115TH CONGRESS, 2d Session | HOUSE OF REPRESENTATIVES | REPORT 115–1075

SMALL BUSINESS AUDIT CORRECTION ACT OF 2018

DECEMBER 12, 2018.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. HENSARLING, from the Committee on Financial Services, submitted the following

REPORT

together with

MINORITY VIEWS

[To accompany H.R. 6021]

[Including cost estimate of the Congressional Budget Office]

The Committee on Financial Services, to whom was referred the bill (H.R. 6021) to amend the Sarbanes-Oxley Act of 2002 to exclude privately held, non-custody brokers and dealers that are in good standing from certain requirements under title I of that Act, and for other purposes, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are as follows:

Strike all after the enacting clause and insert the following:

SECTION 1. SHORT TITLE.

This Act may be cited as the "Small Business Audit Correction Act of 2018".

SEC. 2. EXEMPTION.

(a) AMENDMENTS TO TITLE I OF THE SARBANES-OXLEY ACT OF 2002.—Section 110 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7220) is amended—

(1) in paragraph (3), by inserting ", except that the term does not include a non-custody broker or dealer that is privately held and in good standing" after "registered public accounting firm";

(2) in paragraph (4), by inserting ", except that the term does not include a non-custody broker or dealer that is privately held and in good standing" after "registered public accounting firm";

(3) by redesignating paragraphs (5) and (6) as paragraphs (8) and (9), respectively; and

(4) by inserting after paragraph (4) the following:

"(5) IN GOOD STANDING.—The term 'in good standing' means, with respect to a broker or dealer (as those terms are defined in section 3(a) of the Securities

Exchange Act of 1934 (15 U.S.C. 78c(a))), that, as of the last day of the most recently completed fiscal year of the broker or dealer, as applicable, the broker or dealer—

"(A) was registered with the Commission;

"(B) was a member of a registered securities association (as defined under section 15A of the Securities Exchange Act of 1934 (15 U.S.C. 78o-3));

"(C) was compliant with the minimum dollar net capital requirements under section 240.15c3–1 of title 17, Code of Federal Regulations, or any successor regulation;

"(D) had not, during the 10-year period preceding that date, been convicted of a felony under Federal or State law;

"(E) does not have an associated person (as that term is defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a))) who, during the 10-year period preceding that date, was convicted of a felony under Federal or State laws for fraudulent conduct; and

"(F) was not, as provided by section 3(a)(39) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a))—

"(i) expelled or suspended from membership or participation in any self-regulatory organization (as provided in section 3(a)(26) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(26))) or a registered futures association (as provided in section 17 of the Commodity Exchange Act (7 U.S.C. 21));

"(ii) subject to an order of the Commission, or other appropriate regulatory agency, denying, suspending, or revoking its registration as any regulated entity; or

"(iii) subject to an order of the Commodity Futures Trading Commission, or other appropriate regulatory agency, denying, suspending, or revoking its registration under the Commodity Exchange Act (7 U.S.C. 1 et seq.) or its authority to engage in any transactions.

"(6) NON-CUSTODY BROKER OR DEALER.—The term 'non-custody broker or dealer' means a broker or dealer (as those terms are defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a))), as applicable, that—

"(A) as of the last day of the most recently completed fiscal year of the broker or dealer had not less than 1 and not more than 150 associated persons (as that term is defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a))) registered with a self-regulatory organization (as provided in section 3(a)(26) of the Securities Exchange Act (15 U.S.C. 78c(a)(26))) of which the broker or dealer is a member; and

"(B) throughout the most recently completed fiscal year of the broker or dealer—

"(i) did not, as a matter of ordinary business practice in connection with the activities of the broker or dealer, receive customer checks, drafts, or other evidence of indebtedness made payable to the broker or dealer;

"(ii) promptly forwarded customer securities and customer checks, drafts, or other evidence of indebtedness payable to a third party, including a clearing broker or dealer, in compliance with section 240.15c3-3 of title 17, Code of Federal Regulations, or any successor regulation;

