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Changes to the SEC's and PCAOB's Reporting Requirements for Broker-Dealers and Their Auditors

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The Bottom Line

- On June 15, 2011, the SEC proposed significant changes[1] to Rule 17a-5, "Reports to Be Made by Certain Brokers and Dealers," of the Securities Exchange Act of 1934 in an effort to strengthen the audits and reporting of broker-dealers.
- The proposed amendments would require carrying broker-dealers to file, on an annual basis, a compliance report that asserts compliance, and effective internal control over compliance, with the SEC's financial responsibility rules (FRRs). Noncarrying broker-dealers would be required to file an exemption report asserting that they are exempt from the customer protection provisions of Exchange Act Rule 15c3-3.
- The proposed amendments would require broker-dealers to grant the SEC and other regulators access to audit documentation. As part of this access, regulators would be able to discuss audit findings with the broker-dealer's independent auditors.
- Broker-dealers would also have to file a form, known as "form custody," on a quarterly basis. The form custody would require broker-dealers to disclose various information about their custodial activities and would enhance regulators' insight into current custodial practices.
- On July 12, 2011, the PCAOB proposed three new standards (two attestation standards and one audit standard) on audits of broker-dealers. The two attestation standards relate to the independent auditor's examination of the compliance report and review of the exemption report. The audit standard relates to the auditor's responsibilities with respect to the supplemental information accompanying broker-dealers' audited financial statements.

The proposed rule amendments reflect the SEC's continued focus on (1) investor protection and (2) audits of broker-dealers' custody activities and related internal controls.

[1] SEC Proposed Rule Release No. 34-63676, *Broker-Dealer Reports.*

Beyond the Bottom Line

On June 15, 2011, the SEC unanimously proposed amendments to Rule 17a-5 of the Securities Exchange Act of 1934. The objective of the amendments is to strengthen the audits of broker-dealers and the SEC's oversight of the ways in which broker-dealers handle their customer securities and cash. The proposals change the reporting requirements for both broker-dealers and independent auditors.

Amendments to Rule 17a-5

Overall, these proposed rule amendments reflect the SEC's continued focus on (1) investor protection and (2) audits of broker-dealers' custody activities and related internal controls. They also would allow the SEC to have timely and increased insight into broker-dealers' custody practices. The paragraphs below summarize the proposed amendments and their impact on affected broker-dealers.

Annual Reporting Requirements

The proposal's most significant change is to the reporting requirements. The objective of this change is to "update the existing requirements of Exchange Act Rule 17a-5, facilitate the ability of the [PCAOB] to implement oversight of independent public accountants of broker-dealers as required by the [Dodd-Frank Act], and eliminate potentially redundant requirements for certain broker-dealers affiliated with, or dually-registered as, investment advisers." The changes in the reporting requirements would affect not only the types of reports that broker-dealers are required to annually file with regulators but also the notification requirements and the nature of work performed by the broker-dealers' independent auditors.

The compliance report will assert compliance, and effective internal control over compliance, with the financial responsibility rules.

Annual Compliance or Exemption Reports

Although the proposed amendments to Rule 17a-5 would require all broker-dealers to file annual reports with regulators, the report content would differ depending on whether the firm is a carrying broker-dealer (i.e., maintains custody of customer funds or securities) or a noncarrying broker-dealer (i.e., does not have custody of customer assets and claims an exemption from Rule 15c3-3). Firms that meet the definition of a carrying broker-dealer would be required to file a compliance report. This report would assert compliance, and effective internal control over compliance, with the FRRs. The FRRs are defined as "The Uniform Net Capital Rule" (Rule 15c3-1), "Customer Protection — Reserves and Custody of Securities" (Rule 15c3-3), "Quarterly Security Count" (Rule 17a-13), and the account statement rules of relevant designated examining authorities (DEAs).

