SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240 and 249

[Release No. 34–70073; File No. S7–23–11]

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Broker-Dealer Reports

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (''Commission''), under the Securities Exchange Act of 1934 (''Exchange Act''), is amending certain broker-dealer annual reporting, audit, and notification requirements. The amendments include a requirement that broker-dealer audits be conducted in accordance with standards of the Public Company Accounting Oversight Board (''PCAOB'') in light of explicit oversight authority provided to the PCAOB by the Dodd-Frank Wall Street Reform and Consumer Protection Act (''Dodd-Frank Act'') to oversee these audits. The amendments further require a broker-dealer that clears transactions or carries customer accounts to agree to allow representatives of the Commission or the broker-dealer's designated examining authority (''DEA'') to review the documentation associated with certain reports of the broker-dealer's independent public accountant and to allow the accountant to discuss the findings relating to the reports of the accountant with those representatives when requested in connection with a regulatory examination of the broker-dealer. Finally, the amendments require a broker-dealer to file a new form with its DEA that elicits information about the broker-dealer's practices with respect to the custody of securities and funds of customers and non-customers.

DATES: This rule is effective June 1, 2014, except the amendment to § 240.17a–5(e)(5), which is effective October 21, 2013 and the amendments to § 240.17a–5(a) and (d)(6) and § 249.639, which are effective December 31, 2013.

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SUPPLEMENTARY INFORMATION: The Commission is adopting amendments to Rule 17a–5 (17 CFR 240.17a–5) and technical and conforming amendments to Rule 17a–11 (17 CFR 240.17a–11) and is adopting Form Custody (17 CFR 249. 639) under the Exchange Act.

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I. Background

A. Overview

In 2009, the Commission began reviewing rules regarding the safekeeping of investor assets in connection with several cases the Commission brought alleging fraudulent conduct by investment advisers and broker-dealers, including, among other things, misappropriation or other misuse of customer securities and funds.[1] As part of the rule review effort, the Commission amended Rule 206(4)–2 under the Investment Advisers Act of 1940 (''Rule 206(4)–2''), which governs the custody of client securities and funds by investment advisers.[2] When adopting this amendment, the Commission stated that it represented ''a first step in the effort to enhance custody protections, with consideration of additional enhancements of the rules governing custody of customer assets by broker-dealers to follow.'' [3]

In June 2011, the Commission proposed rule amendments and a new form designed, among other things, to provide additional safeguards with respect to broker-dealer custody of customer securities and funds.[4] The proposed amendments would have amended certain annual reporting, audit, and notification requirements for broker-dealers.[5] The proposed amendments also would have required a broker-dealer that clears transactions or carries customer accounts (each, a ''clearing broker-dealer'') to agree to allow representatives of the Commission or the broker-dealer's DEA to review the documentation associated with certain reports of the broker-dealer's independent public accountant and to allow the accountant to discuss with representatives of the Commission or DEA the accountant's findings associated with those reports when requested in connection with an examination of the broker-dealer.[6] Further, the proposed amendments would have required a broker-dealer to file with its DEA on a quarterly basis a new form—Form Custody—that would have elicited information as to whether, and if so how, a broker-dealer maintains custody of securities and funds of customers and others.[7] The Commission also proposed requiring that a broker-dealer file its annual reports with the Securities Investor Protection Corporation (''SIPC'').[8]

The proposed amendments were designed to enhance the ability of the Commission to oversee broker-dealer custody practices and, among other things, to: (1) Increase the focus of broker-dealers that maintain custody of customer funds and securities (''carrying broker-dealers'') and their independent public accountants on compliance, and internal control over compliance, with certain financial and custodial requirements; (2) strengthen and clarify broker-dealer audit and reporting requirements in order to facilitate consistent compliance with these requirements; (3) facilitate the ability of the PCAOB to implement the explicit oversight authority over broker-dealer audits provided to the PCAOB by the Dodd-Frank Act; [9] (4) ensure that SIPC receives the necessary information to assess whether the liquidation fund it maintains is appropriately sized to the risks of a large broker-dealer failure; (5) enable Commission and DEA examiners to conduct risk-based examinations of carrying and clearing broker-dealers by

[1] *See, e.g., SEC* v. *Bernard L. Madoff, et al.,* Litigation Release No. 20889 (Feb. 9, 2009); *SEC* v. *Stanford International Bank, et al.,* Litigation Release No. 20901 (Feb. 17, 2009); *SEC* v. *Donald Anthony Walker Young, et al.,* Litigation Release No. 21006 (Apr. 20, 2009); *SEC* v. *Isaac I. Ovid, et al.,* Litigation Release No. 20998 (Apr. 14, 2009); *SEC* v. *The Nutmeg Group, LLC, et al.,* Litigation Release No. 20972 (Mar. 25, 2009); *SEC* v. *WG Trading Investors, L.P., et al.,* Litigation Release No. 20912 (Feb. 25, 2009).

[2] *See Custody of Funds or Securities of Clients by Investment Advisers,* Investment Advisers Act of 1940 (''Advisers Act'') Release No. 2968 (Dec. 30, 2009), 75 FR 1456 (Jan. 11, 2010). *See also* 17 CFR 275.206(4)–2.

[3] *See Custody of Funds or Securities of Clients by Investment Advisers,* 75 FR at 1456.

[4] *See Broker-Dealer Reports,* Exchange Act Release No. 64676 (June 15, 2011), 76 FR 37572 (June 27, 2011).

[5] *Id.* at 37575–37583.

[6] *Id.* at 37583–37584.

[7] *Id.* at 37584–37592.

[8] *Id.* at 37592–37594.

[9] Public Law 111–203, 124 Stat. 1376, H.R. 4173 (July 21, 2010).

assisting the examiners in selecting areas of focus for their examinations; and (6) provide the Commission and the DEAs with a comprehensive overview of a broker-dealer's custody practices.[10]

The Commission received 27 comment letters on the proposal.[11] The Commission has considered the comments and, as discussed in detail below, is adopting the amendments and the new form with modifications, in part in response to comments received. A number of commenters stated that the Commission should coordinate with the Commodity Futures Trading Commission (''CFTC'') to account for broker-dealers that also are registered as futures commission merchants (''FCMs'') in order to align the broker-dealer reporting and audit requirements with FCM reporting and audit requirements.[12] The Commission staff is in discussions with the CFTC staff concerning ways to align the reporting and audit requirements for dually-registered broker-dealer/FCMs with the goal of coordinating these requirements, including the requirements that the Commission is adopting today.

B. Rules Governing Broker-Dealer Financial and Custodial Responsibility

Rule 15c3–1,[13] Rule 15c3–3,[14] and Rule 17a–13,[15] under the Exchange Act and applicable DEA rules that require broker-dealers to periodically send account statements to customers (''Account Statement Rules'')[16] (collectively for the purposes of this release, ''the financial responsibility rules'') are central to today's amendments to the broker-dealer reporting, audit, and notification requirements. In light of the significance of the financial responsibility rules to today's amendments, the following section briefly summarizes the requirements of each rule in order to provide a foundation for the later discussion of the amendments.

1. The Broker-Dealer Net Capital Rule

Rule 15c3–1 requires broker-dealers to maintain a minimum level of net capital (consisting of highly liquid assets) at all times.[17] In computing net capital, a broker-dealer must, among other things, calculate net worth in accordance with U.S. generally accepted accounting principles (''GAAP'') and then make certain adjustments to net worth, such as deducting illiquid assets and taking other capital charges and adding qualifying subordinated loans.[18] The amount remaining after these deductions is defined as ''tentative net capital.''[19] The final step in computing net capital is to deduct certain percentages (''haircuts'') from the market value of the broker-dealer's proprietary positions to account for the market risk inherent in the positions[20] and to create a buffer of liquidity to protect against other risks associated with the broker-dealer's business.[21] The broker-dealer must cease conducting a securities business if the amount of net capital maintained by the firm falls below the minimum required amount.[22]

2. The Broker-Dealer Customer Protection Rule

Rule 15c3–3 imposes two key requirements on a carrying broker-dealer: first, the broker-dealer must maintain physical possession or control over customers' fully paid and excess margin securities;[23] and second, the firm must maintain a reserve of funds or qualified securities[24] in an account at one or more banks that is at least equal in value to the amount of net funds owed to customers.[25] These requirements are designed to protect customers by requiring broker-dealers to segregate customers' securities and

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[10] The proposed amendments also were designed to avoid duplicative requirements for broker-dealers that are dually-registered as investment advisers in view of the internal control report requirement that was added by the amendment to Rule 206(4)–2. *See* discussion below in section VII.A. of this release identifying further motivations for the amendments.

[11] Comment letter of Naphtali M. Hamlet (June 22, 2011) (''*Hamlet Letter*''); comment letter of Robert R. Kelley (June 27, 2011) (''*Kelley Letter*''); comment letter of Chris Barnard (July 20, 2011) (''*Barnard Letter*''); comment letter of Suzanne Shatto (July 25, 2011) (''*Shatto Letter*''); comment letter of Suzanne H. Shatto (July 25, 2011) (''*Shatto Letter II*''); comment letter of Todd Genger (Aug. 2, 2011) (''*Genger Letter*''); comment letter of Suzanne Shatto (Aug. 14, 2011) (''*Shatto Letter III*''); comment letter of Deloitte & Touche LLP (Aug. 25, 2011) (''*Deloitte Letter*''); comment letter of the Securities Industry and Financial Markets Association (Aug. 25, 2011) (''*SIFMA Letter*''); comment letter of the Center for Audit Quality (Aug. 25, 2011) (''*CAQ Letter*''); comment letter of KPMG LLP (Aug. 25, 2011) (''*KPMG Letter*''); comment letter of PricewaterhouseCoopers, LLP (Aug. 25, 2011) (''*PWC Letter*''); comment letter of Citrin Cooperman & Co., LLP (Aug. 25, 2011) (''*Citrin Letter*''); comment letter of Grant Thornton LLP (Aug. 26, 2011) (''*Grant Thornton Letter*''); comment letter of James J. Angel (Aug. 26, 2011) (''*Angel Letter*''); comment letter of James J. Angel (Aug. 26, 2011) (''*Angel Letter II*''); comment letter of McGladrey & Pullen, LLP (Aug. 26, 2011) (''*McGladrey Letter*''); comment letter of the Certified Financial Planner Board of Standards, Inc. (Aug. 26, 2011) (''*CFP Letter*''); comment letter of Integrated Management Solutions USA LLC (Aug. 26, 2011) (''*IMS Letter*''); comment letter of the American Institute of Certified Public Accountants (Aug. 26, 2011) (''*AICPA Letter*''); comment letter of the Committee of Annuity Insurers (Aug. 26, 2011) (''*CAI Letter*''); comment letter of Ernst & Young LLP (Aug. 26, 2011) (''*E&Y Letter*''); comment letter of Van Kampen Funds Inc. and Invesco Distributors, Inc. (Aug. 26, 2011) (''*Van Kampen/Invesco Letter*''); comment letter of Suzanne H. Shatto (Sept. 13, 2011) (''*Shatto Letter IV*); comment letter N.M. Hamlet (Sept. 14, 2011) (''*Hamlet Letter II*''); comment letter of the Federal Regulation of Securities Committee, Business Law Section, American Bar Association (Sept. 15, 2011) (''*ABA Letter*''); and comment letter of the Committee of Annuity Insurers (Apr. 17, 2012) (''*CAI II Letter''*). The comment letters are available on the Commission's Web site at *http://www.sec.gov/comments/s7-23-11/s72311.shtml*. Comments are also available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC (File No. S7–23–11).

[12] *See CAQ Letter; Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter; PWC Letter.*

[13] 17 CFR 240.15c3–1 (a rule prescribing net capital requirements for broker-dealers).

[14] 17 CFR 240.15c3–3 (a rule prescribing requirements regarding the holding of customer securities and funds by broker-dealers).

[15] 17 CFR 240.17a–13 (a rule requiring broker-dealers to perform quarterly securities counts).

[16] *See, e.g.,* Rule 9.12 of the Chicago Board Options Exchange (''CBOE''); NASD Rule 2340 of the Financial Industry Regulatory Authoirty (''FINRA'').

[17] *See* 17 CFR 240.15c3–1. The rule requires that a broker-dealer perform two calculations: (1) A computation of the minimum amount of net capital the broker-dealer must maintain; and (2) a computation of the amount of net capital the broker-dealer is maintaining. *See* 17 CFR 240.15c3–1(a) and (c)(2). The computation of net capital is based on the definition of the term ''net capital'' in paragraph (c)(2) of Rule 15c3–1. *Id.* Generally, a broker-dealer's minimum net capital requirement is the greater of a fixed-dollar amount specified in the rule and an amount determined by applying one of two financial ratios. *See* 17 CFR 240.15c3–1(a).

[18] *See* 17 CFR 240.15c3–1(c)(2)(i)–(xiii).

[19] *See* 17 CFR 240.15c3–1(c)(15).

[20] *See* 17 CFR 240.15c3–1(c)(2)(vi).

[21] *See, e.g., Uniform Net Capital Rule,* Exchange Act Release No. 13635 (June 16, 1977), 42 FR 31778 (June 23, 1977).

[22] *See* 15 U.S.C. 78o(c)(3)(A).

[23] *See* 17 CFR 240.15c3–3(d). *Control* means the broker-dealer must hold these securities free of lien in one of several locations specified in the rule (*e.g.,* at a bank or clearing agency). *See* 17 CFR 240.15c3–3(c). The broker-dealer must make a daily determination from its books and records (as of the preceding day) of the quantity of fully paid and excess margin securities not in its possession or control. *See* 17 CFR 240.15c3–3(d). If the amount in the broker-dealer's possession or control is less than the amount indicated as being held for customers on the broker-dealer's books and records, the broker-dealer generally must initiate steps to retrieve customer securities from non-control locations or otherwise obtain possession of them or place them in control locations. *Id.* The terms *fully paid securities, margin securities,* and *excess margin securities* are defined in Rule 15c3–3. *See* 17 CFR 240.15c3–3(a)(3), (a)(4), and (a)(5), respectively.

[24] The term *qualified security* is defined in Rule 15c3–3 to mean a security issued by the U.S. or a security in respect of which the principal and interest are guaranteed by the U.S. *See* 17 CFR 240.15c3–3(a)(6).

[25] *See* 17 CFR 240.15c3–3(e). The amount of the net funds owed to customers (''customer reserve requirement'') is computed by adding customer credit items (*e.g.,* cash in securities accounts) and subtracting from that amount customer debit items (*e.g.,* margin loans) pursuant to a formula in Exhibit A to Rule 15c3–3. *See* 17 CFR 240.15c3–3a. Carrying broker-dealers are required to compute the customer reserve requirement on a weekly basis, except where customer credit balances do not exceed $1 million (in which case the computation can be performed monthly, although the broker-dealer must maintain 105% of the required deposit amount and may not exceed a specified aggregate indebtedness limit). *See* 17 CFR 240.15c3–3(e)(3).

funds from the broker-dealer's proprietary business activities. If the broker-dealer fails financially, customers' securities and funds should be readily available to be returned to customers. In addition, if the failed broker-dealer is liquidated in a proceeding under the Securities Investor Protection Act of 1970 (''SIPA''), as amended, the customers' securities and funds should be isolated and readily identifiable as ''customer property'' and, consequently, available to be distributed to customers ahead of other creditors.[26]

Provisions of Rule 15c3–3 exempt a broker-dealer from the requirements of Rule 15c3–3 under certain circumstances.[27] Generally, a broker-dealer is exempt from Rule 15c3–3 if it does not hold customer securities or funds, or, if it does receive customer securities or funds, it promptly delivers the securities or promptly transmits the funds to appropriate persons.[28]

3. The Broker-Dealer Quarterly Securities Count Rule

Rule 17a–13 generally requires a broker-dealer that maintains custody of securities (proprietary, customer, or both), on a quarterly basis, to physically examine and count the securities it holds, account for the securities that are subject to its control or direction but are not in its physical possession (*e.g.,* securities held at a control location), verify the locations of securities under certain circumstances, and compare the results of the count and verification with its records.[29] In accordance with a schedule, the broker-dealer must take an operational capital charge under Rule 15c3–1 for short securities differences (which include securities positions reflected on the broker-dealer's securities record that are not susceptible to either count or confirmation) that are unresolved after discovery.[30] The differences also must be recorded in the broker-dealer's books and records.[31]

4. The Broker-Dealer Account Statement Rules

The Account Statement Rules of DEAs require member broker-dealers to send, at least once every calendar quarter, a statement of account containing a description of any securities positions, money balances, or account activity to each customer whose account had a security position, money balance, or account activity during the period since the last such statement was sent to the customer.[32] The Account Statement Rules provide a key safeguard for customers by requiring that they receive information concerning securities positions and other assets held in their accounts on a regular basis, which they can use to identify discrepancies and monitor the performance of their accounts.

II. Final Amendments to Broker-Dealer Reporting, Audit, Notification, and Other Requirements

A. Overview of New Requirements

The Commission is adopting amendments to the reporting, audit, and notification requirements in Rule 17a–5, and additional amendments to other provisions of the rule, including technical changes. The Commission also is adopting amendments to the notification requirements in Rule 17a–11, and certain other technical amendments to that rule.

Under the amendments to the reporting and audit requirements, broker-dealers must, among other things, file with the Commission annual reports consisting of a financial report and either a compliance report or an exemption report that are prepared by the broker-dealer, as well as certain reports that are prepared by an independent public accountant covering the financial report and the compliance report or the exemption report.[33] The filing of a compliance or exemption report and the related report of the independent public accountant are new requirements. The financial report must contain the same types of financial statements that were required to be filed under Rule 17a–5 prior to these amendments (a statement of financial condition, a statement of income, a statement of cash flows, and certain other financial statements).[34] In addition, the financial report must contain, as applicable, the supporting schedules that were required to be filed under Rule 17a–5 prior to these amendments (a computation of net capital under Rule 15c3–1, a computation of the reserve requirements under Rule 15c3–3, and information relating to the possession or control requirements under Rule 15c3–3).[35]

A broker-dealer that did not claim that it was exempt from Rule 15c3–3 throughout the most recent fiscal year must file the compliance report, and a broker-dealer that did claim it was exempt from Rule 15c3–3 throughout the most recent fiscal year (generally, a ''non-carrying broker-dealer'') must file the exemption report.[36] Broker-dealers must make certain statements and provide certain information relating to the financial responsibility rules in these reports.[37]

In addition to preparing and filing the financial report and the compliance report or exemption report, a broker-dealer must engage a PCAOB-registered independent public accountant to prepare a report based on an examination of the broker-dealer's financial report in accordance with PCAOB standards.[38] A carrying broker-dealer also must engage the PCAOB-registered independent public accountant to prepare a report based on an examination of certain statements in the broker-dealer's compliance report.[39] A non-carrying broker-dealer must engage the PCAOB-registered independent public accountant to prepare a report based on a review of certain statements in the broker-dealer's exemption report.[40] In each case, the examination or review must be conducted in accordance with PCAOB standards. The broker-dealer must file these reports with the Commission along with the financial report and the compliance report or exemption report prepared by the broker-dealer.[41]

The annual reports also must be filed with SIPC if the broker-dealer is a member of SIPC.[42] In addition, broker-dealers must generally file with SIPC a supplemental report on the status of the membership of the broker-dealer in SIPC.[43] The supplemental report must include a report of the independent public accountant that covers the SIPC annual general assessment reconciliation or exclusion from membership forms based on certain

[26] *See* 15 U.S.C. 78aaa *et seq.*

[27] *See* 17 CFR 240.15c3–3(k).

[28] *Id.*

[29] *See* 17 CFR 240.17a–13(b).

[30] *See* 17 CFR 240.15c3–1(c)(2)(v).

[31] *See* 17 CFR 240.17a–3(a)(4)(vi).

[32] *See, e.g.,* CBOE Rule 9.12; NASD Rule 2340.

[33] *See* paragraph (d) of Rule 17a–5.

[34] *See* paragraph (d)(2)(i) of Rule 17a–5. The requirements for the financial report are discussed below in more detail in section II.B.2. of this release.

[35] *See* paragraph (d)(2)(ii) of Rule 17a–5.

[36] *See* paragraphs (d)(1)(i)(B)(*1*) and (*2*) of Rule 17a–5.

[37] *See* paragraphs (d)(3) and (4) of Rule 17a–5. The requirements for the compliance report and the exemption report are discussed below in more detail in section II.B.3. and section II.B.4. of this release, respectively.

[38] *See* paragraphs (f)(1) and (g)(1) of Rule 17a–5.

[39] *See* paragraphs (f)(1) and (g)(2)(i) of Rule 17a–5.

[40] *See* paragraphs (f)(1) and (g)(2)(ii) of Rule 17a–5.

[41] *See* paragraph (d)(1)(i)(C) of Rule 17a–5. The requirements for the engagement of the independent public accountant are discussed below in more detail in section II.D.3. of this release.

[42] *See* paragraph (d)(6) of Rule 17a–5. This requirement is discussed below in more detail in section II.B.6. of this release.

[43] *See* paragraph (e)(4) of Rule 17a–5. This requirement is discussed below in more detail in section II.C.4. of this release.

procedures specified in the rule. In the future, SIPC may determine the format of this report by rule, subject to Commission approval.[44]

Finally, the PCAOB-registered independent public accountant must immediately notify the broker-dealer if the accountant determines during the course of preparing the accountant's reports that the broker-dealer is not in compliance with the financial responsibility rules or if the accountant determines that any material weakness exists in the broker-dealer's internal control over compliance with the financial responsibility rules.[45] The broker-dealer, in turn, must file a notification with the Commission and its DEA under Rule 15c3–1, Rule 15c3–3, or Rule 17a–11 if the independent public accountant's notice concerns an instance of non-compliance that would trigger notification under those rules.[46] Under the amendments to Rule 17a–11, a broker-dealer also must file a notification with the Commission and its DEA if the broker-dealer discovers or is notified by the independent public accountant of the existence of any material weakness (as defined in the amendments) in the broker-dealer's internal control over compliance with the financial responsibility rules.[47]

Each of these amendments is discussed in more detail in the following sections of this release.

B. Annual Reports To Be Filed—Paragraph (d) of Rule 17a–5

Prior to today's amendments, paragraph (d) of Rule 17a–5 generally required a broker-dealer to annually file the financial statements and supporting schedules discussed below in section II.B.2. of this release and a report prepared by the broker-dealer's independent public accountant covering the financial statements and supporting schedules.[48] The Commission proposed amendments that would, among other things, restructure paragraph (d) and—as part of the proposed revisions to the attestation engagement provisions—add the requirement that a broker-dealer file either a compliance report or an exemption report, as applicable, and a report prepared by the broker-dealer's independent public accountant based on an examination of the compliance report or a review of the exemption report.[49] As discussed in sections II.B.1. through II.B.6. of this release, the Commission is adopting the proposed amendments to paragraph (d) with modifications.[50]

1. Requirement To File Reports—Paragraph (d)(1) of Rule 17a–5

i. Proposed Amendments

The Commission proposed to amend paragraph (d)(1) of Rule 17a–5 [51] to require that a broker-dealer file a financial report containing financial statements and supporting schedules and either a compliance report or an exemption report, as applicable.[52] The proposal provided that a broker-dealer must file a compliance report ''unless the [broker-dealer] is exempt from the provisions of [Rule 15c3–3]'' in which case the broker-dealer would be required to file an exemption report.[53] The proposed amendments also would have required a broker-dealer generally to file reports prepared by an independent public accountant covering the financial report and compliance report or exemption report, as applicable, unless the broker-dealer was exempt from the requirement to file the reports or from the requirement to engage an independent public accountant with respect to the reports.[54] To accommodate these changes, the Commission also proposed to reorganize the provisions of paragraph (d)(1) of Rule 17a–5, and to make other technical amendments.[55]

The proposed amendments with respect to the compliance report and exemption report set forth different requirements for carrying broker-dealers as compared with broker-dealers that do not hold customer securities and funds.[56] In order to provide clarity with respect to this distinction, the proposed amendments referenced Rule 15c3–3, which applies to carrying broker-dealers and contains provisions under which a broker-dealer is exempt from the requirements in the rule. The goal was to establish a clear way of determining whether a broker-dealer would need to file a compliance report or an exemption report. However, not all broker-dealers that are subject to Rule 15c3–3 regularly hold customer securities or funds. This prompted the Commission to inquire in the proposing release as to whether there are broker-dealers that would not qualify to file the proposed exemption report because they are not exempt from Rule 15c3–3, but that should be allowed to file a more limited report than the proposed compliance report based on the limited scope of their business.[57]

ii. Comments Received

The Commission received several comments on its proposed amendments to paragraph (d)(1) of Rule 17a–5.[58] Some commenters asked whether the provision that would require the broker-dealer to file an exemption report instead of a compliance report related to a period end date or to a period of time.[59] Further, as discussed in more detail in sections II.B.4. and II.D.3. of this release, commenters raised questions and concerns about how instances of exceptions to meeting the exemption provisions of paragraph (k) of Rule 15c3–3 would be treated under the proposed reporting requirements.[60] One commenter also stated that ''limited purpose'' carrying broker-dealers should not be required to file a compliance report, and broker-dealers with certain business model characteristics should not be required to file the compliance report.[61] Similarly, another commenter stated that broker-dealers engaging

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[44] *Id.* Currently, Rule 17a–5 prescribes the format of the report. *See* 17 CFR 240.17a–5.

[45] *See* paragraph (h) of Rule 17a–5. As discussed below, material weakness is defined for purposes of the compliance report and, therefore, the notification of a material weakness only can occur in the context of the audit of a broker-dealer that files a compliance report.

[46] *Id.* Notifications under Rule 17a–11 also must be filed with the CFTC if the broker-dealer is registered as a FCM with the CFTC. *See* 17 CFR 240.17a–11(g).

[47] *See* paragraph (e) of Rule 17a–11. These notification provisions are discussed below in more detail in section II.F. of this release.

[48] *See* 17 CFR 240.17a–5(d)(1)(i). Certain types of broker-dealers were exempt from the requirement to file the reports or to file reports that had been audited by an independent public accountant. *See* 17 CFR 240.17a–5(d)(1)(ii)–(iii).

[49] *See Broker-Dealer Reports,* 76 FR at 37575–37581.

[50] Before today's amendments, paragraph (d) of Rule 17a–5 was titled ''Annual filing of audited financial statements.'' In the proposing release, the Commission proposed to change the title to ''Annual reports'' to reflect that, under the proposed amendments to paragraph (d), broker-dealers would be required to prepare and file two reports with the Commission—a financial report and a compliance report or an exemption report. *See Broker-Dealer Reports,* 76 FR at 37575. The Commission received no comments on this proposal and is adopting the new title as proposed. *See* paragraph (d) of Rule 17a–5. In addition, the Commission is making a technical amendment to paragraph (d) of Rule 17a–5 to replace the term ''fiscal or calendar year'' with the term ''fiscal year.'' The Commission is adopting this technical amendment because the term ''fiscal year'' includes instances in which December 31st, *i.e.,* the calendar year end, is the broker-dealer's fiscal year end.

[51] *See* 17 CFR 240.17a–5(d)(1).

[52] *See Broker-Dealer Reports,* 76 FR at 37575.

[53] *Id.*

[54] *Id.*

[55] *Id.* at 37575–37578, 37603–37604.

[56] *Id.* at 37575–37578, 37580–37581 (discussing the compliance report and exemption report, respectively).

[57] *Id.* at 37581.

