

SUPPORTING STATEMENT
for the Paperwork Reduction Act Information Collection Submission for
Rule 15c3-4 – Internal Risk Management Control Systems for OTC Derivatives Dealers
(OMB Control No. 3235-0497)

A. JUSTIFICATION

1. Necessity of Information Collection

Rule 15c3-4 (17 CFR 240.15c3-4) under the Securities Exchange Act of 1934 (“Exchange Act”) requires broker-dealers that are registered with the U.S. Securities and Exchange Commission (the “Commission”) as over-the-counter (“OTC”) derivatives dealers, or ANC firms that use Appendix E to Rule 15c3-1 (17 CFR 240.15c3-1e),¹ to establish, document, and maintain an internal risk management control system. In addition, security-based swap dealers (“SBSDs”) that are subject to Rule 18a-1 (17 CFR 240.18a-1) must comply with Rule 15c3-4 as if they were OTC derivatives dealers.² Paragraph (b) of Rule 17a-4 (17 CFR 240.17a-4(b)) requires that a broker-dealer’s documentation of its risk management control systems and periodic reviews thereof must be preserved for a period of not less than three years, the first two years in an easily accessible place. In addition, an OTC derivatives dealer, SBSBD subject to Rule 18a-1, or ANC firm is expected to be able to provide the Commission staff with a copy of its documented risk management control procedures when it registers with the Commission as an OTC derivatives dealer, SBSBD subject to Rule 18a-1, or ANC firm and it is expected to be able to provide examiners with a copy of such procedures when it is subsequently examined.

Rule 15c3-4 further sets forth the basic elements governing the establishment, execution, and review of an OTC derivatives dealer’s, SBSBD’s or an ANC firm’s risk management control system. These elements are designed to ensure the integrity of an OTC derivatives dealer’s, SBSBD’s or an ANC firm’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.

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 OTC derivatives market. Because of these and other risks, an OTC derivatives dealer, SBSBD subject to Rule 18a-1, or ANC firm must comply with, among other things, Rule 15c3-4, which makes it necessary for such broker-dealer to implement a risk management

¹ 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 Rule 15c3-1 (which are collectively referred to as “ANC firms”). *See* Securities Exchange Act Release No. 49380 (June 8, 2004), 69 FR 34472 (June 21, 2004) (S7-22-03).

² *See* paragraph (f) of Rule 18a-1. 17 CFR 240.18a-1(f).

control system.

An OTC derivatives dealer, SBSBD subject to Rule 18a-1, or ANC firm 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, SBSBD subject to Rule 18a-1, or ANC firm must consider, among other things, the sophistication and experience of relevant trading, risk management, and internal audit personnel and the firm's management philosophy, when designing and implementing its internal control system's guidelines, policies, and procedures. This ensures that the implemented control system adequately addresses the risks posed by the business being conducted and the environment in which it is being conducted. In addition, this enables the firm 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). 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 and Use of the Information Collection

Rule 15c3-4 is an integral part of the Commission's financial responsibility program for OTC derivatives dealers, SBSBDs subject to Rule 18a-1, and ANC firms. The information collected under Rule 15c3-4 is essential to the regulation and oversight of OTC derivatives dealers, SBSBDs subject to Rule 18a-1, and ANC firms and to their financial responsibility. More specifically, requiring these firms 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, SBSBDs subject to Rule 18a-1, and ANC firms.

A strong risk management control system is necessary for firms to manage the complex risks arising from the business of an OTC derivatives dealer, SBSBD subject to Rule 18a-1, or an ANC firm. 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, leverage, legal, and liquidity risks; and (2) to protect the financial industry from systemic risk.

3. Consideration Given to Information Technology

Each OTC derivatives dealer, SBSBD subject to Rule 18a-1, and ANC firm utilizes or is

anticipated to utilize automated systems for preparing and reporting information about their internal risk management control systems. Thus, improved technology would not reduce the burden.³

4. Duplication

We are not aware of duplication of this information, because OTC derivatives dealers, SBSDs subject to Rule 18a-1, and ANC firms are not otherwise required to obtain and maintain the information required by Rule 15c3-4.

5. Effect on Small Entities

Rule 15c3-4 does not and will not affect small entities because the definition of an OTC derivatives dealer excludes small entities.

6. Consequences of Not Conducting Collection

If the required activities were not conducted or were conducted less frequently (*i.e.*, due to a reduction in risk management procedures), the protection afforded to the public would be diminished.

7. Inconsistencies with Guidelines in 5 CFR 1320.5(d)(2)

There are no special circumstances. This collection is consistent with the guidelines in 5 CFR 1320.5(d)(2).

8. Consultations Outside the Agency

The required Federal Register notice with a 60-day comment period soliciting comments on this collection of information was published. No public comments were received.