The compliance report would state whether the carrying broker-dealer "has established and maintained a system of internal control to provide the [broker-dealer] with reasonable assurance that any instances of [material noncompliance with the FRRs] will be prevented or detected on a timely basis." The report would also contain a description of any instances of material noncompliance and material weakness. Material noncompliance is defined as the broker-dealer's failure to comply with any of the FRRs in all material respects. Lastly, the compliance report would include the three assertions mandated by the proposal:

- Whether the broker-dealer was in compliance with the FRRs in all material respects as of its fiscal year-end.
- Whether the "information used to assert compliance with [the FRRs] was derived from the books and records of the broker-dealer."
- Whether the "internal control over compliance with [the FRRs] was effective during the most recent fiscal year such that there were no instances of material weakness."

Noncarrying broker-dealers would be required to file an exemption report asserting that the broker-dealer "is exempt from the provisions of Rule 15c3-3 because it meets one or more of the conditions set forth in paragraph (k) of Rule 15c3-3 with respect to all of its business activities." The proposed rule also suggests that noncarrying broker-dealers would no longer have to obtain a report on internal controls over the procedures performed in connection with Rule 15c3-1, which is a change from prior years.

Independent Auditors' Reports

The proposed rule would require both carrying and noncarrying broker-dealers to engage an independent auditor to perform procedures with respect to their compliance and exemption reports, respectively. For the work performed on the assertions in the compliance report filed by carrying broker-dealers, the independent auditor would be required to issue an examination report in accordance with PCAOB standards. This report would pertain solely to the assertions themselves and not to the broker-dealer's process in arriving at them. For noncarrying broker-dealers, the independent auditor would be required to review the assertions in the exemption report and to issue a review report in accordance with PCAOB standards on the basis of that review. However, the independent auditor would not be required to opine on the effectiveness of the broker-dealer's internal control over financial reporting.

A broker-dealer that is also a registered investment adviser or that maintains custody of customer assets for related investment advisers would no longer have to obtain an internal control report under the investment advisers custody rule, since the independent auditor's examination report would satisfy the requirements.

The form custody requirement will enhance the ability of applicable regulators to oversee broker-dealers' custody practices.

Notification Requirements

Another modification being made to the current rule relates to notifying the SEC about material noncompliance. The proposal states that upon determining that material noncompliance exists, the independent auditor must notify the SEC within one business day. This time frame is triggered at the point when the independent auditor determines that an instance of material noncompliance exists.

Access to Audit Documentation

Another amendment in the proposal requires that broker-dealers that clear transactions or carry customer accounts (i.e., clearing broker-dealers) allow the SEC and their DEAs to discuss annual audit findings with their independent auditor and to review related audit documentation. Such access would be granted through a change-in-accountant form, "Notice to Rule 17a-5," which broker-dealers subject to the rule would have to refile.

Although the SEC would have access to an auditor's workpapers, the SEC's objective is not to evaluate the audit procedures performed but to use the workpapers to help regulators establish the scope and focus of their own examination of broker-dealers.

Form Custody Requirement

The SEC's proposal would require broker-dealers to file a new form, known as "form custody," on a quarterly basis. The proposed rule contains an example of the form custody, which includes nine areas in which broker-dealers will have to disclose their custodial activities. Each line item comprises multiple questions and requests for information, including, but not limited to, security types, locations, reconciliation frequency, and market value. The SEC believes that adding the form custody requirement will enhance the ability of applicable regulators to oversee broker-dealers' custody practices through the regular receipt of current information.

To provide guidance on implementing this new requirement, the SEC would add paragraph (a)(5) to Rule 17a-5. This paragraph would outline the time frame within which the form custody must be filed with its DEA, which is "within 17 business days after the end of each calendar quarter and within 17 business days after the date selected for the annual reports where said date is other than the end of a calendar quarter."

The proposed time frame for filing the form custody would coincide with the broker-dealer's filing of its quarterly unaudited Financial and Operational Combined Uniform Single Report (FOCUS), and each filing would be considered confidential. Currently, it is expected that independent auditors would not have to provide assurance before the form custody is filed.