[58] *See, e.g., CAI Letter; CAI II Letter; CAQ Letter; Citrin Letter; Deloitte Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter.*

[59] *See CAQ Letter; Deloitte Letter; Grant Thornton Letter; KPMG Letter.*

[60] *See CAI Letter; SIFMA Letter.*

[61] *See CAI Letter; CAI II Letter.*

exclusively in proprietary trading or investment banking may not technically be exempt from Rule 15c3–3 but nonetheless should not have to file the compliance report as they do not have ''customers.'' [62] Finally, one commenter stated that the Commission should clarify who must sign the compliance reports and exemption reports and the liability that attaches in the event of a misstatement or omission in the reports.[63]

iii. The Final Rule

After considering these comments, the Commission is adopting the proposed amendments with certain modifications.[64] Under the final rule, all broker-dealers generally must prepare and file a financial report and either the compliance report or the exemption report.[65] A broker-dealer that did not claim an exemption from Rule 15c3–3 at any time during the most recent fiscal year or claimed an exemption for only part of the fiscal year must prepare and file the compliance report.[66] A broker-dealer must prepare and file the exemption report if the firm *did claim* that it was exempt from Rule 15c3–3 throughout the most recent fiscal year.[67] Broker-dealers also must file reports prepared by a PCAOB-registered independent public accountant covering the financial report and the compliance report or exemption report, as applicable.[68]

The final rule is modified from the proposal in three key ways. First, the final rule provides that the broker-dealer must file the exemption report if it did ''claim that it was exempt'' from Rule 15c3–3 [69] throughout the most recent fiscal year.[70] This modification from the proposal—which provided that a broker-dealer ''shall'' file the exemption report if the broker-dealer ''is exempt from the provisions of [Rule 15c3–3]''—is designed to provide greater clarity as to whether a broker-dealer must file the exemption report (as opposed to the compliance report), particularly when the broker-dealer had exceptions to meeting the exemption provisions in paragraph (k) of Rule 15c3–3 during the fiscal year.[71] Specifically, if the broker-dealer claimed an exemption from Rule 15c3–3 in its *Financial and Operational Combined Uniform Single Reports* (''FOCUS Reports'') throughout the fiscal year,[72] it must file the exemption report even it had exceptions to the exemption provisions.[73] Consequently, the applicability of the exemption report under the final rule is based on an objective and easily ascertainable factor: whether the broker-dealer claimed an exemption from Rule 15c3–3 throughout the most recent fiscal year.[74]

As noted above, several commenters argued that broker-dealers that engage in limited custodial activities and, therefore, are not exempt from Rule 15c3–3, should not be required to file a compliance report.[75] Specifically, one of these commenters suggested that a ''new'' category of ''limited purpose'' broker-dealer with certain business model characteristics should be addressed in the rule and that this ''new'' category of broker-dealer should not be required to file the compliance report.[76] The Commission has considered these comments but has determined not to provide for a broader exception from the requirement to file a compliance report for broker-dealers with limited custodial activities. The objectives of the compliance report and related examination of the compliance report are intended, among other things, to ''increase the focus of independent public accountants on the custody practices of broker-dealers'' and to ''help identify broker-dealers that have weak controls for safeguarding investor assets.'' [77] Therefore, broker-dealers that hold customer assets—even if their custodial activities are limited—generally should be subject to the requirement to file the compliance report and related accountant's report.[78]

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[62] *See McGladrey Letter.*

[63] *See CAI Letter.*

[64] *See* paragraph (d)(1) of Rule 17a–5. Paragraph (d)(1)(iii) of Rule 17a–5 (now re-designated as paragraph (d)(1)(iv)) contains an exemption from filing an annual report if the broker-dealer is a member of a national securities exchange and has transacted business in securities solely with or for other members of a national securities exchange, and has not carried any margin account, credit balance or security for any person who is defined as a ''customer'' in paragraph (c)(4) of Rule 17a–5. *See* paragraph (d)(1)(iv) of Rule 17a–5. The Commission also proposed to move the exemptions from having to file financial statements under paragraph (d) of Rule 17a–5 from paragraphs (d)(1)(ii) and (d)(1)(iii) of Rule 17a–5 to paragraphs (d)(1)(iii) and (d)(1)(iv), respectively. The Commission received no comments on these amendments and is adopting them as proposed. *See* paragraphs (d)(1)(iii) and (d)(1)(iv) of Rule 17a–5. For clarity, the amendments to paragraph (d)(1)(i) of Rule 17a–5 include a reference to the exemptions from the requirement for a broker-dealer to file the annual reports so that the paragraph now states ''[e]xcept as provided in paragraphs (d)(1)(iii) and (d)(1)(iv) of this section, every broker or dealer registered under section 15 of the Act must file annually . . . .'' *See* paragraph (d)(1)(i) of Rule 17a–5. As proposed, the final rule provided that the reports must be filed annually ''on a calendar or fiscal year basis.'' The final rule deletes the phrase ''on a calendar or fiscal year basis'' as the rule provides elsewhere that the annual reports must be filed on a fiscal year basis. *Id.* In addition, the Commission proposed to move the requirement that reports under paragraph (d) of Rule 17a–5 be as of the same fixed or determinable date each year, unless a change is approved in writing by the broker-dealer's DEA, from paragraph (d)(1)(i) of Rule 17a–5 to paragraph (d)(1)(ii). The Commission received no comments on this proposed amendment and is adopting it substantially as proposed. *See* paragraph (d)(1)(ii) of Rule 17a–5. The final rule also includes a technical modification from the proposal to require that the reports required to be filed under paragraph (d) must be as of the same ''fiscal year end each year,'' rather than as of the same ''fixed or determinable date each year.'' *See* paragraph (d)(1)(ii) of Rule 17a–5. This change, by having the rule refer to the broker-dealer's ''fiscal year,'' eliminates outdated language and conforms the language in paragraph (d) of Rule 17a–5 to language in paragraph (n) of Rule 17a–5. *See* 17 CFR 240.17a–5(n). The final rule also adds a clarifying cross-reference to the provision in Rule 17a–5 pursuant to which a broker-dealer requests a change of its fiscal year end. *See* paragraph (d)(1)(i) of Rule 17a–5. Furthermore, the final rule requires that a copy of the written approval by the broker-dealer's DEA of a change in the broker-dealer's fiscal year be sent to the Commission's principal office in Washington, DC, in addition to the regional office of the Commission for the region in which the broker-dealer has its principal place of business. *Id.* This change is consistent with paragraph (n) of Rule 17a–5, which requires that when a broker-dealer changes its fiscal year, it must file a notice with the Commission's principal office in Washington, DC as well as the regional office of the Commission for the region in which the broker-dealer has its principal place of business. *See* 17 CFR 240.17a–5(n).

[65] *See* paragraph (d)(1)(i) of Rule 17a–5. The financial report, compliance report, and exemption report are discussed below in more detail in sections II.B.2., II.B.3., and II.B.4., respectively, of this release.

[66] *See* paragraph (d)(1)(i)(B)(*1*) of Rule 17a–5.

[67] *See* paragraph (d)(1)(i)(B)(*2*) of Rule 17a–5.

[68] *See* paragraph (d)(1)(i)(C) of Rule 17a–5. The proposed requirements and final rule with respect to the attestation engagement for the independent public accountant are discussed below in section II.D. of this release.

[69] *See* paragraph (d)(1)(i)(B)(2) of Rule 17a–5. A broker-dealer claiming an exemption from Rule 15c3–3 is required to indicate the basis for the exemption on the periodic reports it files with securities regulators. *See, e.g.,* Item 24 of Part IIa of the Financial and Operational Combined Uniform Single Report. *See* 17 CFR 249.617.

[70] As discussed below in more detail in section II.B.4. of this release, the provisions of paragraph (k) of Rule 15c3–3 prescribe ''exemptions'' from the requirements of Rule 15c3–3. *See* 17 CFR 240.15c3–3(k)(1), (k)(2)(i), (k)(2)(ii), and (k)(3).

[71] *See CAI Letter; SIFMA Letter.*

[72] The FOCUS Reports are: Form X–17A–5 Schedule I; Form X–17A–5 Part II; Form X–17A–5 Part IIa; Form X–17A–5 Part IIb; and Form X–17A–5 Part III.

[73] As discussed in detail below in section II.B.4. of this release, a broker-dealer that has exceptions to meeting the exemption provisions in paragraph (k) of Rule 15c3–3 must identify them in the exemption report.

[74] *See* discussion in section II.B.4. of this release. There may be circumstances in which a broker-dealer has not held customer securities or funds during the fiscal year, but does not fit into one of the exemptive provisions listed under Item 24 of Part IIa. Even though there is not a box to check on the FOCUS Report, these broker-dealers should file an exemption report and related accountant's report.

[75] *See, e.g., CAI Letter; CAI II Letter; McGladrey Letter.*

[76] *See CAI II Letter.*

[77] *See Broker-Dealer Reports,* 76 FR at 37599.

[78] Broker-dealers with extremely limited custodial activities (*e.g.,* holding customer checks made out to a third party for limited periods of

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The level of effort required by carrying broker-dealers to prepare a compliance report will depend on the nature and extent of their activities. For example, the controls of a carrying broker-dealer that engages in limited custodial activities could be less complex than the controls of a carrying broker-dealer that engages in more extensive custodial activities.[79] Therefore, this requirement is intended to be scalable so that a carrying broker-dealer with limited custodial activities generally should have to expend less effort to support its statements in the compliance report, particularly with respect to the statements relating to Rules 15c3–3 and 17a–13.

The second key modification is that the final rule provides that the requirement to file the exemption report applies if the broker-dealer did claim that it was exempt from Rule 15c3–3 ''throughout the most recent fiscal year.'' [80] Thus, a broker-dealer that did not claim an exemption from Rule 15c3–3 at any time during the most recent fiscal year or claimed an exemption for only part of the fiscal year must file the compliance report.[81]

The third key modification is that the final rule specifies the individual who must execute the compliance reports and exemption reports.[82] As noted above, one commenter stated that the Commission should make clear who should sign the compliance reports and exemption reports and what liability attaches in the event of a misstatement or omission.[83] The commenter suggested a reasonableness standard, and stated that the Commission should make clear that the reports do not create a new private right of action.[84] In response to this comment, the final rule provides that the compliance report and the exemption report must be executed by the person who makes the oath or affirmation under paragraph (e)(2) of Rule 17a–5.[85] As discussed below in more detail in section II.C.2. of this release, paragraph (e)(2) of Rule 17a–5 requires an oath or affirmation to be attached to the financial report and provides that the oath or affirmation must be made by certain types of persons depending on the corporate form of the broker-dealer (*e.g.,* a duly authorized officer if the broker-dealer is a corporation).[86] The requirement to file these new reports with the Commission is not intended to establish a new private cause of action.

2. The Financial Report—Paragraph (d)(2) of Rule 17a–5

Before today's amendments, paragraph (d)(2) of Rule 17a–5 required that the annual audited report of a broker-dealer contain certain financial statements in a format consistent with Form X–17A–5 Part II or Form X–17A–5 Part IIa, as applicable, including a statement of financial condition, an income statement, a statement of cash flows, a statement of changes in owners' equity, and a statement of changes in liabilities subordinated to claims of general creditors.[87] Paragraph (d)(3) of Rule 17a–5 required that the annual audited report contain supporting schedules, including a computation of net capital under Rule 15c3–1, a computation for determining reserve requirements under Rule 15c3–3, and information relating to the possession and control requirements of Rule 15c3–3.[88] Paragraph (d)(4) of Rule 17a–5 required a reconciliation between the net capital and reserve computations in the audited report and those in the most recent Form X–17A–5 Part II or Form X–17A–5 Part IIa, if there were material differences between the annual audited report and the form.[89]

The Commission proposed combining the provisions in paragraphs (d)(2) through (d)(4) of Rule 17a–5 in revised paragraph (d)(2) without substantive modification to those provisions.[90] In addition, the Commission proposed that revised paragraph (d)(2) be titled ''Financial report'' to reflect that the information required in this report would be financial in nature and to differentiate it from the proposed compliance reports and exemption reports. The Commission did not receive comments concerning the amendments to paragraph (d)(2) of Rule 17a–5 and is adopting them substantially as proposed.[91]

3. The Compliance Report—Paragraph (d)(3) of Rule 17a–5

i. The Proposed Amendments

As proposed, the requirements for the contents of the compliance report were prescribed in paragraph (d)(3) of Rule 17a–5.[92] Under the proposal, a carrying broker-dealer would need to include in the compliance report a specific statement, certain assertions, and descriptions.[93] The independent public accountant would examine the assertions in the compliance report in preparing the report of the accountant.[94]

time) could seek exemptive relief under section 36 of the Exchange Act (15 U.S.C. 77mm) from the requirement to file the compliance report and report of the independent public accountant covering the compliance report.

[79] As discussed below in section II.D. of this release, the PCAOB has proposed attestation standards for an independent public accountant's examination of the compliance report and the review of the exemption report. The proposed examination standard provides procedural requirements for independent public accountants that are ''designed to be scalable based on the broker's or dealer's size and complexity.'' *See Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards,* PCAOB Release No. 2011–004, PCAOB Rulemaking Docket Matter No. 035 (July 12, 2011) at 8 (''*PCAOB Proposing Release*'').

[80] *See* paragraphs (d)(1)(i)(B)(*1*)–(*2*) of Rule 17a–5.

[81] There will be cases where a broker-dealer changes its business model to convert from a carrying broker-dealer to a non-carrying broker-dealer during the fiscal year. In this case, the broker-dealer could seek exemptive relief under section 36 of the Exchange Act (15 U.S.C. 78mm) from the requirement to file the compliance report and to instead file the exemption report. In analyzing such a request, the period of time the broker-dealer operated as a carrying broker-dealer would be a relevant consideration.

[82] *See* paragraphs (d)(1)(i)(B)(*1*)–(*2*) of Rule 17a–5.

[83] *See CAI Letter.* The filings discussed above constitute a ''report'' for purposes of 15 U.S.C. 78ff(a) and other applicable provisions of the Exchange Act. As a consequence, it would be unlawful for a broker-dealer to willfully make or cause to be made, a false or misleading statement of a material fact or omit to state a material fact in the filings.

[84] *Id.*

[85] *See* paragraphs (d)(1)(i)(B)(*1*)–(*2*) of Rule 17a–5.

[86] *See* paragraph (e)(2) of Rule 17a–5.

[87] *See* 17 CFR 240.17a–5(d)(2). As noted above, Form X–17A–5 Part II and Form X–17A–5 Part IIa are among the FOCUS Reports that broker-dealers complete and file with the Commission or their DEA on a periodic basis. *See* 17 CFR 240.17a–5(a) and 17 CFR 249.617. These two forms require broker-dealers to file monthly or quarterly financial information with the Commission or their DEA, including information about the broker-dealer's: (1) Assets and liabilities; ownership equity; net capital computation under Rule 15c3–1; minimum net capital requirement under Rule 15c3–1; income (loss); computation of the customer reserve requirement under Rule 15c3–3 in the case of Form X–17A–5 Part II; the possession and control requirements under Rule 15c3–3 in the case of Form X–17A–5 Part II; and changes in ownership equity.

[88] *See* 17 CFR 240.17a–5(d)(3).

[89] *See* 17 CFR 240.17a–5(d)(4).

[90] *See Broker-Dealer Reports,* 76 FR at 37575.

[91] *See* paragraph (d)(2) of Rule 17a–5. The Commission has made plain English changes to the language of the paragraph (*e.g.,* replacing the term ''shall'' with ''must''). The Commission also, consistent with current practice, has clarified that the financial statements must be prepared in accordance with U.S. GAAP to distinguish from other accounting frameworks. *See* paragraph (d)(2) of Rule 17a–5. In addition, the Commission has replaced the words ''notes to the consolidated statement of financial condition'' with ''notes to the financial statements.'' This change in terminology is designed to conform the language in Rule 17a–5 to current accounting practice. Under GAAP, notes to a complete set of financial statements must cover all the financial statements, and not just one of the statements, such as the consolidated statement of financial condition.

[92] *See Broker-Dealer Reports,* 76 FR at 37575–37578.

[93] *Id.*

[94] *Id.* The independent public accountant would not have been required to examine the proposed

Specifically, as proposed, the carrying broker-dealer would be required to include in the compliance report a statement as to whether the firm has established and maintained a system of internal control to provide the broker-dealer with reasonable assurance that any instances of material non-compliance with the financial responsibility rules will be prevented or detected on a timely basis.[95] In addition, the compliance report would need to include the following three assertions: (1) Whether the broker-dealer was in compliance in all material respects with the financial responsibility rules as of its fiscal year end; (2) whether the information used to assert compliance with the financial responsibility rules was derived from the books and records of the broker-dealer; and (3) whether internal control over compliance with the financial responsibility rules was effective during the most recent fiscal year such that there were no instances of material weakness.[96] Finally, the carrying broker-dealer would need to include in the compliance report a description of each identified instance of material non-compliance and each identified material weakness in internal control over compliance with the financial responsibility rules.[97] The independent public accountant would examine the assertions in preparing the report of the accountant.[98] The independent public accountant would not examine the statement regarding the establishment of the system of internal control.

Under the proposal, the broker-dealer would not be able to assert compliance with the financial responsibility rules as of its most recent fiscal year end if it identified one or more instances of material non-compliance.[99] Similarly, the broker-dealer would not be able to assert that its internal control over compliance with the financial responsibility rules during the fiscal year was effective if one or more material weaknesses existed with respect to internal control over compliance.[100]

An instance of *material non-compliance* was proposed to be defined as a failure by the broker-dealer to comply with any of the requirements of the financial responsibility rules in all material respects.[101] When determining whether an instance of non-compliance is material, the Commission stated that the broker-dealer should consider all relevant factors including but not limited to: (1) The nature of the compliance requirements, which may or may not be quantifiable in monetary terms; (2) the nature and frequency of non-compliance identified; and (3) qualitative considerations.[102] The Commission also stated that some deficiencies would necessarily be instances of material non-compliance, including failing to maintain the required minimum amount of net capital under Rule 15c3–1 or failing to maintain the minimum deposit requirement in a special reserve bank account for the exclusive benefit of customers under Rule 15c3–3.[103]

The term *material weakness* was proposed to be defined as a deficiency, or a combination of deficiencies, in internal control over compliance with the financial responsibility rules, such that there is a reasonable possibility that material non-compliance with the financial responsibility rules will not be prevented or detected on a timely basis.[104] The proposed definition of material weakness was modeled on the definition of material weakness in a Commission rule—Rule 1–02(a)(4) of Regulation S–X [105]—and in auditing literature governing financial reporting.[106] In the proposing release, the Commission stated that a deficiency in internal control over compliance would exist when the design or operation of a control does not allow the broker-dealer, in the normal course of performing its assigned functions, to prevent or detect non-compliance with the financial responsibility rules on a timely basis.[107] The Commission also stated that, for purposes of the proposed definition of the term *material weakness,* there is a reasonable possibility of an event occurring if it is probable or reasonably possible.[108] The Commission further stated that an event is probable if the future event or events are likely to occur and that an event is reasonably possible if the chance of the future event or events occurring is more than remote, but less than likely.[109]

ii. Comments Received

The Commission received a number of comments on the proposed compliance report. Generally, the comments focused on the intended scope of the compliance report and the assertions to be included. Specifically, many commenters raised concerns about what would constitute ''material non-compliance.'' [110] Several of these commenters urged the Commission to provide guidance with additional specific examples or quantitative and qualitative factors to be considered when determining whether non-compliance was material.[111] One commenter proposed alternate definitions for material non-compliance and material weakness and provided examples of non-compliance that should not be regarded as material.[112]

Commenters also addressed the time period covered by the assertion relating to effectiveness of internal control. In particular, some commenters stated that the proposed assertion that internal control was effective should be as of a point in time, as opposed to ''during the fiscal year.'' [113] One commenter stated that broker-dealers that must file the internal control report required under

''statement'' and descriptions in the compliance report.

[95] *See Broker-Dealer Reports,* 76 FR at 37575–37576.

[96] *Id.*

[97] *Id.*

[98] *Id.* GAAS and PCAOB standards for attestation engagements provide that accountants ordinarily should obtain written assertions in an examination or review engagement. *See, e.g.,* PCAOB Interim Attestation Standard, *AT Section 101* at ¶ .09. Accordingly, the Commission proposed that the independent public accountant's report cover only the three assertions in the compliance report.

[99] *See Broker-Dealer Reports,* 76 FR at 37576–37577.

[100] *Id.* at 37577.

[101] *Id.*

[102] *Id.*

[103] *Id.*

[104] *Id.*

[105] *See* 17 CFR 210.1–02(a)(4); 17 CFR 240.12b–2.

[106] *See* PCAOB Auditing Standard, *AS No. 5* app. A at ¶ A7; American Institute of Certified Public Accountants (''AICPA''), *AU Section 325* at ¶ .06.

[107] *See Broker-Dealer Reports,* 76 FR at 37577.

[108] *Id. See also Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934,* Securities Act of 1933 Release No. 8810 (June 20, 2007), 72 FR 35324, 35332 n.47 and corresponding text (June 27, 2007).

[109] *Broker-Dealer Reports,* 76 FR at 37577. The Commission has stated in other contexts that there is a reasonable possibility of an event occurring if it is ''probable'' or ''reasonably possible.'' *See Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting,* Exchange Act Release No. 55928 (June 20, 2007), 72 FR 35310 (June 27, 2007). *See also* 17 CFR 240.12b-2; 17 CFR 210.1–02. Commission guidance provides that an event is ''probable'' if the future event or events are likely to occur, and that an event is ''reasonably possible'' if the chance of the future event or events occurring is more than remote, but less than likely. *See Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934,* 72 FR at 35332 n.47 and corresponding text.

[110] *See ABA Letter; CAI Letter; CAQ Letter; Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter; PWC Letter; SIFMA Letter; Van Kampen/Invesco Letter.*

[111] *See ABA Letter; CAQ Letter; E&Y Letter; KPMG Letter; McGladrey Letter; PWC Letter.*

[112] *See SIFMA Letter.*

[113] *See Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter.*

Rule 206(4)–2 should be able to elect to make the assertion pertain to the entire fiscal year in order to satisfy reporting requirements under the IA Custody Rule.[114] Others stated that broker-dealers should have the opportunity to remediate any material weaknesses in internal control that were identified during the period and, if corrective action was taken, not be required to include them in the compliance report.[115]

Regarding the proposed assertion that the broker-dealer was in compliance with the financial responsibility rules, one commenter stated that broker-dealers may need to interpret certain requirements and in other cases broker-dealers may be relying on informal interpretations obtained through dialogue with the Commission or its DEA.[116] This commenter recommended that in those circumstances the Commission require broker-dealers to formally document such interpretations and obtain evidence of agreements reached with the Commission or the DEA.

Some commenters stated that the Commission should provide additional guidance about the control objectives that would need to be met to achieve effective internal control over compliance with the financial responsibility rules.[117] Several commenters urged the Commission to clarify the interaction between material weaknesses in internal control over financial reporting and material weaknesses in internal control over compliance with the financial responsibility rules.[118] One commenter stated that the compliance report was over-inclusive and burdensome, and suggested that the final rule focus instead on ''issues most vital to the financial condition of the broker-dealer and its compliance and internal control over compliance.''[119]

Some commenters had questions and comments about the proposed assertion that information used to assert compliance with the financial responsibility rules was derived from the books and records of the broker-dealer. Three commenters asked whether ''books and records'' means records maintained under Rule 17a–3.[120]

iii. The Final Rule

The Commission is adopting the proposed amendments to Rule 17a–5 requiring a carrying broker-dealer to prepare and file a compliance report, with modifications, some of which are in response to comments.[121] Generally, as adopted, the broker-dealer's compliance report will include five specific statements, and two descriptions, if applicable.

Specifically, paragraph (d)(3) of Rule 17a–5 requires that the compliance report contain statements as to whether: (1) The broker-dealer has established and maintained Internal Control Over Compliance (which, as discussed below, is a defined term in the final rule); (2) the Internal Control Over Compliance of the broker-dealer was effective during the most recent fiscal year; (3) the Internal Control Over Compliance of the broker-dealer was effective as of the end of the most recent fiscal year; (4) the broker-dealer was in compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3 as of the end of the most recent fiscal year; and (5) the information the broker-dealer used to state whether it was in compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3 was derived from the books and records of the broker-dealer. Further, if applicable, the compliance report must contain a description of: (1) Each identified material weakness in the Internal Control Over Compliance during the most recent fiscal year, including those that were identified as of the end of the fiscal year; and (2) any instance of non-compliance with Rule 15c3–1 or paragraph (e) of Rule 15c3–3 as of the end of the most recent fiscal year.

The final rule does not use the term assertion—the assertions contained in the proposal are now referred to as statements.[122] The consistent use of the term statements is designed to simplify the structure of the rule rather than to substantively change the nature of the matters stated in the compliance report or which of the statements are to be examined by the independent public accountant.

In the final rule, the first statement in the compliance report is whether the broker-dealer has established and maintained Internal Control Over Compliance.[123] The rule defines *Internal Control Over Compliance* to mean internal controls that have the objective of providing the broker-dealer with reasonable assurance that non-compliance with the financial responsibility rules will be prevented or detected on a timely basis.[124] In order to clarify the application of the rule, the proposal has been modified so that part of the statement contained in the proposed compliance report, as to the broker-dealer's system of internal control, has been incorporated in the definition of *Internal Control Over Compliance* in the final rule.[125] Under the final rule, a broker-dealer cannot state that it has established and maintained Internal Control Over Compliance if the internal controls do not provide the broker-dealer with reasonable assurance that non-compliance with the financial responsibility rules will be prevented or detected on a timely basis.

The final rule also provides that a broker-dealer is not permitted to conclude that its Internal Control Over Compliance was effective if there were one or more material weaknesses in its Internal Control Over Compliance.[126] A *material weakness* is defined as a deficiency, or a combination of deficiencies, in the broker-dealer's Internal Control Over Compliance such that there is a reasonable possibility[127] that non-compliance with Rule 15c3–1 or paragraph (e) of Rule 15c3–3 will not be prevented or detected on a timely basis, or that non-compliance to a material extent with Rule 15c3–3, except for paragraph (e), Rule 17a–13 or any Account Statement Rule will not be prevented or detected on a timely

[114] *See E&Y Letter.* This commenter also stated that a point-in-time assessment would be consistent with the requirement for issuers subject to internal control reporting under section 404 of the Sarbanes-Oxley Act. Further, for carrying broker-dealers that are not subject to Rule 206(4)–2, this commenter stated that the incremental benefits of having the assertion pertain to the entire year rather than the year end assessment does not justify the cost. *Id.*

[115] *See CAQ Letter; Deloitte Letter; McGladrey Letter.*

[116] *See E&Y Letter.*

[117] *See Angel Letter; Deloitte Letter.*

[118] *See Deloitte Letter; KPMG Letter; PWC Letter.*

[119] *See CAI Letter.*

[120] *See CAQ Letter; Deloitte Letter; E&Y Letter.*

[121] *See* paragraph (d)(3) of Rule 17a–5.

[122] *See* paragraphs (d)(3)(i)(A)(*1*)–(*5*) of Rule 17a–5.

[123] *See* paragraph (d)(3)(i)(A)(*1*) of Rule 17a–5.

[124] *See* paragraph (d)(3)(ii) of Rule 17a–5.

[125] *Id.*

[126] *See* paragraph (d)(3)(iii) of Rule 17a–5. *See also* 17 CFR 229.308(a)(3) (providing that ''[m]anagement is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting.'').

[127] As noted above, the Commission has stated in other contexts that there is a reasonable possibility of an event occurring if it is ''probable'' or ''reasonably possible.'' *See Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting,* 72 FR 35310. *See also* 17 CFR 240.12b–2; 17 CFR 210.1–02. Commission guidance provides that an event is ''probable'' if the future event or events are likely to occur, and that an event is ''reasonably possible'' if the chance of the future event or events occurring is more than remote, but less than likely. *See Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934,* 72 FR at 35332 n.47 and corresponding text.

basis.[128] A deficiency in Internal Control Over Compliance exists when the design or operation of a control does not allow the management or employees of the broker-dealer to prevent or detect on a timely basis non-compliance with the financial responsibility rules in the normal course of performing their assigned functions.

The final amendments reflect several other key changes from the proposal. For example, one commenter stated that the compliance report was overinclusive and burdensome, and therefore suggested that the final rule focus on ''issues most vital to the financial condition of the broker-dealer and its compliance and internal control over compliance.'' [129] The final rule requires a statement as to whether the broker-dealer was in compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3 as of the end of the most recent fiscal year and, if applicable, a description of any instances of non-compliance with these rules as of the fiscal year end. This is a modification from the proposed assertion that the broker-dealer is in compliance with the financial responsibility rules in all *material* respects and proposed description of any material non-compliance with the financial responsibility rules. Thus, the final rule reflects two changes from the proposal: (1) Elimination of the concepts of ''material non-compliance'' and ''compliance in all material respects'' for the purposes of reporting in the compliance report; and (2) a narrowing of these statements and requirements from compliance with all of the financial responsibility rules to compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3. In this way, the final rule more narrowly focuses on the core requirements of the financial responsibility rules, as suggested by the commenter.

