

3507(d) and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to comply with, a collection of information unless it displays a currently valid OMB control number. The titles for the collections of information are: (1) Appendix E to Rule 15c3-1, Market and credit risk capital charges for certain brokers or dealers; (2) Appendix G to Rule 15c3-1, Conditions for holding companies of certain brokers or dealers; (3) Rule 15c3-4, Internal risk management control systems for certain brokers or dealers; (4) Rule 17a-5, Reports to be made by certain brokers and dealers; (5) Rule 17a-11, Notification procedures for brokers and dealers; (6) Rule 17h-1T, Risk assessment recordkeeping requirements for associated persons of brokers and dealers; and (7) Rule 17h-2T, Risk assessment reporting requirements for brokers and dealers.

The Commission proposes to implement a voluntary alternative method for computing net capital charges under the Exchange Act for certain broker-dealers that are part of a holding company that has a group-wide internal risk management system and that consents, as a condition of the net capital treatment, to group-wide Commission supervision. A broker-dealer that maintains tentative net capital of at least \$1 billion and net capital of at least \$500 million could apply to the Commission for a conditional exemption from the application of the standard net capital computation and, upon Commission approval, elect to calculate certain of its market and credit risk net capital charges using internally developed mathematical models that the firm uses to measure risk. Commission supervision would include reporting and recordkeeping requirements and Commission examination of unregulated holding companies and affiliates that are not functionally regulated.

The collection of information obligations imposed by the proposal would be mandatory. However, applying for approval to use the alternative capital calculation is voluntary.

The information collected, retained, and/or filed pursuant to the proposed rule amendments would be accorded confidential treatment.

The Commission would use the information collected under the proposed amendments to monitor the financial condition, internal risk management control system, and activities of broker-dealers that elect to compute certain of their market and credit risk capital charges under the alternative method and their holding

companies and affiliates. In particular, the proposed amendments would allow the Commission access to important information regarding activities of a broker-dealer's affiliates that could impair the financial and operational stability of the broker-dealer.

According to March 31, 2003 FOCUS filings, 28 registered broker-dealers reported that they had tentative net capital of at least \$1 billion and net capital of at least \$500 million. Based on discussions with industry representatives, the Commission believes, however, that only broker-dealers with at least \$1 billion in deductions pursuant to (c)(2)(vi) of Rule 15c3-1 (also known as "haircuts") will find it cost effective to use the alternative capital computation. As of March 2003, based on FOCUS filings, there were 12 such broker-dealers. Therefore, the PRA estimates are based on the assumption that 12 broker-dealers will apply for an exemption under the proposal.

Many of the estimates are also based on information Commission staff receives through the risk assessment rules and meetings with and reports from member firms of the Derivatives Policy Group ("DPG") and other broker-dealers and the Commission's experience in implementing the OTC derivatives dealer rules.

A broker-dealer that applies to use proposed Appendix E and its affiliates would have discretion in allocating the paperwork burden associated with the proposal among the entities in the CSE ("consolidated supervised entity"), including the broker-dealer. In estimating the total burden associated with the proposal on the broker-dealer, we have included the burdens arising from each proposed new rule amendment.

A. Proposed Appendix E to Rule 15c3-1, Market and Credit Risk Capital Charges for Certain Brokers or Dealers

Exchange Act Rule 15c3-1 requires broker-dealers to maintain minimum levels of net capital computed in accordance with the rule's provisions. These net capital reserves are intended to ensure that broker-dealers have sufficient capital to protect the assets of customers and to meet their responsibilities to other broker-dealers.

The Commission is proposing to add Appendix E to the rule to provide 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.

As part of the exemptive application to use Appendix E, the broker-dealer

and its holding company would submit descriptions of internal risk management controls and methods to be used to measure risk, including descriptions of all mathematical models used to price positions and compute market and credit risk and how those models meet the requirements of proposed Appendix E. The application would also include sample capital assessments for the affiliate group and sample risk reports provided to the firm's management and a written undertaking by the holding company to comply with various requirements of the proposal, including those listed in proposed Appendix G.

Proposed Appendix E would also require that mathematical models used to compute market and credit risk be reviewed periodically and backtested quarterly. For example, the mathematical model used to calculate maximum potential exposure would be required to be backtested quarterly for at least 40 counterparties by comparing the daily change in the firm's daily exposure to the counterparty with the maximum potential exposure generated by the model.

Failure to require the current and proposed collections of information included in this proposal would undermine the Commission's ability to monitor the financial condition of these firms and could jeopardize the financial stability of broker-dealers using Appendix E to compute certain of their capital charges.

We estimate that each broker-dealer that applies under the proposal 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 12 broker-dealers we expect to apply to be 12,000 hours.

These estimates are based on estimates the Commission made for the OTC derivatives dealer rules, which include a similar application requirement.⁷⁰ In that proposing release, we estimated that an OTC derivatives dealer would spend approximately 1,000 hours developing and submitting its VaR model and description of its risk management control system to the

⁷⁰ See 17 CFR 240.15c3-1f(a).