

Rule 17a-12/Form X-17A-5IIB

SUPPORTING STATEMENT

A. Justification

1. Necessity For Information Collection

Section 17(a)(1) of the Securities Exchange Act of 1934 ("Exchange Act") requires registered broker-dealers to make, keep, furnish, and disseminate records and reports prescribed by the Commission as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act. Section 17(e) of the Exchange Act requires every registered broker-dealer to file annually with the Commission a certified balance sheet and income statement and such other information concerning its financial condition as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. Pursuant to this authority, the Commission enacted Rule 17a-12 and amended Form X-17A-5 to add Part IIB in October of 1998 to establish the basic periodic reporting structure for OTC (over-the-counter) derivatives dealers. Rule 17a-12 ("Reports to be made by certain OTC derivatives dealers") requires OTC derivatives dealers registered with the Commission to file quarterly Financial and Operational Combined Uniform Single Reports ("FOCUS" reports) on Part IIB of Form X-17A-5¹ and annual audited financial reports. The provisions of Rule 17a-12 are similar to those contained in Exchange Act Rule 17a-5² but take into consideration the more limited and unique business conducted by OTC derivatives dealers.

The quarterly filings must include certain information specified in the Framework for Voluntary Oversight of the Derivatives Policy Group ("DPG").³ This credit and market risk information, which must be reported on Schedules I - V and VII of Form X-17A-5IIB, enables the Commission to ascertain the nature and scope of a firm's OTC derivatives activity and to monitor the firm's risk exposure.

Rule 17a-12 also requires that OTC derivatives dealers file an annual audit report. Among other things, the audit report must include a statement of financial condition, a statement of income, a statement of cash flows, a statement of changes in owners' equity, a statement of changes in subordinated liabilities, and supporting schedules, including a computation of net capital. Concurrently with the annual audit report, OTC derivatives dealers must file supplemental reports by the auditor, including an accountant's report on management controls.

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

The information collected under Rule 17a-12 is essential to the regulation and oversight

¹ Form X-17A-5 [17 C.F.R. § 249.617].

² 17 CFR 240.17a-5

³ See Framework for Voluntary Oversight, Derivatives Policy Group (Mar. 1995).

of OTC derivatives dealers and the primary means the Commission uses to monitor and enforce compliance with the Commission's financial responsibility rules as prescribed by the Exchange Act. These quarterly FOCUS and annual audit reports are used to evaluate the securities-related and other activities each OTC derivatives dealer is engaged in, the extent to which it is engaged in those activities, and how economic events and government policies might affect various segments of the securities industry. In addition, the Commission staff reviews FOCUS report information as part of its preparation for examinations and inspections. A firm's failure to comply with this rule would severely impair the Commission's ability to protect customers, industry counter-parties, and others.

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

Most OTC derivatives dealers and other firms engaged in swaps and related activities use automated systems for preparing information provided on Form X-17A-5IIB. As the staff expects so few OTC derivatives dealers to register, it is not economically feasible for the Commission to develop a system which would allow for electronic filing.

4. Efforts To Identify Duplication

OTC derivatives dealers are not otherwise required to obtain and maintain the information required by the proposed rule.

5. Effects On Small Entities

The proposed rule will not affect 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

Rule 17a-12 was published in the Federal Register for public comment on December 17, 1997 as part of the Commission's OTC Derivatives Dealers proposed rules.⁴ The comment period lasted sixty days, and the Commission received approximately twenty-one comment letters, a few of which specifically mentioned Rule 17a-12. The Commission took these comments into consideration when drafting the final rule.

9. Payment or Gift to Respondents

⁴ Exchange Act Release No. 39454 (December 17, 1997), 62 FR 67940.

Not applicable.

10. Assurance of Confidentiality

Information provided by OTC derivatives dealers in FOCUS reports, supporting schedules, and annual audited reports is confidential pursuant to Rule 17a-12(a)(2) and (c)(3). The statutory basis for this confidential treatment 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

Not applicable. No inquiries of a sensitive nature are made.

12. Estimate of Respondent Reporting Burden

There are currently four OTC derivatives dealers registered with the Commission. We anticipate that one more OTC derivatives dealer will register with the Commission in the next three years. The staff estimates that the average amount of time necessary to prepare and file the information required by the rule is 80 hours per OTC derivatives dealer per year to prepare the quarterly X-17A-5IIB Reports (based upon 4 quarterly responses per year and an average of 20 hours spent preparing each response) and 100 hours per OTC derivatives dealer per year for the annual audit. Thus the total burden for each OTC derivatives dealer would be approximately 180 hours per year. The total annual burden for the five current and anticipated OTC derivatives dealers is estimated to be 900 (5 * 180 = 900). The estimates of the annual burden are based upon discussions with industry participants.

13. Estimate of Total Annualized Cost Burden

Not applicable; (a) it is not anticipated that respondents will have to incur any capital and start up cost to comply with the rule; (b) it is not anticipated that the respondents will have to incur any additional operational or maintenance cost (other than provided for in item no. 12) to comply with the rule.

14. Estimate of Cost to Federal Government

It is estimated that the Commission review of the filings takes approximately 275 hours per year (based upon an average of four quarterly filings at 10 hours each, plus one annual filing at 15 hours for each of 5 OTC derivatives dealers). The staff estimates that the hourly cost of these reviews is \$47.25.⁵ Thus the total annual cost to the Commission of the reviews is approximately \$12,994.

15. Explanation of Changes in Burden

⁵ GSA, Guide to Estimating Reporting Costs (1973) (which sets the value of one hour of staff time at \$35.00) + 35% overhead.

The staff's estimate of the number of firms that would apply to become OTC derivatives dealers when Rule 17a-12 was adopted has been reduced from 6 to 5 firms. As a result of the reduction in the estimate of the number of respondents under Rule 17a-12 the total annual burden hours has decreased from 1,080 hours to 900 hours.

16. Information Collection Planned for Statistical Purposes

This provision is not applicable because compliance with the proposed rule will 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.