"(iii) did not otherwise hold customer securities or cash;

"(iv) if required under section 3(a)(2) of the Securities Investor Protection Act of 1970 (15 U.S.C. 78ccc(a)(2)), was a member of the Securities Investor Protection Corporation; and

"(v) either—

"(I) claimed exemption from section 240.15c3–3 of title 17, Code of Federal Regulations, or any successor regulation; or

"(II) claimed no exemption from such section 240.15c3–3, or any successor regulation, or was not otherwise subject to such, because the broker or dealer did not maintain custody over any customer securities or cash.

"(7) PRIVATELY HELD.—The term 'privately held' means, with respect to a broker or dealer (as those terms are defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a))), that the broker or dealer, as applicable, is not an issuer.".

(b) AMENDMENTS TO REGULATIONS.—Not later than 180 days after the date of enactment of this Act, the Securities and Exchange Commission shall make any necessary amendments to regulations of the Commission that are in effect as of the date of enactment of this Act in order to—

(1) carry out this Act and the amendments made by this Act; and

(2) to exclude the auditors of non-custody brokers and dealers that are privately held and in good standing (as such terms are defined under section 110 of the Sarbanes-Oxley Act of 2002) from the audit requirements of the Public Company Accounting Oversight Board.

(c) EFFECTIVE DATE.—This Act, and the amendments made by this Act, shall take effect on the date that is 180 days after the date of enactment of this Act.

Amend the title so as to read:

A bill to amend the Sarbanes-Oxley Act of 2002 to exclude the audits of privately held, non-custody brokers and dealers that are in good standing from certain requirements under title I of that Act, and for other purposes.

PURPOSE AND SUMMARY

Current regulations require all brokers and dealers—irrespective of whether they are public companies, large or small, or take custody of client funds or securities—to hire a Public Company Accounting Oversight Board or PCAOB-registered audit firm to conduct audits and be subject to the PCAOB's registration, inspection, rule-making and enforcement regime. To limit the applicability of these regulations, on June 6, 2018, Representative French Hill introduced H.R. 6021, the "Small Business Audit Correction Act of 2018" to provide a narrowly tailored exception for privately-held, small noncustodial brokers and dealers in good standing from the requirement to hire a PCAOB-registered audit firm in order to meet the annual Securities Exchange Act Rule 17a–5 reporting obligation.

BACKGROUND AND NEED FOR LEGISLATION

The goal of H.R. 6021 is to eliminate unnecessarily burdensome one-size-fits-all PCAOB regulatory requirements that have been placed on small, privately-held brokers and dealers that do not take custody of client funds or securities.

Current regulations require all investment brokers and dealers to hire a PCAOB-registered audit firm to conduct audits using more complex guidelines that were designed—consistent with the "Public Company" in PCAOB—for larger, public companies. PCAOB audit requirements may make sense for public companies with shareholders and those brokers and dealers that maintain custody over customer funds or securities, as there is greater risk to the public markets, but they do not make sense for small, privately-held, noncustodial brokers and dealers—many of whom find it too burdensome to operate under the PCAOB regime.

Title I of the Sarbanes-Oxley Act of 2002 (Pub. L. 107–204) created the PCAOB to oversee the audits of U.S. public companies in the wake of massive accounting failures at Enron and other large companies such as WorldCom, Global Crossing, Adelphia, Tyco, and HealthSouth. Following the exposure of the Bernie Madoff Ponzi Scheme in late 2008, Subtitle I of Title IX of the Dodd-Frank Act, specifically Section 982, expanded the PCAOB's jurisdiction to apply to auditors of broker-dealers. Although auditors of broker-dealers that also were public companies, such as bank subsidiaries, were already subject to PCAOB regulation prior to Dodd-Frank; that legislation added new requirements for auditors of small- and medium-sized brokers and dealers to be subject to the PCAOB's regulatory regime. The result of Section 982 of the Dodd-Frank Act is a disproportionate and burdensome regulatory obligation imposed on small- and medium-sized brokers and dealers and an auditing regime that does not properly account for the business model of brokers and dealers who are small, privately-held, and noncustodial.