9. Payment or Gift

No payment or gift is provided to respondents.

10. Confidentiality

The information collected by the Commission from OTC derivatives dealers, SBSDs subject to Rule 18a-1, and ANC firms in accordance with Rule 15c3-4 is kept confidential to the extent permitted by the Freedom of Information Act (5 U.S.C. § 552 *et seq.*). To the extent that

³ This information collection does not cover the hour burden associated with ANC firms, because the hour burden for ANC firms is included in the Paperwork Reduction Act collection for Rule 15c3-1, which requires ANC firms to comply with specific provisions of Rule 15c3-4 in Appendix E to Rule 15c3-1. *See* 17 CFR 240.15c3-1(a)(7)(iii), 17 CFR 240.15c3-1e(a)(1)(ii), and 17 CFR 240.15c3-1e(a)(1)(viii)(C).

the information in this collection is provided to the Commission in connection with an application by an OTC derivatives dealer, the assurance of confidentiality is provided in accordance with the applicable rules.⁴

11. Sensitive Questions

The information collection does not collect personally identifiable information. The agency has determined that neither a PIA nor a SORN are required in connection with the collection of information.

12. Burden of Information Collection

The total estimated time burden associated with the requirements of Rule 15c3-4 is approximately 6,533 hours per year, calculated as described below.

At present, eleven respondents (five OTC derivatives dealers, five ANC firms, and one security-based swap dealer (“SBSD”)) are required to comply with Rule 15c3-4. The Commission anticipates that approximately two additional entities may register as OTC derivatives dealers, one entity may register as an ANC firm, and two entities may register as SBSBs subject to the requirements of Rule 15c3-4 during the next three years, for a total of five new respondents.

Based upon discussions with affected and potentially affected industry participants, the Commission estimates that, on average, a firm initially will take approximately 2,000 hours (666.666667 hours per year when annualized over three years) to establish and document its risk management control system. Further, we estimate that, on average, a firm will take approximately 200 hours each year to maintain its risk management control system.

Thus, under Rule 15c3-4, the estimated annual burden would be 2,200 hours for the eleven existing respondents (five OTC derivatives dealers, five ANC firms, and one SBSD) currently required to comply with Rule 15c3-4 to maintain their risk management control systems,⁵ 3,333 hours for the five new respondents (two new OTC derivatives dealers, one new ANC firm, and two new SBSBs) to establish and document their risk management control systems,⁶ and 1,000 hours for the five new respondents (two new OTC derivatives dealers, one new ANC firm, and two new SBSBs) to maintain their risk management control systems.⁷ The total estimated annual time burden is thus 6,533 hours (2,200 + 3,333 + 1000).

⁴ Securities Exchange Act Release No. 40594 (Oct. 23, 1998), 63 FR 593362 (November 3, 1998).

⁵ (200 hours x 11 firms) = 2,200.

⁶ ((2,000 hours/3 years) x 5 firms) = 3,333.

⁷ (200 hours x 5 firms) = 1,000.

SUMMARY OF ANNUAL TIME BURDEN

| Rule | Burden Type | Number of Respondents | Number of Annual Responses Per Respondent | Time Per Response (Hours) | Total Burden Per Burden Type (Hours) |
|--|--------------------|------------------------------|--|----------------------------------|---|
| 15c3-4 Existing Respondents – Maintain Systems | Record Keeping | 11 | 1 | 200 | 2,200 |
| 15c3-4 New Respondents – Establish Systems | Record Keeping | 5 | 1 | 666.666667 | 3,333 |
| 15c3-4 New Respondents – Maintain Systems | Record Keeping | 5 | 1 | 200 | 1,000 |
| <i>Total Aggregate Burden (Hours)</i> | | | | | 6,533 |

13. Cost to Respondents

There are no capital or start-up costs or operation and maintenance costs associated with the rule.

14. Costs to Federal Government

Not applicable. The review of existing and anticipated respondents’ risk management control systems, will be performed by Commission staff as part of their regular duties.

15. Changes in Burden

The increase in estimated burden hours from 5,800 to 6,533 is due to an increase in the estimated number of respondents subject to the requirements of the rule. We previously estimated that 9 respondents (three existing respondents and six new respondents) would be subject to the rule requirements. We now estimate that 16 respondents (eleven existing respondents and five new respondents) will be subject to the rule requirements.

16. Information Collection Planned for Statistical Purposes

Not applicable. The information collection is not used for statistical purposes.

17. Approval to Omit OMB Expiration Date

The Commission is not seeking approval to omit the expiration date.

18. Exceptions to Certification for Paperwork Reduction Act Submissions

This collection complies with the requirements in 5 CFR 1320.9.

B. COLLECTIONS OF INFORMATION EMPLOYING STATISTICAL METHODS

This collection does not involve statistical methods.