The ''material non-compliance'' and ''compliance in all material respects'' concepts were designed to limit the types of instances of non-compliance that would prevent a carrying broker-dealer from stating that it was in compliance with the financial responsibility rules. In order to retain a limiting principle, the final rule focuses on provisions that trigger notification requirements when they are not complied with, namely, Rule 15c3–1 and the customer reserve requirement in paragraph (e) of Rule 15c3–3.[130] Any instance of non-compliance with these requirements as of the fiscal year end must be addressed in the compliance report. As stated in the proposing release, failing to maintain the required minimum amount of net capital under Rule 15c3–1 or failing to maintain the minimum deposit requirement in a special reserve bank account under paragraph (e) of Rule 15c3–3 would have been instances of material non-compliance under the proposed rule.[131] Accordingly, under the proposal, a broker-dealer would have been required to describe all instances of non-compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3. Under the proposal, a broker-dealer also would have been required to describe instances of material non-compliance with Rule 17a–13 and the Account Statement Rules. The final rule is narrower in that a broker-dealer is only required to describe instances of non-compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3.

Consistent with these changes, the final rule requires a statement as to whether the carrying broker-dealer has established and maintained *Internal Control Over Compliance,* which is defined as internal controls that have the objective of providing the broker-dealer with reasonable assurance that non-compliance with the financial responsibility rules will be prevented or detected on a timely basis.[132] The definition of *Internal Control Over Compliance* modifies the proposed statement that the carrying broker-dealer has established and maintained a system of internal control to provide the firm with reasonable assurance that any instances of material non-compliance with the financial responsibility rules will be prevented or detected on a timely basis.[133] Thus, the definition eliminates the concept of material non-compliance. Similarly, the proposed assertion as to whether the information used to assert compliance with the financial responsibility rules was derived from the books and records of the carrying broker-dealer has been modified to a statement as to whether the information used to state whether the carrying broker-dealer was in compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3 was derived from the broker-dealer's books and records.[134]

The definition of *material weakness* similarly has been modified from the proposal. Under the final rule, a *material weakness* would include deficiencies in internal control relating to ''non-compliance'' with Rule 15c3–1 or paragraph (e) of Rule 15c3–3, and ''non-compliance to a material extent'' with Rule 15c3–3, except for paragraph (e), Rule 17a–13, and the Account Statement Rules.[135] This modification of the definition of *material weakness* is based on the practical difficulties in creating a system of control that will eliminate a reasonable possibility of the occurrence of any instances of non-compliance with certain requirements of the financial responsibility rules. For example, the inadvertent failure to send one account statement out of thousands of such statements would not constitute non-compliance to a material extent with the Account Statement Rules though it would be an instance of non-compliance.

Further, and consistent with current auditing standards, the definition of ''deficiency in internal control'' in the final rule has been modified to include the phrase ''the management or employees of the broker or dealer'' in place of the phrase ''the broker or dealer.'' [136]

The final rule—substantially as proposed—requires the carrying broker-dealer to state whether its Internal Control Over Compliance was effective during the most recent fiscal year.[137] Some commenters suggested that a broker-dealer that has remediated a material weakness be permitted to provide an assertion about whether a material weakness still exists at the end of the year, instead of having to state whether internal control was effective during the most recent fiscal year.[138] In light of the importance of a broker-dealer being in continual compliance

[128] *See* paragraph (d)(3)(iii) of Rule 17a–5. *See also* 17 CFR 240.12b–2; 17 CFR 210.1–02(a)(4) (providing that a ''[m]aterial weakness means a deficiency, or a combination of deficiencies, in internal controls over financial reporting . . . such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis.'').

[129] *See CAI Letter.*

[130] *See* 17 CFR 240.15c3–1(a)(6)(iv)(B), (a)(6)(v), (a)(7)(ii), (a)(7)(iii), (c)(2)(x)(B)(*1*), (c)(2)(x)(F)(*3*) (notification requirements with respect to Rule 15c3–1); 17 CFR 240.17a–11(b)–(c) (notification requirements with respect to Rule 15c3–1); 17 CFR 240.15c3–3(i) (notification requirement in the event of a failure to make a required deposit to the reserve account).

[131] *See Broker-Dealer Reports,* 76 FR at 37577.

[132] *See* paragraphs (d)(3)(i)(A)(*1*) and (d)(3)(ii) of Rule 17a–5. As indicated above, the independent public accountant is not required to examine this statement. *See* paragraph (g)(2)(i) of Rule 17a–5.

[133] *See* paragraphs (d)(3)(i)(A)(*1*) and (d)(3)(ii) of Rule 17a–5.

[134] *See* paragraph (d)(3)(i)(A)(*5*) of Rule 17a–5.

[135] *See* paragraph (d)(3)(iii) of Rule 17a–5.

[136] *Id. See also* PCAOB Auditing Standard, *AS No. 5* app. A, at ¶ A3 (providing that ''[a] deficiency in internal control over financial reporting exists when the design or operation of a control does not allow *management or employees,* in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.'').

[137] *See* paragraph (d)(3)(i)(A)(*2*) of Rule 17a–5.

[138] *See CAQ Letter; E&Y Letter; KPMG Letter; PWC Letter.*

with the financial responsibility rules, the Commission believes it is appropriate for the broker-dealer's statement to address effectiveness of its Internal Control Over Compliance throughout the fiscal year. Consequently, the final rule requires the statement to cover the entire fiscal year as opposed to the date that is the end of the fiscal year as suggested by commenters.

However, in response to comments suggesting that the broker-dealer be permitted to report the remediation or whether a material weakness still exists at the end of the year,[139] the final rule also requires the carrying broker-dealer to state whether its Internal Control Over Compliance was effective as of the end of the most recent fiscal year.[140] Thus, if there was a material weakness in the Internal Control Over Compliance of the broker-dealer during the year that has been addressed such that the broker-dealer no longer considers there to be a material weakness at fiscal year end, the compliance report would reflect both the identification of the material weakness and that its Internal Control Over Compliance was effective as of the end of the most recent fiscal year, thereby indicating that the material weakness had been addressed as of the fiscal year end.

Consistent with these changes, the final rule provides that the carrying broker-dealer cannot conclude that its Internal Control Over Compliance was effective during the most recent fiscal year if there were one or more material weaknesses in Internal Control Over Compliance of the broker-dealer during the fiscal year.[141] The final rule adds a similar provision relating to the effectiveness of a broker-dealer's Internal Control Over Compliance at the end of the most recent fiscal year [142] to respond to comments [143] and to align with the additional statement discussed above as to whether the broker-dealer's Internal Control Over Compliance was effective as of the end of the fiscal year.[144]

The final rule also retains the proposed requirement that the carrying broker-dealer provide a description of each identified material weakness in the broker-dealer's Internal Control Over Compliance, but, in conformity with other modifications to the proposal, the final rule requires that the material weaknesses include those identified during the most recent fiscal year as well as those that were identified as of the end of the fiscal year.[145] This change should not add a significant burden because broker-dealers should know whether any material weaknesses identified before year end have been remediated.

As noted above, one commenter recommended that the Commission require broker-dealers to document oral guidance obtained through dialogue with Commission or DEA staff.[146] While such a requirement was not proposed and is not being adopted in the final rule, it may be appropriate and prudent for a broker-dealer to maintain documentation in its books and records of the matters discussed with the Commission or DEA staff, the broker-dealer's own views and conclusion on those matters, and any guidance received by the broker-dealer.

Also as noted above, two commenters asked the Commission to provide additional guidance about the control objectives that should be met to achieve effective internal control over compliance with the financial responsibility rules.[147] As stated in the proposing release, the control objectives identified in the Commission's guidance on Rule 206(4)–2 are more general than the specific operational requirements in the financial responsibility rules.[148] In particular, broker-dealers are subject to operational requirements with respect to handling and accounting for customer assets.[149] Given the specificity of the financial responsibility rules, the Commission does not believe that additional guidance about the control objectives is necessary.

As noted above, several commenters sought assurances that the independent public accountant's examination of the compliance report would not cover the effectiveness of internal control over financial reporting.[150] The final rule does not require that the broker-dealer include a statement regarding the effectiveness of its internal control over financial reporting, nor does it require that the independent public accountant attest to the effectiveness of internal control over financial reporting. The requirement in the final rule is for the broker-dealer to state whether its Internal Control Over Compliance was effective during the most recent fiscal year and at the end of the fiscal year and for the accountant to express an opinion based on an examination of those statements.

A broker-dealer's Internal Control Over Compliance is intended to focus, for example, on a broker-dealer's oversight of custody arrangements and protection of customer assets. In contrast, internal control over financial reporting is focused on the reliability of financial reporting and the preparation of financial statements in accordance with GAAP. As stated in the proposing release, the Commission did not propose that effectiveness of internal control over financial reporting be included as one of the assertions made by the broker-dealer in the compliance report. The Commission intends that the compliance report should focus on oversight of net capital, custody arrangements, and protection of customer assets, and therefore, should be focused on compliance with the financial responsibility rules.

Further, the examination of the compliance report would pertain solely to certain statements in the compliance report and not to the broker-dealer's process for arriving at the statements. The report of the independent public accountant, based on the examination of the compliance report, requires the accountant to perform its own independent examination of the related internal controls. Consequently, it is not necessary for the independent public accountant to provide an opinion with regard to the process that the broker-dealer used to arrive at its conclusions.

As noted above, commenters sought clarification of the meaning of ''books and records'' as used in the compliance report statement. The reference in paragraph (d)(3)(i)(A)(*5*) of Rule 17a–5 to books and records refers to the books and records a broker-dealer is required to make and maintain under Commission rules (*e.g.,* Rule 17a–3 and Rule 17a–4).[151]

4. The Exemption Report—Paragraph (d)(4) of Rule 17a–5

i. Proposed Amendments

The Commission proposed that the exemption report must contain an assertion by the broker-dealer that it is exempt from Rule 15c3–3 because it meets conditions set forth in paragraph (k) of Rule 15c3–3 and ''should identify

[139] *See CAQ Letter; Deloitte Letter; E&Y Letter; McGladrey Letter.*

[140] *See* paragraph (d)(3)(i)(A)(*3*) of Rule 17a–5.

[141] *See* paragraph (d)(3)(iii) of Rule 17a–5. *See also* 17 CFR 229.308(a)(3) (providing that ''[m]anagement is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting.'').

[142] *See* paragraph (d)(3)(iii) of Rule 17a–5.

[143] *See CAQ Letter; Deloitte Letter; E&Y Letter; McGladrey Letter.*

[144] *See* paragraph (d)(3)(i)(A)(*3*) of Rule 17a–5.

[145] *See* paragraph (d)(3)(i)(B) of Rule 17a–5.

[146] *See E&Y Letter.*

[147] *See Angel Letter; Deloitte Letter.*

[148] *See Broker-Dealer Reports,* 76 FR at 37580.

[149] *Id.*

[150] *See Deloitte Letter; KPMG Letter; PWC Letter.*

[151] *See* 17 CFR 240.17a–3; 17 CFR 240.17a–4.

the specific conditions.'' [152] As discussed below in section II.D.3. of this release, under the proposal, the independent public accountant, as part of the engagement, would have been required to prepare a report based on a review of the exemption report in accordance with PCAOB standards.[153]

ii. Comments Received

The Commission received several comments regarding the exemption report.[154] Some commenters stated that the Commission should clarify whether the assertion would cover the entire fiscal year or be as of a fixed date.[155] One commenter stated that the assertion should be as of a fixed date.[156] With respect to the independent public accountant's review of the exemption report, one commenter provided the example of a bank or clerical error that results in a broker-dealer that operates under an exemption to Rule 15c3–3 finding itself in possession of customer assets overnight once during the fiscal year.[157] This commenter stated that such a situation should not ''warrant the 'material modification' of a broker-dealer's Exemption Report.'' [158] Similarly, another commenter noted that ''to consider a single instance of a broker-dealer failing to promptly forward a customer's securities as an instance that would necessitate a material modification creates an unworkable standard.'' [159]

One commenter stated that the exemption report relates only to Rule 15c3–3 and asked how the Commission intended to assess, for a firm that claims an exemption from Rule 15c3–3, compliance with Rule 15c3–1 and the adequacy of the firm's internal control over compliance with that rule.[160] Another commenter asked whether the exemption report should be replaced with a box to check on the FOCUS Report, as the amount of paperwork involved for small firms ''seems rather excessive.'' [161]

iii. The Final Rule

The Commission is adopting, with modifications discussed below, the requirements regarding the exemption report.[162] The modifications are designed to address commenters' concerns that the proposed exemption report assertion would create an unworkable standard given the possibility that a broker-dealer might have instances of exceptions to meeting the exemption provisions in paragraph (k) of Rule 15c3–3 and that the proposed requirements with respect to the exemption report did not explicitly provide how exceptions should be treated. In response to these concerns, the final rule provides that exemption reports must contain the following statements made to the best knowledge and belief of the broker-dealer: (1) A statement that identifies the provisions in paragraph (k) of Rule 15c3–3 under which the broker-dealer claimed an exemption from Rule 15c3–3; (2) a statement the broker-dealer met the identified exemption provisions in paragraph (k) of Rule 15c3–3 throughout the most recent fiscal year without exception or that it met the identified exemption provisions in paragraph (k) of Rule 15c3–3 throughout the most recent fiscal year except as described in the exemption report; and (3) if applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified provisions in paragraph (k) of Rule 15c3–3 and that briefly describes the nature of each exception and the approximate date(s) on which the exception existed.[163]

In response to comments seeking clarity as to whether the assertion in the exemption report should cover a fixed date or the fiscal year,[164] the final rule explicitly provides that the statement and certain information in the exemption report must cover the most recent fiscal year.[165] This corresponds to the provisions of paragraph (d)(1)(i)(B) of Rule 17a–5 governing when a broker-dealer must file the exemption report instead of the compliance report. In particular, a broker-dealer that claimed an exemption from Rule 15c3–3 throughout the most recent fiscal year must file the exemption report.[166]

In addition, as proposed, the exemption report was required to contain an assertion that the broker-dealer ''is exempt from the provisions'' of Rule 15c3–3 ''because it meets conditions set forth in'' paragraph (k) of Rule 15c3–3 and ''should identify the specific conditions.'' [167] Thus, the exemption report would have required the broker-dealer to state definitively that ''it is exempt'' from Rule 15c3–3 because it ''meets the conditions set forth in'' in paragraph (k).[168] As noted above, commenters raised questions and concerns about how certain exceptions would be handled under the proposed exemption report requirements. The final rule addresses these comments in a number of ways.

First, it provides that the statements in the exemption report must be made to the ''best knowledge and belief of the broker or dealer.'' [169] This modification is designed to address situations where the broker-dealer is unaware of an instance or instances in which it had an exception to meeting the exemption provisions in paragraph (k) of Rule 15c3–3 during the most recent fiscal year. As discussed below, the broker-dealer must state in the report that it met the exemption provisions throughout the year without exceptions or with exceptions that must be identified.[170]

Second, the final rule provides that the broker-dealer first must identify in the exemption report the ''provisions'' in paragraph (k) of Rule 15c3–3 under which it ''claimed'' an exemption from Rule 15c3–3.[171] As discussed above in section II.B.1. of this release, the final rule has been modified to provide that a broker-dealer must file the exemption report if it did ''claim that it was exempt'' from Rule 15c3–3 throughout

[152] *See Broker-Dealer Reports,* 76 FR at 37580–37581.

[153] *Id.* at 37578–37579. PCAOB standards for attestation engagements provide that accountants ordinarily should obtain written assertions in an examination or review engagement.

[154] *See CAQ Letter; Deloitte Letter; Grant Thornton Letter; KPMG Letter.* Some of the comments relating to the exemption report and the response to the comments are discussed above in section II.B.1. of this release.

[155] *See CAQ Letter; Deloitte Letter; Grant Thornton Letter; KPMG Letter.*

[156] *See KPMG Letter.*

[157] *See SIFMA Letter.*

[158] *Id.*

[159] *See CAI Letter.*

[160] *See McGladrey Letter.*

[161] *See Angel Letter.*

[162] *See* paragraph (d)(4) of Rule 17a–5.

[163] *Id.*

[164] *See CAQ Letter; Deloitte Letter; Grant Thornton Letter; KPMG Letter.*

[165] *See* paragraph (d)(4)(ii) of Rule 17a–5.

[166] *See* paragraph (d)(1)(i)(B) of Rule 17a–5.

[167] *See Broker-Dealer Reports,* 76 FR at 37604.

[168] *Id.*

[169] *See* paragraph (d)(4) of Rule 17a-5.

[170] As discussed above in section II.B.3. of this release, a carrying broker-dealer must state in the compliance report whether it was in compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3 as of the end of the most recent fiscal year. *See* paragraph (d)(3)(i)(A)(*4*) of Rule 17a-5. In response to comments and in light of the nature of the statements required in the exemption report, the Commission added the best knowledge and belief standard to the exemption report requirement.

[171] *See* paragraph (d)(4)(i) of Rule 17a-5. As proposed, paragraph (d)(4) of Rule 17a-5 provided that the exemption report ''shall contain a statement by the broker or dealer that it is exempt from the provisions of [Rule 15c3–3] because it meets the conditions set forth in [paragraph (k) of Rule 15c3–3] and *should* identify the specific conditions.'' *See Broker-Dealer Reports,* 76 FR 37604 (emphasis added). The Commission intended that the broker-dealer be required to identify the provisions of paragraph (k) of Rule 15c3–3 under which the broker-dealer was claiming the exemption. To make clear that this requirement and the other requirements of the exemption report are mandatory, the final rule uses the word ''must'' in relation to each element of the exemption report. *See* paragraph (d)(4) of Rule 17a-5.

the most recent fiscal year.[172] This change is designed to remove any ambiguity as to when a broker-dealer must file the exemption report as opposed to the compliance report, particularly in situations where the broker-dealer had exceptions to meeting the exemption provisions in paragraph (k) of Rule 15c3–3. Consistent with this change, the final rule requires the broker-dealer to identify in the exemption report the provisions in paragraph (k) under which it ''claimed the exemption.''[173]

Further, as proposed, the broker-dealer would have been required to identify the exemption ''conditions'' in paragraph (k) of Rule 15c3–3.[174] The use of the word ''provisions'' in the final rule is designed to eliminate a potential ambiguity as to whether the exemption provisions in paragraphs (k)(2) and (3) of Rule 15c3–3 applied to the exemption report. In particular, paragraph (k) of Rule 15c3–3 prescribes ''exemptions'' from the requirements of Rule 15c3–3.[175] Paragraph (k)(1) provides that the requirements of Rule 15c3–3 do not apply to a broker-dealer that meets all of the ''conditions'' set forth in the paragraph.[176] Paragraph (k)(2) identifies two sets of conditions (without using the word ''conditions'') either of which exempts a broker-dealer from the requirements of Rule 15c3–3.[177] Paragraph (k)(3) provides that the Commission may exempt a broker-dealer from the provisions of Rule 15c3–3, either unconditionally or on specified terms and conditions, if the Commission finds that the broker-dealer has established safeguards for the protection of funds and securities of customers comparable with those provided for by Rule 15c3–3 and that it is not necessary in the public interest or for the protection of investors to subject the particular broker-dealer to the provisions of Rule 15c3–3.[178] The Commission intended that a broker-dealer file an exemption report if it is exempt from Rule 15c3–3 under the provisions in either paragraph (k)(1), (k)(2)(i), (k)(2)(ii), or (k)(3) of Rule 15c3–3. To make this clear, the final rule refers to the ''provisions'' of paragraph (k) of Rule 15c3–3.[179] Consequently, a broker-dealer filing the exemption report must identify the provisions in paragraph (k) that it relied on to claim an exemption from Rule 15c3–3.[180]

The third modification designed to address commenters' questions and concerns about how to handle exceptions to meeting the exemption provisions in paragraph (k) of Rule 15c3–3 relates to the proposed assertion that the broker-dealer ''is exempt from the provisions'' of Rule 15c3–3 ''because it meets conditions set forth in'' paragraph (k). The final rule provides that the exemption report must contain a statement that the broker-dealer met the identified exemption provisions in paragraph (k) of Rule 15c3–3 throughout the most recent fiscal year without exception or that it met the identified exemption provisions in paragraph (k) of Rule 15c3–3 throughout the most recent fiscal year except as described in the exemption report.[181] This modification from requiring the broker-dealer to state an absolute (*i.e.,* that it is exempt from Rule 15c3–3) allows the broker-dealer to account for instances in which it had exceptions to meeting the exemption provisions in paragraph (k) of Rule 15c3–3 directly in the exemption report (rather than having to file the compliance report). Specifically, if to the broker-dealer's best knowledge and belief, it had no exceptions during the most recent fiscal year to the identified exemption provisions in paragraph (k) of Rule 15c3–3, it must state in the exemption report that it met the identified exemption provisions in paragraph (k) without exception. Alternatively, a broker-dealer that had exceptions must state that it met the identified exemption provisions except as described in the exemption report.

If the broker-dealer states that it had exceptions (*e.g.,* exceptions identified during the year, such as through routine monitoring of its compliance processes as part of the execution of its internal controls, internal or external audits, or regulatory examinations), the final rule requires the firm to identify, to its best knowledge and belief, each exception and briefly describe the nature of the exception and the approximate date(s) on which the exception existed.[182] The Commission expects that non-carrying broker-dealers generally track exceptions as part of monitoring compliance with the exemption provisions in paragraph (k) of Rule 15c3–3.[183] Further, a non-carrying broker-dealer's adherence to the exemption provisions in paragraph (k) of Rule 15c3–3 generally is a focus of Commission examiners when they conduct financial responsibility examinations on this class of firm. For example, examiners will review whether a non-carrying broker-dealer promptly forwards checks in accordance with provisions in paragraph (k) of Rule 15c3–3. The Commission also notes that the 2011 AICPA Broker Dealer Audit Guide states: ''In auditing the financial statements of a broker-dealer claiming exemption from SEC Rule 15c3–3, the auditor should determine whether and to what extent the broker-dealer complied with the specific exemption during the audit period as well as the quality of the broker-dealer's controls and procedures to ensure ongoing compliance.''[184] In addition, under the PCAOB's proposed standards, the independent public accountant should inquire of individuals at the broker-dealer who have relevant knowledge of controls relevant to the broker-dealer's compliance with the exemption provisions and who are responsible for monitoring compliance with the exemption provisions whether they are aware of any deficiencies in controls over compliance or instances of non-compliance with the exemption conditions.[185] Moreover, in the independent public accountant's report, ''[i]f the broker's or dealer's statement is not fairly stated, in all material respects,

[172] *See* paragraph (d)(1)(i)(B)(*2*) of Rule 17a-5. A broker-dealer claiming an exemption from Rule 15c3–3 is required to indicate the basis for the exemption on the periodic reports it files with securities regulators. *See, e.g.,* Item 24 of Part IIa of the FOCUS Reports. *See* 17 CFR 249.617.

[173] *See* paragraph (d)(4)(i) of Rule 17a-5.

[174] *See* paragraph (d)(4)(ii) of Rule 17a-5. The proposed rule provided that the broker-dealer must assert that it is exempt from the provisions of Rule 15c3–3 because it meets ''conditions'' set forth in paragraph (k) *and* should identify the specific ''conditions.'' *See Broker-Dealer Reports,* 76 FR at 37580–37581.

[175] *See* 17 CFR 240.15c3–3(k)(1), (k)(2)(i), (k)(2)(ii), and (k)(3).

[176] *See* 17 CFR 240.15c3–3(k)(1)(i)–(iv).

[177] *See* 17 CFR 240.15c3–3(k)(2)(i)–(ii).

[178] *See* 17 CFR 240.15c3–3(k)(3).

[179] This modification is consistent with Item 24 of Part IIa of the FOCUS Report, which is titled ''EXEMPTIVE PROVISION UNDER RULE 15c3–3'' and requires a broker-dealer that claims to be exempt from the requirements of Rule 15c3–3 to identify the provision in Rule 15c3–3—paragraph (k)(1), paragraph (k)(2)(i), paragraph (k)(2)(ii), or paragraph (k)(3)—under which it is claiming to be exempt. *See* 17 CFR 249.617.

[180] This change also is intended to make clear that the broker-dealer can identify the provisions of paragraph (k) of Rule 15c3–3 that the broker-dealer is relying on to claim the exemption by simply identifying in the exemption report the subparagraph in paragraph (k) (*i.e.,* (k)(1), (k)(2)(i), (k)(2)(ii), or (k)(3)) that contains the particular conditions the broker-dealer is relying on to claim the exemption rather than repeating the conditions themselves in the exemption report. For example, it would be sufficient for a broker-dealer relying on the exemption provisions in paragraph (k)(2)(ii) of Rule 15c3–3 to identify the provisions in the exemption report under which in claimed an exemption by referring to ''paragraph (k)(2)(ii) of Rule 15c3–3'' or ''17 CFR 240.15c3–3(k)(2)(ii).''

[181] *See* paragraph (d)(4)(ii) of Rule 17a-5.

[182] *See* paragraph (d)(4)(iii) of Rule 15c3–3.

[183] *See, e.g., Net Capital Rule,* Exchange Act Release No. 31511 (Nov. 24, 1992), 57 FR 56973 (Dec. 2, 1992), at 56981 n.25 (stating that non-carrying broker-dealers must develop procedures to ensure that they do not receive customer securities or checks made payable to themselves).

[184] *See AICPA Broker-Dealer Audit Guide* at ¶ 3.35.

[185] *See PCAOB Proposing Release* app. 2 at ¶ 10.

because of an instance or certain instances of non-compliance with the exemption conditions, the auditor must modify the review report to describe those instances of non-compliance and state that the broker or dealer is not in compliance with the specified exemption conditions.'' [186]

Under the final rule, a non-carrying broker-dealer must identify in the exemption report and describe each exception during the most recent fiscal year in meeting the identified exemption provisions in paragraph (k) of Rule 15c3–3. The description must include the approximate date(s) on which the exception existed. Without such reporting, the Commission and the broker-dealer's DEA would have no information to assess the nature, extent, and significance of the exceptions.