In 2011, the PCAOB implemented an interim inspection program to gather information on all broker-dealers to develop a permanent audit program. The PCAOB released its first progress report in August 2012, noting deficiencies in all 23 broker-dealer audits it inspected, which were performed under AICPA standards rather than those of the PCAOB. Following the release of this first report, the Securities and Exchange Commission amended Rule 17a–5 to require that audits of broker-dealers be conducted in accordance with PCAOB, rather than AICPA, standards. AICPA standards employ Generally Accepted Auditing Standards (GAAP), which are generally accepted practice among auditors, whereas PCAOB standards are requirements promulgated by a regulator. In addition, the PCAOB inspection process is more rigorous than the AICPA peer-review process.

Under this regime, a registered public accounting firm must certify financial statements for broker-dealers. The accounting firm must cooperate with PCAOB inspection or enforcement processes and must comply with PCAOB annual and special reporting rules. Additionally, registered public accounting firms must follow auditing and attestation, quality control, ethics, and independence standards regarding audit reports for broker-dealers. For non-public broker-dealers, many of whom do not have an audit committee, these new responsibilities to understand applicable financial reporting requirements and audit standards falls on management to ensure compliance.

PCAOB audit standards designed and priced for larger public companies disproportionately affect privately-held small businesses. In 2016, there were 783 PCAOB-registered audit firms. But in 2017, there were only 478—a nearly 40% reduction in the number of firms eligible to audit public companies and the approximately 3,700 broker-dealers around the country. It should not be a surprise that with a decreasing number of audit firms, smaller broker-dealers are experiencing audit cost increases. Small broker-dealers, on average, employ twenty people or less and are much smaller organizations as compared to the larger, public companies for which the PCAOB developed these standards.

According to a small-firm survey conducted in 2017 by the Small Firm Advisory Board of the Financial Institution Regulatory Authority (FINRA), the average time spent on audits nearly doubled and average audit costs are up sharply for small firms in all revenue classes since the full implementation of the PCAOB auditing requirements. The survey found that the average increase in the cost of annual audits had jumped 83%—a jump, on average, from $10,228 to $18,710. If that amount is multiplied across the 3,339 small firms that existed as of May 21, 2018, the cumulative additional cost totals more than $28.3 million. This is $28.3 million that could be invested into technology advancements to protect customer data and information, enhancements to the way small firms can better serve their customers, and job and capital creation—not to mention the staff productivity that could be focused on such issues. After all, the total number of man-hours that small firms report their staff spending to complete the firm's audit almost doubled from 44 hours to 82 hours.

Opponents of this legislation fallback on two misleading headlines. First, they claim that the deficiency rate on auditing firms reported in the PCAOB's annual report on its Interim Program indicates that the PCAOB audit standards for all broker-dealers are important to maintain to ensure effective auditing and to protect broker-dealer customers and investors. Unfortunately, such an argument stops before actually considering the inputs and the regulatory framework at issue. In particular, the deficiency rate in the PCAOB's report is focused on the work of the auditors and not the reliability of the brokers or dealers who shoulder the cost of those audits. After all, the PCAOB's job is to make sure auditors are performing audits in accordance with PCAOB standards. In other words, the deficiencies reported relate to whether certain audit principles were followed properly and do not mean that the broker-dealers' financial statements or supporting materials are materially misstated. To be clear, the PCAOB report has been issued for four-years running, and each year the PCAOB reports deficiencies of 90+%. Such a four-year trend begs the question of why either the PCAOB or SEC have not taken action if such a rate truly is harming investors. The most logical answer is that those writing the report know themselves that the standards do not fit and never will, and they know the vast majority of the "deficiencies"' would not and do not affect the overall audit opinion. The findings of the report and the absence of any urgency to reduce the deficiency rate the past four years actually underscores that deficiencies can be expected when you make public company standards one-size-fits-all and apply them to audits of nonpublic companies, which do not present the same risk to investors when they are noncustodial and which often traditionally have been done by auditors who do not audit public companies.

