

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Parts 240 and 249

[Release No. 34-71194; File No. S7-15-11]

RIN 3235-AL14

### Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule.

**SUMMARY:** The Securities and Exchange Commission (the “Commission”) is adopting amendments that remove references to credit ratings in certain rules and one form under the Securities Exchange Act of 1934 (the “Exchange Act”) relating to broker-dealer financial responsibility and confirmations of securities transactions. This action implements a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).

**DATES:** The amendments will become effective on July 7, 2014.

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**SUPPLEMENTARY INFORMATION:** The Commission is adopting amendments to Rules 10b-10,<sup>1</sup> 15c3-1,<sup>2</sup> 15c3-1a,<sup>3</sup> 15c3-1e,<sup>4</sup> 15c3-1f,<sup>5</sup> 15c3-3,<sup>6</sup> and 17a-4<sup>7</sup> under the Exchange Act and corresponding amendments to the General Instructions to Form X-17A-5, Part IIB.<sup>8</sup>

## I. Introduction

On July 21, 2010, the President signed the Dodd-Frank Act into law.<sup>9</sup> This legislation was enacted to, among other things, promote the financial stability of the United States by improving accountability and transparency in the financial system.<sup>10</sup> Section 939A of the Dodd-Frank Act requires each Federal agency, including the Commission, to review any regulation issued by such agency that requires the use of an assessment of the creditworthiness of a security or money market instrument and any references to or requirements in such regulations regarding credit ratings.<sup>11</sup> The section further provides that each such agency shall “modify any such regulations identified by the review . . . to remove any reference to or requirement of reliance on credit ratings, and to substitute in such regulations such standard of creditworthiness as each respective agency shall determine as appropriate for such regulations.”<sup>12</sup>

## II. Discussion

### A. Background

Prior to and after enactment of the Dodd-Frank Act, the Commission has taken a number of steps toward removing references to credit ratings from its regulations under the federal securities laws.<sup>13</sup> These steps include a

<sup>9</sup> See Public Law 111-203, 124 Stat. 1376 (2010).

<sup>10</sup> *Id.* at Preamble.

<sup>11</sup> Public Law 111-203 § 939A(a)(1)-(2). In July 2011, the Commission published a report on the staff's review of Commission regulations that relied on credit ratings. See Commission Staff, *Report on Review of Reliance on Credit Ratings: As Required by Section 939A(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (July 2011). Section 939A of the Dodd-Frank Act applies to all federal agencies.

<sup>12</sup> See Public Law 111-203 § 939A(b).

<sup>13</sup> See, e.g., *Nationally Recognized Statistical Rating Organizations*, Exchange Act Release No. 34616 (Aug. 31, 1994), 59 FR 46314 (Sep. 7, 1994) (soliciting comment on, among other things, whether references to NRSRO credit ratings should be eliminated from Commission rules); *Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws*, Exchange Act Release No. 47972 (June 4, 2003), 68 FR 35258 (June 12, 2003) (soliciting comment on whether to eliminate the use of NRSRO credit ratings, and, if so, what alternative benchmarks could be used to meet the Commission's regulatory objectives); *References to Ratings of Nationally Recognized Statistical Rating Organizations*, Exchange Act Release No. 58070 (July 1, 2008), 73 FR 40088 (July 11, 2008)

(proposing amendments to remove references to credit ratings from Commission rules under the Securities Act of 1933 (“Securities Act”), Exchange Act, and Investment Company Act of 1940 (“Investment Company Act”)); *References to Ratings of Nationally Recognized Statistical Rating Organizations*, Exchange Act Release No. 60789 (Oct. 5, 2009), 74 FR 52358 (Oct. 9, 2009) (adopting amendments to remove references to credit ratings in certain Commission rules); *References to Ratings of Nationally Recognized Statistical Rating*

2011 proposal to remove references to credit ratings of nationally recognized statistical rating organizations (“NRSROs”) from certain rules under the Exchange Act relating to broker-dealer financial responsibility (Rule 15c3-1, Rule 15c3-3, and Form X-17A-5, Part IIB), confirmations of securities transactions (Rule 10b-10), and distributions of securities (Rules 101 and 102 of Regulation M).<sup>14</sup> Today the Commission is adopting amendments to remove references to credit ratings in the broker-dealer financial responsibility and confirmations of transactions rules. In doing so, the Commission considered its prior actions in this area. Regarding its proposal to remove credit ratings from its rules under Regulation M applicable to distributions of securities, the Commission is currently reviewing comments and considering alternatives and intends to address this proposal separately.<sup>15</sup> In taking these actions, the Commission has carefully considered the eleven comment letters it received in response to the proposing release,<sup>16</sup>

*Organizations*, Exchange Act Release No. 60790 (Oct. 5, 2009), 74 FR 52374 (Oct. 9, 2009) (re-opening comment on proposals to remove references to credit ratings in certain Commission rules); *Security Ratings*, Securities Act Release No. 9186 (Feb. 9, 2011), 76 FR 8961 (Feb. 16, 2011) (proposing amendments to remove references to credit ratings in certain Commission rules); *References to Credit Ratings in Certain Investment Company Act Rules and Forms*, Securities Act Release No. 9193 (Mar. 3, 2011), 76 FR 12896 (Mar. 9, 2011) (proposing amendments to remove references to credit ratings in certain Commission rules); *Security Ratings*, Securities Act Release No. 9245 (July 27, 2011), 76 FR 46603 (Aug. 3, 2011) (adopting amendments to remove references to credit ratings in certain Commission rules).

<sup>14</sup> See *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, Exchange Act Release No. 64352 (Apr. 27, 2011), 76 FR 26550 (May 6, 2011). The Commission also proposed amendments in 2011 to remove references to credit ratings in rules under the Securities Act and the Investment Company Act. See *References to Credit Ratings in Certain Investment Company Act Rules and Forms*, 76 FR 12896; *Security Ratings*, 76 FR 8961.

<sup>15</sup> Regulation M is a set of anti-manipulation rules designed to preserve the integrity of the securities market by prohibiting activities that could artificially influence the market for an offered security. See 17 CFR 242.100-105. The rules include an exception for nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities that are rated by at least one NRSRO in one of its generic rating categories that signifies investment grade. See 17 CFR 242.101(c)(2); 17 CFR 242.102(d)(2).

<sup>16</sup> Comment letter of Chris Barnard (June 6, 2011) (“*Barnard Letter*”); comment letter of Creative Investment Research, Inc. (July 4, 2011) (“*Creative Investment Letter*”); comment letter of Rothwell Consulting LLC (July 5, 2011) (“*Rothwell Consulting Letter*”); comment letter of Davis Polk & Wardwell LLP (July 5, 2011) (“*Davis Polk Letter*”); comment letter of Bond Dealers of America (July 5, 2011) (“*Bond Dealers Letter*”); comment letter of the Securities Industry and Financial Markets Association (July 5, 2011) (“*SIFMA Letter*”);

<sup>1</sup> 17 CFR 240.10b-10.

<sup>2</sup> 17 CFR 240.15c3-1.

<sup>3</sup> 17 CFR 240.15c3-1a.

<sup>4</sup> 17 CFR 240.15c3-1e.

<sup>5</sup> 17 CFR 240.15c3-1f.

<sup>6</sup> 17 CFR 240.15c3-3.

<sup>7</sup> 17 CFR 240.17a-4.

<sup>8</sup> See the General Instructions to Form X-17A-5, Part IIB (referenced in 17 CFR 249.617).

five of which discussed the proposed amendments to the broker-dealer financial responsibility rules,<sup>17</sup> and four of which discussed the proposed amendments to the confirmations of transactions rule.<sup>18</sup>

A number of other federal agencies have also taken action to implement section 939A of the Dodd-Frank Act, including regulations proposed or adopted by the Commodity Futures Trading Commission,<sup>19</sup> the Office of the Comptroller of the Currency,<sup>20</sup> the National Credit Union Administration,<sup>21</sup> the Federal Housing Finance Agency,<sup>22</sup> the Department of Labor,<sup>23</sup> and jointly by the Office of the Comptroller of the Currency and the Federal Reserve Board.<sup>24</sup> The actions taken by these other regulators were

comment letter of Better Markets, Inc. (July 5, 2011) (“*Better Markets Letter*”); comment letter of Sullivan & Cromwell LLP (July 5, 2011) (“*Sullivan & Cromwell Letter*”); comment letter of the Securitization Group, Securities Industry and Financial Markets Association (Sep. 23, 2011) (“*SIFMA Securitization Letter*”); comment letter of the CFA Institute (Dec. 20, 2011) (“*CFA Institute Letter*”); and comment letter of the Honorable Sean P. Duffy, U.S. House of Representatives (Oct. 4, 2013) (“*Duffy Letter*”). These comment letters are available at <http://www.sec.gov/comments/s7-15-11/s71511.shtml>. Comments are also available for Web site viewing and printing in the Commission’s Public Reference Room, 100 F Street NE., Washington, DC (File No. S7–15–11).

<sup>17</sup> See *Barnard Letter*; *Better Markets Letter*; *Bond Dealers Letter*; *CFA Institute Letter*; *SIFMA Letter*.

<sup>18</sup> See *Better Markets Letter*; *CFA Institute Letter*; *SIFMA Letter*; *Sullivan & Cromwell Letter*. In addition, one letter discussed the proposed amendments to Regulation M and one letter discussed reference removal under section 939A generally. See *Rothwell Consulting Letter* (Regulation M); *Duffy Letter* (section 939A generally).

<sup>19</sup> See *Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions*, 76 FR 78776 (Dec. 19, 2011) (final rule); *Removing Any Reference to or Reliance on Credit Ratings in Commission Regulations; Proposing Alternatives to the Use of Credit Ratings*, 76 FR 44262 (July 25, 2011) (final rule).

<sup>20</sup> See *Alternatives to the Use of External Credit Ratings in the Regulations of the OCC*, 77 FR 35253 (June 13, 2012) (final rule).

<sup>21</sup> See *Alternatives to the Use of Credit Ratings*, 77 FR 74103 (Dec. 13, 2012) (final rule).

<sup>22</sup> See *Removal of References to Credit Ratings in Certain Regulations Governing the Federal Home Loan Banks*, 78 FR 30784 (May 23, 2013) (proposed rule).

<sup>23</sup> See *Proposed Amendments to Class Prohibited Transaction Exemptions to Remove Credit Ratings Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 78 FR 37572 (June 21, 2013) (proposed rule).

<sup>24</sup> See *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule*, 78 FR 62018 (Oct. 11, 2013) (interim final rule with request for comment).

considered in adopting today’s amendments.

The following discussion summarizes the Commission’s proposals with respect to the broker-dealer financial responsibility and confirmations of transaction rules, the comments received by the Commission in response to each of the proposals, and the amendments the Commission is adopting today.<sup>25</sup>

## B. Amendments

### 1. The Broker-Dealer Financial Responsibility Rules

#### a. The Net Capital Rule

##### i. Proposal

In 1975, the Commission adopted the term *nationally recognized statistical rating organization* as part of amendments to the broker-dealer net capital rule (“Rule 15c3–1”).<sup>26</sup> The Commission’s initial regulatory use of the term was intended to provide a method for determining net capital charges on different grades of debt securities under Rule 15c3–1.<sup>27</sup> Rule 15c3–1 prescribes a net liquid assets test that is designed to require a broker-dealer to maintain sufficient liquid assets to meet all obligations to customers and counterparties and have adequate additional resources to wind-down its business in an orderly manner without the need for a formal proceeding if the firm fails financially.<sup>28</sup> Among other things, Rule 15c3–1 requires broker-dealers to maintain specified minimum levels of net liquid assets, or net capital.<sup>29</sup> In particular, it requires that a broker-dealer perform two calculations: (1) a computation of the minimum amount of net capital the broker-dealer must maintain;<sup>30</sup> and (2) a computation of the amount of net capital the broker-dealer is maintaining.<sup>31</sup> The minimum net capital requirement is the greater of a fixed-dollar amount specified in the rule or an amount determined by applying one of two financial ratios.<sup>32</sup>

<sup>25</sup> In a separate release, the Commission is adopting final amendments to remove references to credit ratings in Rule 5b–3 and Forms N–1A, N–2, and N–3 under the Investment Company Act.

<sup>26</sup> See *Adoption of Uniform Net Capital Rule and an Alternative Net Capital Requirement for Certain Brokers and Dealers*, Exchange Act Release No. 11497 (June 26, 1975), 40 FR 29795 (July 16, 1975); 17 CFR 240.15c3–1.

<sup>27</sup> See 17 CFR 240.15c3–1.

<sup>28</sup> See *Net Capital Rule*, Exchange Act Release No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997).

<sup>29</sup> See 17 CFR 240.15c3–1.

<sup>30</sup> See 17 CFR 240.15c3–1(a).

<sup>31</sup> See 17 CFR 240.15c3–1(c)(2). The computation of net capital is based on the definition of *net capital* in paragraph (c)(2) of Rule 15c3–1. *Id.*

<sup>32</sup> See 17 CFR 240.15c3–1(a).

In computing net capital, a broker-dealer must, among other things, make certain adjustments to net worth, including deducting illiquid assets, taking other net capital charges, and adding qualifying subordinated loans.<sup>33</sup> The amount remaining after these adjustments is defined as *tentative net capital*.<sup>34</sup> The final step in computing net capital is to take prescribed percentage deductions (“haircuts”) from the mark-to-market value of proprietary positions (e.g., securities, money market instruments, and commodities) that are included in the broker-dealer’s tentative net capital.<sup>35</sup> The haircuts are designed to account for the market risk inherent in these positions and create a buffer of liquidity to protect against other risks associated with the securities business.<sup>36</sup>

Rule 15c3–1 prescribes differing haircut amounts for a variety of classes of securities.<sup>37</sup> The rule also contains catchall provisions to account for securities that are not included in the specified classes of securities.<sup>38</sup> Generally, the catchall provisions impose higher deductions (15% or 40% of the mark-to-market value of the positions) than the haircuts applicable to the specifically identified classes of securities.<sup>39</sup> Further, if a security does not have a ready market, it is subject to a 100% deduction from net worth.<sup>40</sup>

<sup>33</sup> See 17 CFR 240.15c3–1(c)(2)(i) through (xiii).

<sup>34</sup> See 17 CFR 240.15c3–1(c)(15).

<sup>35</sup> See 17 CFR 240.15c3–1(c)(2)(vi).

<sup>36</sup> See, e.g., *Uniform Net Capital Rule*, Exchange Act Release No. 13635 (June 16, 1977), 42 FR 31778 (June 23, 1977) (“[Haircuts] are intended to enable net capital computations to reflect the market risk inherent in the positioning of the particular types of securities enumerated in [the rule.]”); *Net Capital Rule*, Exchange Act Release No. 22532 (Oct. 15, 1985), 50 FR 42961 (Oct. 23, 1985) (“These percentage deductions, or ‘haircuts’, take into account elements of market and credit risk that the broker-dealer is exposed to when holding a particular position.”); *Net Capital Rule*, Exchange Act Release No. 39455 (Dec. 17, 1997), 62 FR 67996 (Dec. 30, 1997) (“Reducing the value of securities owned by broker-dealers for net capital purposes provides a capital cushion against adverse market movements and other risks faced by the firms, including liquidity and operational risks.”) (footnote omitted).

<sup>37</sup> See 17 CFR 240.15c3–1(c)(2)(vi)(A) through (H).

<sup>38</sup> See 17 CFR 240.15c3–1(c)(2)(vi)(J) through (K).

<sup>39</sup> Compare 17 CFR 240.15c3–1(c)(2)(vi)(A) through (H), with 17 CFR 240.15c3–1(c)(2)(vi)(J) through (K).

<sup>40</sup> See 17 CFR 240.15c3–1(c)(2)(vii). The term *ready market* is defined in Rule 15c3–1 as “a market in which there exists independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom.” 17 CFR 240.15c3–1(c)(11).

Prior to today's amendments, commercial paper, nonconvertible debt, and preferred stock rated in higher rating categories by at least two NRSROs were included in the classes of securities that had lower haircuts than securities subject to the catchall provisions.<sup>41</sup> Specifically, to qualify for this treatment, among other things, commercial paper needed to be rated in one of the three highest rating categories by at least two NRSROs,<sup>42</sup> nonconvertible debt needed to be rated in one of the four highest rating categories by at least two NRSROs,<sup>43</sup> and preferred stock needed to be rated in one of the four highest rating categories by at least two NRSROs.<sup>44</sup> Broker-dealers were not required to take as large a haircut for commercial paper, nonconvertible debt, and preferred stock meeting these rating conditions because the securities were considered to be less volatile in price than securities that were rated in lower rating categories or were unrated.

The Commission proposed to remove references to credit ratings in the provisions of Rule 15c3-1 establishing lower haircuts for higher rated commercial paper, nonconvertible debt, and preferred stock and to substitute an alternative standard of creditworthiness as a condition for qualifying for the lower haircut treatment.<sup>45</sup> The proposed amendments retained the non-credit rating conditions for these classes of securities to apply lower haircuts. Under the proposal, a broker-dealer would have been permitted to apply the

lower haircuts for commercial paper (*i.e.*, between zero and 1/2 of 1%), nonconvertible debt (*i.e.*, between 2% and 9%), and preferred stock (*i.e.*, 10%) if the position had only a minimal amount of credit risk as determined by the broker-dealer pursuant to written policies and procedures the broker-dealer established, maintained, and enforced to assess creditworthiness.<sup>46</sup> Consequently, to use these lower haircuts for commercial paper, nonconvertible debt, and preferred stock, a broker-dealer would have been required to establish, maintain, and enforce written policies and procedures designed to assess the credit risks applicable to the position and, based on this process, would have had to determine that the investment had only a minimal amount of credit risk.<sup>47</sup> A broker-dealer would have been required to take a larger deduction, normally the 15% "catchall" haircut, on its proprietary positions in commercial paper, nonconvertible debt, and preferred stock if the firm did not have procedures to assess the creditworthiness of the class of security or money market instrument or determined its position was not of minimal credit risk.<sup>48</sup> Moreover, if an issuance of commercial paper, nonconvertible debt, or preferred stock did not trade in a ready market, the broker-dealer would continue to apply a 100% haircut—meaning that the broker-dealer could not include the value of the security in its net capital.<sup>49</sup>

In the proposing release, the Commission identified the following factors a broker-dealer could consider, to the extent appropriate, when assessing credit risk for purposes of determining whether an issuance of commercial paper, nonconvertible debt, or preferred stock was of minimal credit risk: (1) Credit spreads; (2) securities-related research; (3) internal or external credit risk assessments; (4) default statistics; (5) inclusion in an index; (6) priorities and enhancements; (7) price, yield and/or volume; and (8) asset class-specific factors.<sup>50</sup> The Commission stated that the list of factors was not intended to be exhaustive nor mutually exclusive and that the range and type of specific factors considered would vary depending on the particular securities that were reviewed.<sup>51</sup>

In addition, each broker-dealer would have been required to preserve for a period of not less than three years (the first two years in an easily accessible place) the written policies and procedures that the broker-dealer established, maintained, and enforced for assessing credit risk for commercial paper, nonconvertible debt, and preferred stock.<sup>52</sup> Broker-dealers would have been subject to this requirement in the broker-dealer record retention rule (Rule 17a-4), which the Commission proposed to amend in conjunction with the rulemaking.<sup>53</sup>

## ii. Comments

Five commenters responded to the Commission's request for comment on the amendments to Rule 15c3-1.<sup>54</sup> One additional commenter—writing about section 939A generally—supported the goals of section 939A to provide incentive for more information and diligence for investors and to increase competition in the credit rating agency industry but also cautioned that implementation of section 939A could be confusing to smaller banks and investors.<sup>55</sup> Two commenters raised concerns generally about replacing credit ratings with a more subjective standard of creditworthiness.<sup>56</sup> Three other commenters suggested modifications to the Commission's list of factors that a broker-dealer could consider when assessing creditworthiness under the proposed minimal amount of credit risk standard.<sup>57</sup> Commenters also generally supported the Commission's proposal that broker-dealers document and retain their policies and procedures for assessing a position's creditworthiness to determine whether it is of minimal credit risk.<sup>58</sup>

Among commenters raising concerns about the Commission replacing credit ratings with a more subjective approach for determining haircuts, one commenter stated that the proposal contains an inherent conflict of interest, is complicated, and would disproportionately burden smaller

<sup>41</sup> See 17 CFR 240.15c3-1(c)(2)(vi)(E), (F), and (H). Generally, the haircut requirements in Rule 15c3-1 prior to today's amendments were based on the practice of many NRSROs having at least eight categories of ratings for debt securities, with the top four ratings commonly referred to in the industry as *investment grade*.

<sup>42</sup> See 17 CFR 240.15c3-1(c)(2)(vi)(E). The amount of the haircut ranged from 0% to 1/2 of 1% depending on the time to maturity of the commercial paper. *Id.* Additional conditions to qualify for this treatment were that the commercial paper had a maturity at date of issuance not exceeding nine months exclusive of days of grace, or any renewal thereof, the maturity of which was likewise limited, and a fixed rate of interest or been sold at a discount. *Id.*

<sup>43</sup> See 17 CFR 240.15c3-1(c)(2)(vi)(F). The amount of the haircut ranged from 2% to 9% depending on the time to maturity of the nonconvertible debt security. *Id.* Additional conditions to qualify for this treatment were that the nonconvertible debt security had a fixed rate of interest, a fixed maturity, and did not trade flat and was not in default as to principal or interest. *Id.*

<sup>44</sup> See 17 CFR 240.15c3-1(c)(2)(vi)(H). The amount of the haircut was 10%. *Id.* Additional conditions to qualify for this treatment were that the preferred stock ranked prior to all other classes of stock of the same issuer and was not in arrears as to dividends. *Id.*

<sup>45</sup> See *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, 76 FR at 26552–26554.

<sup>46</sup> *Id.* at 26552.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> *Id.* at 26552–26553.

<sup>51</sup> *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, 76 FR at 26553.

<sup>52</sup> *Id.* at 26553.

<sup>53</sup> *Id.*; see also 17 CFR 240.17a-4.

<sup>54</sup> See *Barnard Letter*; *Better Markets Letter*; *Bond Dealers Letter*; *CFA Institute Letter*; *SIFMA Letter*; see also *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, 76 FR at 26554.

<sup>55</sup> See *Duffy Letter*, at 1.

<sup>56</sup> See *Bond Dealers Letter*, at 2–3; *SIFMA Letter*, at 11.

<sup>57</sup> See *Barnard Letter*, at 1–2; *Better Markets Letter*, at 6–7; *CFA Institute Letter*, at 4.