As noted above, one commenter asked whether the exemption report should be replaced with a box to check on the FOCUS Report, as the amount of paperwork involved for small firms ''seems rather excessive.'' [187] The Commission does not believe this is an appropriate alternative. First, as indicated above, a broker-dealer claiming an exemption from Rule 15c3–3 already is required to indicate the basis for the exemption on its FOCUS Report.[188] Second, the exemption report requires the broker-dealer to make certain statements that the independent public accountant must review. Thus, the exemption report will provide a standardized statement across all broker-dealers claiming an exemption from Rule 15c3–3 for the independent public accountant to review. Third, the exemption report will provide the Commission and the broker-dealer's DEA with more information than currently is reported by non-carrying broker-dealers in the FOCUS Report. Specifically, it requires the broker-dealer to, among other things, state either that it met the identified exemption provisions in paragraph (k) throughout the most recent fiscal year without exception or that it met the identified exemption provisions throughout the most recent fiscal year except as described in the report. This will provide the Commission and the broker-dealer's DEA with information as to whether a broker-dealer is meeting the exemption provisions of paragraph (k) of Rule 15c3–3 (not simply that the broker-dealer is claiming the exemption as is reported in the FOCUS Report). Fourth, requiring that the exemption report be filed with the Commission should increase broker-dealers' focus on the statements being made, facilitating consistent compliance with the exemption provisions in Rule 15c3–3, and therefore, providing better protection of customer assets. Fifth, the requirement to prepare and file the exemption report should not result in excessive paperwork, as stated by one commenter.[189]

As noted above, one commenter pointed out that the exemption report relates solely to Rule 15c3–3 and asked how the adequacy of a non-carrying broker-dealer's internal controls over compliance with Rule 15c3–1 would be assessed.[190] Under the final amendments, a broker-dealer's financial report will continue to include a supporting schedule containing a net capital computation under Rule 15c3–1, which will be covered by the independent public accountant's examination of the financial report. Moreover, the PCAOB has proposed standards for auditing supplemental information accompanying audited financial statements.[191]

5. Time for Filing Annual Reports—Paragraph (d)(5) of Rule 17a–5

Prior to today's amendments, paragraph (d)(5) of Rule 17a–5 required that the annual audit report be filed not more than 60 days after the date of the financial statements.[192] The Commission proposed amending paragraph (d)(5) to replace the term *annual audit report* with *annual reports.*[193] This change was designed to reflect the fact that, under the proposal, broker-dealers must file a financial report, a compliance report or exemption report, and reports prepared by an independent public accountant covering these reports. While the Commission did not receive comments on this proposed change, one commenter stated that the existing requirement in Rule 17a–5 that the annual audit report be filed 60 days after the date of the financial statements should be lengthened to 90 days.[194] In support of this recommendation, the commenter cited CFTC Rule 1.10, which allows an FCM up to 90 days to file annual audit reports.[195]

The Commission is adopting, with modifications, the proposed amendment to paragraph (d)(5) of Rule 17a–5.[196] The modifications add the term ''calendar'' to make explicit that the time for filing the annual reports is 60 calendar days after the fiscal year end (as opposed to business days). The modifications replace the words ''date of the financial statements'' with the words ''end of the fiscal year of the broker or dealer'' to provide consistency in the language of Rule 17a–5.[197] The final rule does not change the time limit for filing the annual reports to 90 days after the end of the fiscal year. The 60-day time frame is a long standing requirement and it provides the Commission and other regulators with relatively current information to, among other things, monitor the financial condition of broker-dealers. Further, broker-dealers may seek an extension of time to file the annual reports from their DEAs.[198]

6. Filing of Annual Reports With SIPC—Paragraph (d)(6) of Rule 17a–5

Prior to today's amendments, paragraph (d)(6) of Rule 17a–5 provided that the ''annual audit report'' must be filed at the regional office of the Commission for the region in which the broker-dealer has its principal place of business, the Commission's principal office in Washington, DC, and the principal office of the DEA of the broker-dealer.[199] Copies were required to be provided to all self-regulatory organizations (''SROs'') of which the broker-dealer is a member.

i. The Proposed Amendments

The Commission proposed two amendments to this provision. First, the Commission proposed that an SRO that is not a broker-dealer's DEA could by rule waive the requirement that broker-dealers file annual reports with it because many SROs do not believe that it is necessary to receive copies of broker-dealer annual reports if they are not the broker-dealer's DEA.[200] The

[186] *Id.* at ¶ 20.

[187] *See Angel Letter.*

[188] *See* Item 24 of Part IIa of the FOCUS Report.

[189] *See Angel Letter.* The commenter did not explain why the exemption report would result in excessive paperwork. *Id. See also* discussion below in section VI.D.1.iii. of this release for the estimated paperwork hour burden associated with this requirement.

[190] *See McGladery Letter.* The material inadequacy report—which applied to carrying and non-carrying broker-dealers—covered Rule 15c3–1. *See* 17 CFR 240.17a–5(g).

[191] *See Proposed Auditing Standard, Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards,* PCAOB Release No. 2011–05, PCAOB Rulemaking Docket Matter No. 036 (July 12, 2011) (''*PCAOB Proposed Auditing Standard for Supplemental Information*'').

[192] *See* 17 CFR 240.17a–5(d)(5).

[193] *See Broker-Dealer Reports,* 76 FR at 37604.

[194] *See IMS Letter.*

[195] *See* 17 CFR 1.10(b)(ii). Rule 1.10 also provides that if the FCM is registered with the Commission as a broker-dealer, the FCM must file the report not later than the time permitted for filing an annual audit report under Rule 17a–5.

[196] *See* paragraph (d)(5) of Rule 17a–5.

[197] *Id. See also* paragraph (n) of Rule 17a–5.

[198] *See* paragraph (m) of Rule 17a–5.

[199] *See* 17 CFR 240.17a–5(d)(6).

[200] *See Broker-Dealer Reports,* 76 FR at 37592.

Commission received no comments on this proposal and is adopting it as proposed.[201]

Second, the Commission proposed amending this provision to require a broker-dealer to file its annual reports with SIPC.[202] SIPC, a nonprofit, nongovernmental membership corporation established by SIPA, is responsible for providing financial protection to customers of failed broker-dealers. SIPA also provided for the establishment of a fund (''SIPC Fund'') to pay for SIPC's operations and activities. SIPC uses the fund to make advances to satisfy customer claims for securities and cash that cannot be readily returned to the customer. SIPA limits the amount of the advance to $500,000 per customer, of which $250,000 can be used to satisfy the cash portion of a customer's claim. The SIPC Fund also covers the administrative expenses of liquidation proceedings for failed broker-dealers when the general estate of the failed firm is insufficient; these include costs incurred by a trustee, trustee's counsel, and other advisors. SIPC finances the SIPC Fund through annual assessments, set by SIPC, on all member firms, plus interest generated from its permitted investments. Generally, all broker-dealers registered with the Commission under section 15(b) of the Exchange Act [203] are required to be members of SIPC.[204] Before today's amendments, broker-dealers were required to file only limited information with SIPC. Specifically: (1) Information elicited on Form SIPC–6, the ''General Assessment Payment Form;'' (2) information elicited on Form SIPC–7, the ''Annual General Assessment Reconciliation;'' and (3) for periods in which the SIPC assessment is not a minimum assessment, a comparison by the independent public accountant of the amounts reflected in the annual report the broker-dealer filed with the Commission with amounts reported on Form SIPC–7.

The Commission explained in the proposing release that the proposed requirement for broker-dealers to file their annual reports with SIPC could allow SIPC to better monitor industry trends and enhance its knowledge of particular firms.[205] The Commission also explained that the requirement that broker-dealers file copies of their annual reports with SIPC was designed to address cases where the SIPC Fund has been used to pay the administrative expenses of the liquidation of a failed broker-dealer and SIPC sought to recover the money advanced when the estate had insufficient assets.[206] In some of these cases, SIPC has sought to recover money damages from the broker-dealer's auditing firm based on an alleged failure to comply with auditing standards. At least one court, however, has held under New York law that SIPC could not maintain such a claim because it was not a recipient of the annual audit filing and could not have relied on it.[207]

ii. Comments Received

The Commission received seven comments on the proposal that broker-dealers be required to file their annual reports with SIPC.[208] Six commenters generally opposed the requirement.[209] One commenter indicated that it is appropriate for broker-dealers to file their annual reports with SIPC if SIPC uses the reports to reconcile the annual reports with the Form SIPC–7 or otherwise places reliance on them.[210] Three of the commenters stated that the Commission failed to adequately articulate the policy considerations driving the proposed change and also failed to discuss the possible costs of increased litigation risk to accountants.[211] Some of the commenters argued that this change would contradict limitations on SIPC's authority to bring claims against accountants under SIPA and the securities laws imposed by the U.S. Supreme Court.[212]

After the proposal, a task force established by SIPC to undertake a comprehensive review of SIPA and SIPC's operations and policies and to propose reforms to modernize SIPA and SIPC recommended to the SIPC Board that SIPC members be required to file audit reports with SIPC concurrently with their filing with the SEC, a position consistent with the proposal. In a report presented to the SIPC Board of Directors in February 2012,[213] the task force stated that including SIPC as a designated recipient of the audit report ''would further the goal of investor protection by providing another layer of review of the report by an organization directly affected by its contents.'' [214] In addition, the task force stated that ''including SIPC as a recipient would help to address the persistent concern that any signs of 'financial weakness, as by non-compliance with net capital requirements or otherwise, [be] watched very carefully and followed up' in order to augment the financial responsibility requirements SIPA was intended to enhance, and to provide greater investor protection.'' [215]

iii. The Final Rule

The Commission is adopting the amendment requiring broker-dealers to file their annual reports with SIPC substantially as proposed.[216] SIPC plays an important role in the securities markets and the SIPC Fund can help reduce losses to investors from the failure of their broker-dealer. SIPC has a legitimate interest in receiving the annual reports of its broker-dealer members to assist it with its maintenance of the SIPC Fund and to monitor trends in the broker-dealer industry. SIPC presently obtains revenue information from broker-dealers, through Form SIPC–7, to determine how best to structure broker-dealer assessments to maintain the SIPC Fund at an appropriate level. However, the information collected in the form is limited and may not assist SIPC in assessing whether the SIPC Fund is appropriately sized to the risks of a large broker-dealer failure. The annual audited reports contain much more detailed information about the assets, liabilities, income, net capital, and Rule

[201] *See* paragraph (d)(6) of Rule 17a–5.

[202] *See Broker-Dealer Reports,* 76 FR at 37592.

[203] *See* 15 U.S.C. 78o(b).

[204] *See* 15 U.S.C. 78ccc(a)(2). However, broker-dealers engaged exclusively in the distribution of mutual fund shares, the sale of variable annuities, the insurance business, the furnishing of investment advice to investment companies or insurance company separate accounts, or whose principal business is conducted outside the U.S. are not required to be members of SIPC. *See* 15 U.S.C. 78ccc(a)(2)(A)(i)–(iii).

[205] *See Broker-Dealer Reports,* 76 FR at 37592.

[206] *Id. See also* SIPC, *2010 Annual Report,* at 18, *available at http://www.sipc.org/pdf/2010%20Annual%20Report.pdf.*

[207] *See SIPC* v. *BDO Seidman, LLP,* 746 NE.2d 1042 (N.Y. 2001).

[208] *See CAQ Letter; Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter; PWC Letter.*

[209] *See CAQ Letter; Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter; PWC Letter.*

[210] *See McGladrey Letter.* Form SIPC–7 is discussed in more detail below in section II.C.4. of this release.

[211] *See CAQ Letter; Deloitte Letter; KPMG Letter.*

[212] *See CAQ Letter; Deloitte Letter; E&Y Letter; KPMG Letter; PWC Letter.*

[213] *See Report and Recommendations of the SIPC Modernization Task Force* (Feb. 2012), *available at http://www.sipc.org/pdf/Final%Report%202012.pdf.* The Task Force was comprised of volunteers, and included investor advocates, regulatory specialists, and academic experts, including the trustee for the liquidation of Lehman Brothers Inc. and MF Global Inc.

[214] *See Report and Recommendations of the SIPC Modernization Task Force,* at 19.

[215] *Id.* (quoting the SEC, *Study of Unsafe and Unsound Practices of Broker-Dealers,* H.R. Doc. No. 92–231, at 152 (1971)).

[216] *See* paragraph (d)(6) of Rule 17a–5. The Commission clarified that the broker-dealer must file the annual reports with SIPC only ''if the broker or dealer is a member of SIPC.'' The Commission believes that SIPC has an interest in receiving annual reports only from broker-dealers that are SIPC members, because only these broker-dealers may pose a risk to the SIPC Fund.

15c3–3 customer reserve requirements of broker-dealers, and also include, for carrying broker-dealers, a compliance report containing information about the broker-dealer's compliance with, and controls over compliance with, the broker-dealer financial responsibility rules. The annual reports also generally include the independent public accountant's reports covering the financial report and compliance report or exemption report, as applicable, prepared by the broker-dealer. This information will assist SIPC in monitoring the financial strength of broker-dealers and, therefore, in assessing the adequacy of the SIPC Fund.[217]

In addition, by receiving the annual reports, SIPC may be able to overcome a legal hurdle to pursuing claims against a broker-dealer's accountant where the accountant's failure to adhere to professional standards in auditing a broker-dealer caused a loss to the SIPC Fund. Although this amendment is intended to remove one potential legal hurdle to SIPC actions against accountants, the other elements of any relevant cause of action would be unaffected. The Commission does not intend by this amendment to take a position on the circumstances under which SIPC may have a viable cause of action against an independent public accountant.[218]

Several commenters stated that the Commission did not address the potential costs and benefits of requiring broker-dealers to file copies of their annual reports with SIPC, including potential accounting litigation costs.[219] As discussed below in section VII. of this release, the Commission recognizes that there may be increased litigation costs (or reserves for potential litigation costs) as a result of the amendment and that to the extent that there are such costs, some of them may be passed on to broker-dealers in the form of increased audit fees. But, while this amendment may facilitate the ability of SIPC to bring actions against accountants for malpractice or material misrepresentation under state law by removing one potential legal hurdle to such actions, it will not necessarily result in a significant increase in such actions. Generally, SIPC initiates a small number of proceedings each year, and most of these proceedings have not involved a claim against a broker-dealer's accountant. Specifically, SIPC was established in 1971. In the period from 1971–2011, SIPC initiated 324 proceedings under SIPA to liquidate a failed broker-dealer.[220] This results in an average of approximately 8 SIPA proceedings per year, though 109 of the 324 proceedings were initiated in the period from 1971–1974, which was the immediate aftermath of the financial crisis of 1968–1970.[221] According to SIPC staff, SIPC has brought 9 lawsuits against accountants since 1971, which is one lawsuit for every 36 SIPA proceedings.[222] Accordingly, the likelihood of a lawsuit against an accountant is small and the Commission anticipates that the overall costs related to litigation as a result of the filing requirement should not be significant. The Commission believes that any such costs are justified by the benefits of enhanced customer protection and the associated ability of SIPC to better assess the financial condition of broker-dealers and the adequacy of the SIPC Fund.

C. The Nature and Form of the Annual Reports

1. Exemptions From Audit Requirement—Paragraph (e)(1) of Rule 17a–5

Prior to today's amendments, paragraph (e)(1)(i) of Rule 17a–5 provided, among other things, that the audit of the broker-dealer's financial statements needed to be performed by an accountant that is independent as defined in paragraph (f) of Rule 17a–5.[223] Paragraph (e)(1)(i) also contained provisions under which certain broker-dealers were not required to engage an accountant to audit their financial statements.[224]

The Commission proposed amending paragraph (e)(1)(i) of Rule 17a–5 to remove the words ''An audit shall be conducted by a public accountant who shall be in fact independent as defined in paragraph (f)(3) of this section herein, and he shall give an opinion covering the statements filed pursuant to paragraph (d).'' This amendment would consolidate the requirements with respect to the qualifications of the accountant in paragraph (f) of Rule 17a–5, and paragraph (e)(1)(i) of Rule 17a–5 would address only exemptions from the requirement to engage an independent public accountant to audit the annual reports prepared by the broker-dealer.[225] The Commission received no comments on this proposal, and is adopting it with modifications.[226] The modifications: (1) Modernize certain terms in the rule in a manner consistent with the Commission's ''plain English'' initiative; and (2) cite to the reports required under ''Rule 17a–5(d)(1)(i)(C)'' to provide a more precise cross reference than the former citation to reports required under ''Rule 17a–5(d).'' [227]

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[217] *See McGladrey Letter.*

[218] Several commenters argue that requiring the annual report to be filed with SIPC would contradict limitations the Supreme Court has imposed on SIPC's authority to bring claims against accountants. The decisions cited by these commenters, however, do not speak to the precise issue the amended rule is intended, among other things, to address—the New York Court of Appeals' decision held that SIPC could not state a cause of action for either fraudulent or negligent misrepresentation against an auditing firm because it was not a recipient of the annual audit report. *See SIPC* v. *BDO Seidman, LLP,* 746 NE.2d 1042 (N.Y. 2001); aff'd, 245 F.3d 174 (2d Cir. 2001). Rather, in *Holmes* v. *Securities Investor Protection Corporation,* the Supreme Court found that the statutory provision relied on by SIPC, 15 U.S.C. 78eee(d), did not, either alone or with the Racketeer Influenced and Corrupt Organizations Act, confer standing. 503 U.S. 258, 275 (1992). And, in *Touche Ross & Co.* v. *Redington,* the Supreme Court determined that customers of securities brokerage firms do not have an implied cause of action for damages under section 17(a) of the Exchange Act against accountants who audit the financial reports filed by such firms; thus, SIPC could not assert this implied cause of action on behalf of these customers. 442 U.S. 560, 567 (1979). As already noted, the Commission does not intend by this amendment to take a position on the circumstances under which SIPC may have a viable cause of action against an independent public accountant.

[219] *See, e.g., CAQ Letter; Deloitte Letter; KPMG Letter.*

[220] *See* SIPC, *Annual Report 2011,* at 6.

[221] *Id. See also* Commission, *Study of Unsafe and Unsound Practices of Brokers and Dealers: Report and Recommendations of the Securities and Exchange Commission* (December 1971) (discussing the financial crisis of 1968–1970). Since its inception through 2001, SIPC initiated 299 proceedings under SIPA.

[222] *See Redington* v. *Touche Ross & Co.,* 592 F.2d 617 (2d Cir. 1978); *In re Bell & Beckwith,* 77 B.R. 606 (Bkrtcy. N.D. Ohio, 1987); *Mishkin* v. *Peat, Marwick, Mitchell & Co.,* 658 F.Supp. 271 (S.D.N.Y. 1987); *SIPC* v. *BDO Seidman, LLP,* 49 F.Supp.2d 644 (S.D.N.Y. 1999); *In re Donahue Securities Inc.,* 2004 WL 3152763 (Bkrtcy S.D. Ohio, 2004); *In re SIPC* v. *R.D. Kushnir & Co,* 274 B.R. 768 (Bkrtcy. N.D. Ill., 2002); *In re Sunpoint Securities, Inc.,* 377 B.R. 513 (Bkrtcy. E.D. Tex., 2007); Compliant at 5–6, *Gilbert* v. *Ohab,* Bkrtcy. M.D. Fl. (May 2010) (No. 6:08-ap-00145–KSJ); Complaint at 2, *Shively* v. *Mortland,* Bkrtcy. D. Co. (Feb. 2004) (No. 03–BK–1102–HRT).

[223] *See* 17 CFR 240.17a–5(e)(1)(i).

[224] *Id.*

[225] *See Broker-Dealer Reports,* 76 FR at 37593–37594. The proposed and final amendments to paragraph (f) of Rule 17a–5 are discussed below in section II.E. of this release.

[226] *See* paragraph (e)(1)(i) of Rule 17a–5.

[227] *Id.* Prior to today's amendments, paragraph (e)(1)(ii) of Rule 17a–5 provided that ''[a] broker or dealer who files a report which is not covered by an accountant's opinion shall include in the oath or affirmation required by paragraph (e)(2) of this section a statement of the facts and circumstances relied upon as a basis for exemption from the requirement that financial statements and schedules filed pursuant to paragraph (d) of this section be covered by the opinion of an accountant.'' *See* 17 CFR 240.17a–5(e)(1)(ii). The Commission did not propose amendments to this subparagraph. However, to be consistent with today's amendments, the Commission is making technical

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2. Affirmation—Paragraph (e)(2) of Rule 17a–5

Prior to today's amendments, paragraph (e)(2) of Rule 17a–5 provided that an oath or affirmation must be attached to the annual audit report that, to the best knowledge and belief of the person making the oath or affirmation, the financial statements and schedules are true and correct and, among other things, that the oath or affirmation must be made by the proprietor if a sole proprietorship, by a general partner, if a partnership, or by a duly authorized officer, if a corporation.[228] The Commission proposed amending the first sentence of paragraph (e)(2) of Rule 17a–5 by adding the word ''financial'' before the word ''report.''[229] The Commission is adopting this amendment as proposed.

One commenter stated that currently paragraph (e)(2) of Rule 17a–5 does not specifically cover limited liability companies, and its reference to partnerships assumes that a general partner is a natural person.[230] The commenter argued that it should be updated to conform to generally accepted business laws.

In response to this comment, the Commission is adopting amendments to paragraph (e)(2) of Rule 17a–5 that modify the proposed amendments.[231] In particular, the Commission is adding that if the broker-dealer is a limited liability company or limited liability partnership, the oath or affirmation must be made by the chief executive officer, chief financial officer, manager, managing member, or any of those members vested with management authority for the limited liability company or limited liability partnership.[232]

3. Confidentiality of Annual Reports—Paragraph (e)(3) of Rule 17a–5

Prior to today's amendments, paragraph (e)(3) of Rule 17a–5 provided that the financial statements filed under paragraph (d) are public, except that if the Statement of Financial Condition is bound separately from the balance of the annual audited financial statements filed under paragraph (d)(1), the balance of the annual audited financial statements will be deemed confidential.[233] As noted in the proposing release, the wording of this provision has led to confusion.[234] In particular, Commission staff has received inquiries on how broker-dealers can indicate that they are requesting confidential treatment for the portion of the financial statements intended to be kept confidential to the extent permitted by law and, on occasion, financial statements broker-dealers intended to be confidential are inadvertently made public.[235] This could happen, for example, if a broker-dealer fails to bind the balance sheet separately from the other portion of the financial statements when it files the financial statements with the Commission.[236]

Consequently, the Commission proposed amending paragraph (e)(3) of Rule 17a–5 to provide that the annual reports filed pursuant to paragraph (d) are public, except that if the Statement of Financial Condition is bound separately from the annual report filed pursuant to ''paragraph (d)(2) of Rule 17a–5,'' and each page of the balance of the annual report is stamped ''confidential,'' the balance of the annual report shall be deemed confidential.[237] The proposed rule text inadvertently referenced only the financial report. It was intended that the financial report, compliance report, exemption report, and related accountant reports would be treated the same under paragraph (e)(3) of Rule 17a–5. Consequently, the Commission is modifying the proposed amendment. Specifically, paragraph (e)(3) of Rule 17a–5, as adopted, provides that if the Statement of Financial Condition is bound separately from the balance of the ''annual reports filed under paragraph (d) of this section,'' and each page of the balance of the annual reports is stamped ''confidential,'' then the balance of the annual reports will be deemed confidential to the extent permitted by law.[238] Consequently, if the compliance reports and exemption reports and the related reports of the independent public accountant are submitted in accordance with the procedures specified in paragraph (e)(3) of Rule 17a–5, these reports will be deemed confidential to the extent permitted by law.[239]

Prior to today's amendments, paragraph (e)(3) of Rule 17a–5 also provided that the broker-dealer's reports, including the confidential portions, will be available, for example, for official use by any official or employee of the U.S. and an official or employee of any national securities exchange and registered national securities association of which the broker-dealer is a member and ''by any other person to whom the Commission authorizes disclosure of such information as being in the public interest.'' [240] The Commission proposed amending this list of permitted recipients to include the PCAOB.[241] The Commission did not receive comments on this proposal and is adopting it essentially as proposed with a minor wording edit for clarity.[242]

4. Supplemental Report on SIPC Membership—Paragraph (e)(4) of Rule 17a–5

As discussed above in section II.B.6. of this release, SIPC maintains the SIPC Fund to be used in liquidations of broker-dealers under SIPA. The SIPC Fund is established and maintained through assessments on broker-dealers that are required to be members of

amendments to paragraph (e)(1)(ii) of Rule 17a–5 so that it now provides that ''[a] broker or dealer that files annual reports under paragraph (d) of this section that are not covered by reports prepared by an independent public accountant must include in the oath or affirmation required by paragraph (e)(2) of this section a statement of the facts and circumstances relied upon as a basis for exemption from the requirement that the annual reports filed under paragraph (d) of this section be covered by reports prepared by an independent public accountant.'' *See* paragraph (e)(1)(ii) of Rule 17a–5.

[228] *See* 17 CFR 240.17a–5(e)(2).

[229] *See Broker-Dealer Reports,* 76 FR at 37603.

[230] *See IMS Letter.*

[231] *See* paragraph (e)(2) of Rule 17a–5.

[232] *See IMS Letter.*

[233] *See* 17 CFR 240.17a–5(e)(3).

[234] *See Broker-Dealer Reports,* 76 FR at 37592–37593.

[235] The public portions of broker-dealer annual audited reports are available on the Commission's Web site. These reports may be accessed via the *Search for Company Filings* link under *Filings & Forms* on the Commission's home page.

[236] The Commission staff has previously posted guidance on the Commission Web site on how to request confidential treatment for the financial statements other than the statement of financial condition. *See http://www.sec.gov/divisions/marketreg/bdnotices.htm.*

[237] *See Broker-Dealer Reports,* 76 FR at 37592–37593.

[238] *See* paragraph (e)(3) of Rule 17a–5.

[239] *See* 5 U.S.C. 552 *et seq.* (Freedom of Information Act—''FOIA''). FOIA provides at least two potentially pertinent exemptions under which the Commission has authority to withhold certain information. FOIA Exemption 4 provides an exemption for ''trade secrets and commercial or financial information obtained from a person and privileged or confidential.'' 5 U.S.C. 552(b)(4). FOIA Exemption 8 provides an exemption for matters that are ''contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions.'' 5 U.S.C. 552(b)(8). However, as discussed below, under paragraph (c)(2)(iv) of Rule 17a–5, if there are material weaknesses, the accountant's report on the compliance report must be made available for customers' inspection and, consequently, it would not be deemed confidential. In addition, paragraph (c)(2)(i) of Rule 17a–5 (which is not being amended today) requires a broker-dealer to furnish to its customers annually a balance sheet with appropriate notes prepared in accordance with GAAP and which must be audited if the broker-dealer is required to file audited financial statements with the Commission. *See* 17 CFR 240.17a–5(c)(2)(i).

[240] *See* 17 CFR 240.17a–5(e)(3).

[241] *See Broker-Dealer Reports,* 76 FR at 37592–37593.

[242] *See* paragraph (e)(3) of Rule 17a–5.

SIPC.[243] In order to assist in the collection of assessments from member broker-dealers, SIPC has promulgated two forms that broker-dealers must file with SIPC, as applicable: Form SIPC–3 and Form SIPC–7. Form SIPC–3 is required when a broker-dealer is claiming an exemption from SIPC membership (*i.e.,* when the broker-dealer does not have to pay an assessment). In this case, the broker-dealer must file Form SIPC–3 each year certifying that the broker-dealer remained qualified for the exemption during the prior year. Form SIPC–7 elicits information from a broker-dealer that is a SIPC member about the broker-dealer's sources of revenue attributable to its securities business. Every broker-dealer that is a member of SIPC must file this form annually.

Prior to today's amendments, paragraph (e)(4) of Rule 17a–5 provided that a broker-dealer must file with its annual report a supplemental report on the status of the membership of the broker-dealer in SIPC, which was required to be ''covered by an opinion of the independent public accountant'' if the annual report of the broker-dealer was required to be audited.[244] Among other things, the supplemental report needed to cover the SIPC annual general assessment reconciliation or exclusion from membership forms (*i.e.,* Form SIPC–7 or Form SIPC–3).[245] Paragraph (e)(4)(iii) of Rule 17a–5 used the terms ''review'' and ''opinion'' in describing the accountant's report that must cover the supplement report.[246] In addition, it required that the review by the accountant include certain minimum procedures.[247]

Under this provision, the supplemental report did not need to be filed if the SIPC Fund assessments were the minimum assessment provided for under SIPA.[248] Between 1996 and 2009, the annual assessment for SIPC members remained at the $150 minimum assessment level provided for under SIPA.[249] In 2009, SIPC raised the assessment above the minimum, which triggered the requirement in paragraph (e)(4) of Rule 17a–5 to file a supplemental report with the Commission, the broker-dealer's DEA, and SIPC.[250]

The Commission stated in the proposing release that, because Forms SIPC–3 and SIPC–7 are used solely by SIPC for purposes of levying its assessments, the supplemental report required pursuant to paragraph (e)(4) of Rule 17a–5 relating to these forms would be more appropriately filed exclusively with SIPC and that SIPC (rather than the Commission) should prescribe by rule the form of the supplemental report.[251] The Commission stated that it would continue to have a role in establishing the requirements for a supplemental report because the Commission must approve SIPC rules.[252]

For these reasons, the Commission proposed to amend paragraph (e)(4) of Rule 17a–5 to require that broker-dealers file with SIPC a report on the SIPC annual general assessment reconciliation or exclusion from membership forms that contains such information and is in such format as determined by SIPC by rule and approved by the Commission.[253] However, because there would be an interim period before a rule determined by SIPC became effective, the Commission proposed amendments to paragraph (e)(4) under which broker-dealers would continue to file a supplemental report with the Commission, the broker-dealer's DEA, and SIPC until SIPC adopts a rule pursuant to paragraph (e)(4)(i) of Rule 17a–5 and the rule is approved by the Commission.[254] Consequently, a broker-dealer would be required to file the SIPC supplemental reports with SIPC using the existing formats for the reports until the earlier of the Commission approving a rule adopted by SIPC or two years. If after two years, a rule promulgated by SIPC has not been approved by the Commission, broker-dealers would no longer be required to file these reports.

