Extension of Rule 15c3-4

SUPPORTING STATEMENT

A. Justification

1. Necessity for Information Collection

Rule 15c3-4 sets forth the basic elements governing the establishment, execution, and review of an OTC derivatives dealer's risk management control system. These elements are designed to ensure the integrity of OTC derivatives dealer's risk measurement, monitoring, and management process, to clarify accountability, at the appropriate organizational level, and to define the permitted scope of the dealer's activity and level of risk. The requirements of Rule 15c3-4 to adopt an internal risk management system also apply to certain broker-dealers that compute specific net capital charges under Appendix E to the Rule 15c3-1 and their ultimate holding companies that submit to group-wide Commission supervision under Appendix G to Rule 15c3-1(which are collectively referred to as consolidated supervised entities or Cases).[1]

Rule 15c3-4 is designed to ensure the integrity of the risk measurement, monitoring, and management process, and to clarify accountability, at the appropriate organizational level, for defining the permitted scope of activity and level of risk. All financial market participants are exposed to various types of risk, whether they conduct business in the standardized securities markets or the over-the-counter derivatives market. Because of these and other risks, a broker-dealer registered with the Securities and Exchange Commission (the "Commission") as an OTC derivatives dealer must comply with, among other things, Rule 15c3-4 under the Securities Exchange Act of 1934 (the "Exchange Act"), which makes it necessary for such dealer to implement a risk management control system.

An OTC derivatives dealer also is required under Rule 15c3-4 to consider a number of issues impacting its business environment when creating its risk management control system. For example, an OTC derivatives dealer must consider, among other things, the sophistication and experience of relevant trading, risk management, and internal audit personnel, as well as the separation of duties among these personnel when

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[1] *See* Securities Exchange Act Release No. 49380 (June 8, 2004). This information collection, however, covers the hour burden associated with OTC derivatives dealers only. The hour burden for CSE firms is included in the Paperwork Reduction Act collection for Rule 15c3-1 which requires CSE firms to comply with specific provisions of Rule 15c3-4 in Appendix E to Rule 15c3-1. *See* 17 CFR 240.15c3-1e(a)(1)(ii) and (a)(viii)(C).

designing and implementing its internal control system's guidelines, policies, and procedures. This ensures that the control system that is implemented adequately addresses the risks posed by the business being conducted and the environment in which it is being conducted. In addition, this enables an OTC derivatives dealer to implement specific policies and procedures that are unique to its circumstances.

The Commission is statutorily authorized to promulgate Rule 15c3-4 under Section 15(c)(3) of the Exchange Act (15 U.S.C. §§78o and 78q). This section authorizes the Commission to adopt rules and regulations regarding the financial responsibility of broker-dealers that the Commission deems necessary or appropriate in the public interest or for the protection of investors. Further statutory authority is found in Section 23(a) of the Exchange Act, 15 U.S.C. §78w.

2. Purpose of, and Consequences of not Requiring the Information Collection

Rule 15c3-4 is an integral part of the Commission's financial responsibility program for OTC derivatives dealers. The information collected under Rule 15c3-4 is essential to the regulation and oversight of OTC derivatives dealers and their financial responsibility. More specifically, requiring the OTC derivatives dealer to document the planning, implementation, and periodic review of their risk management controls ensures that all pertinent issues are considered and that the risk management controls are implemented properly and that they continue to adequately address the risks faced by OTC derivatives dealers.

A strong risk management control system is necessary for firms to manage the complex risks arising from the dealer's OTC derivatives business. Otherwise, the firm is vulnerable to enormous losses or financial failure. The implementation of risk management controls within financial intermediaries promotes their stability, and consequently, the stability of the entire financial system by reducing the risk of significant losses on the part of market participants. This, in turn, reduces the risk that massive defaults could undermine the market as a whole. Specifically, internal risk management controls provide two important functions: (1) to protect against firm specific risks such as operational, market, credit, legal, and liquidity risks; and (2) to protect the financial industry from systemic risk.

3. Role of Improved Information Technology and Obstacles to Reducing Burden

The five OTC derivatives delaers currently subject to Rule 15c3-4 and the one firm anticipated to be subject to Rule 15c3-4, utilize automated systems for preparing and reporting information. Thus, improved technology would not reduce the burden.

4. Efforts To Identify Duplication

OTC derivatives dealers are not otherwise required to obtain and maintain the information required by Rule 15c3-4.

5. Effects On Small Entities

Rule 15c3-4 does not and will not affect small entities because the required minimum net capital for an OTC derivatives dealer excludes small entities.

6. Consequences of Less Frequent Collection

If the required activities were to be conducted less frequently, the protection afforded to the public would be lessened.

7. Inconsistencies With Guidelines In 5 CFR 1320.5(d)(2)

The collection of information requirements are not inconsistent with 5 CFR 1320.5(d)(2).

8. Consultations Outside the Agency

All Commission rule proposals are published in the Federal Register for public comment. This comment period is generally twenty-one days, which affords the public an opportunity to respond to or comment on any such proposals.

9. Payment or Gift to Respondents

Not applicable.