Second, opponents also have falsely claimed that H.R. 6021 will result in a void of oversight of small, privately-held, noncustodial broker-dealers. This simply is false, as it ignores the fact that PCAOB oversight of these firms is duplicative and unnecessary. FINRA and the SEC test for compliance with Federal securities laws, Self-Regulatory Organization rules, and compliance with the broker-dealers' written supervisory procedures. All of these examinations already provide protection for customers whose broker-dealers are noncustodial. Further, FINRA broker-dealers are examined or audited by state securities regulators in the states where they are registered, the SEC, the Commodity Futures Trading Commission (if the entity is registered with the CFTC), the National Futures Association, and the Internal Revenue Service for compliance with the Employee Retirement Income Security Act of 1974.

In short, the PCAOB's one-size-fits-all approach is inappropriate and unnecessarily burdensome for small, privately held noncustodial brokers and dealers—those firms that do not take custody of client assets. H.R. 6021 addresses this problem by narrowly tailoring a legislative exception for privately-held, small noncustodial brokers and dealers in good standing from the requirement to hire a PCAOB-registered audit firm in order to meet the annual SEC Rule 17a–5 reporting obligation.

HEARINGS

The Committee on Financial Services held no hearings examining matters relating to H.R. 6021.

COMMITTEE CONSIDERATION

The Committee on Financial Services met in open session on September 13, 2018, and ordered H.R. 6021 to be reported favorably to the House as amended by a recorded vote of 36 yeas to 16 nays (recorded vote no. FC–213), a quorum being present. An amendment in the nature of a substitute offered by Representative Hill was agreed to by voice vote.

COMMITTEE VOTES

Clause 3(b) of rule XIII of the Rules of the House of Representatives requires the Committee to list the record votes on the motion to report legislation and amendments thereto. The sole recorded vote was on a motion by Chairman Hensarling to report the bill favorably to the House as amended. The motion was agreed to by a recorded vote of 36 yeas to 16 nays (Record vote no. FC–213), a quorum being present.

Record vote no. FC-213

Representative	Yea	Nay	Present	Representative	Yea	Nay	Present
Mr. Hensarling	X			Ms. Maxine Waters (CA)		X	
Mr. McHenry	X			Mrs. Carolyn B. Maloney (NY)		X	
Mr. King	X			Ms. Velázquez		X	
Mr. Royce (CA)	X			Mr. Sherman		X	
Mr. Lucas	X			Mr. Meeks			
Mr. Pearce				Mr. Capuano			
Mr. Posey	X			Mr. Clay			
Mr. Luetkemeyer	X			Mr. Lynch		X	
Mr. Huizenga	X			Mr. David Scott (GA)		X	
Mr. Duffy	X			Mr. Al Green (TX)		X	
Mr. Stivers	X			Mr. Cleaver			
Mr. Hultgren	X			Ms. Moore		X	
Mr. Ross	X			Mr. Ellison			
Mr. Pittenger				Mr. Perlmutter		X	
Mrs. Wagner	X			Mr. Himes	X		
Mr. Barr	X			Mr. Foster		X	
Mr. Rothfus	X			Mr. Kildee		X	
Mr. Messer	X			Mr. Delaney	X		
Mr. Tipton	X			Ms. Sinema	X		
Mr. Williams	X			Mrs. Beatty		X	
Mr. Poliquin	X			Mr. Heck		X	
Mrs. Love	X			Mr. Vargas		X	
Mr. Hill	X			Mr. Gottheimer			
Mr. Emmer	X			Mr. Gonzalez (TX)	X		
Mr. Zeldin	X			Mr. Crist		X	
Mr. Trott	X			Mr. Kihuen		X	
Mr. Loudermilk	X						
Mr. Mooney (WV)	X						
Mr. MacArthur	X						
Mr. Davidson	X						
Mr. Budd	X						
Mr. Kustoff (TN)	X						
Ms. Tenney	X						
Mr. Hollingsworth	X						

COMMITTEE OVERSIGHT FINDINGS

Pursuant to clause 3(c)(1) of rule XIII of the Rules of the House of Representatives, the findings and recommendations of the Committee based on oversight activities under clause 2(b)(1) of rule X of the Rules of the House of Representatives, are incorporated in the descriptive portions of this report.

