a-1 – Net capital requirements for security-based swap dealers for which there is not a prudential regulator**

**A. JUSTIFICATION**

**1. Necessity of Information Collection**

In accordance with Section 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”), the Securities and Exchange Commission (the “Commission”) has proposed new Rule 18a-1 to set forth net capital requirements for nonbank security-based swap dealers that are not also broker-dealers registered with the Commission (“stand-alone SBSDs”).<sup>1</sup> The rule establishes a number of new collection of information requirements. The Commission staff estimates that there will be a total of 9 respondents subject at least in part to these new requirements.

First, under Rule 18a-1, a stand-alone SBSD would need to 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 would be 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 would review and update the models it uses to compute market and credit risk, as well as backtest the models.

Second, under Rule 18a-1, stand-alone SBSDs approved to use models to compute deductions for market and credit risk would be required to perform a liquidity stress test at least monthly and, based on the results of that test, maintain liquidity reserves to address funding needs. The result of the test would need to be provided within 10 business days to senior management that has the responsibility to oversee risk management of the stand-alone SBSD. The assumptions underlying the liquidity stress test must be reviewed at least quarterly by senior management that has responsibility to oversee risk management at the stand-alone SBSD and at least annually by senior management of the stand-alone SBSD. In addition, if such stand-alone SBSD is part of a larger consolidated entity using liquidity tests, the stand-alone SBSD must justify and document any differences between the assumptions used in their liquidity stress tests from those used in stress tests of the consolidated entity. Furthermore, the stand-alone SBSD would be required to establish a written contingency funding plan. The plan would need to address the policies and roles and responsibilities of relevant personnel for meeting its liquidity

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<sup>1</sup> 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. 68071 (Oct. 18, 2012), 77 FR 70213 (Nov. 23, 2012).

needs of the firm and communications with the public and other market participants during a liquidity stress event.

Third, under Rule 18a-1, stand-alone SBSBs would be required to comply with certain requirements of Rule 15c3-4 (17 CFR 240.15c3-4) (OMB Control Number 3235-0497). 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.

Fourth, for purposes of calculating “haircuts” on credit default swaps, Rule 18a-1 would require 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.

Fifth, under Rule 18a-1, stand-alone SBSBs would be required to provide the Commission with certain written notices with respect to equity withdrawals.

Finally, under Rule 18a-1, stand-alone SBSBs would be 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 would also require 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.

## **2. Purpose and Use of the Information Collection**

The requirements in Rule 18a-1 would be 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 liquidity stresses and other risks.

## **3. Consideration Given to Information Technology**

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

#### **4. Duplication**

We are not aware that this information collection duplicates any existing information collection.

#### **5. Effect on Small Entities**

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

#### **6. Consequences of Not Conducting Collection**

If the required information collections were not conducted or were conducted less frequently, the protection afforded to investors and the U.S. financial and banking 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 Commission has issued a release soliciting comment on the new “collection of information” requirements and associated paperwork burdens.<sup>2</sup> A copy of the release is attached. Comments on Commission releases are generally received from registrants, investors, and other market participants. In addition, the Commission and staff participate in ongoing dialogue with representatives of various market participants through public conferences, meetings, and informal exchanges. Any comments received on this proposed rulemaking will be posted on the Commission’s public website, and made available through <http://www.sec.gov/comments/s7-08-12/s70812.shtml>. The Commission will consider all comments received prior to publishing the final rule, and will explain in any adopting release how the final rule responds to such comments, in accordance with 5 C.F.R. 1320.11(f).

#### **9. Payment or Gift**

No payment or gift is provided to respondents.

#### **10. Confidentiality**

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

#### **11. Sensitive Questions**

No information of a sensitive nature is required.

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<sup>2</sup> Id.

## 12. Burden of Information Collection

The staff estimates that the Rule 18a-1 will require in total, on an industry-wide basis, (1) a one-time burden of 23,700 recordkeeping hours and 180 reporting hours, and (2) an annual burden of 33,933 recordkeeping hours and 94.5 reporting hours.