Further, to facilitate this change, the Commission proposed to update the rule text to conform it to existing professional standards and industry practices.[255] Specifically, the Commission proposed amending paragraph (e)(4) of Rule 17a–5 to eliminate the ambiguity that stems from the differing auditing terms used in that rule by removing all references to ''review'' and ''opinion.'' [256] In their place, the Commission proposed that the supplemental report include an independent public accountant's report based on the performance of the procedures listed in paragraph (e)(4)(iii) of Rule 17a–5, which the Commission did not propose to change.[257]

The Commission received two comments relating to the proposed amendments to paragraph (e)(4) of Rule 17a–5, both of which supported the proposed change.[258] One commenter indicated that the proposed amendment would decrease the burden on broker-dealers associated with filing the supplemental report with the Commission and the broker-dealer's DEA.[259] In addition, the other commenter indicated that until the supplemental reports are filed exclusively with SIPC, they should be subject to confidential treatment.[260]

The Commission is adopting the amendments to paragraph (e)(4) of Rule 17a–5 as proposed.[261] With respect to the comment about the Commission keeping the supplemental report confidential, a broker-dealer can request confidential treatment for the report.[262] If such a request is made, the Commission anticipates that it will accord the supplemental report confidential treatment to the extent permitted by law.[263]

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[243] Broker-dealers engaged exclusively in the distribution of mutual fund shares, the sale of variable annuities, the insurance business, the furnishing of investment advice to investment companies or insurance company separate accounts, or whose principal business is conducted outside the U.S. are not required to be members of SIPC. *See* 15 U.S.C. 78ccc(a)(2)(A)(i)–(iii).

[244] *See* 17 CFR 240.17a–5(e)(4).

[245] *Id.*

[246] *See* 17 CFR 240.17a–5(e)(4)(iii).

[247] *See* 17 CFR 240.17a–5(e)(4)(iii)(A)–(F).

[248] *See* 17 CFR 240.17a–5(e)(4); 15 U.S.C. 78ddd(d)(1)(c).

[249] *See* SIPC, *SIPC to Reinstitute Assessments of Member Firms' Operating Revenues* (Mar. 2, 2009) (news release).

[250] *Id.*

[251] *See Broker-Dealer Reports,* 76 FR at 37582.

[252] *Id.*

[253] *Id.*

[254] *Id.*

[255] *Id.*

[256] *Id.*

[257] *See Broker-Dealer Reports,* 76 FR at 37582. The Commission proposed one modification to the procedures listed in former paragraph (e)(4)(iii); namely, amending the procedure described in paragraph (e)(4)(iii)(F), which is now renumbered (e)(4)(ii)(6), to change the reference from ''Form SIPC–7'' to ''Form SIPC–3'' because the reference to Form SIPC–7 is inaccurate. *Id.*

[258] *See CAI Letter; McGladrey Letter.*

[259] *See CAI Letter.*

[260] *See McGladrey Letter.*

[261] *See* paragraph (e)(4) of Rule 17a–5.

[262] *See* 17 CFR 200.83. Information about how to request confidential treatment of information submitted to the Commission is *available at http://www.sec.gov/foia/howfo2.htm#privacy.*

[263] *See, e.g.,* Exchange Act section 24, 15 U.S.C. 78x (governing the public availability of information obtained by the Commission) and 5 U.S.C. 552 *et seq.* (Freedom of Information Act—''FOIA''). FOIA provides at least two pertinent exemptions under which the Commission has authority to withhold certain information. FOIA Exemption 4 provides an exemption for ''trade secrets and commercial or financial information obtained from a person and privileged or confidential.'' 5 U.S.C. 552(b)(4). FOIA Exemption 8 provides an exemption for matters that are ''contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions.'' 5 U.S.C. 552(b)(8).

D. Engagement of the Accountant

As part of today's amendments to the broker-dealer annual reporting requirements in Rule 17a–5, the Commission is amending certain requirements relating to a broker-dealer's engagement of an independent public accountant. Specifically, the Commission is requiring that a broker-dealer engage an independent public accountant to prepare reports based on an examination of the broker-dealer's financial report and either an examination of certain statements in the broker-dealer's compliance report or a review of certain statements in the broker-dealer's exemption report. The examinations and reviews must be made in accordance with the standards of the PCAOB, consistent with the explicit authority granted to the PCAOB by the Dodd-Frank Act to establish (subject to Commission approval) auditing and attestation standards with respect to broker-dealer audits.[264] Among other things, the amendments replace provisions that required the filing of a ''material inadequacy'' report and are intended to update terminology in the rule to make the rule's requirements clear and to provide for a more consistent approach to engaging broker-dealer independent public accountants.

This section addresses statutory requirements for broker-dealer annual reports and the Commission's authority with regard to these reports, describes the engagement of accountant requirements in Rule 17a–5 prior to today's amendments, summarizes the Commission's proposed amendments and comments received, and discusses the final rule amendments.

1. Statutory Requirements and Commission Authority

Section 17(e)(1)(A) of the Exchange Act requires a broker-dealer to file annually with the Commission a ''certified'' balance sheet and income statement as well as ''such other financial statements (which shall, as the Commission specifies, be certified) and information concerning its financial condition as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.'' [265] Section 17(e)(2) of the Exchange Act provides the Commission with authority, by rule, to prescribe the form and content of the financial statements and the accounting principles and standards used in their preparation as it deems necessary or appropriate in the public interest or for the protection of investors.[266] In addition, section 17(a) of the Exchange Act more generally requires registered broker-dealers to make and disseminate such reports as the Commission, by rule, may prescribe as necessary or appropriate in the public interest, for the protection of investors.[267] The Commission adopted Rule 17a–5, in part, under these provisions.[268]

Prior to the enactment of the Sarbanes-Oxley Act of 2002 (''Sarbanes-Oxley Act''),[269] section 17(e)(1)(A) required that the annual financial statements a broker-dealer must file with the Commission be certified by ''an independent public accountant.'' The Sarbanes-Oxley Act established the PCAOB [270] and amended section 17(e)(1)(A) by replacing the words ''certified by an independent public accountant'' with the words ''certified by a registered public accounting firm.'' [271] Title I of the Sarbanes-Oxley Act prescribed specific PCAOB registration, standards-setting, inspection, investigation, disciplinary, foreign application, oversight, and funding programs in connection with audits of issuers.[272] However, as originally enacted, the Sarbanes-Oxley Act did not expressly prescribe similar programs in connection with audits of broker-dealers that are not issuers.

The Dodd-Frank Act, enacted in July 2010, amended the Sarbanes-Oxley Act to provide the PCAOB with explicit authority to, among other things, establish (subject to Commission approval) auditing and related attestation, quality control, ethics, and independence standards for registered public accounting firms with respect to their preparation of audit reports to be included in broker-dealer filings with the Commission, and the authority to conduct and require an inspection program of registered public accounting firms that audit broker-dealers.[273] The Dodd-Frank Act addressed inspection authority by adding section 104(a)(2)(A) to the Sarbanes-Oxley Act, which provides that the PCAOB ''may, by rule, conduct and require a program of inspection* * *of registered public accounting firms that provide one or more audit reports for a broker or dealer'' and that the PCAOB, in establishing a program for inspection, ''may allow for differentiation among classes of brokers or dealers, as appropriate.'' [274]

The Dodd-Frank Act also added section 104(a)(2)(D) to the Sarbanes-Oxley Act, which provides that a public accounting firm is not required to register with the PCAOB if the public accounting firm is exempt from an inspection program established by the PCAOB.[275] The Dodd-Frank Act made a conforming amendment to section 17(e)(1)(A) of the Exchange Act to replace the words ''certified by a registered public accounting firm'' with the words ''certified by an independent public accounting firm, or by a registered public accounting firm if the firm is required to be registered under the Sarbanes-Oxley Act of 2002.'' [276]

Before today's amendments, paragraph (g)(1) of Rule 17a–5 required that audits of broker-dealer reports filed with the Commission under Rule 17a–5 be made in accordance with generally accepted auditing standards (''GAAS''), which are established by the Auditing Standards Board of the American Institute of Certified Public Accountants (''AICPA''). In light of the authority granted to the PCAOB by the Dodd-Frank Act to establish standards governing audit reports to be included in broker-dealer filings with the Commission, the Commission issued transitional interpretive guidance to clarify that references in Commission rules, staff guidance, and in the federal securities laws to GAAS or to specific standards under GAAS, as they relate to non-issuer brokers or dealers, should continue to be understood to mean auditing standards generally accepted in the U.S., in addition to any applicable rules of the Commission.[277] The

[264] *See* Public Law 111–203 § 982.

[265] *See* 15 U.S.C. 78q(e)(1)(A).

[266] *See* 15 U.S.C. 78q(e)(2).

[267] *See* 15 U.S.C. 78q(a).

[268] *See Broker-Dealer Reports,* Exchange Act Release No. 11935 (Dec. 17, 1975), 40 FR 59706 (Dec. 30, 1975).

[269] Public Law 107–204, 116 Stat. 745 (2002).

[270] Public Law 107–204 § 101.

[271] *See* Public Law 107–204 § 205(c)(2). The term *Registered Public Accounting Firm* is defined in section 2(a)(12) as ''a public accounting firm registered with the [PCAOB] in accordance with this Act.'' *See* Public Law 107–204 § 2(a)(12).

[272] Section 2(a)(7) of the Sarbanes-Oxley Act defines the term *issuer* as ''an issuer as defined in section 3 of the [Exchange Act], the securities of which are registered under section 12 of [the Exchange Act], or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933…, and that it has not withdrawn'' (U.S.C. citations omitted). *See* Public Law 107–204 § 2(a)(7).

[273] *See* Public Law 111–203 § 982.

[274] *See* Public Law 111–203 § 982(e)(1).

[275] *Id.*

[276] *See* Public Law 111–203 § 982(e)(2). As discussed below, today's amendments to the qualifications of the independent public accountant provisions require, consistent with amended section 17(e)(1)(A), that the accountant be qualified, independent, and registered with the PCAOB ''if required by the Sarbanes-Oxley Act of 2002.'' *See* paragraph (f)(1) of Rule 17a–5.

[277] *See Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and Dealers,* Exchange Act Release No. 62991 (Sept. 24, 2010), 75 FR 60616, 60617 (Oct. 1, 2010).

guidance also stated that the Commission intended to revisit the interpretation in connection with a rulemaking project to update the audit and related attestation requirements under the federal securities laws for broker-dealers.[278] As discussed below, the Commission is now adopting amendments to Rule 17a–5 to require that audits and attestations of broker-dealer reports filed under Rule 17a–5 be made in accordance with standards of the PCAOB—the rule as amended does not contain references to GAAS.

Since the Commission proposed these amendments, the PCAOB has taken a number of actions to implement the explicit authority over broker-dealer audits provided to it by the Dodd-Frank Act. For example, on August 18, 2011, the Commission approved two PCAOB rule changes: a temporary PCAOB rule that established an interim program of inspection of audits of broker-dealers,[279] and a PCAOB rule change providing that funds to cover the PCAOB's annual budget be allocated among issuers, brokers, and dealers.[280] In addition, as discussed below, subsequent to the Commission's proposal to amend Rule 17a–5, the PCAOB proposed attestation standards to establish requirements for examining broker-dealer compliance reports and reviewing broker-dealer exemption reports ''to align its attestation standards more closely with the auditor's responsibilities under [the proposed amendments to Rule 17a–5].'' [281] The PCAOB concurrently proposed an auditing standard for supplemental information accompanying audited financial statements that would supersede the current standard.[282] The auditing standard would apply to supporting schedules broker-dealers must file under Rule 17a–5, including schedules regarding the computation of net capital and the customer reserve requirement and information related to the broker-dealer's possession or control of customer assets.[283] The PCAOB also proposed amendments ''to tailor certain of its rules to the audits and [independent public accountants] of broker-dealers.'' [284]

2. Engagement of Accountant Requirements Prior to Today's Amendments

Rule 17a–5 requires that a broker-dealer prepare and file certain financial statements and supporting schedules in addition to the balance sheet and income statement required under section 17(e)(1)(A) of the Exchange Act.[285] Before today's amendments, the financial statements and supporting schedules were generally required to be audited in accordance with GAAS by an independent public accountant registered with the PCAOB.[286]

In addition to filing a report of the independent public accountant covering the financial statements and supporting schedules, paragraph (j) of Rule 17a–5 required the broker-dealer to file with the annual audit a supplemental report prepared by the accountant (''material inadequacy report'') that either: (1) Indicated that the accountant did not find any material inadequacies; or (2) described any material inadequacies in internal control the accountant found during the course of the audit of the financial statements and supporting schedules and any corrective action taken or proposed by the broker-dealer.[287]

For purposes of preparing the material inadequacy report, paragraph (g)(1) of Rule 17a–5 required that the audit include a ''review'' of the broker-dealer's accounting system, internal accounting control, and procedures for safeguarding securities.[288] Further, the accountant was required to review the practices and procedures of the broker-dealer in: (1) Making the periodic computations of aggregate indebtedness and net capital under paragraph (a)(11) of Exchange Act Rule 17a–3 and the reserve required by paragraph (e) of Rule 15c3–3; [289] (2) making the quarterly securities examinations, counts, verifications, and comparisons and the recordation of differences required by Rule 17a–13; [290] (3) complying with the requirement for prompt payment for securities under Regulation T of the Board of Governors of the Federal Reserve System (''Regulation T''); [291] and (4) obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3–3.[292] The scope of the independent public accountant's procedures was required to be sufficient to provide ''reasonable assurance'' that any material inadequacies existing at the date of the examination in the broker-dealer's accounting system, internal accounting control, and procedures for safeguarding securities as well as in the practices and procedures described in items (1) through (4) above would be disclosed.[293]

The *AICPA Broker-Dealer Audit Guide* provided that the material inadequacy report should address what the independent public accountant concluded in its ''study'' of the adequacy of the broker-dealer's

[278] *Id.*

[279] *See Public Company Accounting Oversight Board; Order Approving Proposed Temporary Rule for an Interim Program of Inspection Related to Audits of Brokers and Dealers,* Exchange Act Release No. 65163 (Aug. 18, 2011), 76 FR 52996 (Aug. 24, 2011).

[280] *See Public Company Accounting Oversight Board; Order Approving Proposed Board Funding Rules for Allocation of the Board's Accounting Support Fee Among Issuers, Brokers, and Dealers, and Other Amendments to the Board's Funding Rules,* Exchange Act Release No. 65162 (Aug. 18, 2011), 76 FR 52997 (Aug. 24, 2011).

[281] *See PCAOB Proposing Release* at 5.

[282] *See PCAOB Proposed Auditing Standard for Supplemental Information.*

[283] *Id.* at 3.

[284] *See Proposed Amendments to Conform the Board's Rules and Forms to the Dodd-Frank Act and Make Certain Updates and Clarifications,* PCAOB Release No. 2012–002, PCAOB Rulemaking Docket Matter No. 039 (Feb. 28, 2012).

[285] *See* 17 CFR 240.17a–5(d).

[286] *See* 17 CFR 240.17a–5(g). An engagement to perform an audit (or examination) of financial statements is designed to provide reasonable assurance about whether the financial statements are free of material misstatement. *See, e.g.,* PCAOB Interim Auditing Standard, *AU Section 110* at ¶ .02. The term *audit* is defined in section 110(1) of the Sarbanes-Oxley Act, as amended by the Dodd-Frank Act, to mean ''an examination of the financial statements, reports, documents, procedures, controls, or notices of an issuer, broker, or dealer by an independent public accountant in accordance with the rules of the [PCAOB] or the Commission, for the purpose of expressing an opinion on the financial statements or providing an audit report.''

[287] *See* 17 CFR 240.17a–5(j). Prior to today's amendments, paragraph (g)(3) of Rule 17a–5 describes a material inadequacy in a broker-dealer's accounting system, internal accounting controls, procedures for safeguarding securities, and practices and procedures to include any condition which has contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to: (1) Inhibit a broker-dealer from promptly completing securities transactions or promptly discharging its responsibilities to customers, other broker-dealers or creditors; (2) result in material financial loss; (3) result in material misstatements of the broker-dealer's financial statements; or (4) result in violations of the Commission's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in (1) through (3) above. *See* 17 CFR 240.17a–5(g)(3). In addition to the material inadequacy report, a broker-dealer was required to file during certain periods a supplemental report covered by an opinion of the independent public accountant on the status of the broker-dealer's membership in SIPC. *See* 17 CFR 240.17a–5(e)(4). The Commission is amending this requirement as discussed above in section II.C.4. of this release. Further, a broker-dealer that computes net capital under the alternative model-based standard in Appendix E to Rule 15c3–1 (17 CFR 240.15c3–1e) is required to file a supplemental report of an independent public accountant indicating the results of the accountant's review of the internal risk management control system established and documented by the broker-dealer in accordance with Rule 15c3–4 (17 CFR 240.15c3–4). *See* 17 CFR 240.17a–5(k). The Commission is not amending this requirement today.

[288] *See* 17 CFR 240.17a–5(g)(1).

[289] *See* 17 CFR 240.17a–5(g)(1)(i).

[290] *See* 17 CFR 240.17a–5(g)(1)(ii).

[291] *See* 17 CFR 240.17a–5(g)(1)(iii). *See also* 12 CFR 220 *et seq.* (Regulation T).

[292] *See* 17 CFR 240.17a–5(g)(1)(iv).

[293] *See* 17 CFR 240.17a–5(g)(1).

practices and procedures in complying with the financial responsibility rules in relation to the definition of material inadequacy as stated in paragraph (g)(3) of Rule 17a–5.[294] The issuance of a study is relatively unique to broker-dealer audits, however, and while auditing standards at one time referred to the performance of a study, current auditing standards no longer contain such references.

Additional engagement of accountant requirements prior to today's amendments were set forth in paragraphs (g) and (i) of Rule 17a–5. Paragraph (g)(2) of Rule 17a–5 provided that, if the broker-dealer was exempt from Rule 15c3–3, the independent public accountant must ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to the independent public accountant's attention to indicate that the exemption had not been complied with during the period since the last examination.[295]

Paragraph (i) of Rule 17a–5, before today's amendments, was titled, ''Accountant's reports—general provisions.'' [296] Paragraph (i)(1) of Rule 17a–5 provided that the accountant's report must be dated, signed manually, indicate the city and state where issued, and identify the financial statements and schedules covered by the report.[297] Paragraph (i)(2) of Rule 17a–5 provided that the accountant's report must state whether the audit was made in accordance with generally accepted auditing standards; state whether the accountant reviewed the procedures followed for safeguarding securities; and designate any auditing procedures deemed necessary by the accountant under the circumstances of the particular case which have been omitted, and the reason for their omission.[298] Further, the rule provided that ''[n]othing in this section shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required under [Rule 17a–5].'' [299]

Prior to today's amendments, paragraph (i)(3) of Rule 17a–5 provided that the accountant's report must state clearly the opinion of the accountant: (i) with respect to the financial statements and schedules covered by the report and the accounting principles and practices; and (ii) as to the consistency of the application of the accounting principles, or as to any changes in such principles that have a material effect on the financial statements.[300] Paragraph (i)(4) provided that any matters to which the accountant took exception must be clearly identified, the exception specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given.[301] Paragraph (i)(5) of Rule 17a–5 provided that the terms *audit* (*or examination*), *accountant's report,* and *certified* have the meanings given in Rule 1–02 of Regulation S–X (17 CFR 210.1–02).[302]

3. Amended Engagement of Accountant Requirements

i. Proposed Amendments

The Commission proposed to substantially amend paragraph (g) and remove paragraph (j) of Rule 17a–5, in part, to update the engagement of the accountant requirements to address outdated or inconsistent terminology in the rule.[303] The proposed amendments to paragraph (g) and removal of paragraph (j) of Rule 17a–5 would have eliminated the requirement for the accountant to prepare and the broker-dealer to file a material inadequacy report.[304] In its place, the independent public accountant would have been required to prepare, and the broker-dealer would have been required to file, in addition to a report covering the financial report, a report covering either the broker-dealer's compliance report or exemption report, as applicable.[305] Specifically, the Commission proposed to amend paragraph (g) of Rule 17a–5 to be titled ''Engagement of independent public accountant'' and to require a broker-dealer required to file annual reports under paragraph (d) of Rule 17a–5 to engage an independent public accountant, unless the broker-dealer is subject to the exclusions in paragraphs (d)(1) and (e)(1)(i) of Rule 17a–5. The independent public accountant, as part of the engagement, would have been required to undertake to: (1) Prepare a report based on an examination of the broker-dealer's financial report in accordance with standards of the PCAOB; and (2) prepare a report based on an ''examination'' of the assertions of the broker-dealer in the compliance report in accordance with standards of the PCAOB [306] or to prepare a report based on a ''review'' of the broker-dealer's exemption report in accordance with standards of the PCAOB.[307] This provision would have retained the requirement that the financial statements and supporting schedules be audited by the independent public accountant, so that the accountant would have continued to be required to obtain ''reasonable assurance'' about whether they were free of material misstatement, but would have changed

[294] The material inadequacy report is addressed in the AICPA's *Audit & Accounting Guide: Brokers and Dealers in Securities* (Sept. 1, 2011 ed.) (''*AICPA Broker-Dealer Audit Guide*''), which provides that the report should: (1) Address what auditors concluded in their study of the adequacy of the broker-dealer's practices and procedures in complying with the Commission's financial responsibility rules in relation to the definition of a material inadequacy in Rule 17a–5; and (2) disclose material weaknesses in internal control over financial reporting (including procedures for safeguarding securities) that are revealed through auditing procedures designed and conducted for the purpose of expressing an opinion on the financial statements. *See AICPA Broker-Dealer Audit Guide* at ¶ 3.77. The *AICPA Broker-Dealer Audit Guide* further provides that if conditions believed to be material weaknesses are found to exist or have existed during the year, the report should disclose the nature of the weaknesses and the corrective action taken or proposed to be taken by the broker-dealer. *See AICPA Broker-Dealer Audit Guide* at ¶ 3.80. The *AICPA Broker-Dealer Audit Guide* also provides sample reports ''on internal control required by SEC Rule 17a–5(g)(1).'' *See AICPA Broker-Dealer Audit Guide* apps. C, D, and F.

[295] *See* 17 CFR 240.17a–5(g)(2).

[296] *See* 17 CFR 240.17a–5(i).

[297] *See* 17 CFR 240.17a–5(i)(1).

[298] *See* 17 CFR 240.17a–5(i)(2).

[299] *Id.*

[300] *See* 17 CFR 240.17a–5(i)(3).

[301] *See* 17 CFR 240.17a–5(i)(4).

[302] *See* 17 CFR 240.17a–5(i)(5).

[303] *See Broker-Dealer Reports,* 76 FR at 37578–37579. In addition, the Commission proposed changing the title of paragraph (g) from *Audit objectives* to *Engagement of the independent public accountant. Id.* at 37606.

[304] *Id.* at 37578–37579.

[305] *Id.*

[306] An attest engagement designed to provide a high level of assurance is referred to as an ''examination.'' *See, e.g.,* PCAOB Interim Attestation Standard, *AT Section 101* at ¶ .54. For this type of engagement, the accountant's conclusion will be expressed in the form of an opinion. For example, the accountant's conclusion based on an examination of an assertion could state that in the accountant's opinion, [the assertion] is fairly stated in all material respects. *See, e.g.,* PCAOB Interim Attestation Standard, *AT Section 101* at ¶ .84. The proposed rule provided that the examination and related report would apply to the broker-dealer's ''assertions'' in the compliance report (and therefore would not apply to other items in the proposed compliance report; namely, a statement as to whether the broker-dealer has established a system of internal control and a description of instances of material non-compliance, and material weaknesses over compliance with, the financial responsibility rules).

[307] An attest engagement designed to provide a moderate level of assurance is referred to as a ''review.'' *See, e.g.,* PCAOB Interim Attestation Standard, *AT Section 101* at ¶¶ .55, .89. For this type of engagement, the accountant's conclusion will be expressed, not in the form of an opinion, but in the form of ''negative assurance.'' *See, e.g.,* PCAOB Interim Attestation Standard, *AT Section 101* at ¶ .68. For example, the accountant's conclusion based on a review of an assertion could state that no information came to the accountant's attention that indicates that the assertion is not fairly stated in all material respects. *See, e.g.,* PCAOB Interim Attestation Standard, *AT Section 101* at ¶ .88.

the audit standards from GAAS to standards of the PCAOB.[308]

The Commission proposed making conforming amendments to paragraph (i) of Rule 17a–5, substituting the words ''examinations'' and ''reviews'' for the word ''audits,'' substituting the words ''standards of the PCAOB'' for ''generally accepted auditing standards,'' substituting ''annual reports'' for ''financial statements,'' and changing the title to ''Reports prepared by the independent public accountant.'' The Commission also proposed deleting paragraph (i)(5) of Rule 17a–5, which provided that the terms ''audit,'' ''examination,'' ''accountant's report,'' and ''certified'' have the meanings given in Rule 1–02 of Regulation S–X. As proposed, paragraph (i)(1) of Rule 17a–5 would have provided that the independent public accountant's reports must: be dated; be signed manually; indicate the city and state where issued; and identify without detailed enumeration the items covered by the reports. Paragraph (i)(2) of Rule 17a–5 would have provided that the accountant's report must state whether the examination or review was made in accordance with standards of the PCAOB and must designate any examination, and, if applicable, review procedures deemed necessary by the independent public accountant under the circumstances of the particular case that have been omitted, and the reason for their omission. Further, the rule would have provided that ''[n]othing in this section shall be construed to imply authority for the omission of any procedure that independent public accountants would ordinarily employ in the course of an examination or review made for the purpose of expressing the opinions or statement required under [Rule 17a–5].'' Paragraph (i)(3) of Rule 17a–5 would have provided that the independent public accountant's reports must state clearly the opinion of the independent public accountant: (i) with respect to the financial report and the accounting principles and practices reflected therein and the compliance report; and (ii) with respect to the financial report, as to the consistency of the application of the accounting principles, or as to any changes in such principles that have a material effect on the financial statements. Paragraph (i)(4) of Rule 17a–5 would have provided that any matters to which the independent public accountant takes exception must be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on any related items contained in the annual reports.

As stated above, after the Commission proposed the amendments to Rule 17a–5, the PCAOB issued proposed standards that ''would establish requirements for examining the assertions in a broker's or dealer's compliance report and reviewing a broker's or dealer's assertion in the exemption report.'' [309] The PCAOB stated that the proposed standards were ''tailored to the requirements'' in Rule 17a–5 as proposed to be amended by the Commission.[310]

ii. Comments

The Commission received several comments regarding the proposed revisions to the independent accountant engagement requirements in Rule 17a–5.[311] One commenter stated that GAAS should be used for audits of non-carrying broker-dealers; or, in the alternative, that the Commission should delay the effective date for the requirement that the audit be conducted in accordance with PCAOB standards for smaller broker-dealers until one year after the approval of the amendments.[312] A second commenter stated that PCAOB standards should apply only for broker-dealers ''permanently subject to PCAOB inspection'' and that the Commission should not require that audits of broker-dealers be performed in accordance with PCAOB standards for non-issuer broker-dealers until the PCAOB determines which non-issuer broker-dealers will be subject to its permanent inspection program.[313]

One commenter noted that the proposing release states that broker-dealers will be required to file a report by the accountant that ''addresses'' the assertions in the compliance report,[314] and stated that the Commission should provide more guidance on what an accountant must address, as ''nowhere in the Release or in the proposed rules is there guidance as to what 'addresses' means or entails.'' [315] This commenter further stated that the Commission ''presumably'' will rely on PCAOB rules, and suggested that final rules regarding the accountant's obligations with respect to its examination of the compliance report should be deferred until after a comment period of at least 60 days after the PCAOB rules are finalized or the Commission amends its proposal to include specifics as to what ''address'' means and what type of review is required by the accountant.[316] The commenter also stated that the requirement should not be effective unless the *AICPA Broker-Dealer Audit Guide* is revised and updated.[317] One commenter asked what was expected of the auditor with respect to the books and records assertion and stated that a separate opinion on this assertion may entail more detailed procedures as to the source of the information.[318]

Another commenter stated that a review engagement should not be employed for the exemption report because inquiry and observation would not provide sufficient evidence regarding a broker-dealer's assertion that it is exempt from the requirements of Rule 15c3–3 and stated that, under the PCAOB's interim attestation standards, an auditor should not accept an engagement to perform a ''review'' level of service related to an entity's compliance with specified requirements or an assertion with regard to that compliance.[319] As an alternative, this commenter suggested an ''agreed-upon procedures'' approach addressing the results of procedures specified by the Commission or the performance of an examination engagement if suitable criteria were developed.[320] Another commenter stated that the benefit of receiving an audit report covering the exemption report would not justify the cost.[321] Similarly, a commenter stated that the exemption report should be replaced with a box to check on the FOCUS Report as the auditor attestation provided no added benefit.[322]

Several commenters urged the Commission to clarify the interaction between material weaknesses in internal control over financial reporting and material weaknesses in internal control over compliance with the financial responsibility rules.[323] One commenter stated that due to the reliance placed on the financial books and records to

[308] *See Broker-Dealer Reports,* 76 FR at 37606. As stated above, an engagement to perform an audit of financial statements is designed to provide ''reasonable assurance'' about whether the financial statements are free of material misstatement. *See, e.g.,* PCAOB Interim Attestation Standard, *AT Section 101* at ¶ .54.