PERFORMANCE GOALS AND OBJECTIVES

Pursuant to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, the Committee states that H.R. 6021 will reduce the disproportionate regulatory burden on privately held, small non-custodial broker-dealer firms by exempting them from the requirement to hire a PCAOB-registered audit firm to meet certain reporting requirements.

NEW BUDGET AUTHORITY, ENTITLEMENT AUTHORITY, AND TAX EXPENDITURES

In compliance with clause 3(c)(2) of rule XIII of the Rules of the House of Representatives, the Committee adopts as its own the estimate of new budget authority, entitlement authority, or tax expenditures or revenues contained in the cost estimate prepared by the Director of the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974.

CONGRESSIONAL BUDGET OFFICE ESTIMATES

Pursuant to clause 3(c)(3) of rule XIII of the Rules of the House of Representatives, the following is the cost estimate provided by the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974:

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, November 19, 2018.

Hon. JEB HENSARLING,
Chairman, Committee on Financial Services,
House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 6021, the Small Business Audit Correction Act of 2018.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Stephen Rabent.

Sincerely,

KEITH HALL,
Director.

Enclosure.

H.R. 6021—Small Business Audit Correction Act of 2018

Under current law, securities issuers, brokers, and dealers that are registered with the Securities and Exchange Commission (SEC) must be audited by an accounting firm that is registered with the Public Company Accounting Oversight Board (PCAOB) and must follow certain rules and requirements when preparing audit reports. H.R. 6021 would exempt from the PCAOB's definition of broker or dealer certain privately held brokers or dealers that meet other requirements, allowing those brokers or dealers to be audited by a firm that is not registered with the PCAOB.

Using information from the SEC, CBO estimates that implementing H.R. 6021 would cost less than $500,000 for the agency to amend its rules. However, the SEC is authorized to collect fees sufficient to offset its annual appropriation; therefore, CBO estimates that the net effect on discretionary spending would be negligible, assuming appropriation actions consistent with that authority.

Using information from the PCAOB, CBO estimates that implementing H.R. 6021 would increase direct spending by less than $500,000 to make changes to PCAOB regulations. However, the PCAOB is authorized to assess fees (which are recorded in the budget as revenues) to offset its operation costs. Therefore, CBO expects that the net effect on the deficit would be negligible. Because enacting the bill would affect direct spending and revenues, pay-as-you-go procedures apply.

CBO estimates that enacting H.R. 6021 would not significantly increase net direct spending or on-budget deficits in any of the four consecutive 10-year periods beginning in 2029.

H.R. 6021 contains no intergovernmental mandates as defined in the Unfunded Mandates Reform Act (UMRA).

If the SEC and the PCAOB increased fees to offset the costs associated with implementing the bill, H.R. 6021 would increase the cost of an existing mandate on private entities required to pay those assessments and fees. CBO estimates that the incremental cost of the mandate would be less than $1 million, well below the annual threshold for private-sector mandates established in UMRA ($160 million in 2018, adjusted annually for inflation).

The CBO staff contacts for this estimate are Stephen Rabent (for federal costs) and Rachel Austin (for mandates). The estimate was reviewed by H. Samuel Papenfuss, Deputy Assistant Director for Budget Analysis.

Federal Mandates Statement

This information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995.

The Committee has determined that the bill does not contain Federal mandates on the private sector. The Committee has determined that the bill does not impose a Federal intergovernmental mandate on State, local, or tribal governments.