PCAOB's Proposed Standards

Annual Financial Statements and Supporting Schedules

On July 12, 2011, the PCAOB issued proposed standards on broker-dealer audits and auditing supplemental information. Although the current requirement under Rule 17a-5 related to broker-dealers' annual reporting on audited financial statements and supplemental schedules remains unchanged, the proposed amendments to Rule 17a-5 would change the audit standards applicable to broker-dealer audits from generally accepted auditing standards (GAAS) to PCAOB standards. PCAOB Auditing Standards 3, *Audit Documentation*, and 7, *Engagement Quality Review*, would have a particularly great effect on broker-dealer audits, since their requirements are more robust than those under GAAS.

The PCAOB has proposed new standards in response to the changes made by the SEC.

Note that the PCAOB's proposed standard on auditing the supplemental information accompanying the audited financial statements (i.e., the supplemental schedules that broker-dealers must file) describes both the procedural and the reporting requirements for the supplemental information. In contrast, the current standard focuses on the reporting responsibilities only.

Compliance or Exemption Reports

The PCAOB also issued two proposed attestation standards on engagements related to broker-dealer compliance and exemption reports required by the SEC's proposed amendments to Rule 17a-5. The proposed attestation standard on compliance reports would require independent auditors to examine the assertions made by the broker-dealer regarding the FRRs as well as the existence of assets, risk of fraud, and any risks of material misstatement. The proposed attestation standard on exemption reports would require independent auditors to apply a risk-based approach in reviewing the assertions made by the broker-dealer. The proposed attestation standards would also make certain amendments to PCAOB Auditing Standards 3 and 7 with respect to attestation engagements.

Effective Date

The PCAOB's proposed standards on auditing the supplemental schedules and on attestation engagements would be effective for fiscal years ending on or after September 15, 2012. This effective date is intended to coincide with the proposed end of the transition period for the SEC's proposed amendments to Rule 17a-5; however, Rule 17a-5 may be effective for broker-dealers' fiscal years ending on or after December 15, 2011.

It is not yet clear what standards independent auditors will follow during the transition period if the final effective dates of the SEC's and PCAOB's proposals remain different.

Challenges for Broker-Dealers

Broker-dealers should begin to think now about the possible challenges and broader implications associated with the proposed rules. In addition, they should consider the data requirements of the new rules and determine whether the infrastructure that is currently in place is adequate or whether system enhancements will be necessary. Further, the SEC's and PCAOB's proposals would affect the amount of work that broker-dealers and their independent auditors are required to perform. Thus, broker-dealers and their auditors would need to further coordinate their efforts to ensure that the requirements are being satisfied and that reports are being filed on a timely basis. Lastly, broker-dealers should consider the possible impact of the SEC's and relevant DEA's more regular and ongoing involvement in their affairs, specifically the SEC's increased access to the independent auditor's workpapers and the requirement for the independent auditors to provide the SEC with real-time notification of any material noncompliance.

Thinking Ahead

Comments on the SEC's proposed amendments to Rule 17a-5 are due by August 26, 2011, and unless major changes are warranted, the final rule would be effective for annual reports filed by broker-dealers with fiscal years ending on or after December 15, 2011. The SEC intends to implement a transition period for carrying broker-dealers with fiscal years ending on or after December 15, 2011, but before September 15, 2012. For these firms, the assertion about whether internal control over compliance with the FRRs was effective would not take into account the entire fiscal year; rather, it would be a point-in-time assertion as of the date of the compliance report.

Broker-dealers should begin to think now about the possible challenges and broader implications associated with the proposed rules.

Comments on the PCAOB's proposed standards are due by September 12, 2011. While the exact details of the proposed changes to the broker-dealer's financial reporting rule and the PCAOB's standards will be subject to ongoing refinement over the coming months, the broad requirements have become well defined. There are many things broker-dealers and independent public accounting firms can do to begin preparing. Specifically, they can start to identify and evaluate the challenges introduced by the amendments and determine their overall impact on their financial reporting. By being proactive, broker-dealers can more effectively manage what promises to be, for many, a significant change from current practice.

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