<sup>58</sup> See *Barnard Letter*, at 2; *Better Markets Letter*, at 6–8.

firms.<sup>59</sup> This commenter also stated that the Commission's proposal could result in inconsistent net capital treatment across broker-dealers absent a mandatory list of factors or an objective standard that a broker-dealer could apply when determining net capital haircuts—"[f]or example, one firm may determine a security qualifies for a 9% haircut, while another might determine the haircut for the same security is 15%."<sup>60</sup> This commenter also has concerns that a subjective approach would reduce liquidity, increase volatility, and could increase costs for issuers of securities.<sup>61</sup>

The second commenter expressed concern that Commission and self-regulatory organization ("SRO") examiners would "second guess" a broker-dealer's policies and procedures and analysis under the new standard and that examiners should, instead, focus on the reasonableness of the policies and procedures.<sup>62</sup> This commenter also requested that examiners avoid duplicating the work of other regulators who have already considered the adequacy of a broker-dealer's policies and procedures for assessing the creditworthiness of securities positions.<sup>63</sup>

Regarding the Commission's proposed list of factors that broker-dealers could consider when assessing creditworthiness under the minimal amount of credit risk standard, one commenter recommended that the Commission require broker-dealers to consider certain mandatory factors and suggested they be codified in the final rule.<sup>64</sup> In contrast, another commenter did not believe that factors should be codified in the rule.<sup>65</sup> Another stated that a broker-dealer's assessment of a security's creditworthiness should be based on "hard" factors, such as credit spreads and default statistics, rather than "soft" factors, such as securities-related research.<sup>66</sup>

One commenter requested that "term to maturity" and "concentration of credit risk" be included as factors that a broker-dealer could consider in assessing whether a position is of minimal credit risk.<sup>67</sup> Another

suggested that a broker-dealer's policies and procedures for assessing creditworthiness under the proposed standard be permitted to take into account the "size of the [broker-dealer's] position and the purpose for which the position [was] acquired or held by the broker-dealer."<sup>68</sup> This commenter also stated that a broker-dealer's obligation to monitor credit determinations should be based on factors such as the volatility of business conditions within the relevant industry and the frequency with which the securities trade.<sup>69</sup>

One commenter suggested that a broker-dealer be allowed to rely on a parent's or an affiliate's credit determination.<sup>70</sup> Another stated that, to promote regulatory and market transparency, a broker-dealer that develops internal credit ratings should be required to compare its ratings to an external benchmark, such as NRSRO ratings, market data, or other credit information sources.<sup>71</sup> Another stated, however, that a broker-dealer should be prohibited from considering internally or externally developed credit ratings as part of its credit risk assessment process and that permitting such use would conflict with section 939A of the Dodd-Frank Act.<sup>72</sup>

Commenters generally supported the Commission's proposal that broker-dealers document their policies and procedures for determining creditworthiness under the minimal amount of credit risk standard.<sup>73</sup> One commenter suggested that such documentation be maintained indefinitely.<sup>74</sup> Another stated that the Commission should require a broker-dealer to maintain a record for each assessment of creditworthiness under the standard.<sup>75</sup> Another stated that the Commission should only require the retention of records for determinations of credit risk when a broker-dealer is engaged in "sophisticated credit analysis."<sup>76</sup> This commenter stated that a broker-dealer should not be required to document its credit analysis with

respect to a position if the analysis was based on a small number of objective factors and could be easily reconstructed by the broker-dealer.<sup>77</sup>

### iii. Final Rule

The Commission is amending Rule 15c3-1 to remove references to NRSRO credit ratings in the provisions establishing lower haircuts for commercial paper, nonconvertible debt, and preferred stock. The Commission is adopting amendments to these provisions with modifications from the proposal, discussed below, to address issues raised by commenters.

Under the final amendments and consistent with the proposal, when a broker-dealer applies haircuts for commercial paper, nonconvertible debt, and preferred stock that have a ready market for purposes of its net capital computation, it will have the option of: (1) Using the firm's own written policies and procedures to determine whether the security has only a minimal amount credit risk and, if so, applying the appropriate lower haircut if it meets the other conditions prescribed in Rule 15c3-1; or (2) applying the greater deduction applicable to the position, such as the 15% haircut under the catchall provision in paragraph (c)(2)(vi)(j) of Rule 15c3-1.<sup>78</sup> Commercial paper, nonconvertible debt, and preferred stock without a ready market would continue to be subject to a 100% haircut.<sup>79</sup>

Unlike the objective approach of using NRSRO credit ratings, the minimal amount of credit risk standard is a subjective approach because it allows broker-dealers in the first instance to determine through their credit assessments whether a lower haircut is applicable to a given position. Further, whereas the rule prior to today's amendments required that commercial paper, nonconvertible debt, and preferred stock be given high credit ratings by an NRSRO before a reduced haircut is permitted, the minimal amount of credit risk standard provides flexibility to broker-dealers by allowing them to rely on a variety of factors, both objective and subjective, in assessing the credit and liquidity risks associated with their proprietary commercial paper, nonconvertible debt, and preferred stock positions. However, the Commission does not intend for the new standard to result in a more liberal requirement that broadens the scope of

<sup>77</sup> *Id.*

<sup>78</sup> See paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F), (c)(2)(vi)(H), and (c)(2)(vi)(I) of Rule 15c3-1, as amended.

<sup>79</sup> See 17 CFR 240.15c3-1(c)(2)(vii).

<sup>68</sup> *SIFMA Letter*, at 10–11.

<sup>69</sup> *Id.* at 21.

<sup>70</sup> *Id.*

<sup>71</sup> *CFA Institute Letter*, at 4.

<sup>72</sup> *Better Markets Letter*, at 7.

<sup>73</sup> One commenter stated that broker-dealers would otherwise make self-interested determinations at the expense of customers. *Better Markets Letter*, at 6–8. Another commenter stated that these policies and procedures should be preserved for three years and updated to reflect significant changes. *Barnard Letter*, at 2. This commenter further argued that broker-dealers that create and enforce procedures to determine creditworthiness be granted the lesser haircut. *Id.*

<sup>74</sup> *Barnard Letter*, at 2.

<sup>75</sup> *Better Markets Letter*, at 7–8.

<sup>76</sup> *SIFMA Letter*, at 22.

<sup>59</sup> *Bond Dealers Letter*, at 2. This commenter argued that the proposed amendments disadvantage smaller broker-dealers that lack the necessary internal resources to determine creditworthiness and, as a result, will be unable to apply reduced haircuts.

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> *SIFMA Letter*, at 19.

<sup>63</sup> *Id.* at 20–21.

<sup>64</sup> *Better Markets Letter*, at 5–6.

<sup>65</sup> *SIFMA Letter*, at 20.

<sup>66</sup> *Barnard Letter*, at 2.

<sup>67</sup> *CFA Institute Letter*, at 4.

the rule by allowing more positions to qualify for the lower haircuts.<sup>80</sup> The Commission notes that credit ratings and market data (such as credit spreads and yields) can serve as useful benchmarks for evaluating whether a broker-dealer's policies and procedures, as applied to the minimal amount of credit risk standard, are increasing the types of commercial paper, nonconvertible debt, and preferred stock positions to which it applies the lower haircuts as compared to the eliminated NRSRO credit rating standard.

The Commission is amending paragraph (c)(2)(vi)(E) of Rule 15c3-1 (relating to commercial paper haircuts), paragraphs (c)(2)(vi)(F)(1) and (c)(2)(vi)(F)(2) of Rule 15c3-1 (relating to nonconvertible debt haircuts), and paragraph (c)(2)(vi)(H) of Rule 15c3-1 (relating to preferred stock haircuts) by replacing references to NRSRO credit ratings with the alternative minimal amount of credit risk standard.<sup>81</sup> Consistent with the proposal, the final rule provides that a broker-dealer may apply the lower haircuts applicable to commercial paper (*i.e.*, between 0% and ½ of 1%), nonconvertible debt (*i.e.*, between 2% and 9%), and preferred stock (*i.e.*, 10%) if the security has only a minimal amount of credit risk.<sup>82</sup>

The Commission has made several modifications to its proposed rule text. First, the Commission has re-structured the rule by adding new paragraph (c)(2)(vi)(I) to specify requirements for the policies and procedures a broker-dealer must establish, document, maintain, and enforce for purposes of assessing whether a position has only a minimal amount credit risk under paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2), and (c)(2)(vi)(H).<sup>83</sup> Under the proposal, each of the paragraphs (*i.e.*, paragraphs (c)(2)(vi)(E),

(c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2), and (c)(2)(vi)(H)) separately provided that a broker-dealer must determine whether a position has only a minimal amount of credit risk pursuant to "written policies and procedures the broker-dealer establishes, maintains, and enforces to assess creditworthiness."<sup>84</sup> Consistent with the proposal, each paragraph still requires that the security or money market instrument have only a minimal amount of credit risk before the lower haircut may be applied; however the reference to policies and procedures in each paragraph has been removed. Instead, new paragraph (c)(2)(vi)(I) of Rule 15c3-1 requires the broker-dealer to establish, document, maintain, and enforce policies and procedures to assess and monitor the creditworthiness of each security or money market instrument that are reasonably designed for the purpose of determining whether the position has only a minimal amount of credit risk.<sup>85</sup> Securities or money market instruments assessed to have only a minimal amount of credit risk also must meet the other non-credit rating conditions prescribed in Rule 15c3-1 in order to apply the lower haircuts under paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2), or (c)(2)(vi)(H).<sup>86</sup>

Under the final rule, new paragraph (c)(2)(vi)(I) of Rule 15c3-1 provides that in order to apply a deduction under paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2), or (c)(2)(vi)(H), the broker-dealer must assess the creditworthiness of the security or money market instrument pursuant to policies and procedures for assessing and monitoring creditworthiness that the broker-dealer establishes, documents, maintains, and enforces.<sup>87</sup>

<sup>84</sup> See *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, 76 FR at 26576.

<sup>85</sup> See paragraph (c)(2)(vi)(I) of Rule 15c3-1, as amended.

<sup>86</sup> Paragraph (c)(2)(vi)(E) of Rule 15c3-1, as amended, retains the non-credit rating conditions that the commercial paper must have a maturity at date of issuance not exceeding nine months exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited, and a fixed rate of interest, or be sold at a discount. See 17 CFR 240.15c3-1(c)(2)(vi)(E). Paragraph (c)(2)(vi)(F) of Rule 15c3-1, as amended, retains the non-credit rating conditions that the nonconvertible debt security must have a fixed rate of interest, a fixed maturity, and not be traded flat or in default as to principal or interest. See 17 CFR 240.15c3-1(c)(2)(vi)(F). Paragraph (c)(2)(vi)(H) of Rule 15c3-1, as amended, retains the non-credit rating conditions that the preferred stock must rank prior to all other classes of stock of the same issuer and not be in arrears as to dividends. See 17 CFR 240.15c3-1(c)(2)(vi)(H). See also 17 CFR 240.15c3-1(c)(2)(vii) (establishing a 100% deduction for securities for which there is no ready market).

<sup>87</sup> See paragraph (c)(2)(vi)(I) of Rule 15c3-1, as amended.

The Commission added the word "monitoring" to clarify that, after the initial determination by a broker-dealer, a position must continue to have only a minimal amount of credit risk in order to remain qualified for the lower haircut and that monitoring must be done in accordance with the firm's policies and procedures. Under Rule 15c3-1, a broker-dealer must at "all times" have and maintain an amount of net capital that is at least equal to the minimum amount of net capital required by the rule.<sup>88</sup> Consequently, the broker-dealer must monitor its securities and money market instrument positions in order to ensure that it is applying the appropriate haircuts to those positions. For example, under the NRSRO credit rating standard being eliminated today, a broker-dealer needed to monitor whether the positions it held continued to have the required credit ratings to apply the lower haircuts because credit rating agencies may adjust (*e.g.*, downgrade) their credit ratings. The same is true under the new minimal credit risk standard because the creditworthiness of a security or money market instrument can change over time and, consequently, a position that has only a minimal amount of credit risk at one point in time may not retain that status.

In the proposing release, the Commission requested comment on how often a broker-dealer should be required to update its assessments.<sup>89</sup> The Commission received one comment in response to this request.<sup>90</sup> The commenter stated that the frequency of review "should be a function of a number of factors, including, *e.g.*, the size and purpose of the broker-dealer's position in the fixed-income security, the volatility of business conditions within the relevant industry, the amount of fixed-income securities issued, and the frequency with which the securities trade."<sup>91</sup> The Commission generally agrees with the commenter that the frequency of review should depend on a variety factors such as those identified by the commenter. However, as discussed above, the requirement for a broker-dealer to maintain its required minimum amount of net capital is moment-to-moment. Consequently, a broker-dealer's policies and procedures for assessing whether an issuance of commercial paper, nonconvertible debt, or preferred stock

<sup>88</sup> See 17 CFR 240.15c3-1(a).

<sup>89</sup> See *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, 76 FR at 26554.

<sup>90</sup> See *SIFMA Letter*.

<sup>91</sup> *Id.* at 21.

<sup>80</sup> As noted above, to qualify for the lower haircuts under the NRSRO credit rating standard being replaced today, commercial paper needed to be rated in one of the three highest rating categories by at least two NRSROs, nonconvertible debt needed to be rated in one of the four highest rating categories by at least two NRSROs, and preferred stock needed to be rated in one of the four highest rating categories by at least two NRSROs. For an example of one NRSRO's definitions of its four highest credit rating categories, see Standard & Poor's Ratings Definitions for long-term issuances available at [http://img.en25.com/Web/StandardandPoors/Ratings\\_Definitions.pdf](http://img.en25.com/Web/StandardandPoors/Ratings_Definitions.pdf). Information about the credit rating categories of all the NRSROs can be obtained through the Forms NRSRO they file with the Commission and make publicly available. Links to these forms are available at <http://www.sec.gov/about/offices/ocr.shtml>.

<sup>81</sup> See paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F), and (c)(2)(vi)(H) of Rule 15c3-1, as amended.

<sup>82</sup> *Id.*

<sup>83</sup> See paragraph (c)(2)(vi)(I) of Rule 15c3-1, as amended.

has only a minimal amount of credit risk must include a process that is designed to ensure that its credit determinations are current, and address the frequency with which the broker-dealer reviews and reassesses its credit determinations. For example, a broker-dealer's policies and procedures could require more frequent reassessments in the case of securities or money market instruments that are close to the line between having only a minimal amount of credit risk and having a greater level of credit risk or that are subject to macroeconomic conditions or issuer specific events that could have an impact on credit risk. In addition, a higher haircut must be taken when a security or money market instrument no longer has only a minimal amount of credit risk. The Commission expects that a broker-dealer's process for monitoring its credit determinations will be customized to the size and activities of the firm to ensure that it maintains the required amount of net capital at "all times."<sup>92</sup>

The Commission also modified the proposed rule text relating to policies and procedures by including in new paragraph (c)(2)(vi)(I) of Rule 15c3-1 the qualifier that the policies and procedures must be "reasonably designed" for the purpose of assessing creditworthiness.<sup>93</sup> As noted above, one commenter raised a concern that Commission and SRO examiners would "second guess" broker-dealer credit assessments and stated that the regulatory focus on compliance with the rule should be on the "reasonableness" of a firm's policies and procedures for assessing creditworthiness.<sup>94</sup> The Commission agrees that the starting point for reviewing whether a firm is in compliance with the amendments should be to evaluate the reasonableness of the firm's policies and procedures in light of the firm's circumstances (*e.g.*, the size of the broker-dealer and the types and sizes of the positions typically held by the broker-dealer). In this regard, the policies and procedures must specify with sufficient detail the steps the broker-dealer will take in performing a credit assessment so that Commission and SRO examiners can evaluate them.

However, the Commission also modified the final rule to add new text that provides that policies and procedures that are reasonably designed "should result in assessments of creditworthiness that typically are

consistent with market data."<sup>95</sup> In particular, this standard for evaluating the reasonableness of a broker-dealer's policies and procedures will require examiners to compare market data (*e.g.*, external factors such as credit spreads or yields) with the broker-dealer's determinations that a security or money market instrument has only a minimal amount of credit risk. This provision is designed to address concerns raised by commenters that the proposed minimal amount of credit risk standard was too subjective.<sup>96</sup> Commenters raised concerns about requiring the use of a subjective standard because, among other things, it presents an inherent conflict of interest, is complicated, could reduce liquidity, and could result in uncertainty on the part of market participants.<sup>97</sup> Requiring a broker-dealer's policies and procedures to produce credit risk determinations that typically are consistent with market data should mitigate concerns about potential consequences of the subjectivity inherent in the final rule. Furthermore, as explained throughout this release, a broker-dealer can make its credit risk determination pursuant to policies and procedures that specify the use of a small number of objective factors and, if a broker-dealer avails itself of this option, it should help the broker-dealer create a less-complicated methodology that aligns with market data, therefore easing the concerns of commenters.

Notwithstanding the reasonableness of a broker-dealer's policies and procedures, examiners may still question a broker-dealer's credit risk determination, and are particularly likely to question a determination related to large concentrated positions or that is not consistent with market data. In addition, if a broker-dealer incorrectly determines pursuant to paragraph (c)(2)(vi)(I) of Rule 15c3-1 that a security has only a minimal amount of credit risk, the broker-dealer could be in violation of Rule 15c3-1 to the extent the appropriate larger haircut would put the broker-dealer below the required minimum amount of net capital.<sup>98</sup> Thus, a broker-dealer would need to be able to support each credit determination it makes in the context of a Commission or SRO examination. If

the broker-dealer's determination that a position has only a minimal amount of credit risk is not consistent with market data, that result would not necessarily be dispositive that the position is not entitled to the lower haircut. However, the broker-dealer would have a high burden to demonstrate to examiners that the position has only a minimal amount of credit risk.

When assessing whether a security or money market instrument has only a minimal amount of credit risk for purposes of Rule 15c3-1, a broker-dealer could consider pursuant to the policies and procedures it establishes, documents, maintains, and enforces the following factors, to the extent appropriate:

- Credit spreads (*i.e.*, whether it is possible to demonstrate that a position in commercial paper, nonconvertible debt, and preferred stock has only a minimal amount of credit risk based on the spread between the security's yield and the yield on Treasury or other securities, or based on the spreads of credit default swaps that reference the security or money market instrument);
- Securities-related research (*i.e.*, whether providers of research about securities or money market instruments believe the issuer of the security or money market instrument will be able to meet its financial commitments, generally, or specifically, with respect to securities or money market instruments held by the broker-dealer);
- Internal or external credit risk assessments (*i.e.*, whether credit assessments developed internally by the broker-dealer or externally by a credit rating agency, irrespective of its status as an NRSRO, express a view as to the credit risk associated with a particular security or money market instrument of the issuer thereof);
- Default statistics (*i.e.*, whether providers of credit information relating to securities or money market instruments express a view that specific securities or money market instruments (or their issuers) have a probability of default consistent with other securities or money market instruments that have only a minimal amount of credit risk);
- Inclusion in an index (*i.e.*, whether a security, money market instrument, or the issuer of a security or money market instrument, is included as a component of a recognized index of instruments that have only a minimal amount of credit risk);
- Enhancements and priorities (*i.e.*, the extent to which a security or money market instrument is covered by credit enhancements, such as overcollateralization and reserve accounts, or has priority under

<sup>92</sup> See 17 CFR 240.15c3-1(a).

<sup>93</sup> See paragraph (c)(2)(vi)(I) of Rule 15c3-1, as amended.

<sup>94</sup> *SIFMA Letter*, at 19.

<sup>95</sup> See paragraph (c)(2)(vi)(I) of Rule 15c3-1, as amended.

<sup>96</sup> *Bond Dealers Letter*, at 2-3; *SIFMA Letter*, at 3.

<sup>97</sup> *Bond Dealers Letter*, at 2; *SIFMA Letter*, at 3.

<sup>98</sup> Calculating a haircut incorrectly also could cause the broker-dealer to file incorrect reports with the Commission under Rule 17a-5. See 17 CFR 240.17a-5 (requiring broker-dealers to periodically file financial reports that, among other things, contain computations of net capital).

applicable bankruptcy or creditors' rights provisions);

- Price, yield and/or volume (*i.e.*, whether the price and yield of a security or money market instrument or a credit default swap that references the security or money market instrument are consistent with other securities or money market instruments that the broker-dealer has determined have only a minimal amount of credit risk and whether the price resulted from active trading); and

- Asset class-specific factors (*e.g.*, in the case of structured finance products, the quality of the underlying assets).

The Commission does not intend this list of factors to be exhaustive or mutually exclusive. For example, other factors may be appropriate for assessing creditworthiness and, in particular, whether a position has only a minimal amount of credit risk.

As noted above, several commenters identified additional factors that they believe would be appropriate for purposes of assessing whether a security or money market instrument has only a minimal amount of credit risk and one commenter suggested making certain factors mandatory.<sup>99</sup> Some of these factors, such as the term to maturity of the security or money market instrument, are already factored into Rule 15c3-1 and therefore do not need to be specifically added to the list.<sup>100</sup> The Commission does not believe other factors should be added because the list is not meant to be exhaustive and broker-dealers should tailor their policies and procedures for assessing credit risk to their particular circumstances and specify in their policies and procedures those factors they deem appropriate, which may include factors that are not on the list above.<sup>101</sup> In addition, the Commission recognizes that a broker-dealer's policies and procedures may specify the use of different factors, different sets of factors, or different combinations of factors depending on the characteristics of the security or money market instrument being assessed, the amount of time the

<sup>99</sup> *Better Markets Letter*, at 6 (suggesting that the list "be more comprehensive" and include factors such as the nature of the issuer, the terms of the security, and the financial and regulatory context in which the issuer is operating); *Id.* at 3 ("the use of credit spreads and/or inclusion of an index should be the objective standard used to determine creditworthiness of these securities"); *CFA Institute Letter*, at 4 (suggesting the addition of "term to maturity" and "concentration of credit risk" as factors on the list).

<sup>100</sup> *See, e.g.*, 17 CFR 15c3-1(c)(2)(vi)(F)(1) (nonconvertible debt securities must have a "fixed maturity date," among other factors, in order to qualify for a reduced haircut).

<sup>101</sup> One commenter agreed with the Commission. *SIFMA Letter*, at 20.

broker-dealer intends to hold the position, and the size of the position, among other things. Further, the Commission does not expect that in order for a broker-dealer's policies and procedures to be "reasonably designed" that they must specify the use of every factor, or any particular factor, on the list. Certain factors, such as credit spreads, may not be applicable for bonds that are thinly traded. Thus, mandating that factor, or any other factor, would not necessarily help a broker-dealer make a creditworthiness determination. Instead, each broker-dealer should analyze its unique situation when designing its policies and procedures, including, for example, its size, the amount of proprietary trading by the broker-dealer in commercial paper, nonconvertible debt, and preferred stock, and the size and characteristics of the positions the firm typically holds, among other things.

Under the amendments, a broker-dealer must apply a higher deduction, such as the 15% "catchall" haircut, on a proprietary position in commercial paper, nonconvertible debt, and preferred stock if the firm determines the security has more than a minimal amount of credit risk or the firm opts not to have policies and procedures to assess the creditworthiness of the class of security or money market instrument.<sup>102</sup> Moreover, if the commercial paper, nonconvertible debt, or preferred stock held by the broker-dealer does not trade in a ready market, the broker-dealer must apply a 100% haircut irrespective of the firm's credit risk determination.<sup>103</sup>

Under today's amendments, and consistent with the proposed amendments, a broker-dealer must preserve for a period of not less than three years, the first two years in an easily accessible place, the policies and procedures that the broker-dealer establishes, documents, maintains, and

<sup>102</sup> *See* paragraph (c)(2)(vi)(I) of Rule 15c3-1, as amended; 17 CFR 240.15c3-1(c)(2)(vi)(J). If a broker-dealer chooses to apply the net capital deduction under paragraph (c)(2)(vi)(I) of Rule 15c3-1 instead of making an assessment of the creditworthiness of each security, the broker-dealer will not be required to have policies and procedures to assess a security's creditworthiness for purposes of applying the haircuts prescribed in paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2), or (c)(2)(vi)(H) of Rule 15c3-1.