Advisory Committee Statement

No advisory committees within the meaning of section 5(b) of the Federal Advisory Committee Act were created by this legislation.

Applicability to Legislative Branch

The Committee finds that the legislation does not relate to the terms and conditions of employment or access to public services or accommodations within the meaning of the section 102(b)(3) of the Congressional Accountability Act.

Earmark Identification

With respect to clause 9 of rule XXI of the Rules of the House of Representatives, the Committee has carefully reviewed the provisions of the bill and states that the provisions of the bill do not contain any congressional earmarks, limited tax benefits, or limited tariff benefits within the meaning of the rule.

Duplication of Federal Programs

In compliance with clause 3(c)(5) of rule XIII of the Rules of the House of Representatives, the Committee states that no provision of the bill establishes or reauthorizes: (1) a program of the Federal Government known to be duplicative of another Federal program; (2) a program included in any report from the Government Accountability Office to Congress pursuant to section 21 of Public Law 111–139; or (3) a program related to a program identified in the most recent Catalog of Federal Domestic Assistance, published pursuant to the Federal Program Information Act (Pub. L. No. 95–220, as amended by Pub. L. No. 98–169).

Disclosure of Directed Rulemaking

Pursuant to section 3(i) of H. Res. 5, (115th Congress), the following statement is made concerning directed rule makings: The Committee estimates that the bill requires no directed rule makings within the meaning of such section.

Section-by-Section Analysis of the Legislation

Section 1. Short title

This section cites H.R. 6021 as the "Small Business Audit Correction Act of 2018".

Section 2. Exemption

This section amends the Sarbanes-Oxley Act of 2002 to exempt privately-held, non-custodial brokers and dealers in good standing from the requirement to hire a PCAOB registered audit firm in order to meet the annual Securities Exchange Act Rule 17a–5 reporting obligation.

Changes in Existing Law Made by the Bill, as Reported

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, and existing law in which no change is proposed is shown in roman):

SARBANES-OXLEY ACT OF 2002

* * * * * * *

TITLE I—PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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SEC. 110. DEFINITIONS.

For the purposes of this title, the following definitions shall apply:

(1) AUDIT.—The term "audit" means an examination of the financial statements, reports, documents, procedures, controls, or notices of any issuer, broker, or dealer by an independent public accounting firm in accordance with the rules of the Board or the Commission, for the purpose of expressing an opinion on the financial statements or providing an audit report.

(2) AUDIT REPORT.—The term "audit report" means a document, report, notice, or other record—

(A) prepared following an audit performed for purposes of compliance by an issuer, broker, or dealer with the requirements of the securities laws; and

(B) in which a public accounting firm either—

(i) sets forth the opinion of that firm regarding a financial statement, report, notice, or other document, procedures, or controls; or

(ii) asserts that no such opinion can be expressed.

(3) BROKER.—The term "broker" means a broker (as such term is defined in section 3(a)(4) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4))) that is required to file a balance sheet, income statement, or other financial statement under section 17(e)(1)(A) of such Act (15 U.S.C. 78q(e)(1)(A)), where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm*, except that the term does not include a non-custody broker or dealer that is privately held and in good standing*.

(4) DEALER.—The term "dealer" means a dealer (as such term is defined in section 3(a)(5) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(5))) that is required to file a balance sheet, income statement, or other financial statement under section 17(e)(1)(A) of such Act (15 U.S.C. 78q(e)(1)(A)), where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm*, except that the term does not include a non-custody broker or dealer that is privately held and in good standing*.