10. Assurance of Confidentiality

The Commission treats information obtained pursuant to Rule 15c3-4 as confidential. Such information is of a financial nature and generally is not disclosed to the public. The statutory basis for the Commission’s refusal to disclose such information to the public is the exemption contained in Section (b)(4) of the Freedom of Information Act, 5 U.S.C. 552, which essentially provides that the requirement of public dissemination does not apply to commercial or financial information which is privileged or confidential.

11. Sensitive Questions

No questions of a sensitive nature are asked under Rule 15c3-4.

12. Estimate of Respondent Reporting Burden

Under the current Rule 15c3-4, five entities are registered with the Commission as an OTC derivatives dealer. The Commission anticipates that Rule 15c3-4 will eventually affect approximately six OTC derivatives dealers. We estimate that the average amount of time a firm will spend implementing its risk management control system is 2,000 hours. On average, an OTC derivatives dealer should spend approximately 200 hours each year reviewing and updating its risk management control system. Thus, under the present Rule 15c3-4, the total initial burden for the one anticipated OTC derivatives dealer would be 2,000 hours and the annual burden would be 1,200 hours (200 hours for six firms reviewing and updating risk management control systems). The estimates of the annual burden, under the present Rule 15c3-4 are based upon discussions with affected and potentially affected industry participants.

In total, the Commission estimates, that the total number of aggregate annual burden hours for Rule 15c3-4 is 1,200 hours and the total one-time burden for one OTC derivatives dealer would be approximately 2,000. Finally, the total number of respondents under Rule 15c3-4 is 6. The staff believes that the cost of complying with the current Rule 15c3-4 will be approximately $205 per hour, at an annual cost of $246,000 for the six firms.[2]

13. Estimate of Total Annualized Cost Burden

The staff believes that the cost of complying with the current Rule 15c3-4 will be approximately $205 per hour.[3] This per hour cost is based upon an annual average hourly salary

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2 Based on the average annual salary for a Compliance Manager based inside New York City, as reflected in SIA Management and Professional Earnings for 2005, modified to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. The SIA recently spoke with the Commission's Office of Economic Analysis to inform the Commission that the multiplier of 1.35 that the Commission has historically used was too low. The SIA informed the Commission that, with increasing health care costs, the fact that the largest firms that pay higher salaries generally fail to respond to the SIA's salary survey, and other factors, the Commission should increase its multipliers. Consequently, the Commission and the SIA worked together to determine the level at which the multipliers should be set.

3 Based on the average annual salary for a Compliance Manager based inside New York City, as reflected in SIA Management and Professional Earnings for 2005, modified to account for an 1,800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. The SIA recently spoke with the

for a compliance manager who would be responsible for ensuring compliance with the requirements of Rule 15c3-4. The total annual cost for all anticipated OTC Derivatives Dealers is estimated to be $136,700, under the present rule, based on one firm implementing risk management systems within the next three years (2,000 hours at $205 per hour divided by 3 years).

14. Estimate of Cost to Federal Government

It is estimated that reviews of existing and anticipated OTC derivatives dealers' risk management control systems, which will be performed by Commission staff, will take approximately 480 hours, costing the Commission approximately $24,000 based on the number of reviews that are likely to be performed and our computation of the value of staff time devoted to these reviews and the related overhead, valued at 35% of the value of staff time. This estimate was computed according to the guidelines set forth in GSA, Guide to Estimating Reporting Costs (1973). Guide to Estimating Reporting Costs (1973).

15. Explanation of Changes in Burden

Under the current Rule 15c3-4, the initial one-time burden hours was revised as a result of the number of registered OTC derivatives dealers increasing to five. Therefore, the initial one-time burden hours for OTC derivatives dealers decreased due to decrease in the estimated number of OTC derivatives dealers still to register with the Commission three to one. In addition, the number of respondents decreased by 12 broker-dealers, due to the fact that in the final rule amendments in 2004 with respect to the consolidated supervised entities or CSEs,[4] the Commission determined that it was more appropriate to include the requirement that broker-dealers and their holding companies that elect the alternative capital treatment of Appendix E to Rule 15c3-1 establish, document, and maintain a system of internal risk management controls in Rule 15c3-1 rather than include that requirement as an amendment to Rule 15c3-4, as in the proposal.[5]

Further, the Commission has adjusted the per hour cost for the personnel required to comply with Rule 15c3-4 from $56.60 per hour based to $205 per hour based upon information

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Commission's Office of Economic Analysis to inform the Commission that the multiplier of 1.35 that the Commission has historically used was too low. The SIA informed the Commission that, with increasing health care costs, the fact that the largest firms that pay higher salaries generally fail to respond to the SIA's salary survey, and other factors, the Commission should increase its multipliers. Consequently, the Commission and the SIA worked together to determine the level at which the multipliers should be set.

4 *See* Securities Exchange Act Release No. 49380 (June 8, 2004).

5 *See* note 1.

provided from the securities industry, due to a change to the multiplier used to calculate the salary costs for broker-dealer employees.[6]

16. Information Collection Planned for Statistical Purposes

This provision is not applicable because compliance with Rule 15c3-4 does not require the employment of statistical methods. There is no intention to publish the information for any purpose.

17. Explanation as to Why Expiration Date Will Not Be Displayed

Not applicable.

18. Exceptions to Certification

Not applicable.

B. Collection of Information Employing Statistical Methods

Not applicable.

[6] *See* explanation at footnote 1.