<sup>103</sup> *See* 17 CFR 240.15c3-1(c)(2)(vii). As noted above, the term *ready market* is defined in Rule 15c3-1 as "a market in which there exists independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom." 17 CFR 240.15c3-1(c)(11).

enforces for assessing and monitoring the credit risk of commercial paper, nonconvertible debt, and preferred stock. This requirement is codified in new paragraph (b)(13) of Rule 17a-4.<sup>104</sup>

The amendments do not require a broker-dealer to maintain a record of each of its credit risk determinations for purposes of Rule 15c3-1.<sup>105</sup> However, a broker-dealer would need to be able to support each of its credit risk determinations both for internal risk management purposes and in the context of a Commission or SRO examination. A broker-dealer should maintain documentation of its credit risk determinations for this purpose. Alternatively, a firm that maintains or can access the data, information, and inputs used to make a credit risk determination could be in a position to replicate the original credit risk determination using the same process, information, and inputs employed to make the original determination.<sup>106</sup> For example, if a broker-dealer uses market data to assess creditworthiness, it should be able to access information showing the data as of the date the credit risk determination was made.<sup>107</sup> A broker-dealer that uses a model with multiple inputs should be able to replicate the model output upon request or maintain a record of the model output as of the date of the original credit risk determination.

The Commission recognizes that requiring a broker-dealer to make and maintain a record of each credit risk determination, as suggested by one commenter,<sup>108</sup> may help facilitate examinations of broker-dealers, but the Commission believes at this time that requiring broker-dealers to maintain a record of every credit risk determination could be burdensome in light of the benefits expected to be obtained. For example, a broker-dealer may make multiple determinations while assessing and monitoring the creditworthiness of a particular security. If the broker-dealer reaches the same result time after time

<sup>104</sup> *See* paragraph (b)(13) of Rule 17a-4, as amended.

<sup>105</sup> Paragraph (b)(5) of Rule 17a-4 provides, in pertinent part, that a broker-dealer shall preserve for a period of not less than three years (the first two years in an easily accessible place) all trial balances and computations of aggregate indebtedness and net capital (and working papers in connection therewith). *See* 17 CFR 240.17a-4(b)(5). Working papers relating to credit risk determinations made for the purposes of computing net capital under Rule 15c3-1 will need to be preserved under this provision of Rule 17a-4. *Id.*

<sup>106</sup> *See SIFMA Letter*, at 22.

<sup>107</sup> Although not required by today's amendments, a broker-dealer could choose to keep a record of the market data it used to make the creditworthiness determination.

<sup>108</sup> *See Better Markets Letter*, at 7-8.

showing that the security in question has only a minimal amount of credit risk, the benefits of keeping every determination for three years, when the broker-dealer has the ability to replicate the relevant determination for an examiner, could create costs that provide little benefits, given the examiner will have access to the replicated credit risk determinations. Furthermore, if market data and other external factors (e.g., external credit assessments and analysis), strongly support the broker-dealer's assessment that a security has only a minimal amount of credit risk, retaining a record of the credit risk determination may not provide any incremental benefit to examiners. A broker-dealer that can replicate through application of its policies and procedures its original analysis to explain the basis of a credit risk determination should be in a position to demonstrate to examiners whether it is following its policies and procedures, and whether those policies and procedures are reasonably designed and effective in producing credit assessments that typically are consistent with market data.

The Commission is cognizant of the potential conflict of interest inherent in a requirement that relies to some extent on the subjective judgment of the broker-dealer to determine whether a lower haircut should apply to a commercial paper, nonconvertible debt, or preferred stock position, as noted by some commenters.<sup>109</sup> For example, a broker-dealer may want to hold securities with higher yields to earn more interest but at the same time apply lower haircuts to the positions to increase its net capital. This could bias the broker-dealer's credit assessment towards finding the security has only a minimal amount of credit risk. As an initial matter, if a broker-dealer incorrectly determines a position has only a minimal amount of credit risk and applies a lower haircut, it could lead to the firm failing to maintain the minimum amount of required net capital in violation of the rule. As discussed above, the final rule provides that policies and procedures that are reasonably designed should result in assessments of creditworthiness that typically are consistent with market data.<sup>110</sup> This provides objective benchmarks (i.e., market data) to use to evaluate the broker-dealer's policies and procedures. If a broker-dealer has policies and procedures in place that are

reasonably designed under the rule, and those policies and procedures are followed, the potential for bias to be a part of the assessment process should be mitigated. The Commission also expects that this potential conflict of interest will be mitigated by the Commission and SRO examination process, during which Commission and SRO examiners will review the reasonableness of broker-dealers' policies and procedures, the assessments that result from those policies and procedures, and the firms' adherence to the policies and procedures.<sup>111</sup>

The Commission also is aware of the likelihood that broker-dealers may reach different conclusions when assessing whether a particular position has only a minimal amount of credit risk,<sup>112</sup> or may reach conclusions that are contrary to market data. The Commission expects that Commission and SRO staff will examine for these types of differences and raise questions when a broker-dealer consistently determines that positions have only a minimal amount of credit risk notwithstanding the fact that external benchmarks (e.g., market data) in the factors listed above indicate otherwise. A determination that a position has only a minimal amount of credit risk that is contrary to some market data points and factors would not necessarily mean that the broker-dealer has failed to comply with the rule, but the broker-dealer would have a higher hurdle to overcome to demonstrate that its credit risk determination is correct. The Commission also notes that if a broker-dealer determines that a security or money market instrument has only a minimal amount of credit risk when the position actually does not meet that standard, and applies a lower haircut, the broker-dealer's net capital may be less than its minimum net capital requirement in which case the broker-dealer would be in violation of the rule.<sup>113</sup>

The Commission understands, as noted by commenters, that the amount of resources broker-dealers can allocate toward making assessments of creditworthiness for purposes of Rule 15c3-1 will differ across broker-dealers

and expects that this difference will be reflected in the policies and procedures for assessing creditworthiness established by the firms.<sup>114</sup> For example, a small broker-dealer may not have the resources to support a credit risk department comprised of analysts that perform internal credit assessments. In this case, the firm may establish a process for assessing creditworthiness that relies more on external factors, such as credit spreads, default statistics, and credit analysis. A broker-dealer with a large portfolio of debt securities may instead use an internal approach for assessing creditworthiness, which takes into consideration a multitude of factors, such as default probabilities, expected and unexpected losses, time effects, default correlations, and loss distributions, among other things. The Commission also anticipates that some broker-dealers, particularly those that hold few positions, may elect not to devote resources toward performing credit risk analysis and maintaining policies and procedures, and instead will apply a greater haircut to their proprietary positions in commercial paper, nonconvertible debt, and preferred stock, as permitted by the rule.

Finally, as discussed above, a broker-dealer (rather than its parent or an affiliate) must establish, document, maintain, and enforce the policies and procedures for assessing whether a position has only a minimal amount of credit risk.<sup>115</sup> This does not mean that a broker-dealer cannot incorporate into its own policies and procedures the credit policies and procedures used by its parent or an affiliate. However, the broker-dealer must establish, document, maintain, and enforce its own policies and procedures and apply them itself in making creditworthiness determinations. It may not simply rely on determinations made by its parent or an affiliate.

## b. Appendix A to Rule 15c3-1

### i. Proposal

Appendix A to Rule 15c3-1 permits broker-dealers to employ a standardized theoretical option pricing model to determine a potential loss for a portfolio of listed options positions and related positions to compute a single haircut for the group of positions.<sup>116</sup> Under Appendix A, a broker-dealer groups the options and related positions in a portfolio and stresses the current market

<sup>111</sup> As noted above, broker-dealers that do not keep detailed records of their credit risk determinations can replicate those determinations for Commission and SRO examiners to demonstrate that they followed their policies and procedures for assessing and monitoring creditworthiness.

<sup>112</sup> *Bond Dealers Letter*, at 3; *SIFMA Letter*, at 20.

<sup>113</sup> As noted above, applying an incorrect haircut also could cause the broker-dealer to file incorrect reports with the Commission under Rule 17a-5. See 17 CFR 240.17a-5 (requiring broker-dealers to periodically file financial reports that, among other things, contain computations of net capital).

<sup>114</sup> See *Bond Dealers Letter*, at 3; *SIFMA Letter*, at 18.

<sup>115</sup> See *SIFMA Letter*, at 21.

<sup>116</sup> See 17 CFR 240.15c3-1a(b)(1). Broker-dealers also may elect a strategy-based methodology. See 17 CFR 240.15c3-1a(b)(2).

<sup>109</sup> *Better Markets Letter*, at 5-6; *Bond Dealers Letter*, at 2; *CFA Institute Letter*, at 4.

<sup>110</sup> See paragraph (c)(2)(vi)(I) of Rule 15c3-1, as amended.

price for each position at various equidistant points along a range of positive and negative potential future market movements, using an approved theoretical option pricing model that satisfies certain conditions specified in the rule.<sup>117</sup> Positions that have more potential price volatility must be stressed across a wider range of positive and negative potential future market movements than positions with lower price volatility.<sup>118</sup> For example, a broker-dealer other than a non-clearing option specialist or market maker must employ a range of potential future market movements for major market foreign currencies of (±) 6%, whereas the range for all other foreign currencies is (±) 20%.<sup>119</sup> Thus, major market foreign currency options receive more favorable treatment than options on all other currencies when using theoretical option pricing models to compute net capital deductions.<sup>120</sup>

Prior to today's amendments, the rule defined the term *major market foreign currency* to mean "the currency of a sovereign nation whose short term debt is rated in one of the two highest categories by at least two nationally recognized statistical rating organizations and for which there is a substantial inter-bank forward currency market."<sup>121</sup> Further, the rule provided that "the European Currency Unit (ECU) shall be deemed a major market foreign currency."<sup>122</sup>

With respect to the definition of *major market foreign currency*, the Commission proposed to remove the phrase "whose short-term debt is rated in one of the two highest categories by at least two nationally recognized statistical rating organizations."<sup>123</sup> The proposed change would modify the definition to include foreign currencies only "for which there is a substantial inter-bank forward currency market."<sup>124</sup> The Commission also proposed to eliminate the specific reference in the rule to the European Currency Unit ("ECU"), which was the

only currency explicitly identified in the rule as a major market foreign currency for the purposes of Appendix A.<sup>125</sup> As the Commission stated in the proposing release, because of the establishment of the euro as the official currency of the euro-zone, a specific reference to the ECU was no longer needed.<sup>126</sup> The Commission also stated that a specific reference to the euro was not necessary, as it is a foreign currency with a substantial inter-bank forward currency market.<sup>127</sup>

#### ii. Comments

The Commission received two comment letters in response to its request for comment.<sup>128</sup> One commenter supported the proposed definition of the term *major market foreign currency*, stating that "the proposed definition is sufficient to allow broker-dealers to determine what currencies are 'major market foreign currencies.'" <sup>129</sup> Both commenters stated that the Commission should create a list of major market foreign currencies and update it periodically to clarify the new definition in Appendix A.<sup>130</sup> One commenter suggested that if the Commission chooses not to create a list of major market foreign currencies, it should propose an alternative measure of creditworthiness and define the term as one where the currency is issued by a nation whose sovereign debt presents "minimal credit risk."<sup>131</sup>

#### iii. Final Rule

For the reasons described below, the Commission is adopting the amendments to Appendix A as proposed.<sup>132</sup> Specifically, the Commission is removing from the definition of *major market foreign currency* the phrase "whose short-term debt is rated in one of the two highest categories by at least two nationally recognized statistical rating organizations."<sup>133</sup> The change modifies the definition to include foreign currencies only "for which there is a

substantial inter-bank forward currency market."<sup>134</sup> Also, the Commission is eliminating the specific reference in the rule to the ECU, which was identified, by rule, as the only major market foreign currency for the purposes of Appendix A.<sup>135</sup> As the Commission noted in the proposing release, specific reference to the ECU is no longer needed because the euro has been established as the official currency of the euro-zone.<sup>136</sup> Further, the specific reference to the euro is not necessary as it is a foreign currency with a substantial inter-bank forward currency market, consistent with the rule as amended.

In order to retain a degree of flexibility, the Commission is not codifying in the rule a list of currencies that meet the definition of *major market foreign currency* though some commenters requested such a list. However, broker-dealers may treat a foreign currency as a major market foreign currency for the purposes of Appendix A if the currency is a major foreign currency for purposes of applying a 6% (rather than 20%) haircut under Rule 15c3-1. Currently, under a staff interpretation, broker-dealers are subject to a 6% (rather than 20%) unhedged currency risk exposure haircut on foreign currency balances and positions in the euro, the British pound, the Swiss franc, the Canadian dollar, and the Japanese yen.<sup>137</sup> The Commission believes the staff interpretation identifies currencies that all meet the definition of *major market foreign currency* for the purposes of Appendix A as they all have a substantial inter-bank forward currency market. Consequently, broker-dealers may treat these currencies as major market foreign currencies under Appendix A. By treating these currencies as major market foreign currencies, the haircuts applicable to foreign currencies under Rule 15c3-1 are more closely aligned with the haircuts applicable to options on the same foreign currencies under

<sup>117</sup> See 17 CFR 240.15c3-1a(b)(1). Presently, there is only one theoretical options pricing model that has been approved for this purpose.

<sup>118</sup> See 17 CFR 240.15c3-1a(b)(1)(iii).

<sup>119</sup> See 17 CFR 240.15c3-1a(b)(1)(iii)(B) through (C). A broker-dealer that is a non-clearing option specialist or market maker must employ a range of potential future market movements for major market foreign currencies of (±) 4% (i.e., less than the (±) 6% required of other broker-dealers). 17 CFR 240.15c3-1a(b)(1)(iv)(A).

<sup>120</sup> See 17 CFR 240.15c3-1a(b)(1)(iii)(B) through (C) and (b)(1)(iv)(A).

<sup>121</sup> *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, 76 FR at 26554-26555.

<sup>122</sup> *Id.*

<sup>123</sup> *Id.*

<sup>124</sup> *Id.*

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

<sup>127</sup> *Id.*

<sup>128</sup> See *Better Markets Letter*; *CFA Institute Letter*; see also *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, 76 FR at 26555.

<sup>129</sup> See *CFA Institute Letter*, at 4 ("[T]he existence of a substantial inter-bank forward currency market indicates market interest and the existence of market oversight and thus provides a strong indication of market sentiment about the quality of currencies within that definition.")

<sup>130</sup> *Better Markets Letter*, at 9; *CFA Institute Letter*, at 5.

<sup>131</sup> See *Better Markets Letter*, at 9.

<sup>132</sup> See paragraph (b)(1)(i)(C) of Rule 15c3-1a, as amended.

<sup>133</sup> *Id.*

<sup>134</sup> *Id.*

<sup>135</sup> *Id.*

<sup>136</sup> *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, 76 FR at 26555.

<sup>137</sup> See *FINRA Interpretations of Financial and Operational Rules*, Rule 15c3-1(c)(2)(vi)/08, available at <http://www.finra.org/web/groups/industry/@ip/@reg/@rules/documents/interpretationsfor/p037763.pdf>, p. 406 (publishing the staff's interpretation). A 20% haircut applies to unhedged currency risk exposure on all other foreign currency balances and positions. *Id.* These interpretations are provided to FINRA from the Commission staff in the Division of Trading and Markets. Broker-dealers can also seek assurance as to whether another foreign currency meets the definition of *major market foreign currency* by, for example, requesting guidance from the staff.

Appendix A.<sup>138</sup> Given this interpretation identifying certain foreign currencies that meet the definition of *major market foreign currency*, the Commission believes it has addressed the concern raised by one commenter that, in the absence of a list, the Commission should define the term as one where the currency is issued by a nation whose sovereign debt presents minimal credit risk.<sup>139</sup>

c. Appendix E to Rule 15c3-1

i. Proposal

Certain broker-dealers (“ANC broker-dealers”) are approved by the Commission to use internal value-at-risk (“VaR”) models to determine market risk charges for proprietary securities and derivatives positions and to take a credit risk charge in lieu of a 100% charge for unsecured receivables related to OTC derivatives transactions.<sup>140</sup> Specifically, under Appendix E to Rule 15c3-1, ANC broker-dealers are permitted to add back to net worth uncollateralized receivables from counterparties arising from OTC derivatives transactions (*i.e.*, they can add back the amount of the uncollateralized current exposure).<sup>141</sup> Instead of the 100% deduction that applies to most unsecured receivables under Rule 15c3-1, ANC broker-dealers are permitted to take a credit risk charge based on the uncollateralized credit exposure to the counterparty.<sup>142</sup> In most

cases, the credit risk charge is significantly less than a 100% deduction, since it is a percentage of the amount of the receivable that otherwise would be deducted in full. ANC broker-dealers are permitted to use this approach because they are required to implement processes for analyzing credit risk to OTC derivative counterparties and to develop mathematical models for estimating credit exposures arising from OTC derivatives transactions.

Under Appendix E, the credit risk charge is the sum of three calculated amounts: (1) A counterparty exposure charge; (2) a concentration charge if the current exposure to a single counterparty exceeds certain thresholds; and (3) a portfolio concentration charge if aggregate current exposure to all counterparties exceeds certain thresholds.<sup>143</sup> The first component of the credit risk charge is the counterparty exposure charge.<sup>144</sup> The exposure charge for a given counterparty (other than a counterparty that is insolvent, in a bankruptcy proceeding, or in default of an obligation on its senior debt) is the credit equivalent amount of the ANC broker-dealer’s exposure to the counterparty multiplied by an applicable credit risk weight factor and then multiplied by 8%.<sup>145</sup> The credit equivalent amount is the sum of the ANC broker-dealer’s: (1) Maximum potential exposure (“MPE”) to the counterparty multiplied by a back-testing determined factor; and (2) current exposure to the counterparty.<sup>146</sup> The MPE amount is a charge to address potential future exposure and is calculated using the ANC broker-dealer’s VaR model as applied to the counterparty’s positions after giving effect to a netting agreement with the counterparty, taking into account collateral received from the counterparty, and taking into account the current replacement value of the counterparty’s positions.<sup>147</sup> The current exposure amount is the current replacement value of the counterparty’s positions after giving effect to a netting agreement with the counterparty and

it would apply only to uncollateralized receivables from commercial end users arising from security-based swaps (*i.e.*, uncollateralized receivables from other types of counterparties would be subject to the 100% deduction from net worth). See *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*, 77 FR at 70240–70244.

<sup>143</sup> 17 CFR 240.15c3-1e(c).

<sup>144</sup> 17 CFR 240.15c3-1e(c)(1).

<sup>145</sup> See 17 CFR 240.15c3-1e(c)(1)(ii).

<sup>146</sup> See 17 CFR 240.15c3-1e(c)(4)(i). The amount of the factor is based on back-testing exceptions.

<sup>147</sup> See 17 CFR 240.15c3-1e(c)(4)(ii).

taking into account collateral received from the counterparty.<sup>148</sup> The counterparty exposure charge is the sum of the MPE and current exposure amounts multiplied by an applicable credit risk weight factor and then multiplied by 8%.<sup>149</sup> Appendix E to Rule 15c3-1 prescribes three standardized credit risk weight factors (20%, 50%, and 150%) for transactions with counterparties and, as an alternative, permits an ANC broker-dealer with Commission approval to use internal methodologies to determine appropriate credit risk weights to apply to counterparties.<sup>150</sup> A higher percentage credit risk weight factor results in a larger counterparty exposure charge amount. Prior to today’s amendments, ANC broker-dealers were permitted to use NRSRO credit ratings or internally derived credit ratings to determine the appropriate risk weight factor.

The Commission proposed removing paragraphs (c)(4)(vi)(A) through (c)(4)(vi)(D) of Appendix E, which specify the appropriate risk weight factor of counterparties based on NRSRO credit ratings.<sup>151</sup> Consequently, under the proposal, an ANC broker-dealer would need to determine credit risk charges using internal credit ratings or to take a 100% capital charge with respect to the exposure to the counterparty.<sup>152</sup> By removing the option to use NRSRO credit ratings, a broker-dealer that applies to use the approach set forth in Appendix E would need to describe how it will determine the applicable counterparty credit risk charge based on internal credit ratings as part of its initial application to the Commission.<sup>153</sup>

ii. Comments

The Commission received two comments in response to its request for comment.<sup>154</sup> One commenter supported the proposed removal of NRSRO credit ratings as an option but raised two concerns.<sup>155</sup> The commenter stated first that an internal model may not take into account concentration of risk with a specific counterparty, and second that ANC firms will apply low risk weights

<sup>148</sup> See 17 CFR 240.15c3-1e(c)(4)(iii).

<sup>149</sup> See 17 CFR 240.15c3-1e(c)(1)(ii).

<sup>150</sup> See 17 CFR 240.15c3-1e(c)(4)(vi).

<sup>151</sup> See *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, 76 FR at 26555–26556.

<sup>152</sup> *Id.*

<sup>153</sup> *Id.* at 26555.

<sup>154</sup> *Better Markets Letter*; *CFA Institute Letter*; see also *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, 76 FR at 26555–26556.

<sup>155</sup> *CFA Institute Letter*, at 5–6.

<sup>138</sup> Treating the option consistently with the instrument underlying the option is supported by Appendix A. For example, under Appendix A, the range of potential future market movements that must be employed for a portfolio of equity positions with a ready market is (±) 15%. See 17 CFR 240.15c3-1a(b)(1)(iii)(A). Under Rule 15c3-1, the haircut that must be applied to an equity security with a ready market is 15%. See 17 CFR 240.15c3-1(c)(2)(vi)(j).

<sup>139</sup> See *Better Markets Letter*, at 9.

<sup>140</sup> See 17 CFR 240.15c3-1(a)(7); 17 CFR 240.15c3-1e. As part of the application to use internal models, an entity seeking to become an ANC broker-dealer must identify the types of positions it intends to include in its model calculation. See 17 CFR 240.15c3-1e(a)(1)(iii). After approval, an ANC broker-dealer must obtain Commission approval to make a material change to the model, including a change to the types of positions included in the model. See 17 CFR 240.15c3-1e(a)(8). An ANC broker-dealer must maintain minimum tentative net capital of at least \$1 billion and minimum net capital of at least \$500 million. See 17 CFR 240.15c3-1(a)(7)(i). The Commission has proposed raising these requirements to \$5 billion and \$1 billion, respectively. 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).

<sup>141</sup> See 17 CFR 240.15c3-1e(c).