(5) IN GOOD STANDING.—The term "in good standing" means, with respect to a broker or dealer (as those terms are defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a))), that, as of the last day of the most recently completed fiscal year of the broker or dealer, as applicable, the broker or dealer—

(A) was registered with the Commission;

(B) was a member of a registered securities association (as defined under section 15A of the Securities Exchange Act of 1934 (15 U.S.C. 78o-3));

(C) was compliant with the minimum dollar net capital requirements under section 240.15c3–1 of title 17, Code of Federal Regulations, or any successor regulation;

(D) had not, during the 10-year period preceding that date, been convicted of a felony under Federal or State law;

(E) does not have an associated person (as that term is defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a))) who, during the 10-year period preceding that date, was convicted of a felony under Federal or State laws for fraudulent conduct; and

(F) was not, as provided by section 3(a)(39) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a))—

(i) expelled or suspended from membership or participation in any self-regulatory organization (as provided in section 3(a)(26) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(26))) or a registered futures association (as provided in section 17 of the Commodity Exchange Act (7 U.S.C. 21));

(ii) subject to an order of the Commission, or other appropriate regulatory agency, denying, suspending, or revoking its registration as any regulated entity; or

(iii) subject to an order of the Commodity Futures Trading Commission, or other appropriate regulatory agency, denying, suspending, or revoking its registration under the Commodity Exchange Act (7 U.S.C. 1 et seq.) or its authority to engage in any transactions.

(6) NON-CUSTODY BROKER OR DEALER.—The term "non-custody broker or dealer" means a broker or dealer (as those terms are defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a))), as applicable, that—

(A) as of the last day of the most recently completed fiscal year of the broker or dealer had not less than 1 and not more than 150 associated persons (as that term is defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a))) registered with a self-regulatory organization (as provided in section 3(a)(26) of the Securities Exchange Act (15 U.S.C. 78c(a)(26))) of which the broker or dealer is a member; and

(B) throughout the most recently completed fiscal year of the broker or dealer—

(i) did not, as a matter of ordinary business practice in connection with the activities of the broker or dealer, receive customer checks, drafts, or other evidence of indebtedness made payable to the broker or dealer;

(ii) promptly forwarded customer securities and customer checks, drafts, or other evidence of indebtedness payable to a third party, including a clearing broker or dealer, in compliance with section 240.15c3-3 of title 17, Code of Federal Regulations, or any successor regulation;

(iii) did not otherwise hold customer securities or cash;

(iv) if required under section 3(a)(2) of the Securities Investor Protection Act of 1970 (15 U.S.C.

78ccc(a)(2)), was a member of the Securities Investor Protection Corporation; and

(v) either—

(I) claimed exemption from section 240.15c3–3 of title 17, Code of Federal Regulations, or any successor regulation; or

(II) claimed no exemption from such section 240.15c3–3, or any successor regulation, or was not otherwise subject to such, because the broker or dealer did not maintain custody over any customer securities or cash.

(7) PRIVATELY HELD.—The term "privately held" means, with respect to a broker or dealer (as those terms are defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a))), that the broker or dealer, as applicable, is not an issuer.

⟦(5)⟧ *(8)* PROFESSIONAL STANDARDS.—The term "professional standards" means—

(A) accounting principles that are—

(i) established by the standard setting body described in section 19(b) of the Securities Act of 1933, as amended by this Act, or prescribed by the Commission under section 19(a) of that Act (15 U.S.C. 17a(s)) or section 13(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78a(m)); and

(ii) relevant to audit reports for particular issuers, brokers, or dealers, or dealt with in the quality control system of a particular registered public accounting firm; and

(B) auditing standards, standards for attestation engagements, quality control policies and procedures, ethical and competency standards, and independence standards (including rules implementing title II) that the Board or the Commission determines—

(i) relate to the preparation or issuance of audit reports for issuers, brokers, or dealers; and

(ii) are established or adopted by the Board under section 103(a), or are promulgated as rules of the Commission.

⟦(6)⟧ *(9)* SELF-REGULATORY ORGANIZATION.—The term "self-regulatory organization" has the same meaning as in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)).

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MINORITY VIEWS

H.R. 6021 would exempt some of the worst-performing auditors in our capital markets from federal scrutiny. Specifically, the bill would create a permanent statutory exemption for audits of certain privately held brokers and dealers that do not ordinarily receive and or hold client assets (i.e., "non-custody" firms) from Public Company Accounting Oversight Board (PCAOB) oversight.