### VaR Models

The staff estimates that 6 stand-alone SBSBs that elect to use internal models to compute net capital must first have an internal VaR model and submit information relating to the model along with its application to the Commission pursuant to Rule 18a-1. Based on past experience with broker-dealers that applied to use internal models under Rule 15c3-1 and related Appendix E, the Commission staff estimates that stand-alone SBSBs would 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 staff estimates that 90% of the hours will be spent developing the model and the remaining 10% will be spent providing information about the model to the Commission resulting in a one-time industry-wide hours burden of 675 recordkeeping and 75 reporting hours stand-alone SBSB.<sup>3</sup>

The staff estimates that these firms would then spend 4,200 hours per year reviewing and updating its VaR models, and also 480 hours per year backtesting those models against available data. That results in a total annual industry-wide hours burden of 28,080 recordkeeping hours.<sup>4</sup>

### Liquidity Stress Testing

With respect to information collections relating to liquidity stress tests, the staff estimates that the proposed requirements resulting from these provisions would result in a one-time burden to stand-alone SBSBs approved to use internal models as they would need to develop models for the liquidity stress test, document the results of the test to provide to senior management, document differences in the assumptions used in the liquidity stress test of the firm from those used in a consolidated entity of which the firm is a part, and develop a written contingency funding plan. Based on experience supervising ANC broker-dealers, the Commission staff estimates that the estimated 6 stand-alone SBSBs to be approved to use internal models would spend an average of approximately 200 hours to comply with these requirements, resulting in an industry-wide one-time internal hours burden of approximately 1,200 recordkeeping hours.<sup>5</sup> The Commission staff further estimates that these 6 stand-alone SBSBs would spend an average of approximately 50 hours per month reviewing and testing its liquidity testing and reviewing its contingency funding plan, resulting in a burden of 600 recordkeeping hours per stand-alone SBSB and an annual industry-wide hours burden of approximately 3,600 recordkeeping hours.<sup>6</sup>

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<sup>3</sup> These one-time costs are annualized over three years resulting in 225 recordkeeping and 25 reporting hours per respondent.

<sup>4</sup> Accordingly, the total annualized industry-wide reporting burden is 150 hours per year (75 one-time reporting hours annualized over three years x 6 stand-alone SBSBs) and recordkeeping burden is 29,430 hours ((675 one-time hours annualized over 3 years + 4,200 hours + 480 hours) x 6 stand-alone SBSBs).

<sup>5</sup> 6 stand-alone SBSBs using models x 200 hours = 1,200 hours. This number annualized over 3 years is 66.67 hours per stand-alone SBSB.

### Risk Management Control System

Rule 18a-1 would require that all registered nonbank SBSBs comply with Rule 15c3-4. Currently, there are 9 firms expected to register as stand-alone SBSBs. The Commission staff estimates that these firms would bear a one-time burden of 2,000 hours to initially set up risk management control systems,<sup>7</sup> and an annual burden of 250 hours per year.<sup>8</sup> This would result in an estimated industry-wide one-time internal hours burden of approximately 18,000 recordkeeping hours,<sup>9</sup> and an estimated industry-wide annual internal hours burden of approximately 2,250 recordkeeping hours per year.<sup>10</sup>

### Industry Sector Classification

With respect to documenting an industry sector classification system with respect to credit default swap haircuts, the Commission staff expects that 3 stand-alone SBSBs would have to bear internal hours burdens. The Commission staff also expects these firms to utilize third party systems off the shelf because of reduced costs. This results in an estimated industry-wide annual internal hour burden of approximately 3 recordkeeping hours per year.<sup>11</sup>

### Commission Notices

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 9 stand-alone SBSBs will file an average of 2 notices per year. It would require an estimated 30 minutes to file these notices, for an annual industry-wide hours burden of 4.5 reporting hours.<sup>12</sup>

Rule 18a-1 requires stand-alone SBSBs to file subordinated loan agreements with the Commission. The staff estimates that each firm will spend 20 hours updating its agreement templates, resulting in a one-time industry-wide hours burden of 180 reporting hours.<sup>13</sup> 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

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<sup>6</sup> 6 stand-alone SBSBs using models x 50 hours/month x 12 months = 3,600 hours. The total annualized recordkeeping burden is 4,000 hours (200 hours annualized over 3 years x 6 standalone SBSBs + 3,600 hours).