<sup>142</sup> See 17 CFR 240.15c3-1e(c); 17 CFR 240.15c3-1(a)(7). The Commission has proposed narrowing this treatment of OTC derivatives exposures so that

to all but the most illiquid instruments.<sup>156</sup>

Another commenter suggested that the factors listed in the proposing release with respect to determining creditworthiness under Rule 15c3-1 should become part of Appendix E.<sup>157</sup> This commenter further argued that the factors each broker-dealer needed to use to make the determination should be explicitly stated in the rule.<sup>158</sup>

### iii. Final Rule

The Commission is adopting the amendments to Appendix E to Rule 15c3-1 as proposed.<sup>159</sup> The amendments remove paragraphs (c)(4)(vi)(A) through (c)(4)(vi)(D) of Appendix E to Rule 15c3-1, which specify the appropriate risk weight factor based on NRSRO credit ratings.<sup>160</sup> By removing the provisions utilizing NRSRO credit ratings, the final rule requires an ANC broker-dealer to determine the appropriate risk weight factor using internal credit ratings or to take a 100% capital charge with respect to the exposure to the counterparty.<sup>161</sup>

All ANC broker-dealers calculate credit risk charges using internal credit ratings (rather than using NRSRO credit ratings approach) or take a 100% capital charge with respect to the exposure to the counterparty risk.<sup>162</sup> Consequently, removing the option to use NRSRO credit ratings will not have an immediate effect on these broker-dealers. A broker-dealer that applies to become an ANC broker-dealer will need to describe how it will determine internal credit ratings for the purpose of determining the applicable credit charges for counterparty risk in its application to the Commission.

In taking this action, the Commission has considered the views of commenters<sup>163</sup> and determined that whether a model adequately considers risks associated with a counterparty or a specific instrument is a concern that should be addressed during the initial review of the ANC broker-dealer's model, as well as during the monitoring and examination of the firm.<sup>164</sup> The

amendments also do not incorporate the minimal amount of credit risk standard from Rule 15c3-1 into Appendix E, as suggested by one commenter.<sup>165</sup> This standard is replacing a binary NRSRO credit rating standard under which the application of a lower or higher haircut amount depends on whether the commercial paper is rated in the top three rating categories and the nonconvertible debt and preferred stock is rated in the top four rating categories. Consequently, a given instrument either meets the requirement to apply a lower haircut amount or is subject to the higher amount. The NRSRO credit rating standard in Appendix E to Rule 15c3-1 is not binary in that there are three different credit risk weights (20%, 50%, and 150%) that are determined by three different levels of credit rating: The two highest rating categories; the third and fourth highest rating categories; and below the fourth highest rating. Thus, the minimal amount of credit risk standard would not be a suitable replacement for the NRSRO credit ratings standard because the minimal amount of credit risk standard, as drafted for Rule 15c3-1, would apply only to the second gradation (the third and fourth highest rating categories).<sup>166</sup>

In addition, as stated throughout this release, the Commission has determined not to mandate that a broker-dealer use any specific factor in its credit analysis. Consequently, the Commission does not believe it would be appropriate to codify the list of factors in the rule as suggested by one commenter.

### d. Appendix F to Rule 15c3-1 and Form X-17A-5, Part IIB

#### i. Proposal

Similar to ANC broker-dealers, a type of limited purpose broker-dealer that deals solely in OTC derivatives (an "OTC derivatives dealer") is permitted, with Commission approval, to calculate net capital using internal models as the basis for taking market risk and credit risk charges in lieu of the standardized haircuts for classes of positions for which they have been approved to use VaR models.<sup>167</sup> Specifically, under

Appendix F to Rule 15c3-1, OTC derivatives dealers are permitted to add back to net worth uncollateralized receivables from counterparties arising from OTC derivatives transactions (*i.e.*, they can add back the amount of the uncollateralized current exposure). Instead of the 100% deduction that applies to most unsecured receivables under Rule 15c3-1, OTC derivatives dealers are permitted to take a credit risk charge based on counterparty factors and concentration charges.<sup>168</sup> In most cases, the counterparty factors and concentration charges are significantly less than a 100% deduction, since the charges are a percentage of the amount of the receivable that otherwise would be deducted in full. OTC derivatives dealers are permitted to use this approach because they are required to implement processes for analyzing credit risk to OTC derivative counterparties and to develop mathematical models for estimating credit exposures arising from OTC derivative transactions.

Under Appendix F to Rule 15c3-1, OTC derivatives dealers are required to deduct from their net capital credit risk charges that take counterparty risk into consideration.<sup>169</sup> This charge has two parts and is computed on a counterparty-by-counterparty basis. First, for each counterparty with an investment or speculative grade rating, an OTC derivatives dealer must take a net capital charge equal to the net replacement value in the account of the counterparty ("net replacement value") multiplied by 8%, and further multiplied by a counterparty factor.<sup>170</sup> As part of this deduction, the OTC derivatives dealer must apply a counterparty risk weight factor of either 20%, 50%, or 100%.<sup>171</sup> Prior to today's amendments, the counterparty risk weight factor (*i.e.*, 20%, 50%, or 100%) was determined using either NRSRO

240.15b9-2), broker-dealer margin rules (17 CFR 240.36a1-1), and application of the Securities Investor Protection Act of 1970 (17 CFR 240.36a1-2). OTC derivatives dealers are subject to special requirements, including limitations on the scope of their securities activities (17 CFR 240.15a-1), specified internal risk management control systems (17 CFR 240.15c3-4), recordkeeping obligations (17 CFR 240.17a-3(a)(10)), and reporting responsibilities (17 CFR 240.17a-12). They are also subject to alternative net capital treatment (17 CFR 240.15c3-1(a)(5)). See 17 CFR 240.15a-1, Preliminary Note. The minimum net capital requirements for an OTC derivatives dealer are tentative net capital of at least \$100 million and net capital of at least \$20 million. See 17 CFR 240.15c3-1(a)(5) and (c)(15).

<sup>168</sup> See 17 CFR 240.15c3-1f(d); 17 CFR 240.15c3-1(a)(5).

<sup>169</sup> See 17 CFR 240.15c3-1f(d).

<sup>170</sup> See 17 CFR 240.15c3-1f(d)(2).

<sup>171</sup> See 17 CFR 240.15c3-1f(d)(2)(i) through (iii).

<sup>156</sup> *Id.*

<sup>157</sup> *Better Markets Letter*, at 10.

<sup>158</sup> *Id.*

<sup>159</sup> See paragraph (c)(4)(vi) of Rule 15c3-1e, as amended.

<sup>160</sup> *Id.*

<sup>161</sup> *Id.*

<sup>162</sup> Currently, there are six ANC broker-dealers: Barclays Capital Inc.; Citigroup Global Markets, Inc.; Goldman Sachs & Co.; J.P. Morgan Chase Securities LLC; Merrill Lynch Pierce Fenner & Smith Incorporated; and Morgan Stanley & Co. Incorporated.

<sup>163</sup> *CFA Institute Letter*, at 5; *Better Markets Letter*, at 10.

<sup>164</sup> See, e.g., 17 CFR 15c3-1e(a)(1)(iv).

<sup>165</sup> *Better Markets Letter*, at 10.

<sup>166</sup> See 15 CFR 15c3-1e(c)(4)(vi)(B).

<sup>167</sup> See 17 CFR 240.15c3-1(a)(5); 17 CFR 240.15c3-1f. As part of the application to use internal models, an entity seeking to become an OTC derivatives dealer must identify the types of positions it intends to include in its model calculation. See 17 CFR 240.15c3-1f(a)(1)(ii). After approval, an OTC derivatives dealer must obtain Commission approval to make a material change to the model, including a change to the types of positions included in the model. See 17 CFR 240.15c3-1f(a)(3). OTC derivatives dealers are exempt from certain broker-dealer requirements, including membership in an SRO (17 CFR

credit ratings or the firm's internal credit ratings.<sup>172</sup>

The second part of the credit risk charge consists of a concentration charge that applies when the net replacement value in the account of any one counterparty exceeds 25% of the OTC derivatives dealer's tentative net capital.<sup>173</sup> The concentration charge increases in relation to the OTC derivatives dealer's exposure to lower rated counterparties.<sup>174</sup> Prior to today's amendments, this concentration charge was also determined using either NRSRO credit ratings or the firm's internal credit ratings. Currently, OTC derivatives dealers do not use NRSRO credit ratings to determine their counterparty factors and concentration charges.

The Commission proposed to amend paragraphs (d)(2), (d)(3)(i), (d)(3)(ii), (d)(3)(iii), and (d)(4) of Appendix F to Rule 15c3-1, which permit the use of NRSRO ratings (as an alternative to internal credit ratings) to determine an OTC derivatives dealer's counterparty factors and concentration charges. Because the proposal would eliminate the option to use NRSRO credit ratings, a broker-dealer that applies to become an OTC derivatives dealer and operate under Appendix F will need, as part of its initial application, to request Commission approval to use internal credit ratings (as the option to use NRSRO credit ratings is being eliminated). The OTC derivatives dealer would need to describe how it will determine the applicable counterparty factors and concentration charges as part of its initial application to the Commission.

As part of its proposal, the Commission also proposed conforming amendments to the General Instructions to Form X-17A-5, Part IIB. This form constitutes the basic financial and operational report OTC derivatives dealers are required to file with the Commission. Under the heading "Computation of Net Capital and Required Net Capital," the Commission proposed making conforming changes to the section "Credit risk exposure." This section instructs an OTC derivatives dealer on how to compute the counterparty credit risk charges for

purposes of the dealer's net capital computation. The proposed amendments to the instructions would eliminate references to NRSRO credit ratings for purposes of determining these charges.

#### ii. Comments

The Commission received two comments in response to its request for comment.<sup>175</sup> One commenter suggested that the Commission require OTC derivatives dealers to use counterparty factors similar to those proposed under Appendix E discussed above (e.g., 20%, 50% or 150% risk weights based on internal credit ratings to determine capital deductions) and argued against requiring OTC derivatives dealers to reapply to the Commission to use internal credit ratings.<sup>176</sup> This commenter also expressed concern that an OTC derivatives dealer's internal model may not take into account concentration of risk with a specific counterparty.<sup>177</sup>

The second commenter suggested that the Commission "supply an appropriate alternative standard of creditworthiness that derivatives dealers must apply" such as "an explicit set of factors that will appropriately gauge the credit risk associated with counterparties in derivatives transactions."<sup>178</sup>

#### iii. Final Rule

The Commission is adopting the amendments to Appendix F to Rule 15c3-1 as proposed.<sup>179</sup> Specifically, the amendments remove the use of NRSRO credit ratings from paragraphs (d)(2), (d)(3)(i), (d)(3)(ii), (d)(3)(iii), and (d)(4) of Appendix F to Rule 15c3-1, which, prior to today's amendments, permitted the use of NRSRO ratings when determining counterparty credit risk and concentration charges.<sup>180</sup> Because the amendments remove the option to use NRSRO credit ratings, a broker-dealer that applies to become an OTC derivatives dealer will need, as part of its initial application, to request Commission approval to use internal credit ratings (as the option to use NRSRO credit ratings is being eliminated). The applicant will need to describe how it will use internal credit ratings to determine the applicable

credit risk charges for counterparty risk in its application to the Commission. The current OTC derivatives dealers will not need to seek new approval from the Commission.<sup>181</sup>

The Commission also is adopting the conforming amendments to the General Instructions to Form X-17A-5, Part IIB as proposed.

Consistent with the discussion above relating to Appendix E to Rule 15c3-1, the Commission has determined that whether a model adequately considers concentration risk with a specific counterparty is a concern that is best addressed during the initial review of, or an amendment to, an OTC derivatives dealer's model as well as during the monitoring and examination of the OTC derivatives dealer.<sup>182</sup> Further, as stated above, the current OTC derivatives dealers do not use NRSRO ratings to compute the credit risk and concentration charges under Appendix F. Thus, the amendments will not impact these firms.

The Commission is not adopting an alternative standard in the rule, such as the minimal amount of credit risk standard. As discussed above, the minimal amount of credit risk standard is replacing a binary NRSRO credit rating standard under which the application of a lower or higher haircut amount depends on whether the commercial paper is rated in the top three rating categories and the nonconvertible debt and preferred stock is rated in the top four rating categories. Consequently, a given instrument either meets the requirement to apply a lower haircut amount or is subject to the higher amount. The NRSRO credit rating standard in Appendix F to Rule 15c3-1 is not binary in that there are three ranges of credit ratings to determine the applicable risk weight factors and concentration charges: The two highest rating categories; the third and fourth highest rating categories; and below the fourth highest rating category. Thus, the minimal amount of credit risk standard would not be a suitable replacement for the credit risk charges required under Appendix F to Rule 15c3-1 because the minimal amount of credit risk standard, as drafted for Rule 15c3-1, would apply only to the second

<sup>172</sup> See 17 CFR 240.15c3-1f(d)(2) and (4).

<sup>173</sup> See 17 CFR 240.15c3-1f(d)(3).

<sup>174</sup> For counterparties that are highly rated, the concentration charge equals 5% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital. 17 CFR 240.15c3-1f(d)(3)(i). The concentration charge for counterparties with ratings among the lowest rating categories would equal 50% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital. 17 CFR 240.15c3-1f(d)(3)(iii).

<sup>175</sup> *CFA Institute Letter; Better Markets Letter; see also Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, 76 FR at 26556.

<sup>176</sup> *CFA Institute Letter*, at 6.

<sup>177</sup> *Id.*

<sup>178</sup> *Better Markets Letter*, at 10, n.15.

<sup>179</sup> See paragraph (d) of Rule 15c3-1f, as amended.

<sup>180</sup> See paragraphs (d)(2), (d)(3)(i), (d)(3)(ii), (d)(3)(iii), and (d)(4) of Rule 15c3-1f, as amended.

<sup>181</sup> Currently, four firms are operating pursuant to Appendix F to Rule 15c3-1. These firms are: Credit Suisse Capital LLC; Goldman Sachs Financial Markets, L.P.; Merrill Lynch Financial Markets, Inc.; and Natixis Derivatives Inc. Natixis Derivatives, Inc. filed a Form BDW on October 17, 2013.

<sup>182</sup> See, e.g., 17 CFR 15c3-1f(a)(1)(ii); see also *CFA Institute Letter*, at 6.

range (the third and fourth highest rating categories).<sup>183</sup>

In addition, as stated throughout this release, the Commission has determined not to mandate that a broker-dealer use any specific factor in its credit analysis; instead, each firm will need to tailor its procedures for determining credit risk to the broker-dealer's business model.<sup>184</sup>

#### e. Appendix G to Rule 15c3-1

Appendix G to Rule 15c3-1 provides that broker-dealers may use the ANC computation only if their ultimate holding companies agree to provide the Commission with additional information about the financial condition of the holding company and its affiliates.<sup>185</sup> Appendix G is intended to provide the Commission with certain information to assess the financial and operational health of the ultimate holding company and its potential impact on the risk exposure of the broker-dealer.<sup>186</sup> Paragraph (a) of Appendix G sets forth a methodology for computing allowable capital and allowances for market and credit risk at the consolidated holding company level. One aspect of calculating credit risk in Appendix G provided that those firms must use credit ratings in accordance with the applicable provisions of Appendix E. Since those provisions in Appendix E are being deleted, the Commission proposed deleting the corresponding references to those provisions in Appendix G.<sup>187</sup> Specifically, the Commission proposed to delete references in paragraph (a)(3)(i)(F) of Appendix G that correspond to the provisions of Appendix E that the Commission is deleting as described above.<sup>188</sup>

The Commission received no comments addressing these changes.<sup>189</sup> The Commission is amending Appendix G to Rule 15c3-1 as proposed.<sup>190</sup> Accordingly, the Commission is adopting a conforming amendment to Appendix G that deletes references in paragraph (a)(3)(i)(F) of Appendix G that correspond to the provisions of Appendix E that the Commission is deleting as described above.<sup>191</sup>

<sup>183</sup> See 17 CFR 240.15c3-1f(d)(2)(ii); 17 CFR 240.15c3-1f(d)(3)(ii).

<sup>184</sup> *Better Markets Letter*, at 10, n.15.

<sup>185</sup> 17 CFR 240.15c3-1g.

<sup>186</sup> *Id.* Currently, each broker-dealer that uses the ANC computation has an ultimate holding company that has a principal regulator.

<sup>187</sup> See *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, 76 FR at 26556-26557.

<sup>188</sup> *Id.*

<sup>189</sup> *Id.* at 26557.

<sup>190</sup> See paragraph (a)(3)(i)(F) of Rule 15c3-1g, as amended.

<sup>191</sup> *Id.*

#### f. Exhibit A to Rule 15c3-3

Rule 15c3-3 (the "Customer Protection Rule") under the Exchange Act is designed to protect customer funds and securities held by broker-dealers.<sup>192</sup> To meet this objective, Rule 15c3-3 requires a broker-dealer that maintains custody of customer securities and cash (a "carrying broker-dealer") to take two primary steps to safeguard these assets. The steps are designed to protect customers by segregating their securities and cash from the broker-dealer's proprietary business activities. If the broker-dealer fails financially, the securities and cash should be readily available to be returned to the customers. In addition, if the failed broker-dealer is liquidated in a formal proceeding under the Securities Investor Protection Act of 1970, the securities and cash should be isolated and readily identifiable as customer property and, consequently, available to be distributed to customers ahead of other creditors.<sup>193</sup>

The first step to safeguard customer assets under Rule 15c3-3 requires a carrying broker-dealer to maintain possession or control of all fully paid and excess margin securities of its customers.<sup>194</sup> Physical possession or control means the broker-dealer must hold these securities in one of several locations specified in Rule 15c3-3 and free of liens or any other interest that could be exercised by a third party to secure an obligation of the broker-dealer.<sup>195</sup> Permissible locations include a bank, as defined in section 3(a)(6) of the Exchange Act, and a clearing agency.<sup>196</sup> A broker-dealer must make a daily determination of the amount of fully paid and excess margin securities it holds for customers and compare it to the amount actually held in the permissible locations in order to comply with this aspect of the rule.<sup>197</sup>

The second step covers customer funds and requires that a carrying broker-dealer must maintain a reserve of cash or qualified securities in one or more accounts at a bank that is at least equal in value to the net cash owed to customers and the amount of cash obtained from the use of customer securities.<sup>198</sup> The account must be titled "Special Account for the Exclusive Benefit of Customers of the Broker-Dealer" ("customer reserve

account").<sup>199</sup> The amount of cash and/or qualified securities that must be kept in the customer reserve account is computed pursuant to a formula set forth in Exhibit A to Rule 15c3-3.<sup>200</sup> Under the Exhibit A formula, the broker-dealer adds customer credit items (e.g., cash in customer securities accounts) and then subtracts from that amount customer debit items (e.g., margin loans).<sup>201</sup> If credit items exceed debit items, the net amount must be on deposit in the customer reserve account in the form of cash and/or qualified securities.<sup>202</sup> If the debits exceed credits, no deposit is necessary. Funds deposited in a customer reserve account cannot be withdrawn until the broker-dealer completes another computation that shows that the broker-dealer has on deposit more funds than the reserve formula requires.

Under Note G to Exhibit A, a carrying broker-dealer may include margin collateral for transactions in security futures products as a debit in its reserve formula computation if that margin collateral is required and on deposit at a clearing agency or derivatives clearing organization that meets at least one of four conditions: (1) The clearing agency or derivatives clearing organization maintains the highest investment-grade rating from an NRSRO; (2) the clearing agency or derivatives clearing organization maintains security deposits from clearing members in connection with regulated options or futures transactions and assessment power over member firms that equal a combined total of at least \$2 billion, at least \$500 million of which must be in the form of security deposits; (3) the clearing agency or derivatives clearing organization maintains at least \$3 billion in margin deposits; or (4) the clearing agency or derivatives clearing organization obtains an exemption from the Commission.

Margin collateral that is posted for customer positions in security futures products constitutes an unsecured receivable from the clearing agency or derivatives clearing organization. Therefore, requiring a clearing agency or a derivatives clearing organization to meet certain minimum creditworthiness criteria before margin collateral deposited with that entity may be included as a debit in a broker-dealer's customer reserve formula is consistent with the customer protection function of Rule 15c3-3 because the debit offsets any credits when computing the customer reserve deposit requirement.

<sup>192</sup> 17 CFR 240.15c3-3.

<sup>193</sup> See 15 U.S.C. 78aaa *et seq.*

<sup>194</sup> 17 CFR 240.15c3-3(b)(1).

<sup>195</sup> 17 CFR 240.15c3-3(c).

<sup>196</sup> 17 CFR 240.15c3-3(c).

<sup>197</sup> 17 CFR 240.15c3-3(d).

<sup>198</sup> 17 CFR 240.15c3-3(e).

<sup>199</sup> 17 CFR 240.15c3-3(e)(1).

<sup>200</sup> 17 CFR 240.15c3-3a.

<sup>201</sup> 17 CFR 240.15c3-3a.

<sup>202</sup> 17 CFR 240.15c3-3(e).

Accordingly, this requirement is intended to provide reasonable assurance that customer margin collateral deposited with a clearing agency or derivatives clearing organization related to security futures products will be available to be returned to the broker-dealer and, therefore, can serve as an appropriate offset to customer credits in the reserve formula.

The Commission proposed to remove the first criterion described above (*i.e.*, the highest investment-grade rating from an NRSRO).<sup>203</sup> The criteria are disjunctive and, therefore, a clearing agency or derivatives clearing organization needs to satisfy only one criterion to permit a broker-dealer to treat posted customer margin collateral as a reserve formula debit. In the proposing release, the Commission stated that the proposed amendment would not lessen the protections for customer funds and securities.<sup>204</sup> While one potential criterion would be removed, currently, only the Options Clearing Corporation (“OCC”) clears and accepts margin on security futures products. The OCC qualifies under two of the other criteria in Note G.<sup>205</sup> If at a later date another clearing entity accepts margin on security futures products, and it did not meet one of the remaining criteria, a broker-dealer may request an exemption for that clearing entity under Note G to Appendix A to Rule 15c3-3.<sup>206</sup> Thus, the proposed amendment does not disqualify any current clearing entities, nor require a broker-dealer to obtain new clearing memberships to comply with Rule 15c3-3.

The Commission received no comments on the proposed amendment to Rule 15c3-3. The Commission is adopting the amendment to Note G to Exhibit A to Rule 15c3-3 as proposed by removing paragraph (b)(1)(i).

<sup>203</sup> See *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, 76 FR at 26557.

<sup>204</sup> *Id.*

<sup>205</sup> At the end of 2012, OCC maintained \$78.8 billion in margin deposits, well in excess of the \$3 billion threshold set forth in paragraph (b)(1)(iii) of Note G. The OCC also maintained \$2.7 billion in clearing member deposits, well in excess of the \$500 million threshold set forth in paragraph (b)(1)(ii) of Note G. See OCC, *2012 Annual Report* (2012) (Notes 3 and 4 to the Financial Statements).

<sup>206</sup> The Commission may, in its sole discretion, grant such an exemption subject to such conditions as are appropriate under the circumstances if the Commission determines that such conditional or unconditional exemption is necessary or appropriate in the public interest and is consistent with the protection of investors. See 17 CFR 240.15c3-3a(b)(1)(iv), Note G.