[309] *See PCAOB Proposing Release* at 5.

[310] *Id.*

[311] *See, e.g., ABA Letter; AICPA Letter; Citrin Letter; E&Y Letter; Van Kampen/Invesco Letter.*

[312] *See Citrin Letter.* The Commission also received many comments seeking additional time to transition to the final rules. Those comments are discussed below in section V. of this release.

[313] *See AICPA Letter.*

[314] *See Broker-Dealer Reports,* 76 FR at 37575.

[315] *See ABA Letter.*

[316] *Id.*

[317] *Id.* As stated below, AICPA guidance will no longer be applicable once standards of the PCAOB apply to broker-dealer annual reports.

[318] *See Grant Thornton Letter.*

[319] *See E&Y Letter.*

[320] *Id.*

[321] *See Citrin Letter.*

[322] *See Angel Letter.*

[323] *See Deloitte Letter; KPMG Letter; PWC Letter.*

calculate net capital, it will not be feasible to attest to the effectiveness of internal control over the financial responsibility rules without also attesting to internal control over financial reporting.[324] The commenter stated that, accordingly, it is necessary to include internal control over financial reporting within the scope of the rule. The commenter stated its understanding that accountants expect to include internal control over financial reporting in their attestation scope over the financial responsibility rules, and that the process will include documenting all existing processes and engaging internal audit to validate the effectiveness of the procedures implemented through procedural walkthroughs and control testing to validate management's assertions.[325] This commenter also stated its belief that independent public accountants will need ''to include an attestation of the additional in scope processes within the scope of their audit work in order to comply with PCAOB requirements.'' [326]

As noted above in section II.B.4.ii. of this release, with respect to the independent public accountant's review of the exemption reports, one commenter stated that, for example, a bank or clerical error that results in a broker-dealer that operates under an exemption to Rule 15c3–3 finding itself in possession of customer assets overnight once during the fiscal year should not ''warrant the 'material modification' of a broker-dealer's Exemption Report.'' [327] Another commenter noted that ''to consider a single instance of a broker-dealer failing to promptly forward a customer's securities as an instance that would necessitate a material modification creates an unworkable standard.'' [328]

iii. The Final Rule

The Commission is adopting amendments to the engagement of the accountant requirements in Rule 17a–5 substantially as proposed, except for revisions, as discussed in detail below, to clarify the rule's requirements and to make technical changes. Paragraph (g) of Rule 17a–5 as adopted provides that the independent public accountant engaged by the broker-dealer to provide reports on the financial report and either the compliance report or exemption report must, as part of the engagement undertake to: (1) Prepare a report based on an examination of the broker-dealer's financial report in accordance with standards of the PCAOB; and (2) prepare a report based on an examination of certain enumerated statements of the broker-dealer in the compliance report [329] in accordance with standards of the PCAOB or prepare a report based on a review of the statements in the broker-dealer's exemption report in accordance with standards of the PCAOB. Additionally, as proposed, the amendments delete paragraph (j) of Rule 17a–5, which, as explained above, required that the broker-dealer file with the annual audit report a material inadequacy report, as well as provisions in paragraph (g) of Rule 17a–5 requiring that the audit be conducted in accordance with GAAS and addressing the accountant's review for material inadequacies.

Various commenters suggested that GAAS instead of PCAOB standards should apply for engagements of accountants with respect to certain broker-dealer reports, such as reports of non-carrying broker-dealers.[330] The Commission believes that requiring GAAS for audits of broker-dealers that are exempt from Rule 15c3–3 would not be consistent with the provisions of the Dodd-Frank Act that provide the PCAOB with explicit authority to establish standards with regard to audits of broker-dealer reports filed with the Commission.[331] These provisions enable the PCAOB to exercise its standard-setting authority over audits of broker-dealers registered with the Commission. The change from GAAS to PCAOB auditing standards will facilitate the Commission's regulatory oversight authority because the Commission has direct oversight authority over the PCAOB, including the ability to approve or disapprove the PCAOB's rules and standards. The Commission also has greater confidence in the quality of audits conducted by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.[332] Further, as the PCAOB develops and implements an inspection program of broker-dealer audits as contemplated by the Dodd-Frank Act, that program will include inspection of, among other things, ''registered public accounting firms' current compliance with laws, rules, and standards in performing audits of brokers and dealers.'' [333] The requirement that all broker-dealer independent public accountants comply with the standards established by the PCAOB should facilitate the development and implementation of its permanent inspection program, as contemplated by the Dodd-Frank Act.

As noted above, the PCAOB has proposed an auditing standard for supplemental information accompanying audited financial statements, including the supporting schedules broker-dealers must file as part of the financial report.[334] The PCAOB stated that a primary factor that led it to reexamine its requirements regarding supplemental information was the Commission's proposal to amend the reporting requirements of Rule 17a–5.[335] In addition, as noted above, the PCAOB has proposed specific attestation standards for examining compliance reports and reviewing exemption reports. The PCAOB's proposing release noted that the proposed standards ''are tailored to the requirements in SEC Proposed Rule 17a–5.'' [336] The proposed standards, if adopted, would establish a single and broker-dealer-specific approach to examining compliance reports and reviewing exemption reports. This should provide greater clarity as to procedures an independent public accountant should use in examining a compliance report and reviewing an exemption report.

With respect to comments suggesting that PCAOB standards should apply only to auditors of broker-dealers ''permanently subject to PCAOB inspection,'' [337] the PCAOB has not exempted the audits by independent

[324] *See Van Kampen/Invesco Letter.*

[325] *Id.*

[326] *Id.*

[327] *See SIFMA letter.*

[328] *See CAI Letter.*

[329] As discussed above in section II.B.3. of this release, the final rule does not use the term assertion—the assertions contained in the proposal are now referred to as statements. These changes are not intended to be substantive. Paragraph (g) of Rule 17a–5 specifies that the accountant prepare a report based on an examination of certain statements enumerated in the rule. Similar to the proposal, the statements subject to the examination do not include a statement as to whether the broker-dealer has established a system of internal control or a description of instances of non-compliance with certain financial responsibility rules.

[330] *See AICPA Letter; Citrin Letter.*

[331] *See* Public Law 111–203 § 982. For example, section 982(a) of the Dodd-Frank Act added section 110 to the Sarbanes-Oxley Act, which contains definitions of terms such as *audit, audit report,* and *professional standards.* These definitions apply to audits, audit reports, and professional standards with respect to audits of broker-dealers as well as audits of issuers. In addition, section 982(b) of the Dodd-Frank Act amended section 101 of the Sarbanes-Oxley Act to substitute the words ''issuers, brokers, and dealers'' for the word ''issuers.''

[332] *See Custody of Funds or Securities of Clients by Investment Advisers,* 75 FR at 1460.

[333] *See Temporary Rule for an Interim Program of Inspection Related to Audits of Brokers and Dealers,* PCAOB Release No. 2011–001, PCAOB Rulemaking Docket Matter No. 32, 1 (June 14, 2011).

[334] *See PCAOB Proposed Auditing Standard for Supplemental Information.*

[335] *Id.* at 2–3.

[336] *See PCAOB Proposing Release* at 5.

[337] *See AICPA Letter.*

public accountants of any class of broker-dealer from the PCAOB's permanent inspection program.[338] In fact, the PCAOB has established an interim inspection program for all broker-dealer audits by independent public accountants that will ''allow the Board to begin inspections of relevant audits and auditors and provide a source of information to help guide decisions about the scope and elements of a permanent program.'' [339] The PCAOB stated that it did not intend ''to postpone all use of its new inspection authority until after those judgments were made.'' [340]

At this time, there is no reason to expect that any type of broker-dealer audit will be exempt from the PCAOB's permanent inspection program, and any PCAOB determination to exempt broker-dealer audits from the PCAOB's permanent inspection program must be approved by the Commission. Therefore, notwithstanding any such exemption, paragraph (g) of Rule 17a–5 is amended to require that broker-dealer independent public accountants prepare reports covering the financial report and compliance report or exemption report in accordance with standards of the PCAOB.

On August 20, 2012, the PCAOB published its first report on the progress of the interim inspection program.[341] The report contains observations from inspections of portions of 23 broker-dealer audits conducted by ten independent public accounting firms that were all conducted in accordance with GAAS.[342] The inspections did not exclude any broker-dealer audits from being eligible for selection.[343] PCAOB staff identified deficiencies in all of the audits inspected.[344] For example, as to all of the 14 audits of broker-dealers that claimed an exemption from Rule 15c3–3, the staff stated that the accountant ''did not perform sufficient procedures to ascertain that the broker or dealer complied with the conditions of the exemption,'' [345] and in 21 of the 23 audits, that the accountant ''failed to perform sufficient audit procedures to obtain reasonable assurance that any material inadequacies found to exist since the date of the last examination . . . would have been disclosed in the accountant's supplemental report.'' [346] The deficiencies noted in the PCAOB's report on the progress of the interim inspection program provide further support for the amendments that the Commission is adopting today to establish the foundation for the PCAOB's development of standards that are tailored to Rule 17a–5, and to strengthen and facilitate consistent compliance with broker-dealer audit and reporting requirements.

Several commenters suggested that the Commission delay the applicability of these requirements because, among other things, PCAOB standards regarding broker-dealer audits, including standards that apply to compliance reports and exemption reports, will not be final when these rule amendments are adopted.[347] In response, as discussed below in section V. of this release, the Commission is delaying the effective dates of most of the rule amendments. In accordance with the effective dates, broker-dealers must file compliance reports or exemption reports, as applicable, and broker-dealers must file reports of independent public accountants covering compliance reports or exemption reports in accordance with Rule 17a–5 as amended, for fiscal years ending on or after June 1, 2014. In the interim, broker-dealers must continue to file material inadequacy reports in accordance with the provisions of Rule 17a–5 as they existed before today's amendments. Broker-dealer independent public accountants must prepare reports based on an examination of broker-dealer financial reports in accordance with PCAOB standards for fiscal years ending on or after June 1, 2014. In the interim, audits of broker-dealer financial statements filed with the Commission under Rule 17a–5 should continue to be understood to mean auditing standards generally accepted in the U.S., plus any applicable rules of the Commission.[348] The June 1, 2014 effective date should provide sufficient time for the PCAOB to finalize, subject to Commission approval, the standards for broker-dealer audits and for broker-dealers and their independent public accountants to prepare to comply with the new requirements and standards.

As noted above, one commenter stated the Commission should provide more guidance on what an independent public accountant must address, and that the requirement for PCAOB standards should not be effective unless the *AICPA Broker-Dealer Audit Guide* is revised and updated.[349] Another commenter sought clarification on what was expected of the auditor with respect to the books and records assertion.[350] In response to these comments, the Commission notes that the PCAOB's proposed standards with respect to the examination of the compliance report by the independent public accountant address, among other things: (1) The objective of the examination; (2) the relationship between the examination engagement and the audit of the financial report; (3) considerations for broker-dealers with multiple divisions or branches; (4) identifying risks of material non-compliance; (5) testing controls over compliance; (6) performing compliance tests; (7) testing information used to assert compliance; (8) evaluating the results of the examination procedures; (9) subsequent events; (10) obtaining a representation letter; (11) communication requirements; (12) reporting on the examination engagement; (13) the examination report date; and (14) examination report modifications.[351] The PCAOB's proposed standards with respect to the review of the exemption report by the independent public accountant address, among other things: (1) The objective of the review; (2) the relationship between the review engagement and the audit of the financial report; (3) the review procedures; (4) evaluating the results of the examination procedures; (5) obtaining a representation letter; (6) communication requirements; (7) reporting on the review engagement; (8) the review report date; and (9) review report modifications.[352] The Commission expects that the final standards of the PCAOB, which are subject to Commission approval, will provide sufficient guidance to independent public accountants performing examinations of compliance reports and reviews of exemption reports.

In response to the comment that the requirements with respect to the compliance reports and exemption reports should not be effective unless

[338] *See Public Company Accounting Oversight Board: Order Approving Proposed Temporary Rule for an Interim Program of Inspection Related to Audits of Brokers and Dealers,* Exchange Act Release No. 65163 (Aug. 18, 2011), 76 FR at 52996 (Aug. 24, 2011).

[339] *Id.* at 52997.

[340] *Id.*

[341] *See* PCAOB, *Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers,* PCAOB Release No. 2012–005 (August 20, 2012) (''*PCAOB Inspection Report*'').

[342] *Id.* at ii.

[343] *Id.* at 8.

[344] *Id.* at ii.

[345] *Id.* at iii.

[346] *Id.*

[347] *See, e.g., CAQ Letter; Deloitte Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter.*

[348] *See Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and Dealers,* Exchange Act Release No. 62991 (Sept. 24, 2010), 75 FR 60616, 60617 (Oct. 1, 2010).

[349] *See ABA Letter.*

[350] *See Grant Thorton Letter.*

[351] *See PCAOB Proposing Release* app. 1.

[352] *See PCAOB Proposing Release* app. 2.

the *AICPA Broker-Dealer Audit Guide* is revised and updated, as stated above, once adopted, only the standards of the PCAOB apply to broker-dealer annual reports. The PCAOB has proposed standards with respect to the examination of the compliance report and the review of the exemption report and it is expected that final standards will be in place before the audit requirements with respect to the compliance report and the exemption report are effective. Consequently, there is no need to wait for the *AICPA Broker-Dealer Audit Guide* to be updated.

As noted above, several commenters requested clarity about the interaction between material weaknesses in internal control over financial reporting and material weaknesses in internal control over compliance with the financial responsibility rules.[353] Additionally, one commenter stated that due to the reliance placed on the financial books and records of the broker-dealer, it will not be feasible for the independent public accountant to attest to the effectiveness of internal control over the financial responsibility rules without also attesting to internal control over financial reporting.[354] As discussed above in section II.B.3.iii. of this release, although a broker-dealer is required to state in the compliance report that the information it used to state whether it was in compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3 was derived from its books and records, the final rule does not require that the broker-dealer include a statement regarding the effectiveness of its internal control over the accuracy of its books and records, nor does it require that the independent public accountant attest to the effectiveness of internal control over the accuracy of the broker-dealer's books and records. Additionally, under the final rule, the independent public accountant is not required to opine on the effectiveness of the broker-dealer's internal control over financial reporting. However, the independent public accountant's existing obligation to gain an understanding and perform appropriate procedures relative to the broker-dealer's internal control over financial reporting, as a necessary part of the independent public accountant's financial report audit, remains unchanged.[355] Further, as discussed above in section II.B.3.iii. of this release, the examination of the compliance report would pertain solely to certain statements in the compliance report and not to the broker-dealer's process for arriving at the statements. The report of the independent public accountant, based on the examination of the compliance report, requires the accountant to perform its own independent examination of the related controls and procedures. Consequently, it is not necessary for the independent public accountant to provide an opinion with regard to the process that the broker-dealer used to arrive at its conclusions.

As noted above, one commenter stated that a review engagement should not be employed for the exemption report, because an accountant's inquiry and observation would not provide sufficient evidence regarding a broker-dealer's assertion that it is exempt from Rule 15c3–3, and under the PCAOB's attestation standards, an auditor should not accept an engagement to perform a ''review'' engagement related to an entity's compliance with specified requirements.[356] As an alternative, this commenter suggested an ''agreed-upon procedures'' approach or an examination engagement.[357]

The PCAOB's attestation standards *currently* provide that an accountant should not accept an engagement to perform a review of an entity's compliance with specified requirements or about the effectiveness of an entity's internal control over compliance, and that an agreed upon procedures engagement be considered as an alternative.[358] Irrespective of the PCAOB's current standards, Rule 17a–5, as amended, provides that the broker-dealer engage an independent public accountant to perform a review of the exemption report. Moreover, in July 2011, as part of its proposed standards for attestation engagements related to broker-dealer compliance reports or exemption reports, the PCAOB proposed replacing the provision cited by the commenter with the following: ''When a practitioner is engaged to perform a review engagement on assertions made by a broker or dealer in an exemption report that is prepared pursuant to SEC Proposed Rule 17a–5, the practitioner must conduct the review engagement pursuant to *Proposed Attestation Standard, Review Engagements Regarding Exemption Reports of Brokers and Dealers.''*[359] In addition, as discussed above, the PCAOB has proposed specific standards for an accountant to perform a review of the exemption report.[360] The PCAOB's final standards, which must be approved by the Commission, are intended by the PCAOB to clarify the procedures an independent public accountant will need to perform in a review of an exemption report.[361]

In response to the comment that a review engagement should not be employed for the exemption report because inquiry and observation would not provide sufficient evidence,[362] the independent public accountant would be able to obtain the moderate level of assurance contemplated by the required review through a combination of procedures that the accountant would perform in connection with the financial audit currently required under Rule 17a–5 and certain inquiries and other procedures specifically targeting the exemption report. Also, the PCAOB's proposal includes specific requirements for a review engagement regarding exemption reports of brokers and dealers. In addition to inquiry and observation, the PCAOB's proposal states that ''in performing the review engagement, the auditor should . . . [e]valuate whether the evidence obtained and the results of the procedures performed in the audit of the financial statements and supplemental information corroborate or contradict the broker's or dealer's assertion regarding compliance with the exemption conditions.'' [363] Additionally, the auditor should ''[p]erform other procedures as necessary in the circumstances to obtain moderate assurance.'' [364] The PCAOB's final standards will provide clarity on the procedures to be performed by the independent public accountant to obtain a moderate level of assurance to form a conclusion with respect to the review of the exemption report.[365]

The commenter's suggestion to use an ''agreed-upon procedures'' engagement for the exemption report was considered. The final rule, however, requires a review engagement as proposed. Under an ''agreed-upon procedures'' engagement, the independent public accountant is

[353] *See Deloitte Letter; KPMG Letter; PWC Letter.*

[354] *See Van Kampen/Invesco Letter.*

[355] *See* PCAOB Auditing Standard, *AS No. 12* (for audits of fiscal years beginning on or after December 15, 2010).

[356] *See E&Y Letter.*

[357] *Id.*

[358] *See* PCAOB Interim Attestation Standard, *AT Section 601* at ¶ 7.

[359] *See PCAOB Proposing Release* app. 3 at A3–4. The PCAOB's attestation standards currently provide that an accountant should not accept an engagement to perform a review of an entity's compliance with specified requirements or about the effectiveness of an entity's internal control over compliance or an assertion regarding those items. *See* PCAOB Interim Attestation Standard, *AT Section 601* at ¶ 7.

[360] *See PCAOB Proposing Release* app. 2.

[361] *Id.*

[362] *See E&Y Letter.*

[363] *See PCAOB Proposing Release* app. 2.

[364] *Id.*

[365] *Id.*

engaged by a client to issue a report of findings based on specific procedures performed on subject matter that the specified parties believe are appropriate.[366] Additionally, in an ''agreed-upon procedures'' engagement, the independent public accountant does not perform an examination or a review, and does not provide an opinion or negative assurance. Thus, no conclusion would be rendered as to the broker-dealer's statement that it met certain exemption provisions in Rule 15c3–3.

In addition to the commenter advocating an ''agreed-upon procedures'' standard,[367] a second commenter stated that the cost ''would not justify the need'' for an audit report covering the exemption report [368] and a third commenter stated that the exemption report should be replaced with a box to check on the FOCUS Report as the auditor attestation provided no added benefit.[369] In response to all these comments, the Commission notes that previously Rule 17a–5 required that if a broker-dealer is exempt from Rule 15c3–3, the independent public accountant is required to ascertain whether the conditions of the exemption were being complied with and that no facts came to the accountant's attention to indicate that the exemption had not been complied with.[370] Consequently, the rule previously required the independent public accountant to reach a conclusion with respect to a broker-dealer's claimed exemption from Rule 15c3–3. The Commission believes that the rule should continue to require a conclusion from the independent public accountant on the broker-dealer's claimed exemption from Rule 15c3–3 because of the importance of safeguarding customer securities and cash. Consequently, the Commission does not believe that it would be appropriate to use a lower standard (*i.e.,* the agreed-upon procedures standard) or to have no requirement for the independent public accountant to perform any work with respect to the exemption report. Moreover, because the independent public accountant was previously required to render a conclusion with respect to the broker-dealer's claimed exemption from Rule 15c3–3, the exemption report review should not result in significant incremental cost over the existing requirement.

As noted above, two commenters raised concerns that minor exceptions to meeting the exemption provisions of paragraph (k) of Rule 15c3–3 could result in the independent public accountant becoming aware of material modifications that should be made to the statement in the exemption report.[371] Under PCAOB standards for attestation engagements, the independent public accountant's review report on a statement in an exemption report would be required to include a statement about whether the accountant is aware of any material modifications that should be made to the statement in the exemption report in order for it to be fairly stated in all material respects.[372] As discussed above in section II.B.4.iii. of this release, the exemption report requirements have been modified from the proposal so that a broker-dealer must either state that it met the identified exemption provisions in paragraph (k) throughout the most recent fiscal year without exception or that it met the identified exemption provisions throughout the most recent fiscal year except as described in the report. Consequently, a broker-dealer that had exceptions will state that fact in the exemption report and describe the exceptions. Under PCAOB standards, if the statement is fairly stated in all material respects, including descriptions of any exceptions, the broker-dealer's independent public accountant would not need to state that the accountant is aware of any material modifications that should be made to the statement.[373]

The Commission did not receive comments regarding the proposed amendments to paragraph (i) of Rule 17a–5. However, the final rule has been revised from the proposal for clarity and consistency with the other amendments to Rule 17a–5. The title of the rule has been modified from the proposal to add a citation for clarity. As adopted, the title is, ''Reports of the independent public accountant required under paragraph (d)(1)(i)(C) of [Rule 17a–5].'' As adopted, paragraph (i)(1) of Rule 17a–5 provides, as proposed, that the independent public accountant's reports must: Be dated; be signed manually; indicate the city and state where issued; and identify without detailed enumeration the items covered by the reports.

Paragraph (i)(2) of Rule 17a–5, as adopted, is also consistent with the proposal except that the word ''Identify'' is substituted for the word ''Designate'' for clarity and the phrase ''opinions or conclusions'' is substituted for the phrase ''opinions or statement'' because as explained above, consistent with auditing standards, a review engagement will not result in an opinion, but in the accountant's conclusion in the form of ''negative assurance''—for example, a conclusion that no information came to the accountant's attention that indicates that a statement is not fairly stated in all material respects.[374] The rule therefore provides that the independent public accountant's reports must: (i) State whether the examinations or review, as applicable, were made in accordance with standards of the PCAOB; (ii) identify any examination and, if applicable, review procedures deemed necessary by the independent public accountant under the circumstances of the particular case that have been omitted and the reason for their omission. The rule also provides that: ''[n]othing in this section may be construed to imply authority for the omission of any procedure that independent public accountants would ordinarily employ in the course of an examination or review made for the purpose of expressing the opinions or conclusions required under [Rule 17a–5].''

Paragraph (i)(3) of Rule 17a–5, as adopted, is re-organized for clarity. Specific reference has been added to those statements in the compliance report that the accountant must examine, consistent with other amendments to Rule 17a–5 (*e.g.,* the amendments to paragraph (g)(2)(i) of Rule 17a–5 regarding the engagement of the accountant to prepare a report based on the examination of specified statements in the compliance report). In addition, a subparagraph is added to include a reference to the exemption

[366] *See* PCAOB Interim Attestation Standard, *AT Section 201* at ¶ .03.

[367] *See E&Y Letter.*

[368] *See Citrin Letter.*

[369] *See Angel Letter.*

[370] *See* 17 CFR 240.17a–5(g)(2).

[371] *See CAI Letter; SIFMA letter.*

[372] *See* PCAOB Interim Attestation Standard, *AT Section 101* at ¶ .90. *See also PCAOB Proposing Release* app. 2 at ¶ 11 (''The auditor should evaluate the identified instances of non-compliance with the exemption conditions to determine whether the instances of non-compliance, individually or in combination, cause the broker's or dealer's assertion not to be fairly stated, in all material respects. If the broker's or dealer's assertion is not fairly stated, in all material respects, the auditor should: (a) Modify the review report . . . and (b) evaluate the effect of the matter on the audit of the financial statements and supplemental information.'').

[373] *See* PCAOB Interim Attestation Standard, *AT Section 101* at ¶ .67 (stating that in expressing its conclusion, an independent public accounting ''should consider an omission or a misstatement to be material if the omission or misstatement—individually or when aggregated with others—is such that a reasonable person would be influenced by the omission or misstatement.'').

[374] *Id.* at ¶¶ .68, .88.

report.[375] The rule provides that the independent public accountant's reports must state clearly: (i) The opinion of the independent public accountant with respect to the financial report required under paragraph (d)(1)(i)(A) of Rule 17a–5 and the accounting principles and practices reflected in that report; (ii) the opinion of the independent public accountant with respect to the financial report required under paragraph (d)(1)(i)(A) of Rule 17a–5, as to the consistency of the application of the accounting principles, or as to any changes in those principles, that have a material effect on the financial statements; and (iii) either (A) the opinion of the independent public accountant with respect to the statements required under paragraphs (d)(3)(i)(A)(*2*), (*3*), (*4*), and (*5*) of Rule 17a–5 in the compliance report required under paragraph (d)(1)(i)(B)(*1*) of Rule 17a–5, or (B) the conclusion of the independent public accountant with respect to the statements required under paragraphs (d)(4)(i), (ii), and (iii) of Rule 17a–5. The specific references to the compliance report and exemption report in paragraph (i)(3) are intended to provide a complete description of what must be contained in the report of the independent public accountant under current attestation standards, which require a conclusion in the case of an examination to be expressed in the form of an opinion and a conclusion in the case of a review that is not expressed in the form of an opinion, but in the form of ''negative assurance.'' [376]

Paragraph (i)(4) of Rule 17a–5 has been modified from the proposal to add a reference to paragraph (d) to make it more clear that the annual reports referenced in the paragraph are the financial report, compliance report, and exemption report prescribed in paragraph (d). In addition—in the interest of using ''plain English'' in the Commission's rules—the word ''must'' has been substituted for the word ''shall'' and the word ''thereto'' has been eliminated. The rule as adopted therefore provides that ''[a]ny matters to which the independent public accountant takes exception must be clearly identified, the exceptions must be specifically and clearly stated, and, to the extent practicable, the effect of each such exception on any related items contained in the annual reports required under paragraph (d) of [Rule 17a–5] must be given.''