In recognition of the role auditing failures played in enabling Bernie Madoff's $65 billion Ponzi scheme, the Dodd-Frank Act gave the PCAOB oversight authority over the audits of all brokers and dealers registered with the SEC. Congress, in doing so, charged the PCAOB with the task of setting standards for auditors of broker-dealers and ensuring their compliance through annual inspections. Far from a "one-size fits all requirement," the Dodd-Frank Act gave the PCAOB express authority to tailor its inspection program to, "allow for differentiation among classes of brokers and dealers, as appropriate." [1] Additionally, the Dodd-Frank Act clearly aligned PCAOB oversight with the inspection program so that any auditor the PCAOB decides to exempt from inspection would not be required to register with the PCAOB or adhere to PCAOB standards.[2]

Although the PCAOB currently subjects broker-dealers of all classes to inspection, the program is in a temporary phase designed to inform the PCAOB's determination of how to ultimately tailor its permanent inspection program. Despite these ongoing fact-finding efforts, H.R. 6021 would statutorily exempt audits of certain brokers and dealers from PCAOB oversight. The bill is unnecessary as the PCAOB possesses express authority to tailor its inspection program through a rulemaking process that would (1) take into account the PCAOB's unique insight into the performance of broker-dealer auditors and (2) be subject to public notice and comment and approval by the SEC.

In addition to being unnecessary, H.R. 6021 is far too broad in scope. The bill's exemption applies to broker-dealers with up to 150 representatives—a number derived from the definition of "small firm" included in the by-laws of the Financial Industry Regulatory Authority (FINRA), the self-regulatory organization for the broker-dealer industry. However, the number of representatives that a brokerage firm employs bears no meaningful relationship to the complexity of the firm's finances for auditing purposes. Even limited to non-custody firms, this threshold accounts for approximately 80% of registered broker-dealers.

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[1] *See* Pub. L. No. 111–203 982(e)(1).

[2] *See* 15 U.S.C. § 7214(a)(2)(D) (". . . a public accounting firm shall not be required to register with the Board if the public accounting firm is exempt from the inspection program which may be established by the Board. . . .").

Moreover, according to the results of the PCAOB's interim inspection program, reduced auditing oversight appears to be unwarranted for the very class of broker-dealers that H.R. 6021 would exempt. The PCAOB has consistently found that auditors of non-custody broker-dealers generally have a higher rate of deficiencies than other firms. These deficiencies include material auditing failures such as inadequate revenue testing and overlooking red flags that could indicate fraud. In fact, in its fiscal year 2017 inspections, the PCAOB found that 71% of audits of non-custody firms had deficiencies related to "assessing and responding to risks of material misstatement due to fraud." [3] By comparison, the same deficiency was observed in 50% of audits for custodial brokers and dealers. Overall, the PCAOB found deficiencies at 85% of the 54 inspected auditing firms that only audited non-custody brokers and dealers. These results counsel against eliminating oversight over the performance of these auditors.

The exemption contemplated by H.R. 6021 is inappropriate considering the prevalence of auditing deficiencies among auditors of non-custody brokers and dealers. Additionally, the bill ignores the fact that auditors represent a primary, independent source of verifying how a brokerage firm treats client assets. Importantly, FINRA employs a risk-based approach to its oversight, pursuant to which it relies, in part, on a broker-dealer's audited filings to determine the degree of supervision it will apply to a particular firm.

By eliminating auditing oversight for self-proclaimed non-custody broker-dealers, H.R. 6021 would erode an important accountability mechanism and potentially put investors at risk.

For these reasons, we oppose H.R. 6021.

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[3] *See Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers*, PCAOB Release No. 2018–003 (Aug. 20, 2018), available at https://pcaobus.org/Inspections/Documents/Broker-Dealer-Auditor-Inspection-Annual-Report-2018.pdf.