## 2. Rule 10b-10

### a. Proposal

Rule 10b-10 under the Exchange Act, the Commission’s customer confirmation rule, generally requires broker-dealers effecting transactions for customers in securities, other than U.S. savings bonds or municipal securities, to provide those customers with a written notification, at or before completion of the securities transaction, disclosing certain information about the terms of the transaction.<sup>207</sup> This required disclosure includes, among other things, the date, time, identity, and number of securities bought or sold; the capacity in which the broker-dealer acted (*e.g.*, as agent or principal); yields on debt securities; and, under special circumstances, the amount of compensation the broker-dealer will receive from the customer and any other parties.<sup>208</sup> By requiring these disclosures, the rule serves a basic customer protection function by conveying information that: (1) Allows customers to verify the terms of their transactions; (2) alerts customers to potential conflicts of interest; (3) acts as a safeguard against fraud; and (4) allows customers a means of evaluating the costs of their transactions and the quality of the broker-dealer’s execution.

The Commission proposed to delete paragraph (a)(8) from Rule 10b-10.<sup>209</sup> Paragraph (a)(8), which the Commission adopted in 1994, requires a broker-dealer to inform the customer in the confirmation if a debt security, other than a government security, is unrated by an NRSRO.<sup>210</sup> As explained when it was added to Rule 10b-10 in 1994, paragraph (a)(8) was intended to alert customers to the potential need to obtain more information about a security from a broker-dealer; it was not intended to suggest that an unrated security is inherently riskier than a rated security.<sup>211</sup>

<sup>207</sup> See 17 CFR 240.10b-10.

<sup>208</sup> *Id.*

<sup>209</sup> See *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, 76 FR at 26563–26564 & n.80. Consistent with this proposed change, the Commission also proposed to re-designate paragraph (a)(9) of the rule, under which a broker-dealer that is not a member of the Securities Investor Protection Corporation generally must disclose that fact, as paragraph (a)(8). *Id.* at 26564 n.89, 26576.

<sup>210</sup> See 17 CFR 240.10b-10(a)(8); *Confirmation of Transactions*, Exchange Act Release No. 34962 (Nov. 10, 1994), 59 FR 59612, 59617 (Nov. 17, 1994), *corrected*, Securities Exchange Act Release No. 34962A (Nov. 18, 1994), 59 FR 60555 (Nov. 25, 1994).

<sup>211</sup> *Id.* (stating, “In most cases, this disclosure should verify information that was disclosed to the investor prior to the transaction. If the customer was not previously informed of the security’s unrated status, then confirmation disclosure may

The Commission had previously proposed, and re-proposed, the deletion of paragraph (a)(8) from Rule 10b-10.<sup>212</sup> These previous proposals, however, were prompted by concerns regarding the undue reliance on NRSRO ratings and confusion about the significance of those ratings. Because paragraph (a)(8) of Rule 10b-10 does not refer to NRSRO ratings as a means of determining creditworthiness, it arguably does not come strictly within section 939A. Nevertheless, to the extent that the provision may focus investor attention on ratings issued by NRSROs, as distinct from other items of information, the Commission believed deleting it would be consistent with the intent of the Dodd-Frank Act.

### b. Comments

The Commission received four comments regarding the proposed removal of paragraph (a)(8) from Rule 10b-10. One commenter was supportive of the deletion, without providing any additional comment.<sup>213</sup> Another commenter recommended that in place of the deletion, the proposed rules should require Rule 10b-10 confirmations to include information that would ensure that investors understand the potential need to learn more about the debt securities that they have acquired from their broker-dealers.<sup>214</sup> The commenter recommended requiring broker-dealers to inform investors that debt securities vary in terms of their creditworthiness; that investors should understand the credit quality of the specific debt securities acquired through their broker-dealer; and that credit quality can affect not only the value of the debt securities, but also their liquidity and price stability.<sup>215</sup> In contrast, a third commenter believed that the removal of paragraph (a)(8) serves no useful purpose, stating: “We do not see how requiring disclosure of the *absence* of a credit rating in any way encourages greater reliance on credit ratings.”<sup>216</sup> The commenter further recommended that if paragraph (a)(8) were deleted, the Commission should not replace it with

prompt a dialogue between the customer and the broker-dealer,” and noting that the disclosure was “not intended to suggest that an unrated security is inherently riskier than a rated security.”)

<sup>212</sup> See *References to Ratings of Nationally Recognized Statistical Rating Organizations*, 74 FR 52374; *References to Ratings of Nationally Recognized Statistical Rating Organizations*, 73 FR 40088.

<sup>213</sup> See *SIFMA Letter*, n.3 (“SIFMA endorses the Commission’s proposed changes to Rules 15c3-3 and Rule 10b-10.”).

<sup>214</sup> See *Better Markets Letter*.

<sup>215</sup> *Id.*

<sup>216</sup> See *Sullivan & Cromwell Letter*.

any further required disclosures.<sup>217</sup> A fourth commenter recommended that paragraph (a)(8) of Rule 10b-10 should be retained.<sup>218</sup> The commenter stated that, given that the types of securities that are unrated by NRSROs typically include small offerings, the required broker-dealer disclosures may no longer signal to investors any need to investigate the quality of the securities being purchased.<sup>219</sup> The commenter added that the required notification that certain securities are unrated serves to encourage investors to evaluate the securities in which they are investing without undermining the overall intent to eliminate *reliance* upon ratings bestowed by NRSROs.<sup>220</sup>

### c. Final Rule

After careful consideration of the received comments, the Commission has decided to delete paragraph (a)(8) from Rule 10b-10, as proposed. The Commission acknowledges that, to some extent, the paragraph may have served the purpose for which it was added to the rule in 1994 by prompting investors to investigate or question a broker-dealer about the quality of certain securities. Based on the comments received in response to the proposing release, however, the Commission believes it is likely that the paragraph's disclosure requirement has to a greater extent added to investors' undue reliance on credit ratings, and that the deletion of the paragraph is consistent with the intent of section 939A of the Dodd-Frank Act to reduce reliance on NRSRO credit ratings. In addition, requiring broker-dealers to use customer confirmations as a means of providing investors with general information related to credit risk and debt securities as suggested by commenters would not further paragraph (a)(8)'s purpose of flagging unrated securities for more careful investor scrutiny. The paragraph was added to the rule to require disclosure of information suggesting that investors may want to obtain more information about certain unrated securities, not to "require that confirmations alert customers to the importance of understanding the credit quality of a debt security and the impact of credit quality on the value, resale, and price of such securities."<sup>221</sup> The purpose of Rule 10b-10 is not to educate investors about the characteristics of different kinds of securities in general, but rather, in the

context of particular transactions, convey information allowing investors to verify the terms of their transactions, alert investors to potential conflicts of interest with their broker-dealers, deter and prevent deceptive and fraudulent acts and practices, and assist customers in evaluating the costs and quality of services proved by broker-dealers in connection with the execution of their securities transactions.<sup>222</sup>

The Commission further notes, as it did in the proposing release, that after the deletion of paragraph (a)(8), broker-dealers will not be prohibited from continuing to provide the information currently required by paragraph (a)(8) on a voluntary basis.<sup>223</sup> If broker-dealers believe that continuing to provide such information on confirmations would, for example, give investors an incentive to carry out additional research on their debt securities, the broker-dealers may continue to provide this disclosure at their discretion.<sup>224</sup> Also, in particular circumstances they may believe that a reasonable investor likely would consider a security's lack of a credit rating significant.

After consideration of the comments received, the Commission is removing paragraph (a)(8) and believes that it is unnecessary to replace the paragraph with any other disclosure requirement. Although the Commission recognizes the potential benefit of requiring broker-dealers to remind investors of the varying creditworthiness of debt securities, the Commission believes that such a requirement would be unnecessary given the other security-specific disclosures currently required by Rule 10b-10.<sup>225</sup> Also, general information about credit risk and other risks associated with corporate bonds is widely available to investors.<sup>226</sup>

<sup>222</sup> See *Confirmation of Transactions*, at 59 FR 59613; *Securities Confirmations*, Exchange Act Release No. 15219 (Oct. 4, 1978), 43 FR 47495, 47496 (Oct. 16, 1978).

<sup>223</sup> See *Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934*, 76 FR at 26564. The Commission understands that, as a practical matter, broker-dealers will likely not reprogram their systems solely to remove the information even though the legal obligation to include it has been eliminated. Rather, it is anticipated that firms may choose to make the change at a later date as part of a larger reprogramming initiative.

<sup>224</sup> Based on a limited review of customer confirmations, the Commission understands that some broker-dealers currently disclose NRSRO ratings for rated securities even though this information is not required by paragraph (a)(8).

<sup>225</sup> See information broker-dealers must disclose as specified in paragraphs (a)(1) through (a)(7) of Rule 10b-10, as amended.

<sup>226</sup> See, e.g., SEC's Office of Investor Education and Advocacy's Investor Bulletin, *What Are Corporate Bonds?* (June 2013), available at [http://www.sec.gov/investor/alerts/ib\\_corporatebonds.pdf](http://www.sec.gov/investor/alerts/ib_corporatebonds.pdf).

### III. Paperwork Reduction Act

Certain provisions of the amendments to the rules and form contain "collection of information requirements" within the meaning of the Paperwork Reduction Act of 1995 ("PRA").<sup>227</sup> The Commission solicited comment on the estimated burden associated with the collection of information requirements in the proposed amendments. The Commission submitted the proposed collection of information requirements to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507 and 5 CFR 1320.11. The titles of the affected information collections are Rule 15c3-1 (OMB Control Number 3235-0200), Rule 15c3-3 (OMB Control Number 3235-0078), Rule 17a-4 (OMB Control Number 3235-0279), Rule 10b-10 (OMB Control Number 3235-0444), and the General Instructions to Form X-17A-5, Part IIB (OMB Control Number 3235-0498). An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information requirement unless it displays a currently valid OMB control number.

As discussed above, the Commission received eleven comment letters on the proposed amendments. Some of the comments in these letters relate indirectly to the PRA and are addressed below. The estimates contained in this section do not include any other possible costs or economic effects beyond the costs required for PRA purposes.<sup>228</sup>

#### A. Summary of Collection of Information

As discussed above, the Commission is adopting amendments to Rule 15c3-1, Appendices A, E, F, and G to Rule 15c3-1, Exhibit A to Rule 15c3-3, Rule 17a-4, the General Instructions to Form X-17A-5, Part IIB, and Rule 10b-10. These amendments are consistent with section 939A of the Dodd-Frank Act.

The amendments to Rule 15c3-1, and Rule 17a-4 establish a new standard of creditworthiness that will allow broker-dealers to establish their own policies and procedures to determine whether a security has only a minimal amount of credit risk. If a broker-dealer chooses to establish these policies and procedures, it would create a new "collection of information" burden for those broker-dealers, as explained below. The amendments to Appendices A, E, F, and G to Rule 15c3-1 and the General Instructions to Form X-17A-5, Part IIB remove provisions permitting reliance

<sup>227</sup> 44 U.S.C. 3501 *et seq.*

<sup>228</sup> See discussion below in Section IV.D.

<sup>217</sup> *Id.*

<sup>218</sup> See *CFA Institute Letter*.

<sup>219</sup> *Id.*

<sup>220</sup> *Id.*

<sup>221</sup> See *Better Markets Letter*, at 4.

on NRSRO ratings to calculate haircuts and credit risk charges related to counterparties. In addition, the amendments to the Customer Protection Rule remove one method for verifying the status of a registered clearing agency or derivatives clearing organization under Note G to Exhibit A. Broker-dealers have to use a new method for verifying the status of a registered clearing agency or derivatives clearing organization may have to comply with a new “collection of information” within the meaning of the PRA.

The Commission does not believe that the amendment to Rule 10b–10, which eliminates a requirement that broker-dealers inform customers in transaction confirmations for debt securities (other than government securities) if a security is unrated by an NRSRO, would change the existing paperwork burden for Rule 10b–10.

*B. Proposed Use of Information*

The written policies and procedures required by the amendments to Rule 15c3–1, and the retention of these policies and procedures required by the amendment to Rule 17a–4, will assist Commission and SRO examination staff in evaluating whether the broker-dealer has a reasonable basis for determining if a security has only a minimal amount of credit risk. It also will assist examination staff and the broker-dealer in evaluating whether the broker-dealer has followed those policies and procedures when acquiring positions in commercial paper, nonconvertible debt, and preferred stock. In addition, written policies and procedures will provide a broker-dealer’s personnel with consistent guidance on how to determine if a security has a minimal amount of credit risk for the purposes of complying with Rule 15c3–1.

The amendment to Rule 10b–10 will eliminate a requirement for transaction confirmations for debt securities (other than government securities) to inform customers if a security is unrated by an NRSRO. This amendment will alter neither the general requirement that broker-dealers generate transaction confirmations and send those confirmations to customers, nor the potential use of information contained in confirmations by the Commission, SROs, and other securities regulatory authorities in the course of examinations, investigations and enforcement proceedings.

*C. Respondents*

The Commission estimates that the collections of information would apply to the number of respondents as indicated in the following table.<sup>229</sup>

Rules	Number of broker-dealers
Amendments to Rule 15c3–1 (not including appendices) and Rule 17a–4 .....	434
Amendments to Appendices A, E, F, and G to Rule 15c3–1 .....	115
Amendments to Exhibit A to Rule 15c3–3 .....	72
Amendments to the General Instructions to Form X–17A–5, Part IIB .....	4
Amendments to Rule 10b–10 .....	502

*D. Total Initial and Annual Reporting and Recordkeeping Burden*

1. Rule 15c3–1 Appendices A, E, F, and G to Rule 15c3–1, Rule 17a–4, and the General Instructions to Form X–17A–5, Part IIB

The amendments to Rule 15c3–1 and Rule 17a–4 modify broker-dealers’ existing practices to impose additional voluntary recordkeeping burdens. The amendments to Rule 15c3–1 replace NRSRO ratings-based criteria for evaluating creditworthiness with an option for a broker-dealer to apply a new standard based on the broker-dealer’s own evaluation of creditworthiness. A broker-dealer that chooses not to make such an evaluation could instead take the higher haircuts as specified in Rule 15c3–1. A broker-dealer that chooses to evaluate the creditworthiness of securities will have to establish, document, maintain, and enforce policies and procedures that are reasonably designed to determine whether a security has a minimal amount of credit risk. Broker-dealers will be required to develop (if they have not already) criteria for assessing

creditworthiness and apply those criteria to commercial paper, nonconvertible debt, and preferred stock included in their net capital calculations.

The Commission requested comment on the PRA burden associated with its proposed amendments to Rule 15c3–1 and Rule 17a–4. Two commenters discussed costs, although the comments did not explicitly address the PRA.<sup>230</sup> One commenter stated that “[a] significant number of large broker-dealers have sophisticated internal credit review functions” but those broker-dealers may not “have access to internally generated analyses of all or nearly all issuers and securities.”<sup>231</sup> Both commenters were concerned that the costs imposed by the proposed amendments could be considerable, particularly for small and medium-sized broker-dealers.<sup>232</sup> One commenter noted, however, that “the burden on small and medium-sized broker-dealers would be significantly reduced if the proposed amendment were to be interpreted . . . to permit policies and procedures that base the credit risk analysis solely on a small number of

objectively determinable factors.”<sup>233</sup> The amended rule allows a broker-dealer to establish policies and procedures customized to its size and business activities.<sup>234</sup> For example, a smaller broker-dealer may decide to establish procedures that use a small number of objective factors or that default to the higher haircuts with respect to certain types of securities or money market instruments in lieu of establishing policies and procedures to address them. Both of these options should minimize the compliance burden on the broker-dealer. Furthermore, the Commission believes that many of the firms that hold commercial paper, nonconvertible debt securities, and preferred stock (or combinations thereof) have established policies and procedures for assessing creditworthiness; broker-dealers that have not established such policies and procedures do not typically hold large portfolios of these types of positions.<sup>235</sup> In addition, the broker-dealer should be able to use its policies and procedures to replicate its credit determinations and is not required to create and maintain records of those

<sup>229</sup> See also section IV.B., *infra*.

<sup>230</sup> *Bond Dealers Letter*; *SIFMA Letter*.

<sup>231</sup> *SIFMA Letter*, at 11, 18.

<sup>232</sup> *Bond Dealers Letter*, at 2; *SIFMA Letter*, at 18.

<sup>233</sup> *SIFMA Letter*, at 18.

<sup>234</sup> See section II.B.1.a.iii., *supra*.

<sup>235</sup> *SIFMA Letter*, at 18 (“A number of broker-dealers have access to credit analysis functions that could be applied to generate internal credit analysis of debt instruments.”).

determinations. Nonetheless, the Commission believes that those broker-dealers that already have policies and procedures in place for evaluating the overall risk and liquidity levels of proprietary securities for the purposes of Rule 15c3-1 may incur additional burdens as a result of the amendments. In particular, the policies and procedures may need to be modified to address the particular requirements of the amendments.

According to data collected by the Commission, of the approximately 4,462 broker-dealers registered with the Commission as of year-end 2012, approximately 434 broker-dealers maintained proprietary positions in debt securities and took haircuts on these securities pursuant to paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2) and (c)(2)(vi)(H) of Rule 15c3-1.<sup>236</sup> The Commission estimated in the proposing release that, on average, broker-dealers would spend 25 hours developing policies and procedures or revising their current policies and procedures for evaluating creditworthiness for purposes of the amendments to Rule 15c3-1.<sup>237</sup> The Commission received no comments on this estimate. The Commission believes that this estimate is still valid, resulting in an aggregate initial burden of 10,850 hours.<sup>238</sup> This estimate is based on the Commission's belief that many of these broker-dealers already have their own criteria in place for evaluating creditworthiness and, therefore, most broker-dealers will only be revising their current policies and procedures. If a broker-dealer does not have policies and procedures in place (e.g., a small broker-dealer holding only a few debt

securities) but determines to establish them rather than taking the larger haircut, the Commission believes that such a firm will likely establish less complex policies and procedures using a small number of objective factors.<sup>239</sup>

The Commission also estimated in the proposing release that, on average, each broker-dealer will spend an additional 10 hours a year reviewing and adjusting its own standards for evaluating creditworthiness for purposes of the amendments to Rule 15c3-1.<sup>240</sup> The Commission received no comments on this estimate and believes it is still valid. As a result, the Commission estimates that a broker-dealer will spend approximately twenty-five hours initially and ten hours on an annual basis on its policies and procedures. Thus, the industry, as a whole, is estimated to spend approximately 10,850 hours initially and 4,340 hours<sup>241</sup> annually reviewing and adjusting its standards for evaluating creditworthiness for purposes of the amendments to Rule 15c3-1.<sup>242</sup>

The Commission received no comments on the estimated burdens associated with the record retention

requirements arising from the proposed amendments to Rule 17a-4. The Commission continues to believe that the requirement to retain the policies and procedures for three years pursuant to Rule 17a-4 would result in de minimis incremental costs beyond those already incurred under Rule 17a-4. The three-year preservation requirement in Rule 17a-4 will only be applicable once a broker-dealer changes its policies and procedures as the operative policies and procedures must be documented and maintained under the amendments to Rule 15c3-1. In addition, all broker-dealers are currently required to comply with the three-year preservation period in Rule 17a-4 for other records and should have procedures in place to satisfy such preservation requirements.

The amendments to the appendices to Rule 15c3-1 include amendments to certain recordkeeping and disclosure requirements that are subject to the PRA. The amendment to Appendix A to Rule 15c3-1 removes the NRSRO reference from the definition of the term *major market foreign currency*. However, the Commission does not intend to change which currencies would meet the definition of *major market foreign currency* because they will still have to have a substantial inter-bank foreign currency market. In the proposing release the Commission stated that there would be a recordkeeping burden if a broker-dealer wanted to request that a currency be deemed to meet the definition of *major market foreign currency*, by submitting such a request to the Commission. After further review, and based on staff experience with paragraph (c)(2)(vi) of Rule 15c3-1, the Commission believes that broker-dealers will rarely formally request in writing that a currency be added to the list. Thus, the Commission does not believe there is a burden associated with this amendment.<sup>243</sup>

The amendments to Appendices E and F to Rule 15c3-1 and conforming amendments to Appendix G would remove the provisions permitting reliance on NRSRO ratings for the purposes of determining counterparty risk. As a result of these deletions, an entity that wishes to use the approach set forth in these appendices to determine counterparty risks would need, as part of its initial application to use the alternative approach or in an amendment, to request Commission

<sup>236</sup> The number of 434 broker-dealers was obtained by reviewing broker-dealer Financial and Operational Combined Single (or "FOCUS") Reports for 2012 year-end and then calculating how many firms reported holding proprietary debt positions. For FOCUS Part II filers, the balances examined were "Bankers Acceptances" and "Corporate Debt." For FOCUS CSE filers, the balances examined were: "Money Market Instruments," "Private Label Mortgage Backed Securities," "Other Asset Backed Securities," and "Corporate Debt." For Part IIA filers, the balance examined was "Debt Securities." Broker-dealers that hold preferred stock also may hold positions in debt securities. However, because preferred stock is not a separate line item on the FOCUS Report, broker-dealers that hold only preferred stock and no other debt securities are not included in this estimate.

<sup>237</sup> *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, 76 FR at 26568.

<sup>238</sup>  $434 \text{ broker-dealers} \times 25 \text{ hours} = 10,850 \text{ hours}$ . It should be noted that this hour burden is less than the hour burden in the proposing release. This decrease is a result of the number of broker-dealers that reported holding proprietary debt positions on the FOCUS Report. The number decreased from 480 at 2009 year end to 434 at 2012 year end.

<sup>239</sup> See *SIFMA Letter*, at 18 ("the burden on small and medium-sized broker-dealers would be significantly reduced if the proposed amendment were to be interpreted . . . to permit policies and procedures that base the credit risk analysis solely on a small number of objectively determinable factors . . .").

<sup>240</sup> *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, 76 FR at 26568. Although the Commission has added language to the rule to clarify that a broker-dealer's policies and procedures must be reasonably designed to monitor its creditworthiness determination, the duty to monitor was required under the proposed rule and was reflected in the corresponding burden estimate. See section II.B.1.a.iii, *supra*.

<sup>241</sup>  $434 \text{ broker-dealers} \times 10 \text{ hours} = 4,340 \text{ hours}$ .

<sup>242</sup> The Commission estimated in the proposing release that firms would use a controller to review these standards, both initially and on an annual basis. The Commission received no comments on this estimate. Thus, the Commission believes the per-firm costs of the controller to be approximately \$10,475 initially and \$4,190 on an annual basis, for an aggregate industry cost of \$4,546,150 initially and \$1,818,460 on an annual basis. For purposes of this analysis, the Commission is using salary data from the Securities Industry and Financial Markets Association ("SIFMA") Report on Management and Professional Earnings in the Securities Industry 2012, which provides base salary and bonus information for middle management and professional positions within the securities industry, as modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. Hereinafter, references to data derived from the report as modified in the manner described above will be cited as *SIFMA Report on Management and Professional Earnings in the Securities Industry 2012*. The Commission believes that the reviews required by the proposed amendments would be performed by the controller at an average rate \$419 per hour.  $\$419 \times 25 = \$10,475 \times 434 = \$4,546,150$ ;  $\$419 \times 10 = \$4,190 \times 434 = \$1,818,460$ .

<sup>243</sup> In the proposing release, the Commission estimated that submitting a request that a new currency met the definition of "major market foreign currency" would take 10 hours for a total burden to the industry of 1,580 hours. See *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, 76 FR at 26568.

approval to determine credit charges based on internal credit ratings and make and keep current a record of the basis for the credit risk weight applied to each counterparty.