<sup>7</sup> This amount will be annualized over three years, which results an annual burden of 666.66 recordkeeping hours.

<sup>8</sup> The one-time estimate of 2,000 hours and the annual estimate of 250 hours is 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.

<sup>9</sup> 9 stand-alone SBSBs x 2,000 hours = 18,000 hours.

<sup>10</sup> 9 stand-alone SBSBs x 250 hours/year = 2,250 hours/year. The total annualized recordkeeping burden is 8,250 hours (18,000 one-time hours annualized over 3 years + 2,250 hours).

<sup>11</sup> 3 non-model stand-alone SBSBs x 1 hour/year = 6 hours/year.

<sup>12</sup> 9 stand-alone SBSBs x 30 minutes/year = 4.5 hours/year.

<sup>13</sup> 9 stand-alone SBSBs x 20 hours = 180 hours. This amount annualized is 6.66 hours per respondent.

year and that it would take approximately 10 hours to prepare and file the agreement, resulting in an annual industry-wide hours burden of 90 reporting hours.<sup>14</sup>

### **13. Costs to Respondents**

With respect to the external costs for respondents associated with developing VaR models and applying to the Commission for approval to use them, the staff estimates that, based upon previous experience with broker-dealers that developed internal models, 25% of these tasks would be handled by outside consultants. This results in 250 hours per respondent. The outside consultants are estimated to charge at a rate of \$400 per hour. This would result in a one-time industry-wide external recordkeeping cost of \$100,000 per respondent.<sup>15</sup>

With respect to the external costs associated with 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 would be handled by outside consultants. The outside consultants are estimated to charge at a rate of \$400 per hour resulting in a recordkeeping cost of \$624,000 per respondent. This would result in an annual industry-wide external cost of \$3,744,000.<sup>16</sup>

Nonbank SBSBs may need to 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 nonbank SBSBs would incur an average of approximately \$16,000 for initial hardware and software expenses, while the average ongoing cost would be approximately \$20,500 per nonbank SBSB. This would result in a one-time industry-wide external cost of \$48,000 annualized over three years,<sup>17</sup> and an ongoing industry-wide external cost of \$184,500 per year.<sup>18</sup>

### **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**

Not applicable. The information collection is related to a new rule.

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<sup>14</sup> 9 stand-alone SBSBs x 10 hours/year = 90 hours/year. The total annualized industry-wide hour reporting burden is 154.5 hours (4.5 hours + (180 hours annualized over 3 years) + 90 hours).

<sup>15</sup> This amount annualized over three years is \$33,333.33 per respondent.

<sup>16</sup> The total annualized industry-wide recordkeeping cost is \$3,944,900 (6 stand-alone SBSBs x (\$100,000 annualized over 3 years + \$624,000)).

<sup>17</sup> 9 nonbank SBSBs x \$16,000 / 3 years = \$48,000.

<sup>18</sup> 9 nonbank SBSBs x \$20,500/year = \$184,500. The total annualized industry-wide recordkeeping cost is \$232,500 (9 nonbank SBSBs x (\$16,000 annualized over 3 years + \$20,500)).

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

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

**17. Display of OMB Approval Date**

Not applicable. The Commission is not seeking approval to omit the OMB expiration date.

**18. Exceptions to Certification**

Not applicable. This collection complies with the requirements in 5 CFR 1320.9.

**B. COLLECTIONS OF INFORMATION EMPLOYING STATISTICAL METHODS**

Not applicable. This collection would not employ statistical methods.