E. PCAOB Registration of Independent Public Accountant—Paragraph (f)(1) of Rule 17a–5

Prior to today's amendments, paragraph (f)(1) of Rule 17a–5 was titled ''Qualification of accountants'' and provided that: ''The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of his place of residence or principal office.'' [377] Paragraph (f)(3) of Rule 17a–5 provided that the accountant ''shall be independent in accordance with the provisions of § 210.2–01 (b) and (c) of this chapter'' and, paragraph (e)(1)(i) of Rule 17a–5 provided that the accountant ''shall be in fact independent as defined in paragraph (f)(3) of this section.'' [378]

As discussed above, section 17(e)(1)(A) of the Exchange Act, as amended by the Dodd-Frank Act, requires registered broker-dealers to annually file financial statements with the Commission certified by ''an independent public accounting firm, or by a registered public accounting firm if the firm is required to be registered under the Sarbanes-Oxley Act of 2002.'' Accordingly, the Commission proposed amending paragraph (f)(1) to provide that: ''The independent public accountant must be qualified and independent in accordance with § 210.2–01 of this chapter and, in addition, the independent public accountant must be registered with the Public Company Accounting Oversight Board if required by the Sarbanes-Oxley Act of 2002.'' [379] The Commission further proposed deleting the accountant independence language in paragraph (e)(1)(i) of Rule 17a–5.[380] In addition, the Commission proposed deleting paragraph (f)(3) and re-designating paragraph (f)(4) as paragraph (f)(3).[381] These proposed amendments to paragraph (f) of Rule 17a–5 would consolidate the provisions of paragraphs (e)(1)(i), (f)(1), and (f)(3) of Rule 17a–5 into paragraph (f)(1) and make Rule 17a–5 consistent with other Commission requirements governing the qualifications of accountants. The Commission received no comments on these proposals and is adopting them substantially as proposed.[382]

Although the underlying independence requirements have not changed, broker-dealers and their independent public accountants are reminded that they must comply with the independence requirements of Rule 2–01 of Regulation S–X.[383] As a result of the Sarbanes-Oxley Act of 2002, Rule 2–01 of Regulation S–X was strengthened, including increased restrictions on the provision of certain non-audit services to an audit client.[384]

Under the Commission's rules, an accountant will not be recognized as independent with respect to an audit client if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.[385] The standard is predicated largely on whether a relationship or the provision of a service: (1) Creates a mutual or conflicting interest between the accountant and the audit client; (2) places the accountant in the position of auditing his or her own work; (3) results in the accountant acting as management or an employee of the audit client; or (4) places the accountant in a position of being an advocate for the audit client.[386]

Further, Rule 2–01 of Regulation S–X sets forth a non-exclusive specification

[375] As proposed, paragraph (i)(3) did not contain a reference to the exemption report. *See Broker-Dealer Reports,* 76 FR at 37607. The final rule makes clear that the auditor's conclusion must be included in the independent public accountant's report covering the exemption report.

[376] As noted above, the accountant's conclusion in an examination engagement will be expressed in the form of an opinion. For example, the accountant's conclusion based on an examination of an assertion could state that in the accountant's opinion, the assertion is fairly stated in all material respects. *See, e.g.,* PCAOB Interim Attestation Standard, *AT Section 101* at ¶ .84. The accountant's conclusion in a review engagement will be expressed, not in the form of an opinion, but in the form of ''negative assurance.'' *See, e.g.,* PCAOB Interim Attestation Standard, *AT Section 101* at ¶ .68. For example, the accountant's conclusion based on a review of an assertion could state that no information came to the accountant's attention that indicates that the assertion is not fairly stated in all material respects. *See, e.g.,* PCAOB Interim Attestation Standard, *AT Section 101* at ¶ .88.

[377] *See* 17 CFR 240.17a–5(f)(1).

[378] *See* 17 CFR 240.17a–5(f)(3).

[379] *See Broker-Dealer Reports,* 76 FR at 37593–37594.

[380] *Id.*

[381] *Id.*

[382] *See* paragraph (f)(1) of Rule 17a–5. The Commission has revised paragraph (f)(1) of Rule 17a–5 from the proposal to: Change the title from ''Qualification of accountants'' to ''Qualifications of independent public accountant;'' and deleting the words ''in addition.''

[383] *See* 17 CFR 210.2–01.

[384] *See Strengthening the Commission's Requirements Regarding Auditor Independence,* Exchange Act Release No. 47265 (Jan. 28, 2003), 68 FR 6006 (Feb. 5, 2003). *See also Auditor Independence: SEC Review of Auditor Independence Rules,* NASD Notice to Members 02–19 (Mar. 2002).

[385] *See* 17 CFR 210.2–01(b).

[386] *See* 17 CFR 210.2–01, Preliminary Note 2.

of circumstances that are inconsistent with the general standard. For example, the accountant is prohibited from providing the following non-audit services, among others, to an audit client: [387]

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;
- Financial information systems design and implementation; and
- Management functions or human resources.

With respect to bookkeeping or other services related to the accounting records or financial statements of the audit client, Rule 2–01(c)(4)(i) of Regulation S–X specifies that these services include: (1) Maintaining or preparing the audit client's accounting records; (2) preparing financial statements that are filed with the Commission or the information that forms the basis of financial statements filed with the Commission; or (3) preparing or originating source data underlying the audit client's financial statements.[388]

Not all of the independence requirements in Rule 2–01 of Regulation S–X that are applicable to audits of issuers are applicable to engagements under Rule 17a–5. Specifically, auditors of broker-dealers are not subject to the partner rotation requirements or the compensation requirements of the Commission's independence rules because the statute mandating those requirements is limited to issuers.[389] Additionally, auditors of broker-dealers are not subject to the audit committee pre-approval requirements [390] or the cooling-off period requirements for employment [391] because those requirements only reference issuers.

F. Notification of Non-Compliance or Material Weakness

As discussed in detail below, the Commission is amending the notification provisions in Rule 17a–5 and amending Rule 17a–11 to align that rule with the amendments to Rule 17a–5. Under Rule 17a–11, a broker-dealer must provide notice to the Commission and its DEA in certain circumstances.[392] For example, paragraph (b)(1) of Rule 17a–11 requires a broker-dealer to give notice if its net capital declines below the minimum amount required under Rule 15c3–1.[393] Rule 15c3–1 and Rule 15c3–3 also require broker-dealers to provide notification in certain circumstances.[394] For example, paragraph (i) of Rule 15c3–3 requires a carrying broker-dealer to immediately notify the Commission and its DEA if it fails to make a deposit into its customer reserve account as required by paragraph (e) of Rule 15c3–3.[395]

1. New Notification Requirements—Paragraph (h) of Rule 17a–5

Prior to today's amendments, paragraph (h)(2) of Rule 17a–5 provided that if, during the course of the audit or interim work, the independent public accountant determined that any ''material inadequacies'' existed, then the independent public accountant was required to inform the chief financial officer (''CFO'') of the broker-dealer, who, in turn, was required to give notice to the Commission and the broker-dealer's DEA within 24 hours in accordance with the provisions of Rule 17a–11.[396] The rule also provided that the broker-dealer must furnish the independent public accountant with the notice, and if the independent public accountant failed to receive the notice within the 24 hour period, or if the accountant disagreed with any statements contained in the notice, the independent public accountant was required to inform the Commission and the DEA within the next 24 hours.[397] In that event, the independent public accountant was required to describe any material inadequacies found to exist or, if the broker or dealer filed a notice, the independent public accountant was required to detail the aspects of the broker-dealer's notice with which the independent public accountant did not agree.[398]

i. The Proposed Amendments

The proposed amendments to Rule 17a–5 would have replaced references to material inadequacies, including the material inadequacy report, with a requirement applicable to carrying broker-dealers to identify an instance of ''material non-compliance'' with the financial responsibility rules and any material weakness in internal control over compliance with the financial responsibility rules in the compliance report and the requirement to engage an independent public accountant to examine the compliance report.[399] Consistent with those proposed changes, the Commission proposed amending the notification provisions of paragraph (h)(2) of Rule 17a–5 to replace the term ''material inadequacy'' with the term ''material non-compliance,'' which would result in a requirement to notify the Commission upon the discovery by the accountant during the course of preparing a report based on an examination of the compliance report of an instance of material non-compliance as that term was proposed to be defined under the amendments.[400]

The Commission also proposed amending provisions regarding the notification process.[401] Under the proposal, the accountant would have been required to notify the Commission and the broker-dealer's DEA directly.[402] In the proposing release, the Commission stated that it preliminarily believed these changes would provide more effective and timely notice of broker-dealer compliance deficiencies and enable the Commission to react more quickly to protect customers and others adversely affected by those deficiencies.[403] The amendments also would have been consistent with the notification requirement in Rule 206(4)–2 that is triggered in the context of a ''surprise'' examination of an investment adviser.[404]

ii. Comments Received

The Commission received numerous comments in response to this proposal.[405] Most of these commenters objected to the proposed notification process.[406] Among the reasons given were that it would be inappropriate to require the accountant to notify the Commission and the DEA directly, because, among other things, the broker-dealer is principally responsible for compliance with the securities laws,

[387] *See* 17 CFR 210.2–01(c).

[388] *See* 17 CFR 210.2–01(c)(4)(i).

[389] *See* 15 U.S.C. 78j–1.

[390] *See* 17 CFR 210.2–01(c)(7).

[391] *See* 17 CFR 210.2–01(c)(2).

[392] *See* 17 CFR 240.17a–11.

[393] *See* 17 CFR 240.17a–11(b)(1).

[394] *See, e.g.,* 17 CFR 240.15c3–1(a)(6)(iv)(B); 17 CFR 240.15c3–1(a)(6)(v); 17 CFR 240.15c3–1(a)(7)(ii); 17 CFR 240.15c3–1(c)(2)(x)(C)(*1*); 17 CFR 240.15c3–1(e); 17 CFR 240.15c3–1d(c)(2); 17 CFR 240.15c3–3(i).

[395] *See* 17 CFR 240.15c3–3(i).

[396] *See* 17 CFR 240.17a–5(h)(2).

[397] *Id.*

[398] *Id.*

[399] *See Broker-Dealer Reports,* 76 FR at 37575–37579.

[400] *Id.* at 37579.

[401] *Id.*

[402] *Id.*

[403] *Id.*

[404] *Id.* Rule 206(4)–2 provides, in pertinent part, that upon finding any ''material discrepancies'' during the ''surprise'' examination of an investment adviser to verify client funds and securities, the independent public accountant must notify the Commission within one business day. 17 CFR 275.206(4)–2(a)(4)(ii).

[405] *See ABA Letter; CAI Letter; CAQ Letter; Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter; PWC Letter; SIFMA Letter; Van Kampen/Invesco Letter.*

[406] *See ABA Letter; CAI Letter; CAQ Letter; Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter; PWC Letter; Van Kampen/Invesco Letter.*

including timely notification;[407] that PCAOB standards provide that ''the practitioner should not take on the role of the responsible party;''[408] and that PCAOB attestation standards (which were referenced in the proposing release) clearly provide that management is responsible for the subject matter to which it is asserting, and not the accountant.[409] In addition, one commenter stated that alignment of notification procedures (that is, to require the accountant to notify the Commission directly) between Rule 17a–5 and Rule 206(4)–2 is not necessary, given the other auditing and reporting responsibilities in place or proposed.[410] In addition to suggestions that the notification process that existed prior to today's amendments should not be changed,[411] one commenter stated that the rule should require simultaneous notice by the accountant to the Commission and to the firm's management.[412]

In addition, one commenter asked whether the notification provisions apply to a review of the exemption report.[413] Another commenter stated that a report of non-compliance also will trigger a Rule 17a–11 notice, which would be duplicative and create confusion.[414]

iii. The Final Rule

In part in response to comments received, and to achieve consistency with other revisions to the proposed rule amendments described above, the notification provisions in the final rule have been modified from the proposed amendments.[415] First, the Commission is persuaded by comments received that the primary obligation to notify the Commission should remain with the broker-dealer.[416] Therefore, the notification process in place before today's amendments generally has been retained.

Second, the final rule amendments require that, if the independent public accountant determines that the broker-dealer ''is not in compliance with'' any of the financial responsibility rules during the course of preparing the accountant's reports, the independent public accountant must immediately notify the broker-dealer's CFO of the nature of the non-compliance.[417] As proposed, the independent public accountant would have been required to provide notification if the accountant determined that any ''material non-compliance'' existed. As discussed above in section II.D.3. of this release, the final rule does not include a definition of the term *material non-compliance,* as in the proposal. Thus, the independent public accountant will be required to provide notification to the broker-dealer of all instances of non-compliance with the financial responsibility rules as opposed to the proposal, which required the independent public accountant to report to the Commission and the DEA only instances of material non-compliance. While this may increase the number of times the independent public accountant must provide notification of non-compliance with the financial responsibility rules, the independent public accountant will not have to analyze whether an instance of non-compliance is ''material non-compliance'' under the proposed definition.

If the independent public accountant provides notice to the broker-dealer of an instance of non-compliance with the financial responsibility rules, the broker-dealer must provide notice to the Commission and its DEA in accordance with the notification provisions of Rule 15c3–1, Rule 15c3–3, or Rule 17a–11, but only if the notice provided by the independent public accountant concerns an instance of non-compliance that requires the broker-dealer to provide notification under those rules. The proposal would have required the accountant to notify the Commission ''upon determining that any material non-compliance exists.''[418] Rule 15c3–1, Rule 15c3–3, and Rule 17a–11 specify instances of non-compliance that require notification by the broker-dealer, and paragraph (h) of Rule 17a–5, as amended, refers to the notification provisions in those rules.

The broker-dealer must provide a copy of the notification to the accountant within one business day and, if the accountant does not receive the notice or the accountant does not agree with any statements in the notice, the accountant must provide a report to the Commission and the broker-dealer's

[407] *See Deloitte Letter.*

[408] *See KPMG Letter. See also* PCAOB Interim Attestation Standard, *AT Section 101* at ¶ .13.

[409] *See PWC Letter. See also* PCAOB Interim Attestation Standard, *AT Section 101* at ¶¶ .11–.13.

[410] *See E&Y Letter.*

[411] *See, e.g., ABA Letter; E&Y Letter; McGladrey Letter.*

[412] *See Van Kampen/Invesco Letter.*

[413] *See KPMG Letter.*

[414] *See ABA Letter.*

[415] *See* paragraph (h) of Rule 17a–5.

[416] As the proposal noted, the proposed amendment to require the independent public accountant to notify the Commission directly of material non-compliance would have been consistent with the surprise examination notification requirement in Rule 206(4)–2 under the Advisers Act. A surprise examination of an investment adviser by an independent public accountant generally verifies that client funds and securities of which the investment adviser has custody are held by a qualified custodian, such as a bank or broker-dealer. The accountant's surprise examination report opines on the adviser's compliance with the custody rule requirement that client funds and securities are maintained by a qualified custodian and also opines on the adviser's compliance with certain recordkeeping obligations between surprise examinations. The difference in nature and scope of custodial and other activities between broker-dealers and advisers results in significantly broader examination requirements for broker-dealers. Broker-dealers are required to undergo an annual examination by an independent public accountant of their financial statements and certain supporting schedules: A computation of net capital under Rule 15c3–1, a computation for determining reserve requirements under Rule 15c3–3, and information relating to the possession and control requirements of Rule 15c3–3. Moreover, under today's amendments, the independent public accountant must examine the compliance report of broker-dealers that maintain custody of customer funds or securities. The differences in the overall nature of an examination also supports continuing to maintain today's model under which a broker-dealer has the primary notification obligation (*e.g.,* unlike in the case of a surprise examination of an investment adviser, a broker-dealer would already be making its own assessment and preparing its own report in the case of a compliance report examination). Further, the Dodd-Frank Act provided the PCAOB with explicit authority to, among other things, establish (subject to Commission approval) auditing and related attestation, quality control, ethics, and independence standards for registered public accounting firms with respect to their preparation of audit reports to be included in broker-dealer filings with the Commission, and the authority to conduct and require an inspection program of registered public accounting firms that audit broker-dealers. The PCAOB oversight of broker-dealer examinations provides additional regulatory oversight with respect to the examination of the broker-dealer further supporting the retention of the primary obligation with the broker-dealer to provide notice to the Commission and the broker-dealer's DEA.

[417] *Id.* Under the current provisions of paragraph (h) of Rule 17a–5 (which are being amended), the independent public accountant ''shall call it to the attention'' of the CFO of the broker-dealer any material inadequacies. *See* 17 CFR 240.17a–5(h)(2). In the final rule, the independent public accountant is required to ''immediately notify'' the CFO of the ''nature'' of any non-compliance with the financial responsibility rules or material weakness. This change from the current notification requirement is designed to make the rule more clear as ''shall call it to the attention'' does not specify when the notification must be given. Further, as proposed, the independent public accountant would have been required to provide the Commission with notice of any material non-compliance within one business day of determining that the material non-compliance exists. *See Broker-Dealer Reports,* 76 FR at 37606. Under the final rule, the independent public accountant provides notice to the broker-dealer's CFO of any non-compliance with the financial responsibility rules or material weakness and the CFO, in turn, is required to provide the Commission and other securities regulators with notice if the non-compliance requires notice under Rule 15c3–1, Rule 15c3–3, or Rule 17a–11 or in the case of a material weakness. Consequently, because there is an intermediate step before the Commission receives notice, it is important that the independent public accountant notify the CFO immediately so that the Commission and other securities regulators receive timely notice.

[418] *See Broker-Dealer Reports,* 76 FR at 37606.

DEA within one business day.[419] The report from the accountant must, if the broker-dealer failed to file a notification, describe any instances of non-compliance that required the broker-dealer to provide a notification.[420] If the broker-dealer filed a notification but the independent public accountant does not agree with the statements in the notice, the report from the accountant must detail the aspects of the notification of the broker-dealer with which the accountant does not agree.[421] This notification process is generally the same as that in place before today's amendments.

While the final rule incorporates the existing notification process, the Commission wants to emphasize the importance of broker-dealers providing notification to the Commission and other securities regulators of non-compliance with Rule 15c3–1 as required by Rule 17a–11 and non-compliance with paragraph (e) of Rule 15c3–3 as required by paragraph (i) of Rule 15c3–3.[422] Consequently, the Commission is adding a note to paragraph (h) of Rule 17a–5 calling the attention of the broker-dealer and independent public accountant to these notification requirements.[423] Further, an important element of this process is the back-up provided by the independent public accountant in terms of the obligation under the rule to provide the Commission and DEA with notification of the instance of non-compliance if the accountant does not receive a copy of the broker-dealer's notification or the accountant does not agree with the statements in the notification. Therefore, of necessity, the independent public accountant would have to have measures in place to determine whether, and if so when, the accountant received a copy of the notification required to be provided by the broker-dealer to the Commission or the broker-dealer's DEA. An independent public accountant could decide not to rely solely on the receipt of a copy of the notice from the broker dealer and take other steps to check whether the broker-dealer provided notice to the Commission and the DEA, such as obtaining a copy of a facsimile transmission from the broker-dealer to the Commission and DEA.

Third, the proposal has been modified to add that, if the accountant determines in connection with the audit of a carrying broker-dealer's annual reports that any material weakness (as defined in paragraph (d)(3)(iii) of Rule 17a–5) exists, the independent public accountant must immediately notify the broker-dealer's CFO of the nature of the material weakness.[424] As discussed above, before today's amendments, paragraph (h)(2) of Rule 17a–5 required the accountant to notify the broker-dealer's CFO if the accountant determined that any ''material inadequacies'' existed. However, as explained above in section II.B.3. of this release, the final rules do not contain the concept of material inadequacy. Also, as the term *material weakness* is defined with respect to the compliance report, this notification requirement only applies to carrying broker-dealers, whereas the requirement to provide notification of a material inadequacy applied to carrying and non-carrying broker-dealers.

As discussed in more detail below in section II.F.2. of this release, the Commission is amending Rule 17a–11 to provide that a broker-dealer must provide notification to the Commission and its DEA if the broker-dealer discovers, or is notified by its independent public accountant, of the existence of a material weakness.[425] Paragraph (h) of Rule 17a–5, as stated above, requires that the independent public accountant notify the broker-dealer if the accountant determines that a material weakness exists.[426] The rule also requires the broker-dealer to provide notice to the Commission and its DEA in accordance with paragraph (g) of Rule 17a–11 within 24 hours and transmit a report within 48 hours of the notice stating what the broker-dealer has done or is doing to correct the situation.[427] Paragraph (h) of Rule 17a–5 requires the broker-dealer to provide the accountant with a copy of the notice it sends to the Commission within one business day and, if the accountant does not receive the notice or the accountant does not agree with the statements in the notice, the accountant must provide a report to the Commission and the broker-dealer's DEA within one business day.[428] The report from the accountant must, if the broker-dealer failed to file a notification, describe any material weakness.[429] If the broker-dealer filed a notification and the accountant does not agree with the statements in the notification, the report from the accountant must detail the aspects of the notification of the broker-dealer with which the accountant does not agree.[430] Again, this notification process is generally the same as the one in place before today's amendments.[431] In response to the comment that the rule should require simultaneous notice by the accountant to the Commission and to the firm's management, the notification procedures adopted today require that the accountant notify management of the broker-dealer and also ensure that the Commission receives timely notice.

As stated above, one commenter asked whether the notification provisions apply to a review of an exemption report.[432] The notification provisions in paragraph (h) of Rule 17a–5 with respect to non-compliance with the financial responsibility rules apply regardless of whether the independent public accountant is engaged to prepare a report based on examination of a broker-dealer's compliance report or a review of a broker-dealer's exemption report.[433] An independent public accountant may determine that a broker-dealer is not in compliance with a requirement in the financial responsibility rules (*e.g.,* not in compliance with Rule 15c3–1) during

[419] *See* paragraph (h) of Rule 17a–5.

[420] *Id.*

[421] *Id.*

[422] Paragraph (b)(1) of Rule 17a–11 provides, among other things, that every broker-dealer whose net capital declines below the minimum amount required pursuant to Rule 15c3–1 shall give notice of such deficiency that same day in accordance with paragraph (g) of Rule 17a–11 and that the notice shall specify the broker-dealer's net capital requirement and its current amount of net capital. *See* 17 CFR 240.17a–11(b)(1). Paragraph (g) of Rule 17a–11 provides, among other things, that the notice shall be given or transmitted to the principal office of the Commission in Washington, DC, the regional office of the Commission for the region in which the broker-dealer has its principal place of business, the DEA of which such broker-dealer is a member, and the CFTC if the broker-dealer is registered as a futures commission merchant with such Commission, and that the notice shall be given or transmitted by telegraphic notice or facsimile transmission. *See* 17 CFR 240.17a–11(g). Paragraph (i) of Rule 15c3–3 provides that if a broker-dealer shall fail to make a reserve bank account or special account deposit, as required by Rule 15c3–3, the broker-dealer shall by telegram immediately notify the Commission and the regulatory authority for the broker-dealer, which examines such broker-dealer as to financial responsibility and shall promptly thereafter confirm such notification in writing. *See* 17 CFR 240.15c3–3(i). The Commission staff is considering ways to modernize the process by which broker-dealers file these and other notices with the Commission.

[423] *See* note to paragraph (h) of Rule 17a–5, as adopted.

[424] *See* paragraph (h) of Rule 17a–5.

[425] *See* paragraph (e) of Rule 17a–11.

[426] *See* paragraph (h) of Rule 17a–5.

[427] *See* paragraph (h) of Rule 17a–5; 17 CFR 240.17a–11(g).

[428] *See* paragraph (h) of Rule 17a–5.

[429] *Id.*

[430] *Id.*

[431] One change from the current rule (which is being amended) is to provide that required actions be completed within ''one business day'' as opposed to within a ''24 hour period.'' This change is designed to account for non-business days during which certain actions may not be feasibly completed.

[432] *See KPMG Letter.*

[433] *See* paragraph (h) of Rule 17a–5.

the course of an audit engagement of a non-carrying broker-dealer that files an exemption report either as part of the examination of the broker-dealer's financial statements or the review of certain statements the broker-dealer's exemption report. In this case, the independent public accountant would need to immediately notify the CFO of the broker-dealer of the nature of the non-compliance. The notification provisions with respect to an instance of material weakness only apply to broker-dealers that file a compliance report because material weakness is defined for purposes of the compliance report.

The rule as amended does not require the accountant to notify the Commission directly when the accountant determines that a non-compliance with the financial responsibility rules exists, which eliminates the concern of a commenter that a report of non-compliance by the accountant, as proposed, would also trigger a Rule 17a–11 notice, which would be duplicative and create confusion.[434] As adopted, the responsibility to provide notification rests with the broker-dealer in the first instance.

2. Conforming and Technical Amendments to Rule 17a–11

Before today's amendments, paragraph (e) of Rule 17a–11 provided that whenever a broker-dealer discovered, or was notified by an independent public accountant, pursuant to paragraph (h)(2) of Rule 17a–5 or paragraph (f)(2) of Rule 17a–12 of the existence of any material inadequacy as defined in paragraph (g) of Rule 17a–5 or paragraph (e)(2) of Rule 17a–12, the broker-dealer was required to give notice to the Commission within 24 hours of the discovery or notification and transmit a report to the Commission within 48 hours of the notice stating what the broker-dealer has done or was doing to correct the situation.[435] The Commission proposed amending paragraph (e) of Rule 17a–11 to delete the references to Rule 17a–5 and to correct the references to Rule 17a–12.[436]

One commenter stated that the current notification process under paragraph (h)(2) of Rule 17a–5 and paragraph (e) of Rule 17a–11 satisfies the objective of notifying the Commission in a timely manner and that the commenter was concerned that the proposal could undermine the effectiveness of the notification process in part because it would require notice to the Commission only when the accountant determines that there is a deficiency, and not when it is independently discovered by the broker-dealer.[437]

The Commission agrees with the commenter that notification should be provided to the Commission when a deficiency in internal control is discovered by the broker-dealer, in addition to when it is notified by its accountant of the existence of any material weakness. Therefore, the final rule retains references to Rule 17a–5 in paragraph (e) of Rule 17a–11. The Commission is conforming paragraph (e) of Rule 17a–11 to today's amendments to Rule 17a–5 to substitute the term *material weakness* as defined in paragraph (d)(3)(iii) of Rule 17a–5 for the term material inadequacy with respect to Rule 17a–5 and to replace the reference to paragraph (h)(2) of Rule 17a–5 with a reference to paragraph (h) of Rule 17a–5. Specifically, the final rule provides that whenever a broker-dealer discovers, or is notified by its accountant under paragraph (h) of Rule 17a–5 of the existence of any material weakness, the broker-dealer must: (1) Give notice of the material weakness within 24 hours of the discovery or notification; and (2) transmit a report within 48 hours of the notice stating what the broker or dealer has done or is doing to correct the situation.[438] The rule retains a reference to material inadequacy as defined in paragraph (h)(2) of Rule 17a–12, but the amendments correct citations to that rule.

G. Other Amendments to Rule 17a–5

1. Information Provided to Customers—Paragraph (c) of Rule 17a–5

i. Background

Paragraph (c) of Rule 17a–5 generally requires a broker-dealer that carries customer accounts to send its balance sheet with appropriate notes and certain other financial information to each of its customers twice a year.[439] The Commission did not propose to amend this requirement. Accordingly, a broker-dealer that carries customer accounts must continue to send its customers: (1) An audited balance sheet with footnotes, including a footnote specifying the amount of the broker-dealer's net capital and required net capital, under paragraph (c)(2) of Rule 17a–5;[440] and (2) an unaudited balance sheet dated six months after the date of the audited balance sheet with footnotes, including a footnote regarding the amount of the broker-dealer's net capital and required net capital, under paragraph (c)(3) of Rule 17a–5.[441] The information required by paragraphs (c)(2) and (c)(3) of Rule 17a–5 must either be mailed to customers, or, if the broker-dealer meets certain conditions under paragraph (c)(5) of Rule 17a–5, the broker-dealer can semi-annually send its customers summary information regarding its net capital, as long as it also provides customers with a toll-free number to call for a free copy of its balance sheet with appropriate notes, makes its balance sheet with appropriate notes available to customers on its Web site, and meets other specified requirements.[442]

ii. Availability of Independent Public Accountant's Comments on Material Inadequacies—Paragraph (c)(2) of Rule 17a–5

Prior to today's amendments, paragraph (c)(2)(iii) of Rule 17a–5 provided that if, in conjunction with a broker-dealer's most recent audit report, the broker-dealer's independent public accountant commented on any material inadequacies in the broker-dealer's internal controls, its accounting system, or certain of its practices and procedures[443] under paragraphs (g) and (h) of Rule 17a–5, and paragraph (e) of Rule 17a–11, the broker-dealer's audited statements sent to customers were required to include a statement that a copy of the auditor's comments were available for inspection at the Commission's principal office in Washington, DC, and the regional office of the Commission in which the broker-

[434] *See ABA Letter.*

[435] *See* 17 CFR 240.17a–11(e).