The Commission does not believe that the removal of the option permitting reliance on NRSRO ratings would affect the small number of entities that currently elect to compute their net capital deductions pursuant to the alternative methods set forth in Appendices E or F. Although the collections of information obligations imposed by the amendments are mandatory, applying for approval to use the alternative capital calculation is voluntary.<sup>244</sup> To date, a total of six entities are using the methods set forth in Appendix E, while four are using the methods set forth in Appendix F. All of the approved firms already use internal credit ratings to calculate market and credit risks under the alternative net capital calculation methods set forth in the appendices or are taking a 100% charge for counterparty risk. No firms are using NRSRO ratings to measure counterparty risk.<sup>245</sup> For each entity that already employs its own models to calculate market and credit risk and keeps current a record of the basis for the credit risk weight of each counterparty, the amendments would not alter the paperwork burden currently imposed by Appendices E and F. Firms that have Commission-approved models to calculate market and credit risk, but have chosen not to seek Commission approval to calculate counterparty risk during their initial applications, can file an amendment to their applications to calculate counterparty risk. Based on the staff's review of how firms approved to use Appendices E and F are calculating counterparty risk, the staff believes that of the firms that do not have models approved to calculate counterparty risk, none would use NRSRO ratings to calculate counterparty risk even if it remained an option. Instead, these firms would continue to take a 100% charge for counterparty risk or would amend their application if charges related to counterparty risk increased to the point

<sup>244</sup> See, e.g., *Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities*, Exchange Act Release No. 34-49830 (June 8, 2004), 69 FR 34428 at 34456 (June 21, 2004).

<sup>245</sup> In the proposing release, the Commission stated that all firms have models approved to calculate counterparty risk. Although the Commission received no comments on this estimate, upon further review the staff has determined that although no firm is using NRSRO ratings to calculate counterparty risk, not all firms have models approved to calculate counterparty risk (i.e., some firms take the 100% charge).

that the 100% charge was no longer economically practical. Any PRA burdens from these amended applications are included in the PRA burden associated with Appendix E or Appendix F. Thus, the Commission does not believe there are any additional burdens associated with this rulemaking.

The staff estimates that three additional firms may apply for permission to use Appendix E and one additional firm may apply to use Appendix F. However, the Commission believes, and commenters did not contest, that there should be no additional paperwork burden on these firms based on the amendments. Any firm that applies to use Appendices E or F to Rule 15c3-1 must submit its internal models to the Commission for approval as part of that process. These models will calculate market risk and credit risk, including the counterparty charge, which is not a change from the previous approval process for a firm that is applying to use Appendix E or Appendix F. Thus, the Commission does not believe the amendments to Appendices E and F will alter the existing paperwork burden estimates for these collections.

The instructions to Form X-17A-5, Part IIB currently include a summary of the credit risk calculation in paragraph (d) of Rule 15c3-1f. Paragraph (d) of Rule 15c3-1f is amended to remove that part of the credit risk calculation that is summarized in Form X-17A-5, Part IIB. Accordingly, the Commission is adopting a conforming amendment to the form that would remove the summary of the credit risk calculation. The Commission received no comments on its estimate in the proposing release that there would be no change in the burden for the collection of information related to the instructions to Form X-17A-5, Part IIB in the proposing release. The summary in the instructions provides additional information for the benefit of the filer and is not related to the information reported on the forms. Accordingly, the Commission does not believe the amendment would result in a substantive revision to these collections of information.

## 2. Exhibit A to Rule 15c3-3

The amendment to Note G to Exhibit A to Rule 15c3-3 imposes additional recordkeeping burdens on certain broker-dealers that are mandatory. Note G allows a broker-dealer to include, as a debit in its customer reserve formula, the amount of customer margin related to customer positions in security futures products posted to a registered clearing or derivatives clearing organization that

meets certain minimum standards that are indicia of long-term financial strength. Prior to this amendment, clearing organizations that maintained the highest investment grade rating from an NRSRO qualified under Note G.<sup>246</sup> The amendment removes this NRSRO criterion such that firms including the debit in their reserve formula calculations must rely on one of the remaining three non-NRSRO criteria, or seek an exemption from the Commission. Broker-dealers are expected to ensure that any clearing or derivatives clearing organization it posts margin to meets one of the criteria under Note G, which results in the creation and maintenance of records of those assessments. The Commission requested comment on all aspects of the burdens associated with Note G to Exhibit A to Rule 15c3-3 and received no comments. The Commission estimates that approximately 72 firms would be required to comply with the provisions of Note G as amended.<sup>247</sup> In the final release that added Note G to Exhibit A to Rule 15c3-3,<sup>248</sup> the Commission estimated that firms would each spend approximately 0.25 hours to verify that the clearing or derivatives clearing organizations they post customer margin to satisfy the conditions of Note G. In the proposing release for these rule amendments, the Commission again estimated that firms would spend approximately 0.25 hours to verify that a clearing or derivatives clearing organization satisfies the conditions of Note G. The Commission

<sup>246</sup> A broker-dealer may also include customer margin related to customers' positions in security futures products posted to a registered clearing or derivatives clearing organization: (1) That maintains security deposits from clearing members in connection with regulated options or futures transactions and assessment power over member firms that equal a combined total of at least \$2 billion, at least \$500 million of which must be in the form of security deposits; (2) that maintains at least \$3 billion in margin deposits; or (3) which does not meet any of the other criteria but which the Commission has agreed, upon a written request from the broker-dealer, that the broker-dealer may utilize. 17 CFR 240.15c3-3a, Note G, (b)(1)(ii)-(iv).

<sup>247</sup> The number 72 comes from reviewing the members of the OCC listed in the member directory on the OCC's Web site, available at <http://www.optionsclearing.com/membership/member-information/>. Of the list of 228 members, the Commission looked only at those who trade in single stock futures. Of the list of members that trade in single stock futures, the Commission deleted any members who had the exact same firm name but different firm numbers. This methodology is consistent with the methodology used in the proposing release. *Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934*, 76 FR at 26570 n.115. The Commission received no comments on this estimate.

<sup>248</sup> See *Reserve Requirements for Margin Related to Security Futures Products*, Exchange Act Release No. 34-50295 (Aug. 31, 2004), 69 FR 54182, 54188 (Sep. 7, 2004).

received no comments on this estimate and believes it is still valid. The Commission therefore estimates that broker-dealers that trade in single stock futures will spend a total of approximately 18 hours per year, initially and on an ongoing basis, to verify the status of a registered clearing or derivatives clearing organization imposed by this amendment.<sup>249</sup>

The Commission estimated in the proposing release that firms would spend one hour changing their methods of determining whether a clearing or derivatives clearing organization meets the remaining four requirements of Note G. The Commission received no comments on this estimate and believes it is still accurate. The result is an aggregate, one-time initial burden of 72 hours.<sup>250</sup>

### 3. Rule 10b-10

In the proposing release, the Commission stated that the proposed amendment to Rule 10b-10 was not expected to result in any significant change to the cost of providing confirmations to customers in connection with those transactions covered by paragraph (a)(8) of the rule.<sup>251</sup> The Commission did not receive any comments that addressed the Rule 10b-10 amendment's potential effects on the burden associated with generating and sending confirmations. The Commission continues to believe that broker-dealers need not incur any new costs if they choose not to input information that a debt security is unrated into their existing confirmation systems. Accordingly, the Commission continues to believe that the Rule 10b-10 amendment will not result in any significant change to the recordkeeping or reporting burdens of generating and sending confirmations, and retains this conclusion as originally proposed.

<sup>249</sup> 72 broker-dealers × .25 hours = 18 hours.

<sup>250</sup> 72 broker-dealers × 1 hour = 72 hours. The Commission notes that this hour burden is less than the hour burden in the proposing release. This decrease is a result of the number of OCC member firms that trade in single stock futures decreasing from 90 to 72. The Commission estimated in the proposing release that firms will use a senior operations manager to review these standards. The Commission received no comments on this estimate and believes that it is still accurate. The Commission therefore estimates that the one-time costs of a senior operations manager to be \$341 per hour, resulting in an aggregate, one-time cost to the industry of \$24,552. 72 broker-dealers × \$341/hour × 1 hour = \$24,552. *SIFMA Report on Management and Professional Earnings in the Securities Industry 2012*.

<sup>251</sup> See *Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934*, 76 FR at 26575.

## IV. Economic Analysis

### A. Overview

The Commission is sensitive to the costs and benefits of its rules. When engaging in rulemaking that requires the Commission to consider or determine whether an action is necessary or appropriate in the public interest, section 3(f) of the Exchange Act requires that the Commission consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.<sup>252</sup> In addition, section 23(a)(2) of the Exchange Act requires that the Commission consider the effects on competition of any rules the Commission adopts under the Exchange Act, and prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.<sup>253</sup>

In the proposing release, the Commission solicited comment on the costs and benefits of the proposed amendments, including whether estimates of the costs and benefits were accurate and comprehensive.<sup>254</sup> The Commission further encouraged commenters to provide specific data and analysis in support of their views.<sup>255</sup> The Commission also requested comment on whether the proposed amendments would place a burden on competition, and promote efficiency, competition, and capital formation.<sup>256</sup>

The Commission received two comment letters addressing the Commission's estimates of the costs associated with the proposed amendments.<sup>257</sup> Generally, these commenters expressed concerns that the potential costs associated with the proposed rules could be considerable.<sup>258</sup> While commenters stated that the costs may be high, they did not provide quantified estimates of the costs—this reflects the fact that many of the costs and benefits of today's amendments are difficult to quantify with any degree of certainty, especially

<sup>252</sup> 15 U.S.C. 78c(f).

<sup>253</sup> 15 U.S.C. 78w(a)(2).

<sup>254</sup> An economic analysis was included in the proposing release. See *Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934*, 76 FR at 26571–26574.

<sup>255</sup> See *Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934*, 76 FR at 26574.

<sup>256</sup> *Id.*

<sup>257</sup> See *SIFMA Letter; Bond Dealers Letter*.

<sup>258</sup> See *Bond Dealers Letter*, at 2 (“the cost to comply may be prohibitively high for the smaller or middle-market broker-dealers”); *SIFMA Letter*, at 18 (“we believe the cost and complexity of developing a credit evaluation infrastructure covering many issuers and securities may be beyond the means of many broker-dealers”).

as practices at broker-dealers are expected to evolve and appropriately adapt to market developments. Moreover, this difficulty is aggravated by the fact that limited public data exists that is related to a broker-dealer's net capital calculation that could assist in quantifying certain costs. Consequently, the Commission has relied on qualitative assessments of the likely costs and benefits in its analysis. As discussed throughout this release, the Commission has modified the amendments being adopted today in a way that it believes will help to minimize costs to broker-dealers. A number of costs and benefits that are related to the rules being adopted today are discussed below.

As discussed above, the amendments to Rule 15c3-1, Appendices A, E, F, and G to Rule 15c3-1, Exhibit A to Rule 15c3-3, Rule 17a-4, the General Instructions to Form X-17A-5, Part IIB, and Rule 10b-10 implement section 939A of the Dodd-Frank Act by eliminating the reference to and requirement for the use of NRSRO ratings in these rules. The Commission recognizes that there are additional costs associated with adopting the amendments that are separate from the costs associated with the hour and cost burdens discussed in the PRA. The discussion below focuses on the Commission's reasons for adopting these amendments, the affected parties, the impact on efficiency, competition, and capital formation, and the costs and benefits of the amendments as compared to the baseline, described below, and to alternative courses of action.

### B. Economic Baseline

The regulatory changes adopted today amend requirements that apply to broker-dealers registered with the Commission. However, security issuers, NRSROs, non-NRSRO credit rating agencies, and other providers of credit risk analysis as well as a broker-dealer's customers and counterparties could all be affected by the amendments. The discussion below characterizes the economic baseline against which the costs and benefits, as well as the impact on efficiency, competition, and capital formation, of today's amendments are measured. It includes the approximate numbers of broker-dealers that would be directly affected by today's amendments and a description of the relevant features of the economic and regulatory environment in which the various impacted parties operate. The economic baseline being used for this analysis is the economic and regulatory framework

in existence just prior to the adoption of today's amendments.

The regulations that are affected by today's amendments include Rule 15c3-1, which provided prior to today's amendments, among other things, that a broker-dealer could apply a lesser capital charge (e.g., less than the 15% catchall charge) for commercial paper, nonconvertible debt, and preferred stock if the instrument is rated in the higher rating categories by two NRSROs; the Appendices to Rule 15c3-1, which rely on credit ratings for calculating haircuts or credit risk charges related to counterparties; Exhibit A to Rule 15c3-3, which uses NRSRO ratings to determine whether a broker-dealer can include customer margin for transactions in securities futures products as a debit in its reserve formula; and Rule 10b-10, which requires disclosing in customer confirmations of securities transactions if non-government debt securities have not been rated by an NRSRO. The rule amendments would help to reduce any perceived Commission endorsement of NRSROs and NRSRO ratings and reduce reliance on credit ratings. The relevant rule amendments are described in detail below.

The broker-dealers registered with the Commission vary significantly in terms of their size, business activities, and the complexity of their operations. For example, carrying broker-dealers hold customer securities and funds.<sup>259</sup> Clearing broker-dealers clear transactions as members of securities exchanges, the Depository Trust &

Clearing Corporation, and the OCC.<sup>260</sup> Many clearing broker-dealers are carrying broker-dealers, but some clearing broker-dealers clear only their own transactions and do not hold customer securities and cash.

A broker-dealer that claims an exemption from Rule 15c3-3 is generally referred to as "non-carrying broker-dealer." Non-carrying broker-dealers include "introducing brokers."<sup>261</sup> These non-carrying broker-dealers typically accept customer orders and introduce their customers to a carrying broker-dealer that will hold the customers' securities and cash along with the securities and cash of customers of other introducing broker-dealers and those of direct customers of the carrying broker-dealer. The carrying broker-dealer generally receives and executes orders of the introducing broker-dealer's customers.<sup>262</sup> Carrying broker-dealers generally also prepare trade confirmations, settle trades, and organize book entries of the securities.<sup>263</sup> Introducing broker-dealers also may use carrying broker-dealers to clear the firm's proprietary trades and carry the firm's securities. Another group of non-carrying broker-dealers effects transactions in securities such as mutual funds on a subscription-way basis.<sup>264</sup> Generally, customers purchase the securities by providing the funds directly to the issuer. Finally, some non-carrying broker-dealers act as finders by referring prospective purchasers of securities to issuers.<sup>265</sup>

The broker-dealer industry is the primary industry affected by the rule

amendments, although the amendments impose different requirements on different types of broker-dealers. For example, only those broker-dealers that hold proprietary positions in commercial paper, nonconvertible debt, and preferred stock will be affected by the amendments to Rules 15c3-1 and 17a-4, only those broker-dealers that trade in foreign currency options will be affected by the amendments to Appendix A to Rule 15c3-1, and only those broker-dealers that clear and carry positions in security futures products for customers will be affected by the amendment to Exhibit A to Rule 15c3-3. The amendments to Appendices E and F to Rule 15c3-1 and the conforming amendments to Appendix G to Rule 15c3-1 and the General Instructions to Form X-17A-5, Part IIB will affect only ANC broker-dealers and OTC derivatives dealers. The amendment to Rule 10b-10 eliminates a disclosure requirement for broker-dealers that currently produce transaction confirmations for debt securities other than government securities.

To establish a baseline for competition among broker-dealers, the Commission looks at the status of the broker-dealer industry detailed below. In terms of size, the following tables illustrate the variance among broker-dealers with respect to total capital. The information in the tables is based on FOCUS Report data for calendar year 2012.

**BROKER-DEALER CAPITAL AT CALENDAR YEAR-END 2012**  
[\$ Millions]

Capital	Number of firms	Sum of total capital
Less than \$500,000 .....	2,347	\$345

<sup>259</sup> Rule 15c3-1 specifies that a broker-dealer shall be deemed to carry customer or broker-dealer accounts "if, in connection with its activities as a broker or dealer, it receives checks, drafts, or other evidences of indebtedness made payable to itself or persons other than the requisite registered broker or dealer carrying the account of a customer, escrow agent, issuer, underwriter, sponsor, or other distributor of securities" or "if it does not promptly forward or promptly deliver all of the securities of customers or of other brokers or dealers received by the firm in connection with its activities as a broker or dealer." 17 CFR 240.15c3-1(a)(2)(i); see also the description of Rule 15c3-1 in section II.B.1.a.i., *supra*. Further, Rule 15c3-3, defines the term securities carried for the account of a customer to mean "securities received by or on behalf of a broker or dealer for the account of any customer and securities carried long by a broker or dealer for the account of any customer," as well as securities sold to, or bought for, a customer by a broker-dealer. 17 CFR 240.15c3-3(a)(2); see also the description of

the Customer Protection Rule in section II.B.1.f., *supra*.

<sup>260</sup> See *Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks and Exemptions for Banks Under Section 3(a)(5) of the Securities Exchange Act of 1934*, Exchange Act Release No. 34-56501 (Sep. 24, 2007), 72 FR 56514 (Oct. 3, 2007), at n.269.

<sup>261</sup> See *Net Capital Rule*, Exchange Act Release No. 34-31511 (Nov. 24, 1992), 57 FR 56973 (Dec. 2, 1992) (describing the role of introducing broker-dealers).

<sup>262</sup> *Id.*

<sup>263</sup> See, e.g., FINRA Rule 4311 (Carrying Agreements). This FINRA rule governs the requirements applicable to FINRA members when entering into agreements for the carrying of any customer accounts in which securities transactions can be effected. Historically, the purpose of this rule has been to require that certain functions and responsibilities are clearly allocated to either the introducing or carrying firm, consistent with the requirements of the SRO's and Commission's

financial responsibility rules and other rules and regulations, as applicable. See also *Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change Adopting, as Modified by Amendment No. 1, Rules Governing Guarantees, Carrying Agreements, Security Counts and Supervision of General Ledger Accounts in the Consolidated FINRA Rulebook*, Exchange Act Release 34-63999 (Mar. 7, 2011), 76 FR 12380 (Mar. 7, 2011).

<sup>264</sup> See *Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934*, Exchange Act Release No. 34-44992 (Oct. 26, 2001), 66 FR 55818 (Nov. 2, 2001) ("[T]he Commission recognizes that for some types of transactions, such as purchases of mutual funds or variable annuities, the customer may simply fill out an application or a subscription agreement that the broker-dealer then forwards directly to the issuer.").

<sup>265</sup> See American Bar Association, *Report and Recommendations of the Task Force on Private Placement Broker-Dealers*, 23-24 (2005); see also *Net Capital Rule*, 57 FR 56973.

BROKER-DEALER CAPITAL AT CALENDAR YEAR-END 2012—Continued  
[\$ Millions]

Capital	Number of firms	Sum of total capital
Greater than or equal to 500,000 and less than 5 million .....	1,273	2,207
Greater than or equal to 5 million and less than 50 million .....	569	9,712
Greater than or equal to 50 million and less than 100 million .....	83	5,632
Greater than or equal to 100 million and less than 500 million .....	121	25,465
Greater than or equal to 500 million and less than 1 billion .....	27	19,688
Greater than or equal to 1 billion and less than 5 billion .....	26	56,034
Greater than or equal to 5 billion and less than 10 billion .....	7	47,922
Greater than or equal to 10 billion .....	9	185,022
<b>Total .....</b>	<b>4,462</b>	<b>352,028</b>

According to FOCUS Report data, as of December 31, 2012, there were approximately 4,462 broker-dealers registered with the Commission. Nine broker-dealers account for more than half of all capital held by broker-dealers. Of the 4,462 registered broker-dealers, 434 firms reported holding proprietary debt positions on their FOCUS Reports.<sup>266</sup> The Commission has also estimated that there are 101 broker-dealers that trade foreign currency options and are, therefore, subject to Appendix A to Rule 15c3-1.<sup>267</sup> Furthermore, there are six ANC broker-dealers (*i.e.*, firms that operate under Appendix E to Rule 15c3-1) and four OTC derivatives dealers (*i.e.*, firms that operate under Appendix F to Rule 15c3-1). In addition, the staff estimates that, for reasons unrelated to the rule amendments being adopted today, an additional three firms will apply to operate as ANC broker-dealers and one additional firm will apply to operate as an OTC derivatives dealer. The Commission also has estimated that there are 72 firms subject to Note G to Exhibit A to Rule 15c3-3.<sup>268</sup>

The Commission also believes other parties could be affected by today's amendments. Under the economic baseline, issuers of securities who obtain favorable ratings from two or

more NRSROs enjoy the benefit of greater access to the capital markets because such securities are—holding other things constant—more attractive to broker-dealers who can take lower haircuts on such securities for the purposes of compliance with Rule 15c3-1. While the Commission does not intend the amendments to Rule 15c3-1 to alter the scope of securities and money market instruments that qualify for the lower haircuts, eliminating preferential regulatory treatment of NRSRO-rated securities could affect security issuers by altering the portfolio preferences of broker-dealers if, for example, broker-dealers establish policies and procedures for assessing creditworthiness that produce more conservative results than the NRSRO credit rating standard. These conservative results could cause broker-dealers to avoid holding positions that they would have held under the NRSRO credit rating standard. Alternatively, if the policies and procedures produce less conservative results, the amendments could alter the risk of broker-dealers' portfolios by causing them to hold positions that they would not have held when applying the NRSRO credit rating standard. Altering the risk of broker-dealers' portfolios could affect broker-dealers' customers, counterparties, and investors, all of whom are protected by Rule 15c3-1.

Finally, today's amendments could have a significant effect on the credit ratings industry. Currently there are ten NRSROs with the three largest accounting for the majority of all credit ratings.<sup>269</sup> The favorable regulatory

treatment of NRSRO-rated securities increases demand for securities that have been favorably rated by at least two NRSROs. Eliminating this favorable treatment may alter incentives for broker-dealers to hold NRSRO-rated securities and may increase a broker-dealer's use of alternative providers of credit risk analysis, which could increase competition in the credit ratings industry.

1. Overview of Rule 15c3-1, Appendices A, E, F, and G to Rule 15c3-1, Exhibit A to Rule 15c3-3, the General Instructions to Form X-17A-5, Part IIB, and Rule 10b-10 Prior to Today's Amendments

a. Rule 15c3-1

As discussed above, Rule 15c3-1 prescribes minimum regulatory capital requirements for broker-dealers.<sup>270</sup> Rule 15c3-1 prescribes a "net liquid assets test" designed to require a broker-dealer to maintain at all times more than one dollar of highly liquid assets for each dollar of liabilities (*e.g.*, money owed to customers and counterparties), excluding liabilities subordinated by contract to all other creditors. Under the economic baseline, Rule 15c3-1 prescribed a lower haircut to certain types of debt instruments held by a broker-dealer if the securities were rated in higher rating categories by at least two NRSROs, since those securities typically are less volatile in price than securities that are rated in the lower categories or are unrated. Specifically, to receive the benefit of a reduced haircut on commercial paper, the commercial paper had to be rated in one of the three highest rating categories by at least two NRSROs;<sup>271</sup> to receive the benefit of a reduced haircut on a nonconvertible debt security and preferred stock, the security had to be

<sup>266</sup> See section III.C., *supra*.

