

the broker-dealer, we have included the costs arising from each proposed new rule amendment.

The proposed alternative net capital system is designed to increase a broker-dealer's operational efficiency by having its supervisory risk assessment and the computation of certain capital charges more closely aligned to the mathematical model-based methods the firm already uses to manage its business risk and capital, while establishing net capital requirements sufficient to require maintenance of capital to achieve the goals of the net capital rule and Exchange Act § 15(c)(3). The incorporation of mathematical risk management techniques into the calculation of net capital charges should enable such a broker-dealer to reallocate capital from the broker-dealer to affiliates that may receive a higher return than the broker-dealer. The proposed rule amendments should also allow broker-dealers to increase operational efficiency by adopting risk management practices which have become industry best practice.

We anticipate that cost savings would result in several areas. Under the proposal, a broker-dealer would become subject to specifically tailored capital and other requirements. The broker-dealer would be able to compute certain of its net capital charges using internally developed mathematical models that the firm uses to manage risk and to report risks to the Commission using internal reports that the firm already generates for risk management purposes.

The primary benefit for the broker-dealer would be the reduction in net capital charges that we expect would result from the use of the alternative method. This benefit, however, is difficult to quantify. While reductions in net capital requirements would likely result from the use of the alternative method, broker-dealers typically maintain higher levels of capital than the rules require. Also, the mix of positions held by the broker-dealer may change if the regulatory cost of holding certain positions is reduced. Finally, the reduction in net capital charges would vary significantly among broker-dealers based on the size and risk of their portfolios.

The 12 firms we expect to apply under this proposal reported capital charges ranging from approximately \$1 billion to approximately \$4 billion, for a total of approximately \$32 billion, on their first quarter of 2003 FOCUS reports. We expect that firms with larger capital charges would realize a larger percentage reduction in their capital charges than firms with smaller capital charges. We estimate that the 12 firms

would realize an average reduction in capital charges of approximately 40%, or a total reduction in capital charges for the 12 firms of approximately \$13 billion. If the firms reallocate that capital to fund business activities for which the rate of return is 20 basis points (0.2%) higher, the 12 broker-dealers could receive a total annual benefit of approximately \$26 million.

Firms that do business in the EU have indicated that they may need to demonstrate that they are subject to consolidated supervision at the holding company level that is "equivalent" to EU consolidated supervision. Without a demonstration of "equivalent" supervision, we understand that the affiliate institution located in the EU may either be subject to additional capital charges or be required to form a sub-holding company in the EU. We expect the Commission supervision contemplated by this proposal would meet this standard. As a result, we believe this proposal would minimize duplicative regulatory burdens on firms that are active in the EU as well as in other jurisdictions that may have similar laws.

Based on the responses of five firms to a survey conducted during the OTC derivatives dealer rulemaking process, we estimate that it would cost approximately \$8 million per year for a firm to form and maintain a sub-holding company in the EU.⁷⁴ Consequently, for the 12 broker-dealers we expect will apply under this proposal, not being required to form and maintain a sub-holding company in the EU would save the firms a total of approximately \$96 million per year.

These amendments would exempt broker-dealers that use Appendix E from Rules 17h-1T and 17h-2T. The current PRA burden estimate for Rules 17h-1T and 17h-2T is approximately 10 hours per year for each respondent. We estimate that the aggregate savings under the proposed amendments for the 12 firms we expect to apply under the proposal would be approximately 120 hours per year, and we expect that a financial reporting manager would do the work. The staff estimates that the hourly salary of a financial reporting manager is \$50.63 per hour.⁷⁵ The total

⁷⁴ The five firms estimated that their annual operating costs would increase by an average of approximately \$7 million to set up a separate company operating as an OTC derivatives dealer. We multiplied by 1.12 to account for inflation since 1998.

⁷⁵ Securities Industry Association's (SIA) Report on Management and Professional Earnings in the Securities Industry—2002 ("SIA Report"). Generally, to calculate an hourly cost using the SIA's Report, the staff takes the median (or, if no median is provided, the mean) salary provided in

cost savings for the 12 firms would be approximately \$6,000 ($120 * \$50.63 = \$6,076$).

To the extent that firms electing the proposed regulatory system improve their internal risk management control systems, we would expect that the firms would realize a benefit in the form of reduced borrowing costs. This benefit will vary widely depending on the risk management practices the firms already have in place. For some firms that already have formally documented group-wide control systems, there may be no benefit.

We believe that the proposed regulatory system would also result in benefits to regulators and to financial markets. The Commission would have access to group-wide information concerning the operation and financial condition of the broker-dealer's holding company and affiliates. This information would help the Commission to assess whether the activities or financial condition of the holding company or affiliates may pose risks to the financial health of the broker-dealer. Also, the broker-dealer and holding company would have to comply with stringent requirements concerning their internal risk management control systems. We expect that this requirement would promote the financial responsibility of these entities and reduce the risk of significant losses by the broker-dealer. By reducing the risk of significant losses by a single firm, internal risk management control systems would also reduce the risk that the problems of one firm would spread, causing defaults by other firms and undermining securities markets as a whole.

Firms electing the alternative capital computation would incur various costs. These firms would incur the one-time and ongoing costs of submitting an application and amendments to the application to use the alternative computation. 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. The staff anticipates that this would include approximately 100 hours for an in-house attorney and 900 hours for a senior compliance staff member. The

the SIA's Report for the position cited, divide that amount by 1,800 hours (in the average year), then multiply the result by 135% to account for employee overhead costs. (Financial Reporting Manager) + 35% overhead (based on end-of-year 2002 figures) (\$67,500 per year/1800 hours/year * 1.35 = \$50.63 per hour).