<sup>267</sup> To arrive at this number, the Commission reviewed the members of the OCC listed in the member directory on the OCC's Web site available at <http://www.optionsclearing.com/membership/member-information/>. Of the list of 228 members, the Commission looked only at those that trade in index options because members approved to trade index options are also approved to trade such foreign currency options. Of the list of members that trade in index options, the Commission deleted any members that had the exact same firm name but different firm numbers. The Commission received no comments on its estimate of the number of broker-dealers that would be affected by the amendment to Appendix A to Rule 15c3-1 in the proposing release. See also *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, 76 FR at 26568.

<sup>268</sup> See section III.C., *supra*.

<sup>269</sup> See Commission, *Annual Report on Nationally Recognized Statistical Rating Organizations* (December 2012) (estimating that as of December 2011, the three largest NRSROs accounted for approximately 96% of all outstanding credit ratings); Commission, *Report to Congress on Assigned Credit Ratings* (December 2012) (estimating that as of December 2011, the three largest credit rating agencies accounted for approximately 91% of structured product ratings).

<sup>270</sup> See 17 CFR 240.15c3-1; see also discussion in section II.B.1.a.i., *supra*.

<sup>271</sup> 17 CFR 240.15c3-1(c)(2)(vi)(E).

rated in one of the four highest rating categories by at least two NRSROs.<sup>272</sup> If securities were not eligible for the reduced haircut, they were subject to a greater haircut (e.g., 15%), provided they had a ready market. The 15% haircut is derived from the catchall haircut amount that applies to a security not specifically identified in Rule 15c3-1 as having an asset-class specific haircut, provided the security is otherwise deemed to have a ready market, among other requirements. Securities without a ready market are subject to a 100% haircut.

b. Appendix A to Rule 15c3-1

Appendix A to Rule 15c3-1 permits broker-dealers to employ a standardized theoretical option pricing model to determine a potential loss for a portfolio of listed options positions and related positions to compute a single haircut for the group of positions.<sup>273</sup> Under Appendix A, a broker-dealer groups the options and related positions in a portfolio and stresses the current market price for each position at ten equidistant points along a range of positive and negative potential future market movements, using an approved theoretical option pricing model that satisfies certain conditions specified in the rule.<sup>274</sup> Positions that have more potential price volatility must be stressed across a wider range of positive and negative potential future market movements than positions with lower price volatility.<sup>275</sup> For example, a broker-dealer other than a non-clearing option specialist or market maker must employ a range of potential future market movements for major market foreign currencies of ( $\pm$ ) 6%, whereas the range for all other foreign currencies is ( $\pm$ ) 20%.<sup>276</sup> Thus, major market foreign currency options receive more favorable treatment than options on all other currencies when using theoretical option pricing models to compute net capital deductions.<sup>277</sup> Under the economic baseline, the rule defined the term *major market foreign currency* to mean “the currency of a sovereign nation whose short term debt is rated in one of the two highest categories by at least two nationally recognized statistical rating organizations and for

which there is a substantial inter-bank forward currency market.”

c. Appendix E to Rule 15c3-1

Under Appendix E to Rule 15c3-1, ANC broker-dealers are permitted to add back to net worth uncollateralized receivables from counterparties arising from OTC derivatives transactions (i.e., they can add back the amount of the uncollateralized current exposure).<sup>278</sup> Instead of the 100% deduction that applies to most unsecured receivables under Rule 15c3-1, ANC broker-dealers are permitted to take a credit risk charge based on the uncollateralized credit exposure to the counterparty.<sup>279</sup> The credit risk charge is derived, in part, by using an applicable credit risk weight factor.<sup>280</sup> Appendix E to Rule 15c3-1 prescribes three standardized credit risk weight factors (20%, 50%, and 150%) and, as an alternative, permits an ANC broker-dealer with Commission approval to use internal methodologies to determine appropriate credit risk weights to apply to counterparties.<sup>281</sup> Under the economic baseline, ANC broker-dealers were permitted to use NRSRO credit ratings or internally derived credit ratings to determine the appropriate credit risk weight factor.

d. Appendix F to Rule 15c3-1 and Form X-17A-5, Part IIB

Under Appendix F to Rule 15c3-1, OTC derivatives dealers are required to deduct from their net capital credit risk charges that take counterparty risk into consideration.<sup>282</sup> As part of this deduction, the OTC derivatives dealer must apply a counterparty risk weight factor of either 20%, 50%, or 100%.<sup>283</sup> In addition, OTC derivatives dealers must take a concentration charge where the net replacement value in the account of any one counterparty exceeds 25% of the OTC derivatives dealer's tentative net capital.<sup>284</sup> Under the economic baseline, the counterparty risk weight factor (i.e., 20%, 50%, or 100%) was determined using either NRSRO credit ratings or the firm's internal credit ratings.<sup>285</sup> The concentration charge also was determined using either NRSRO credit

ratings or the firm's internal credit ratings.

e. Appendix G to Rule 15c3-1

Appendix G to Rule 15c3-1 provides that broker-dealers may use the ANC computation only if their ultimate holding companies agree to provide the Commission with additional information about the financial condition of the holding company and its affiliates.<sup>286</sup> Paragraph (a) of Appendix G sets forth a methodology for computing allowable capital and allowances for market and credit risk at the consolidated holding company level. Under the economic baseline, one aspect of calculating credit risk in Appendix G provided that those firms must use credit ratings in accordance with the applicable provisions of Appendix E.

f. Exhibit A to Rule 15c3-3

Rule 15c3-3 is designed to protect customer funds and securities held by broker-dealers.<sup>287</sup> In general, Rule 15c3-3 requires a broker-dealer to take two steps. First, a broker-dealer must maintain possession or control of all fully paid and excess margin securities of its customers. In this regard, a broker-dealer must make a daily determination in order to comply with this aspect of the rule. Second, the broker-dealer must make a periodic computation to determine how much money it is holding that is either customer money or money obtained from the use of customer securities (“credits”). From that figure, the broker-dealer subtracts the amount of money that it is owed by customers relating to customer transactions (“debits”). If the credits exceed the debits after this “reserve formula” computation, the broker-dealer must deposit the excess in a customer reserve account. If the debits exceed credits, no deposit is necessary. Funds deposited in a customer reserve account cannot be withdrawn until the broker-dealer completes another computation that shows that the firm has on deposit more funds than the reserve formula requires.

Exhibit A to Rule 15c3-3 prescribes the formula that a broker-dealer must use to determine its reserve requirement. Under the economic baseline, Note G to Exhibit A provided that a broker-dealer could include margin required for customer transactions in security futures products as a debit in its reserve formula computation if that margin is on deposit

<sup>272</sup> See 17 CFR 240.15c3-1(c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2) and (c)(2)(vi)(H).

<sup>273</sup> See 17 CFR 240.15c3-1(a)(b)(1); see also discussion in section II.B.1.c.i., *supra*.

<sup>274</sup> See 17 CFR 240.15c3-1(a)(b)(1).

<sup>275</sup> See 17 CFR 240.15c3-1(a)(b)(1)(iii).

<sup>276</sup> See 17 CFR 240.15c3-1(a)(b)(1)(iii)(B) through (C).

<sup>277</sup> See 17 CFR 240.15c3-1(a)(b)(1)(iii)(B) through (C) and (b)(1)(iv)(A).

<sup>278</sup> See 17 CFR 240.15c3-1e(c); see also discussion in section II.B.1.c.i., *supra*.

<sup>279</sup> See 17 CFR 240.15c3-1e(c); 17 CFR 240.15c3-1(a)(7).

<sup>280</sup> See 17 CFR 240.15c3-1e(c)(1)(ii).

<sup>281</sup> See 17 CFR 240.15c3-1e(c)(4)(vi).

<sup>282</sup> See 17 CFR 240.15c3-1f(d); see also discussion in section II.B.1.d.i., *supra*.

<sup>283</sup> See 17 CFR 240.15c3-1f(d)(2).

<sup>284</sup> See 17 CFR 240.15c3-1f(d)(3).

<sup>285</sup> See 17 CFR 240.15c3-1f(d)(2) and (4); see also discussion in section II.B.1.d.i., *supra*.

<sup>286</sup> 17 CFR 240.15c3-1g.

<sup>287</sup> See 17 CFR 240.15c3-3; see also discussion in section II.B.1.f., *supra*.

at a clearing agency or derivatives clearing organization that: (1) Maintains the highest investment-grade rating from an NRSRO; (2) maintains security deposits from clearing members in connection with regulated options or futures transactions and assessment power over member firms that equal a combined total of at least \$2 billion, at least \$500 million of which must be in the form of security deposits; (3) maintains at least \$3 billion in margin deposits; or (4) obtains an exemption from the Commission.<sup>288</sup>

#### g. Rule 10b-10

Rule 10b-10, the Commission's customer confirmation rule, generally requires broker-dealers effecting transactions for customers in securities, other than U.S. savings bonds or municipal securities, to provide those customers with a written notification, at or before completion of the securities transaction, disclosing certain information about the terms of the transaction.<sup>289</sup> This required disclosure includes the date, time, identity, and number of securities bought or sold; the capacity in which the broker-dealer acted (e.g., as agent or principal); yields on debt securities; and, in some circumstances, the amount of compensation the broker-dealer will receive from the customer and any other parties. By requiring these disclosures, the rule serves a basic customer protection function by conveying information that: (1) Allows customers to verify the terms of their transactions; (2) alerts customers to potential conflicts of interest; (3) acts as a safeguard against fraud; and (4) allows customers a means of evaluating the costs of their transactions and the quality of the broker-dealer's execution. Under the economic baseline, Rule 10b-10 required a broker-dealer to inform the customer in the confirmation if a debt security, other than a government security, is unrated by an NRSRO.

#### C. Effect on Efficiency, Competition, and Capital Formation

The amendments adopted today have the potential to affect competition, efficiency, and capital formation. This section discusses what the Commission believes to be potential effects across three groups of market participants: (1) Broker-dealers, (2) security issuers, and (3) issuers of credit ratings.<sup>290</sup>

#### 1. Effects on the Broker-Dealer Industry

Under the economic baseline, all broker-dealers employ a uniform standard—an NRSRO credit rating—to determine whether a position in commercial paper, nonconvertible debt, or preferred stock is entitled to a lower haircut for purposes of Rule 15c3-1. Today's amendments eliminate this uniform standard and require that broker-dealers develop internal policies and procedures for determining whether these types of positions have only a minimal amount of credit risk and, therefore, are entitled to the lower haircut. As one commenter noted, "the cost and complexity of developing a credit evaluation infrastructure covering many issuers and securities may be beyond the means of many broker-dealers."<sup>291</sup> Also, as the FOCUS Report data for calendar year 2012 makes clear, the majority of broker-dealers are small (with capital less than \$500,000).<sup>292</sup> As noted by several commenters, any new regulatory requirement with significant fixed costs has the potential to disadvantage small and medium-sized broker-dealers.<sup>293</sup> Such disadvantages could result in increased concentration in the broker-dealer industry.

However, the Commission does not intend or expect broker-dealers to individually duplicate the function of credit rating agencies. To do so would require broker-dealers, particularly small and medium sized broker-dealers, to incur significant expense, potentially reducing competition in the broker-dealer industry and harming economic efficiency through duplication of effort.<sup>294</sup> Instead, the Commission expects that today's amendments will create opportunities for NRSROs, non-NRSRO credit rating agencies, and other providers of credit risk analysis to offer products and services that facilitate compliance with today's amendments. Although broker-dealers with large portfolios of debt securities and well-developed credit analysis capabilities may prefer to use an internal credit risk function for assessing creditworthiness, it will not be cost effective or practical for other broker-dealers to support an internal credit risk department comprised of analysts who perform internal credit assessments. These broker-dealers may instead establish a process for assessing creditworthiness that relies more on external factors, such as external credit assessments and

market data, and that process will be evaluated for reasonableness in light of the firm's circumstances (e.g., the size of the broker-dealer and the types and sizes of the positions typically held by the broker-dealer). The Commission also anticipates that some broker-dealers, particularly those with minimal proprietary positions in commercial paper, nonconvertible debt, and preferred stock, will choose to devote no resources toward credit risk analysis and to maintenance of policies and procedures, and instead will apply a greater haircut to their proprietary positions as permitted by the rule.<sup>295</sup>

Based on these considerations, the Commission does not believe that the burden of complying with today's amendments will result in significant changes to the competitive structure of the broker-dealer industry in general, nor to the small subset of broker-dealers with positions in commercial paper, nonconvertible debt, and preferred stock that are directly affected by today's amendments.

In addition to the aforementioned potential direct effects on efficiency and competition, today's amendments may affect economic efficiency indirectly by altering the net capital levels in the broker-dealer industry. A broker-dealer that elects to take a higher haircut rather than make a credit risk determination or one that overestimates the credit risk in its position will reserve more net capital than is required by Rule 15c3-1. This could affect the broker-dealer's ability to hold (or add to) its positions. Conversely, some broker-dealers may underestimate the credit risk of their positions. Indeed, broker-dealers have an incentive to underestimate credit risk in order to apply the lower capital charge. Such a determination could have a potential impact on the firm's ability, if it experiences financial difficulties, to be in a position to meet its obligations to customers, investors, and other counterparties and generate resources to wind-down its operations in an orderly manner without the need of a formal liquidation proceeding, with attendant costs. Increasing discretion in assessing creditworthiness for purposes of Rule 15c3-1 can facilitate such underestimation of credit risk. The Commission believes that this represents a significant risk in today's amendments. Broker-dealers whose internal evaluations typically are inconsistent with market data likely will

<sup>288</sup> 17 CFR 240.15c3-3a, Note G.

<sup>289</sup> 17 CFR 240.10b-10; see also discussion in section II.B.2.a., *supra*.

<sup>290</sup> Although this section IV.C. of the release focuses on these three groups of market participants whose businesses may be more directly impacted by the final rules, the impacts on other participants

are discussed elsewhere in the release. See, e.g., section IV.D., *infra*.

<sup>291</sup> SIFMA Letter, at 18.

<sup>292</sup> See section IV.B., *supra*.

<sup>293</sup> SIFMA Letter, at 11; *Bond Dealers Letter*, at 2.

<sup>294</sup> See generally SIFMA Letter, at 11.

<sup>295</sup> Although this approach would decrease the firm's direct cost of complying with the rule amendments, it would increase the amount of capital the broker-dealer is required to maintain to comply with Rule 15c3-1, increasing the indirect compliance costs.

need to spend more time addressing examiners' concerns regarding the reasonableness of their policies and procedures and the accuracy of their determinations that a security or money market instrument has only a minimal amount of credit risk; a broker-dealer's desire to avoid these costs may help mitigate the broker-dealers' incentives to underestimate credit risk.

## 2. Effects on Security Issuers

Today's amendments could impact capital formation by altering the set of securities that qualify for preferential treatment under Rule 15c3-1. Under the economic baseline, issuers of commercial paper, nonconvertible debt securities, and preferred stock who obtain favorable ratings from two or more NRSROs benefit from having lower haircuts apply to their issuances. Consequently, these issuers may have greater access to the capital markets, while issuers without such a rating may have more limited access. The regulatory preference for NRSRO-rated securities also benefits issuers who can afford to have their securities rated by NRSROs, and discourages broker-dealers from considering all the relevant credit risk factors when making portfolio decisions. By eliminating the regulatory preference for NRSRO-rated securities, today's amendments could alter the set of securities qualifying for lower net capital charges, which would affect broker-dealers' portfolio preferences. For example, the amendments could increase access to capital markets for smaller issuers whose commercial paper, nonconvertible debt securities, or preferred stock have only a minimal amount of credit risk, but for whom the costs of obtaining an NRSRO rating is potentially prohibitive. Such changes could increase competition among issuers for capital and improve the efficiency of the capital allocation process.

While it is the intent of the Commission that today's amendments not alter the quality of assets that qualify for the lower haircut, it is nonetheless a possibility that the policies and procedures that broker-dealers establish will change the risk and/or net capital levels of broker-dealers. Changes or perceived changes to the amount of net capital being held by a broker-dealer could have negative repercussions on confidence in broker-dealers' financial position among their customers, counterparties, and investors. These impacts on confidence could disrupt the orderly functioning of the markets—for example, by encouraging counterparties to reduce

their exposures to broker-dealers in response to uncertainty about broker-dealers' financial positions—and thereby harm the capital formation process.

## 3. Effects on the Credit Ratings Industry

Finally, today's amendments could have an effect on competition in the credit rating agency industry with consequences on economic efficiency. Currently there are ten NRSROs with the three largest accounting for the majority of all credit ratings. As noted earlier, the favorable regulatory treatment of NRSRO-rated securities increases demand for securities that have been rated by at least two NRSROs. Eliminating this favorable treatment may increase broker-dealers' use of alternative providers of credit risk analysis, which could increase competition in the credit rating agency industry. Furthermore, to the extent that NRSRO ratings are biased, as some have argued, additional competition among credit rating providers could help expose any such biases and increase incentives for NRSROs to produce accurate ratings.

Reducing the emphasis on NRSRO ratings also could adversely affect the quality of NRSRO ratings. Currently, the importance attached to NRSRO ratings may impart franchise value to the NRSRO's ratings business. Eliminating references to NRSRO ratings in certain federal regulations could reduce these franchise values and mitigate NRSROs' incentives to produce credible and reliable ratings. Moreover, the Commission recognizes that the elimination of the required use of credit ratings in the specified Commission rules and forms may reduce the incentive for credit rating agencies to register as NRSROs with the Commission and thereby be subject to the Commission's oversight and the statutory and regulatory requirements applicable to NRSROs. To the extent that the quality and accuracy of NRSRO ratings is adversely affected, negative impacts on the capital allocation process and economic efficiency could result.

## D. Costs and Benefits of the Rule Amendments

### 1. Rule 15c3-1 and Rule 17a-4

#### a. Benefits

The Commission requested comment on all aspects of the benefits associated with the amendments to Rule 15c3-1, the appendices to Rule 15c3-1, and Rule 17a-4, and received no comments. The Commission believes that one of the primary benefits of the amendments

being adopted today is reducing potential undue reliance on NRSRO ratings that could be caused by references to NRSROs in Commission rules. Significantly, the Commission believes that eliminating references to NRSRO ratings in its rules would remove any appearance that the Commission has placed its imprimatur on such ratings. The Commission, however, also recognizes that credit ratings provide useful information to institutional and retail investors as part of the process of making an investment decision.

The Commission believes that the amendments to Rule 15c3-1 and its appendices, as well as the conforming amendment to Rule 17a-4, will encourage a more complete assessment of the credit risks associated with securities held by broker-dealers. As the NRSROs themselves have stressed, NRSRO ratings are a one-dimensional measure that summarizes the likelihood that an obligor or financial obligation will fail to repay investors in accordance with the terms on which they made their investment and investors' expected recoveries in the event of such a failure.<sup>296</sup> The simplicity of a one-dimensional measure is both its major advantage and its main limitation. For comparing securities with similar risk profiles, one-dimensional credit ratings are a useful summary measure. However, for securities with different risk profiles, such ratings can obscure important information about underlying differences in risk, such as time effects, default correlations, and the shape of loss distributions. The Commission expects that the amendments adopted today will encourage broker-dealers to incorporate this additional information in their credit risk evaluation process.

Many broker-dealers already conduct their own risk evaluation. As one commenter noted "[a] significant number of large broker-dealers have sophisticated internal credit review functions."<sup>297</sup> However, for those broker-dealers that do not currently have their own means of evaluating risk for purposes of the amendments to Rule 15c3-1, the approach being adopted today will allow them to incorporate various observable factors and external

<sup>296</sup> See, e.g., Fitch, *Inside the Ratings: What Credit Ratings Mean*, (Aug. 2007), at 1; Testimony of Michael Kanef, Group Managing Director, Moody's Investors Service, Before the United States Senate Committee on Banking, Housing, and Urban Affairs (Sep. 26, 2007), at 2; Testimony of Vickie A. Tillman, Executive Vice President, Standard & Poor's Credit Market Services, Before the United States Senate Committee on Banking, Housing, and Urban Affairs (Sep. 26, 2007), at 3.

<sup>297</sup> *SIFMA Letter*, at 11.

information sources in their new risk evaluation processes, which will lead to a better understanding of the risks associated with those securities.

#### b. Costs

The Commission recognizes, as a result of today's amendments, that broker-dealers may incur additional costs associated with performing a more detailed and comprehensive analysis of the debt securities they own. The Commission received two comments on the costs associated with the proposed amendments to Rule 15c3-1.<sup>298</sup> As stated above, one commenter noted that "the cost and complexity of developing a credit evaluation infrastructure covering many issuers and securities may be beyond the means of many broker-dealers."<sup>299</sup> Another commenter worried that "the cost to comply may be prohibitively high for the smaller or middle-market broker-dealers."<sup>300</sup> As has been noted above, the Commission does not intend or expect broker-dealers to individually duplicate the function of credit rating agencies. Thus, the Commission believes that the costs of compliance with the amendments to Rule 15c3-1 and its appendices, as well as the conforming amendment to Rule 17a-4, would be minimal for the "significant number of large broker-dealers" that have a "sophisticated internal credit review function" for net capital purposes.<sup>301</sup> Of the approximately 434 broker-dealers that hold proprietary debt positions, the Commission recognizes that the level of sophistication varies widely. The broker-dealers with less sophisticated internal procedures for analyzing credit risk may incur costs to establish and develop procedures that would be used to assess financial instruments for the purposes of determining whether the lower haircuts could appropriately be applied. However, the Commission believes that because the determination of a minimal amount of credit risk will vary among firms, and because broker-dealers may create policies and procedures using a small number of objective factors and external assessments, firms will be able to keep costs lower than if they were mandated to create policies and procedures based on numerous specified factors.<sup>302</sup>

<sup>298</sup> *Bond Dealers Letter*, at 2; *SIFMA Letter*, at 11, 18.

<sup>299</sup> *SIFMA Letter*, at 18.

<sup>300</sup> *Bond Dealers Letter*, at 2.

<sup>301</sup> *SIFMA Letter*, at 11.

<sup>302</sup> See *SIFMA Letter*, at 18 ("we believe the burden on small and medium-sized broker-dealers would be significantly reduced if the proposed amendment were to be interpreted . . . to permit policies and procedures that base the credit risk

There will be minimal costs associated with the amendments for firms that use Appendix A to Rule 15c3-1. The amendment to the definition of *major market foreign currency* is not intended to change the foreign currencies that currently receive lower haircuts under the rule. Therefore, the Commission does not believe there will be any costs associated with the amendments.

Firms that use Appendices E and F to Rule 15c3-1 already undergo an approval process to use internal credit ratings to determine credit risk charges for each counterparty. Any new firms that apply to use either Appendix E or Appendix F will not incur any separate costs as a result of the amendments. Currently, firms that apply to use these appendices must have their internal models approved by the Commission prior to using their selected appendix. Although the Commission will have to assess the firm's process for determining internal credit ratings, this step will not cause broker-dealers who are applying to use these appendices to incur any additional costs. Furthermore, because the firms currently using these appendices have traditionally used models to compute capital charges, as opposed to NRSRO ratings, these firms will not incur any additional costs by complying with the amendments.

#### 2. Exhibit A to Rule 15c3-3

##### a. Benefits

The Commission requested comment on all aspects of the benefits associated with the amendment to Exhibit A to Rule 15c3-3 and received no comments. The amendment eliminates a criterion that qualified the debits at a clearing agency or derivatives clearing organization if it was assigned the highest credit rating given by any NRSRO. Broker-dealers instead will be required to look to two other criteria based on financial metrics.

##### b. Costs

The Commission requested comment on all aspects of the costs associated with Note G to Exhibit A to Rule 15c3-3 and received no comments. The total cost of compliance with Note G to Exhibit A to Rule 15c3-3 will be minimal as the removal of the NRSRO credit ratings criterion from Note G is neither intended nor expected to change current security futures margining practices by broker-dealers. As stated in the PRA section, the Commission anticipates that a broker-dealer will incur a one-time cost to verify that a

analysis solely on a small number of objectively determinable factors . . .').

clearing or derivatives clearing organization meets the requirements of Note G. If a broker-dealer is currently using one of the non-NRSRO criteria, it will not incur any one-time costs.

#### 3. Rule 10b-10

##### a. Benefits

The Commission believes that the amendment to Rule 10b-10 will benefit investors. As explained previously, the existing requirement to inform customers if a debt security, other than a government security, is unrated by an NRSRO may have the unintended effect of suggesting that rated securities are inherently better or less risky than unrated debt securities. The Commission believes that the existence of a rating should not give an investor extra comfort regarding the risks associated with the rated security. The amendment, by removing paragraph (a)(8)'s requirement to disclose whether certain securities are rated by an NRSRO, should help avoid promoting excessive reliance on NRSRO ratings. It also should help encourage investors to view NRSRO ratings as only one of multiple types of information relevant to evaluating credit risk. This in turn should help investors make more informed decisions regarding investments in debt securities.

##### b. Costs

As stated in the proposing release, the Commission does not expect the amendment to result in any significant changes in the costs associated with Rule 10b-10. Broker-dealers will continue to generate transaction confirmations and send those confirmations to customers, and the amendment is not expected to change the cost of generating and sending confirmations. Moreover, the Commission believes that broker-dealers may not incur costs if they choose not to input information that a debt security is unrated into their existing confirmation systems.

As stated above, the Commission acknowledges that, in some instances, eliminating paragraph (a)(8) of Rule 10b-10 may remove some incentive to investigate the quality of unrated debt securities. The Commission believes, however, that any such potential cost would be balanced by the benefit of encouraging investors not to rely excessively on credit ratings for information about credit risk and to consider additional information.

## E. Alternatives

### 1. Rule 15c3-1 and Rule 17a-4

In adopting the amendments to Rule 15c3-1, the Commission considered several alternative approaches, including suggestions by commenters. The main suggestion by commenters was to use an objective standard of creditworthiness instead of a subjective standard of creditworthiness.<sup>303</sup> Specifically, one commenter suggested the use of credit spreads and/or inclusion on an index as an objective standard.<sup>304</sup> Although the Commission considered these standards, it determined the alternatives would not be practical because not all bonds are included on an index and for bonds that are thinly traded the yield spreads could include liquidity premia that have little relation to the credit risk of the bond, reducing the usefulness of the yield spreads as a signal for credit risk. Furthermore, creating different standards of creditworthiness for different securities could increase costs for broker-dealers that hold multiple types of securities. The Commission does, however, believe that objective factors could play an important role in determining whether a security or money market instrument has a minimal amount of credit risk. To emphasize this point, the Commission added language to paragraph (c)(2)(vi)(I) that was not in the proposed rule text that states that policies and procedures that are reasonably designed “should result in assessments of creditworthiness that typically are consistent with market data.” This language should encourage broker-dealers to review at least one external factor, such as credit spreads or pricing, when making its credit risk determination. In addition, assessments that are consistent with market data should take some of the subjectivity away from each broker-dealer when making a credit risk determination. Rather than mandate a specific set of factors that broker-dealers must use when assessing credit risk, the Commission thought it was better to allow broker-dealers to determine what specific factors would work best for their specific circumstances.

The Commission understands that by not mandating an objective standard to determine the creditworthiness of a security or money market instrument there is a risk that a broker-dealer may incorrectly assess the credit risk. Using a subjective standard also could lead to inconsistent determinations of credit

risk of the same security or money market instrument among broker-dealers. Inconsistent determinations of credit risk will lead to situations where broker-dealers that determine the security has only a minimal amount of credit risk will apply a lower haircut to the position than broker-dealers that determine that the security does not have a minimal amount of credit risk. The Commission expects, however, that the risk of this occurring will be mitigated by the Commission and SRO examination process, during which Commission and SRO examiners will assess the reasonableness of broker-dealers’ policies and procedures for determining net capital haircuts under the minimal amount of credit risk standard and review the firms’ adherence to the policies and procedures. A broker-dealer will need to be able to explain its credit risk analysis and ultimate determination to examiners as part of the examination process. If a broker-dealer has reasonable policies and procedures in place for determining credit risk, and those policies and procedures are followed, the potential for bias to be a part of the assessment process should be mitigated.

The Commission also considered mandating that broker-dealers use a certain number of factors or specific factors when making a credit risk determination. Ultimately, the Commission decided that allowing broker-dealers to establish policies and procedures that are tailored to the size and activities of the broker-dealer would keep costs down. Further, a given factor may be appropriate only for certain types of positions and could, if applied inappropriately, lead to inaccurate credit risk determinations. Allowing a broker-dealer the flexibility in selecting the factors it uses to assess the credit risk of its portfolio could lead to more accurate credit risk determinations.

In adopting the amendments to Appendices E and F of Rule 15c3-1, the Commission considered the alternative proposed by commenters that the minimal amount of credit risk standard be used. However, as explained earlier, the Commission does not believe such a standard would work in Appendices E and F because the minimal amount of credit risk standard in Rule 15c3-1 replaced a binary NRSRO credit rating standard under which the application of a lower or higher haircut amount depends on whether the commercial paper is rated in the top three rating categories and the nonconvertible debt and preferred stock is rated in the top four rating categories. Thus, the instrument either meets the requirement

to apply the lower haircut or is subject to the higher haircut. The NRSRO credit ratings standard in Appendices E and F to Rule 15c3-1 is not binary because there are three gradations for credit risk weights. Thus, the minimal amount of credit risk standard would not be a suitable replacement.<sup>305</sup>

### 2. Exhibit A to Rule 15c3-3

In adopting the amendments to Exhibit A to Rule 15c3-3, the Commission did not consider any alternatives to the proposal and did not receive comments offering any alternatives to the proposal. The Commission could have established an alternative criterion but chose not to because the remaining three criteria in the rule are alternatives that permit broker-dealers to meet the objectives of the rule.

### 3. Rule 10b-10

In adopting the amendments to Rule 10b-10, the Commission considered not deleting paragraph (a)(8) as proposed. The Commission also considered requiring broker-dealers to disclose alternative information relating to the credit risk of certain debt securities. The Commission determined, however, that requiring the disclosure of alternative information regarding credit risk associated with debt securities similar to that required by paragraph (a)(8) would be inconsistent with the goal of reducing investors’ reliance on credit ratings. Elevating an alternative measure of credit risk to the status now conferred upon NRSRO ratings by paragraph (a)(8) would merely substitute one standard upon which investors may have come to rely upon excessively for another. Prohibiting any reference to NRSRO credit ratings in confirmations, however, would seem to go too far by preventing broker-dealers from including information that they believe a reasonable investor would want to consider in particular circumstances. The Commission also determined that substituting another credit risk-related disclosure requirement for paragraph (a)(8) was unnecessary, given that credit risk information is likely to be disclosed before a transaction for reasons independent of paragraph (a)(8),<sup>306</sup> and given the other disclosures required by Rule 10b-10 in connection with

<sup>305</sup> See sections II.B.1.c.iii. and II.B.1.d.iii., *supra*.

<sup>306</sup> See *Confirmation of Transactions*, at 59 FR 59617 (explaining that the information required by paragraph (a)(8) should, in most cases, “verify information that was disclosed to the investor prior to the transaction.”).

<sup>303</sup> See *Bond Dealers Letter*, at 3; *SIFMA Letter*, at 11.

<sup>304</sup> *Bond Dealers Letter*, at 3.

transactions in certain asset-backed securities.<sup>307</sup>

### V. Final Regulatory Flexibility Analysis

The Regulatory Flexibility Act of 1980 (“RFA”)<sup>308</sup> requires the Commission, in promulgating rules, to consider the impact of those rules on small entities. An Initial Regulatory Flexibility Act Analysis was prepared in accordance with the Regulatory Flexibility Act and included in the proposing release. The Commission certified in the proposing release, pursuant to section 605(b) of the RFA,<sup>309</sup> that the proposed rule would not, if adopted, have a significant impact on a substantial number of small entities. The Commission received no comments on this certification.

For purposes of Commission rulemaking in connection with the RFA, small entities include broker-dealers with total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5 under the Exchange Act,<sup>310</sup> or, if not required to file such statements, a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter) and is not affiliated with any person (other than a natural person) that is not a small business or small organization.<sup>311</sup>

The amendments adopted today relating to the securities haircut provisions in Rule 15c3-1 and the conforming amendment to Rule 17a-4 will not have a significant economic impact on a small number of entities. Only seven of the 434 broker-dealers that hold proprietary debt positions are considered small for purposes of the RFA and, in the staff’s experience, broker-dealers with less than \$500,000 in total capital typically hold very few proprietary securities positions and, in particular, a small number of debt securities. Thus, there are few small entities that will be impacted by these amendments. In addition, the amendments allow broker-dealers that hold these debt positions, including those broker-dealers that are considered small for purposes of the RFA, to establish policies and procedures that

rely on only a few factors to keep costs low. Further, a small broker-dealer could choose to take the 15% catchall haircut instead of establishing policies and procedures if it determines such an approach is cost-effective. Accordingly, the amendments will not have a significant economic impact on a substantial number of small entities because even if the small entities have to change their current process, they can do so in such a way to minimize economic impact and still comply with the rule amendments.

The amendment to Appendix A to Rule 15c3-1 will not result in a significant impact on small entities. Although the definition of *major market foreign currency* will change, the Commission does not intend that the currencies that meet the definition of major market foreign currency will change because the currency will still have to have a substantial inter-bank forward currency market. Consequently, the amendments should not have a significant impact on broker-dealers, including small broker-dealers. Furthermore, the broker-dealers that operate under Appendix A to Rule 15c3-1 generally are market makers and trading firms that are not small entities as defined in Rule 0-10.

The amendments to the Appendices E and F to Rule 15c3-1 (which include conforming amendments to Appendix G to Rule 15c3-1 and the General Instructions to Form X-17A-5, Part IIB) will not apply to small entities. Appendices E and G apply to ANC broker-dealers and Appendix F and Form X-17A-5, Part IIB apply to OTC derivatives dealers. The ANC broker-dealers and the OTC derivatives dealers are not small entities as defined in Rule 0-10.

The amendments to Exhibit A to Rule 15c3-3 will not have a significant economic impact on a substantial number of small entities. As noted above, the OCC is the only clearing agency that meets the criteria to qualify for the debit for purposes of the reserve computation. The fact that the OCC meets the criteria to qualify for the debit is well understood among broker-dealers, including small broker-dealers.

The amendment to Rule 10b-10 will not have a significant economic impact on a substantial number of small entities. While a number of the broker-dealers that effect transactions in the debt securities currently subject to paragraph (a)(8) may be small entities, the Commission believes that it is uncommon for small broker-dealers to

issue confirmations.<sup>312</sup> The Commission does not have a precise numerical estimate of the small broker-dealers that issue confirmations in connection with transactions in securities covered by paragraph (a)(8). The Commission believes, however, that the number is unlikely to be significant. In addition, the Commission continues to believe that the proposed amendment should not result in any significant change to the cost of providing confirmations to customers in connection with transactions in securities covered by paragraph (a)(8). Consequently, the Commission continues to believe that the removal of paragraph (a)(8) from Rule 10b-10 should not have a significant economic impact on a substantial number of small entities.

For the reasons described above, the Commission again certifies that the amendments to Rule 15c3-1, Appendices A, E, F, and G to Rule 15c3-1, Exhibit A to Rule 15c3-3, Rule 17a-4, the General Instructions to Form X-17A-5, Part IIB, and Rule 10b-10 will not have a significant economic impact on a substantial number of small entities.

### VI. Statutory Basis and Text of the Proposed Amendments

Pursuant to the Exchange Act, 15 U.S.C. 78a *et seq.*, and particularly, Sections 3(b), 15, 23(a), and 36 (15 U.S.C. 78c(b), 78o, 78w(a), and 78mm), thereof, and Sections 939 and 939A of the Dodd-Frank Act, the Commission is amending §§ 240.10b-10, 240.15c3-1, 240.15c3-1a, 240.15c3-1e, 240.15c3-1f, 240.15c3-1g, 240.15c3-3a, 240.17a-4, and Form X-17A-5 Part IIB General Instructions under the Exchange Act.

#### List of Subjects in 17 CFR Parts 240 and 249

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

#### Text of Amendment

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

#### PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

■ 1. The authority citation for part 240 is amended by revising the general authority and adding sectional authorities for §§ 240.15c3-1a, 240.15c3-1e, 240.15c3-1f, 240.15c3-1g

<sup>312</sup> The Commission understands that most small broker-dealers introduce their accounts to clearing firms that, in turn, would typically issue the confirmations.

<sup>307</sup> For example, in connection with transactions in certain asset-backed securities, paragraphs (a)(4) through (a)(7) of Rule 10b-10 require disclosure of information relating to prepayment risk and yield information.

<sup>308</sup> 5 U.S.C. 601 *et seq.*

<sup>309</sup> See 5 U.S.C. 605(b).

<sup>310</sup> See 17 CFR 240.17a-5(d).

<sup>311</sup> See 17 CFR 240.0-10(c).

and § 240.15c3-3a in numerical order to read as follows:

**Authority:** 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c-3, 78c-5, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78o-10, 78p, 78q, 78q-1, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, 7201 *et seq.*, and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350, unless otherwise noted.

\* \* \* \* \*

Sections 240.15c3-1a, 240.15c3-1e, 240.15c3-1f, 240.15c3-1g are also issued under Pub. L. 111-203, secs. 939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 U.S.C. 78o-7 note).

\* \* \* \* \*

Section 240.15c3-3a is also issued under Pub. L. 111-203, §§ 939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 U.S.C. 78o-7 note).

\* \* \* \* \*

#### § 240.10b-10 [Amended]

■ 2. Section 240.10b-10 is amended by removing paragraph (a)(8) and redesignating paragraph (a)(9) as paragraph (a)(8).

■ 3. Section 240.15c3-1 is amended by:

- a. Revising paragraphs (c)(2)(vi)(E) introductory text, (c)(2)(vi)(F)(1) introductory text, (c)(2)(vi)(F)(2) introductory text, and (c)(2)(vi)(H); and
- b. Adding paragraph (c)(2)(vi)(I).

The revisions and addition read as follows:

#### § 240.15c3-1 Net capital requirements for brokers or dealers.

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(vi) \* \* \*

(E) *Commercial paper, bankers' acceptances and certificates of deposit.* In the case of any short term promissory note or evidence of indebtedness which has a fixed rate of interest or is sold at a discount, which has a maturity date at date of issuance not exceeding nine months exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited and has only a minimal amount of credit risk, or in the case of any negotiable certificates of deposit or bankers' acceptance or similar type of instrument issued or guaranteed by any bank as defined in section 3(a)(6) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(6)), the applicable percentage of the market value of the greater of the long or short position in each of the categories specified below are:

\* \* \* \* \*

(F)(1) *Nonconvertible debt securities.* In the case of nonconvertible debt

securities having a fixed interest rate and a fixed maturity date, which are not traded flat or in default as to principal or interest and which have only a minimal amount of credit risk, the applicable percentages of the market value of the greater of the long or short position in each of the categories specified below are:

\* \* \* \* \*

(2) A broker or dealer may elect to exclude from the above categories long or short positions that are hedged with short or long positions in securities issued by the United States or any agency thereof or nonconvertible debt securities having a fixed interest rate and a fixed maturity date and which are not traded flat or in default as to principal or interest, and which have only a minimal amount of credit risk if such securities have maturity dates:

\* \* \* \* \*

(H) In the case of cumulative, non-convertible preferred stock ranking prior to all other classes of stock of the same issuer, which has only a minimal amount of credit risk and which are not in arrears as to dividends, the deduction shall be 10% of the market value of the greater of the long or short position.

(I) In order to apply a deduction under paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2), or (c)(2)(vi)(H) of this section, the broker or dealer must assess the creditworthiness of the security or money market instrument pursuant to policies and procedures for assessing and monitoring creditworthiness that the broker or dealer establishes, documents, maintains, and enforces. The policies and procedures must be reasonably designed for the purpose of determining whether a security or money market instrument has only a minimal amount of credit risk. Policies and procedures that are reasonably designed for this purpose should result in assessments of creditworthiness that typically are consistent with market data. A broker-dealer that opts not to make an assessment of creditworthiness under this paragraph may not apply the deductions under paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2), or (c)(2)(vi)(H) of this section.

**Note to paragraph (c)(2)(vi)(I):** For a discussion of the "minimal amount of credit risk" standard, see *Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934*, Exchange Act Release No. 34-71194 (Dec. 27, 2013), at <http://www.sec.gov/rules/final.shtml>.

\* \* \* \* \*

#### § 240.15c3-1a [Amended]

■ 4. Section 240.15c3-1a, paragraph (b)(1)(i)(C), is amended by removing the phrase "whose short term debt is rated in one of the two highest categories by at least two nationally recognized statistical rating organizations and" and by removing the last sentence.

■ 5. Section 240.15c3-1e is amended by:

- a. Revising the introductory text in paragraph (c)(4)(vi);
- b. Removing paragraphs (c)(4)(vi)(A) through (c)(4)(iv)(D);
- c. Redesignating paragraphs (c)(4)(vi)(E), (F), and (G) as paragraphs (c)(4)(vi)(A), (B), and (C), respectively; and
- d. Revising newly redesignated paragraph (c)(4)(vi)(A).

The revisions read as follows:

#### § 240.15c3-1e Deductions for market and credit risk for certain brokers or dealers (Appendix E to 17 CFR 240.15c3-1).

\* \* \* \* \*

(c) \* \* \*

(4) \* \* \*

(vi) *Credit risk weights of counterparties.* A broker or dealer that computes its deductions for credit risk pursuant to this Appendix E shall apply a credit risk weight for transactions with a counterparty of either 20%, 50%, or 150% based on an internal credit rating the broker or dealer determines for the counterparty.

(A) As part of its initial application or in an amendment, the broker or dealer may request Commission approval to apply a credit risk weight of either 20%, 50%, or 150% based on internal calculations of credit ratings, including internal estimates of the maturity adjustment. Based on the strength of the broker's or dealer's internal credit risk management system, the Commission may approve the application. The broker or dealer must make and keep current a record of the basis for the credit rating of each counterparty;

\* \* \* \* \*

■ 6. Section 240.15c3-1f is amended by:

- a. Removing from paragraph (d)(2) introductory text the phrase "the counterparty factor. The counter party factors are:" and adding in its place "a counterparty factor of 20%, 50%, or 100% based on an internal credit rating the OTC derivatives dealer determines for the counterparty; and";
- b. Removing paragraphs (d)(2)(i) through (d)(2)(iii); and
- c. Revising paragraphs (d)(3)(i), (d)(3)(ii), (d)(3)(iii), and (d)(4).

The revisions read as follows:

**§ 240.15c3-1f Optional market and credit risk requirements for OTC derivatives dealers (Appendix F to 17 CFR 240.15c3-1).**

\* \* \* \* \*  
(d) \* \* \*  
(3) \* \* \*

(i) For counterparties for which an OTC derivatives dealer assigns an internal rating for senior unsecured long-term debt or commercial paper that would apply a 20% counterparty factor under paragraph (d)(2) of this section, 5% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital;

(ii) For counterparties for which an OTC derivatives dealer assigns an internal rating for senior unsecured long-term debt that would apply a 50% counterparty factor under paragraph (d)(2) of this section, 20% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital;

(iii) For counterparties for which an OTC derivatives dealer assigns an internal rating for senior unsecured long-term debt that would apply a 100% counterparty factor under paragraph (d)(2) of this section, 50% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital.

(4) Counterparties may be rated by the OTC derivatives dealer, or by an affiliated bank or affiliated broker-dealer of the OTC derivatives dealer, upon approval by the Commission on application by the OTC derivatives dealer. Based on the strength of the OTC derivatives dealer's internal credit risk management system, the Commission

may approve the application. The OTC derivatives dealer must make and keep current a record of the basis for the credit rating for each counterparty.  
\* \* \* \* \*

**§ 240.15c3-1g [Amended]**

■ 7. Section 240.15c3-1g(a)(3)(i)(F) is amended by removing the phrase "paragraphs (c)(4)(vi)(D) and (c)(4)(vi)(E)" and adding in its place "paragraphs (c)(4)(vi)(A) and (c)(4)(vi)(B)".

**§ 240.15c3-3a [Amended]**

■ 8. Section 240.15c3-3a is amended by removing paragraph (b)(1)(i) of Note G and redesignating paragraphs (b)(1)(ii), (iii), and (iv) of Note G as paragraphs (b)(1)(i), (ii), and (iii), respectively.

■ 9. Section 240.17a-4 is amended by:

■ a. Removing from paragraph (b)(12) the phrase "§ 240.15c3-1e(c)(4)(vi)(D) and (E)" and adding in its place "§ 240.15c3-1e(c)(4)(vi)"; and

■ b. Adding paragraph (b)(13).

The addition reads as follows:

**§ 240.17a-4 Records to be preserved by certain exchange members, brokers and dealers.**

\* \* \* \* \*  
(b) \* \* \*

(13) The written policies and procedures the broker-dealer establishes, documents, maintains, and enforces to assess creditworthiness for the purpose of § 240.15c3-1(c)(2)(vi)(E), (c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2), and (c)(2)(vi)(H).

\* \* \* \* \*

**PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934**

■ 10. The authority citation for Part 249 is amended by adding a sectional authority for § 249.617 in numerical order to read as follows:

**Authority:** 15 U.S.C. 78a *et seq.* and 7201 *et seq.*; 12 U.S.C. 5461 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

\* \* \* \* \*  
Section 249.617 is also issued under Pub. L. 111-203, §§ 939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 U.S.C. 78o-7 note).  
\* \* \* \* \*

■ 11. Amend Form X-17A-5 Part IIB General Instructions (referenced in § 249.617) by:

■ a. Removing Schedule IV: Internal Credit Rating Conversion; and

■ b. Removing all but the first sentence in the section "Credit risk exposure" under the heading "Computation of Net Capital and Required Net Capital," and adding a second sentence that reads "The counter-party charge is computed using the credit risk weights assigned to the OTC derivatives dealer's internal calculations by the Commission under paragraph (d)(2) of Appendix F."

**Note:** The text of Form X-17A-5 Part IIB does not, and this amendment will not, appear in the Code of Federal Regulations.

\* \* \* \* \*

By the Commission.

Dated: December 27, 2013.

**Lynn M. Powalski,**  
*Deputy Secretary.*

[FR Doc. 2013-31426 Filed 1-7-14; 8:45 am]

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