[436] *See Broker-Dealer Reports,* 76 FR at 37579. Rule 17a–12 contains reporting requirements for over-the-counter (''OTC'') derivatives dealers. *See* 17 CFR 240.17a–12. The rule is similar to Rule 17a–5. *Compare* 17 CFR 240.17a–12, with 17 CFR 240.17a–5. For example, paragraph (h)(2) of Rule 17a–12 describes material inadequacies and paragraph (i)(2) of Rule 17a–12 provides that if the accountant determines that any material inadequacy exists, the accountant must call it to the attention of the CFO of the OTC derivatives dealer, who must inform the Commission. *See* 17 CFR 240.17a–12(h)(2) and (i). The Commission did not propose amending Rule 17a–12. Consequently, Rule 17a–12 retains the concept of material inadequacy.

[437] *See Deloitte Letter.*

[438] *See* paragraph (e) of Rule 17a–11. As stated above, this provision only applies to broker-dealers that file compliance reports, as the tern material weakness is defined with respect to the compliance report.

[439] *See* 17 CFR 240.17a–5(c).

[440] 17 CFR 240.17a–5(c)(2).

[441] 17 CFR 240.17a–5(c)(3).

[442] *See* 17 CFR 240.17a–5(c)(5). *See also Broker-Dealer Exemption from Sending Certain Financial Information to Customers,* Exchange Act Release No. 48282 (Aug. 1, 2003), 68 FR 46446 (Aug. 6, 2003).

[443] These practices and procedures include, for example, periodic net capital computations under Rule 15c3–1 and periodic counts of securities under Rule 17a–13.

dealer had its principal place of business.[444]

As discussed above in sections II.D.3. and II.F. of this release, the Commission proposed deleting references to, and the definition of, the term material inadequacy in Rule 17a–5, and proposed amending paragraph (h) of Rule 17a–5 to require a broker-dealer's independent public accountant to notify the Commission and the broker-dealer's DEA if the accountant determined that any material non-compliance existed at the broker-dealer during the course of preparing its reports.[445] Consequently, the Commission proposed replacing paragraph (c)(2)(iii) of Rule 17a–5, which contained the term material inadequacies, with a requirement that, if a broker-dealer's accountant provided notice to the Commission of an instance of material non-compliance, the financial information sent to customers under paragraph (c)(2) of Rule 17a–5 must include a statement that a copy of the accountant's notice was available for customers' inspection at the principal office of the Commission in Washington, DC.[446] Under this proposal, notices to the Commission regarding an accountant's determination that one or more instances of material non-compliance existed at a broker-dealer would be publicly available.

Three commenters responded to the proposed amendments to paragraph (c)(2) of Rule 17a–5.[447] These commenters each stated that the Commission should accord confidential treatment to accountants' notices to the Commission regarding determinations of material non-compliance.[448] One commenter stated that due to the technical nature of the financial responsibility rules, there was a risk that notices of material non-compliance could be misinterpreted by the media and others.[449]

The Commission is revising its proposal to amend paragraph (c)(2) of Rule 17a–5 to be consistent with the new notification provisions in paragraph (h) described above relating to the identification by a broker-dealer's accountant of a material weakness rather than an instance of material non-compliance.[450] Specifically, if, in connection with the most recent annual reports, the report of the independent public accountant covering the broker-dealer's compliance report identifies a material weakness, the broker-dealer must include a statement that one or more material weaknesses have been identified and that a copy of the report of the independent public accountant is currently available for the customer's inspection at the principal office of the Commission in Washington, DC, and the regional office of the Commission for the region in which the broker-dealer has its principal place of business.[451]

In response to commenters' concerns about making the report of material non-compliance available to the public, the report that now will be made publicly available is a report that identifies the existence of a material weakness—not a report of material non-compliance. In addition, making the report of the independent public accountant covering the compliance report publicly available if it identifies the existence of a material weakness is consistent with the previous treatment of a report of a material inadequacy. Providing customers notice of an accountant's finding that goes directly to the financial and operational condition of their broker-dealer and making the report containing the finding publicly available will make available to customers information that facilitates their ability to make more informed decisions in selecting broker-dealers through which they prefer to conduct business. For these reasons, the final rule does not accord confidential treatment to a report of an independent public accountant covering the compliance report if it identifies a material weakness as some commenters suggested should be the case with respect to the proposed—but not adopted—report of material non-compliance. Consequently, an independent public accountant's report covering the compliance report will be made available for the customer's inspection at the principal office of the Commission in Washington, DC, and the regional office of the Commission for the region in which the broker-dealer has its principal place of business if the report identifies the existence of a material weakness.[452]

iii. Exemption From Mailing Financial Information to Customers—Paragraph (c)(5) of Rule 17a–5

Before today's amendments, paragraph (c)(5) of Rule 17a–5 provided a conditional exemption from the requirement that a broker-dealer send paper copies of financial information to customers if the broker-dealer mailed to customers a financial disclosure statement with summary information and an Internet link to its balance sheet and other information on the broker-dealer's Web site.[453] One of the conditions of the exemption, contained in paragraph (c)(5)(vi) of Rule 17a–5, was that the broker-dealer was not required by paragraph (e) of Rule 17a–11 to give notice of a material inadequacy during the prior year. The Commission proposed revising the condition in paragraph (c)(5)(vi) of Rule 17a–5 to provide that the broker-dealer's financial statements must receive an unqualified opinion from the independent public accountant and neither the broker-dealer, under proposed paragraph (d) of Rule 17a–5, nor the independent public accountant, under proposed paragraph (g) of Rule 17a–5, identified a material weakness or an instance of material non-compliance.[454]

The Commission received several comments on the proposal.[455] One commenter stated that broker-dealers should be able to deliver the financial information available to customers via its Web site regardless of whether an instance of material non-compliance or material weakness was identified.[456] Another commenter stated that the rule should not require a 100% rate of compliance with the financial responsibility rules to qualify for the exemption.[457] A third commenter stated that the proposed amendment should be eliminated, or replaced with the requirement that broker-dealers include a notice of the material weakness or non-compliance on customer account

[444] *See* 17 CFR 240.17a–5(c)(2)(iii).

[445] *See Broker-Dealer Reports,* 76 FR at 37579.

[446] This proposal would have been codified in paragraph (c)(2)(iv) of Rule 17a–5 as a result of paragraph (c)(2)(iii) being removed and paragraph (c)(2)(iv) being redesignated as paragraph (c)(iii). *See Broker-Dealer Reports,* 76 FR at 37603.

[447] *See ABA Letter; CAI Letter; Deloitte Letter.*

[448] *Id.*

[449] *See ABA Letter.*

[450] *See* paragraph (c)(2)(iv) of Rule 17a–5.

[451] *Id.*

[452] Paragraph (c)(2)(iv) of Rule 17a–5, as adopted, includes both the principal office of the Commission in Washington, DC and the regional office of the Commission for the region in which a broker-dealer has its principal place of business as locations where the accountant's reports are available. Including the applicable regional office of the Commission as a location where these notices are available will make them more accessible to customers and is consistent with the previous treatment of material inadequacy reports.

[453] 17 CFR 240.17a–5(c)(5).

[454] *See Broker-Dealer Reports,* 76 FR at 37577.

[455] *See ABA Letter; CAI Letter; SIFMA Letter.*

[456] *See ABA Letter.*

[457] *See CAI Letter.* This commenter stated that as FINRA has proposed that broker-dealers send customer account statements monthly instead of quarterly, broker-dealers are already potentially facing ''extremely high'' costs of sending information to customers. FINRA withdrew its proposals to send customer account statements monthly instead of quarterly on July 30, 2012. *See Proposed Rule Change to Adopt FINRA Rule 2231 (Customer Account Statements) in the Consolidated FINRA Rulebook,* File No. SR–2009–028, (July 30, 2012), *available at http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p143262.pdf* (withdrawal of proposed rule change).

statements for a year following its identification.[458]

In response to comments received, the Commission has decided not to adopt the proposed condition in paragraph (c)(5)(vi) of Rule 17a–5 for qualifying for the conditional exemption. Requiring paper delivery of financial information to customers when a broker-dealer's financial statements do not receive an unqualified opinion from its independent public accountant, or when the broker-dealer fails to comply with certain regulatory requirements, will not necessarily result in a more effective means of communication to customers and runs counter to the dominant trend toward electronic communications between financial entities and their customers. Further, as discussed above, if a broker-dealer or its independent public accountant provides notice to the Commission of a material weakness in the broker-dealer's Internal Control Over Compliance, paragraph (c)(2)(iv) of Rule 17a–5 as adopted requires the broker-dealer to include with the semi-annual financial disclosure statement it sends its customers a statement that the independent public accountant identified a material weakness and that a copy of the report of the independent public accountant is available for the customers' inspection.

2. Technical Amendments

i. Deletion of Paragraph (b)(6) of Rule 17a–5

Before today's amendments, paragraph (b)(6) of Rule 17a–5 provided that ''a copy of [a broker-dealers] annual audit report shall be filed at the regional office of the Commission for the region in which the broker or dealer has its principal place of business and the principal office of the designated examining authority for said broker or dealer. Two copies of said report shall be filed at the Commission's principal office in Washington, DC. Copies thereof shall be provided to all self-regulatory organizations of which said broker or dealer is a member.'' The Commission proposed to delete this paragraph because the same provisions are in paragraph (d)(6) of Rule 17a–5.[459] The Commission received no comments on this proposal and is deleting paragraph (b)(6) of Rule 17a–5 as proposed.

ii. Deletion of Provisions Relating to the Year 2000

Before today's amendments, paragraph (e)(5) of Rule 17a–5 required broker-dealers to file Form BD–Y2K. Form BD–Y2K elicited information with respect to a broker-dealer's readiness for the year 2000 and any potential problems that could arise with the advent of the new millennium.[460] Form BD–Y2K was required to be filed in April 1999 and only then. In the proposing release, the Commission proposed to delete paragraph (e)(5) of Rule 17a–5 in its entirety because the provisions of that paragraph are now moot.[461] The Commission received no comments on this proposal and is deleting paragraph (e)(5) of Rule 17a–5 as proposed.

iii. Deletion of Paragraph (i)(5) of Rule 17a–5

In the proposing release, the Commission proposed to delete paragraph (i)(5) of Rule 17a–5, which, before today's amendments, provided that ''the terms *audit* (or *examination*), *accountant's report,* and *certified* shall have the meanings given in § 210.1–02 of this chapter.'' [462] The Commission received no comments on this proposal and is deleting paragraph (i)(5) of Rule 17a–5 as proposed.

iv. Amendments to Paragraph (f)(2) of Rule 17a–5

Before today's amendments, paragraph (f)(2) of Rule 17a–5 provided that a broker-dealer that was required to file an annual audit report must file a statement with the Commission and its DEA that it has designated an independent public accountant responsible for performing the annual audit of the broker-dealer, which was called ''Notice pursuant to Rule 17a–5(f)(2)''.[463] Paragraph (f)(2)(iii) of Rule 17a–5 prescribed the items that were required to be included in the notice: the name, address, telephone number and registration number of the broker-dealer; the name, address and telephone number of the accounting firm; and the audit date of the broker-dealer for the year covered by the agreement.[464]

In addition to the proposed amendments discussed below in section III. of this release, the Commission proposed certain technical amendments to paragraph (f)(2) of Rule 17a–5.[465] First, the Commission proposed amending the language in paragraph (f)(2)(i) of Rule 17a–5 to streamline the paragraph and to add a reference to proposed paragraph (f)(2)(ii) of Rule 17a–5, which would have prescribed the information a broker-dealer would have been required to include in its notice designating its accountant. In addition, the Commission proposed to amend paragraph (f)(2)(i) of Rule 17a–5 to require that a broker-dealer include a statement in its notice as to whether the engagement with its independent public accountant was for a single year or was of a continuing nature. This statement was previously required by paragraph (f)(2)(ii) of Rule 17a–5, which the Commission proposed to delete as part of its revisions to that paragraph. The Commission did not receive any comments on these proposed changes and is adopting them as proposed. The Commission also proposed to retain the annual December 10 filing deadline for the statements provided pursuant to paragraph (f)(2), but also added the language ''(or 30 calendar days after the effective date of its registration as a broker or dealer, if earlier).'' The Commission did not receive any comments on this amendment and is adopting it as proposed. In addition, the final rule adds a conforming change to the date of the statement designating the independent public accountant. Under the proposal, the statement must be dated ''no later than December 1.'' Under the final rules, the statement must be dated ''no later than December 1 (or 20 calendar days after the effective date of its registration as a broker or dealer, if earlier)'' to make the timing consistent with the filing deadlines described above.

As discussed in the proposing release, notices pursuant to paragraph (f)(2) of Rule 17a–5 currently on file with the Commission do not contain the representations that are required by the amendments to paragraph (f)(2) that the Commission is adopting today. Accordingly, broker-dealers subject to paragraph (f)(2) of Rule 17a–5 (*i.e.,* all broker-dealers that are required to file audited annual reports) must file a new ''statement regarding the independent

[458] *See SIFMA Letter.*

[459] *See Broker-Dealer Reports,* 76 FR at 37593. As discussed above in section II.B.6. of this release, the Commission is amending paragraph (d)(6) of Rule 17a–5 to require that a copy of a broker-dealer's annual report must be filed with SIPC. Specifically, the Commission is amending paragraph (d)(6) to provide that a broker-dealer's annual reports ''must be filed at the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the Commission's principal office in Washington, DC, the principal office of the designated examining authority for the broker or dealer, and with the Securities Investor Protection Corporation ('SIPC') if the broker or dealer is a member of SIPC. Copies of the reports must be provided to all self-regulatory organizations of which the broker or dealer is a member, unless the self-regulatory organization by rule waives this requirement.''

[460] *See Reports to be Made by Certain Brokers and Dealers,* Exchange Act Release No. 40608 (Oct. 28, 1998), 63 FR 59208 (Nov. 3, 1998).

[461] *See Broker-Dealer Reports,* 76 FR at 37593.

[462] *Id.* at 37594.

[463] *See* 17 CFR 240.17a–5(f)(2).

[464] *See* 17 CFR 240.17a–5(f)(2)(iii)(A)–(C).

[465] *See Broker-Dealer Reports,* 76 FR at 37583–37584, 37605–37606.

public accountant under Rule 17a–5(f)(2).'' [466] As specified in the new rule, if the engagement covered by the new statement is of a continuing nature, no subsequent filing would be required unless and until the broker-dealer changes its independent public accountant or amends the engagement with the accountant.[467]

v. Further Technical Amendments

In the proposing release, the Commission proposed additional technical amendments to Rule 17a–5, including changes that would consistently use the term ''independent public accountant'' throughout Rule 17a–5 when referring to a broker-dealer's accountant,[468] to make the rule gender neutral,[469] and to replace the term ''balance sheet'' with the term ''Statement of Financial Condition'' in all places where that term appeared in Rule 17a–5.[470] These technical amendments were designed to modernize the language of Rule 17a–5, and to make the rule easier to understand. The Commission received no comments on these amendments and is adopting them as proposed.

The Commission is making further technical amendments that are consistent with the Commission's ''plain English'' initiative and do not substantively affect the requirements of Rule 17a–5.[471] In addition, for clarity and consistency throughout Rule 17a–5, the Commission is amending Rule 17a–5 to replace the words ''date selected for the annual audit of financial statements'' that were previously contained in paragraphs (a)(2)(ii) and (iii) of Rule 17a–5 with the words ''end of the fiscal year of the broker or dealer.'' [472] The phrase ''date selected for the annual audit of the financial statements'' has the same meaning as the phrase ''end of the fiscal year of the broker or dealer.'' As discussed earlier, this change eliminates outdated language and conforms the text in paragraph (a) of Rule 17a–5 to the text in paragraph (n) of Rule 17a–5. The Commission is making a technical amendment to paragraph (a)(3) of Rule 17a–5. As proposed, paragraph (a)(3) provided that the reports required under paragraph (a) of Rule 17a–5 were considered filed when received at the Commission's principal office and the regional office of the Commission where the broker-dealer has its principal place of business. However, Form Custody, which broker-dealers must file under paragraph (a)(5) of Rule 17a–5, as amended, must be filed with the broker-dealer's DEA and not with the Commission. The Commission is therefore amending paragraph (a)(3) of Rule 17a–5 to clarify that this provision applies to reports ''that must be filed with the Commission.'' As a result, the Commission is making technical amendments to paragraphs (a)(2)(i) through (a)(2)(iv) of Rule 17a–5 to specify that the FOCUS Reports required under these provisions must be filed with the Commission.

The Commission also is making technical amendments to paragraph (m)(1) of Rule 17a–5, which relates to extensions and exemptions for filing annual reports, and (n)(2) of Rule 17a–5, which relates to a broker-dealer's notification requirements when changing its fiscal year, to replace the words ''annual audit reports'' and ''audit report,'' respectively, with the words ''annual reports.'' The Commission also is deleting an unnecessary citation to paragraph (d)(1)(i) of Rule 17a–5 that was previously included in paragraph (n)(2) of Rule 17a–5.

H. Coordination With Investment Advisers Act Rule 206(4)–2

1. Background

The amendments to Rule 17a–5 that the Commission is adopting today will permit carrying broker-dealers that either also are registered as investment advisers or maintain client assets of an affiliated investment adviser and are subject to the internal control report requirement in Rule 206(4)–2 to satisfy that requirement with a report prepared by the broker-dealer's independent public accountant based on an examination of certain of the broker-dealer's statements in the compliance report.

2. Rule 206(4)–2

Rule 206(4)–2 provides that a registered investment adviser is prohibited from maintaining custody of client funds or securities unless a ''qualified custodian'' maintains those funds and securities: (1) In a separate account for each client under that client's name; or (2) in accounts that contain only the investment adviser's clients' funds and securities, under the investment adviser's name as agent or trustee for the clients.[473] Under Rule 206(4)–2, only banks, certain savings associations, registered broker-dealers, FCMs, and certain foreign financial institutions may act as qualified custodians.[474]

In addition, when an investment adviser or its related person maintains client funds and securities as qualified custodian in connection with advisory services provided to clients, the adviser annually must obtain, or receive from its related person, a written internal control report prepared by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.[475] This report must be supported by the independent public accountant's examination of the qualified custodian's custody controls.[476]

The Commission has issued guidance identifying the control objectives that should be included in the scope of the internal control examination required under Rule 206(4)–2.[477] The control objectives for the Rule 206(4)–2 examination are more general than the specific operational requirements in the

[466] *See* paragraph (f)(2) of Rule 17a–5.

[467] *See* paragraph (f)(2)(i) of Rule 17a–5.

[468] *See Broker-Dealer Reports,* 76 FR at 37594.

[469] *Id.*

[470] *Id.* at 37593.

[471] These amendments replace the term ''shall'' with ''must,'' the term ''pursuant to'' with ''under,'' the term ''said'' with ''the'' or ''that,'' the term ''such'' with ''the'' or ''that,'' the term ''other than'' with ''not,'' and the term ''therewith'' with ''with the.''

[472] For example, 17 CFR 240.17a–5(a)(5), (d)(3)(i)(B), and (d)(5) each refer to the ''end of the fiscal year of the broker or dealer.''

[473] *See* 17 CFR 275.206(4)–2(a)(1)(i)–(ii).

[474] *See* 17 CFR 275.206(4)–2(d)(6).

[475] *Id.*

[476] Rule 206(4)–2 provides that the internal control report must include an opinion of an independent public accountant as to whether controls have been placed in operation as of a specific date, and are suitably designed and are operating effectively to meet control objectives relating to custodial services, including the safeguarding of funds and securities held by either the adviser or its related person on behalf of advisory clients, during the year. The rule also requires that the accountant ''verify that the funds and securities are reconciled to a custodian other than [the adviser or its] related person.'' *See* 17 CFR 275.206(4)–2.

[477] *See Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)–2 Under the Investment Advisers Act of 1940,* Advisers Act Release No. 2969 (Dec. 30, 2009), 75 FR 1492 (Jan. 11, 2010) (identifying the following specified objectives: (1) Documentation for the opening and modification of client accounts is received, authenticated, and established completely, accurately, and timely on the applicable system; (2) client transactions, including contributions and withdrawals, are authorized and processed in a complete, accurate, and timely manner; (3) trades are properly authorized, settled, and recorded completely, accurately, and timely in the client account; (4) new securities and changes to securities are authorized and established in a complete, accurate and timely manner; (5) securities income and corporate action transactions are processed to client accounts in a complete, accurate, and timely manner; (6) physical securities are safeguarded from loss or misappropriation; (7) cash and security positions are reconciled completely, accurately and on a timely basis between the custodian and depositories; and (8) account statements reflecting cash and security positions are provided to clients in a complete, accurate and timely manner).

financial responsibility rules.[478] This approach allows different types of qualified custodians (banks, certain savings associations, broker-dealers, FCMs, and certain foreign financial institutions) to establish controls and procedures that meet the identified control objectives in a manner that reflects differences in business models, regulatory requirements, and other factors.[479]

3. Broker-Dealers Acting as Qualified Custodians Under Rule 206(4)–2

Broker-dealers that also are registered as investment advisers may, acting in their capacity as broker-dealers, maintain client securities and funds as qualified custodians in connection with advisory services provided to clients.[480] As a result of being the adviser and qualified custodian to its clients, under Rule 206(4)–2 these broker-dealers must obtain an internal control report relating to the custody of those assets from an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB. In addition, broker-dealers acting as qualified custodians also may maintain advisory client assets in connection with advisory services provided by related or affiliated investment advisers. Rule 206(4)–2 requires such a broker-dealer to provide an internal control report to its related investment adviser.[481]

4. Proposal to Allow Report Based on Examination of Compliance Report to Satisfy Rule 206(4)–2

i. The Proposal

Broker-dealers that maintain custody of customer funds and securities are subject to specific operational requirements in the financial responsibility rules with respect to handling and accounting for customer assets.[482] The operational requirements of the financial responsibility rules are consistent with the control objectives outlined in the Commission's guidance on Rule 206(4)–2.[483] As a result of the proposed amendments to Rule 17a–5, the Commission stated in the proposing release that a broker-dealer subject to an examination by an independent public accountant of its compliance report that also acts as a qualified custodian for itself as an investment adviser or for its related investment advisers under Rule 206(4)–2 would be able to use the independent public accountant's report resulting from the examination to satisfy the internal control report requirement under Rule 206(4)–2.[484]

ii. Comments on the Proposal

The Commission received several comments regarding the proposal that the independent public accountant's report based on an examination of the compliance report would satisfy the internal control report under Rule 206(4)–2. One commenter stated that it is ''critically important'' that there be a single independent public accountant engagement of the custody function at both the broker-dealer and investment adviser operations of any dually registered entity (or of affiliated broker-dealers and investment advisers) and that this engagement use a single, consistent standard for evaluating custody at both the broker-dealer and investment adviser operations.[485] Two commenters noted that there are non-carrying broker-dealers that act as qualified custodians under the Advisers Act and that these broker-dealers would not be subject to the proposed compliance report requirements and, consequently, would not be able to use the report of the independent public accountant covering the compliance report to satisfy the internal control report requirement in Rule 206(4)–2 because the broker-dealers would be filing exemption reports instead of compliance reports.[486] One commenter characterized this as an area of redundancy that could be eliminated by allowing an accountant's review of a non-carrying broker-dealer's transmittal procedures to be ''recognized by the Investment Adviser regulatory regime promulgated by the Commission.''[487]

In addition, two commenters asked for clarification regarding the interaction of the proposed compliance report requirements with the requirement in Rule 206(4)–2 that investment advisers undergo an annual surprise examination by an independent accountant to verify customer funds and securities held in custody.[488] Specifically, both asked that the Commission clarify whether the independent public accountant performing the surprise examination would be able to place reliance on the proposed compliance report and related compliance examination to determine the nature and extent of the procedures for the surprise examination.[489] One of the commenters also asked that, if the Commission clarifies that the independent public accountant performing the surprise examination is expected to rely on the proposed compliance report requirements, what factors should the independent public accountant consider, given that the report based on an examination of the compliance report would not be required to be completed until 60 days after the fiscal year end while the surprise examination may occur at any time.[490]

5. Adoption of Proposal Relating to Rule 206(4)–2

As discussed above, under today's amendments, a carrying broker-dealer must prepare, and file with the Commission and its DEA, a compliance report on, among other things, its Internal Control Over Compliance, and must file with the compliance report a report prepared by its independent public accountant based on an examination of the compliance report.[491] As a result of the amendments to Rule 17a–5, the Commission has determined that the independent public accountant's report based on an examination of the compliance report

[478] *Compare* the control objectives described in *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)–2 Under the Investment Advisers Act of 1940,* 75 FR at 1494, *with* the requirements in 17 CFR 240.15c3–1, 17 CFR 240.15c3–3, 17 CFR 240.17a–13, and the DEA Account Statement Rules.

[479] *See Broker-Dealer Reports,* 76 FR at 37580.

[480] The Commission staff has estimated that approximately 18% of FINRA-registered broker-dealers also are registered as investment advisers with the Commission or with a state. *See* Commission staff, *Study on Investment Advisers and Broker-Dealers, as required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Jan. 2011).

[481] *See* 17 CFR 275.206(4)–2(a)(6). Based on data collected from the Investment Adviser Registration Depository as of August 2012, close to 200 investment advisers reported on Form ADV that client assets were being held at a qualified custodian that was related to the adviser.

[482] While Rule 15c3–1 prescribes broker-dealer net capital requirements, it also contains provisions relating to custody. For example, a broker-dealer must take net capital charges for short security differences unresolved after specifically enumerated timeframes. *See* 17 CFR 240.15c3–1(c)(2)(v)(A).

[483] *See Broker-Dealer Reports,* 76 FR at 37579–37580; *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)–2 Under the Investment Advisers Act of 1940,* 75 FR at 1493–1494.

[484] *See Broker-Dealer Reports,* 76 FR at 37579–37580.

[485] *See CFP Letter.*

[486] *See CAI Letter; Deloitte Letter.*

[487] *See Deloitte Letter.*

[488] *See CAQ Letter; PWC Letter.* Paragraph (a)(4) of Rule 206(4)–2 requires, among other things, that client funds and securities of which an investment adviser has custody must be verified by actual examination at least once during each calendar year by an independent public accountant, pursuant to a written agreement between the investment adviser and the accountant, at a time that is chosen by the accountant without prior notice or announcement to the investment adviser and that is irregular from year to year. *See* 17 CFR 275.206(4)–2.

[489] *See CAQ Letter; PWC Letter.*

[490] *See PWC Letter.*

[491] *See* 17 CFR 240.17a–5(d)(3) and (g)(2)(i).

will satisfy the internal control report requirement under Rule 206(4)–2 because the operational requirements of the financial responsibility rules are consistent with the control objectives outlined in the Commission's guidance on Rule 206(4)–2.[492] For example, to be able to include a statement that the broker-dealer has established and maintained Internal Control Over Compliance (which is defined as internal controls that have the objective of providing the broker-dealer with reasonable assurance that non-compliance with the financial responsibility rules will be prevented or detected on a timely basis),[493] a broker-dealer's internal control over compliance with Rule 17a–13 will result in controls over the safeguarding of securities from loss or misappropriation and the completeness, accuracy, and timeliness of the securities reconciliation process.[494] To make a similar statement with respect to the Account Statement Rules, a broker-dealer would of necessity have internal controls over compliance with the Account Statement Rules designed to ensure that customers receive complete, accurate, and timely information concerning securities positions and other assets held in their accounts.[495] A statement that the broker-dealer has established and maintained Internal Control Over Compliance would cover these and other internal controls over compliance with the financial responsibility rules and would be examined by the independent public accountant during the examination of the compliance report.

As commenters noted, broker-dealers that are not carrying broker-dealers are not subject to the compliance report requirements and, therefore, those broker-dealers must comply with the internal control report requirement in Rule 206(4)–2 if they are subject to that requirement. The exemption report is not redundant of the internal control report requirement in Rule 206(4)–2 because, among other things, the scope of the required statements included in a broker-dealer's exemption report is different than the scope of the internal control report requirement in Rule 206(4)–2.[496]

As noted above, commenters also asked whether the accountant would be able to place reliance on the proposed compliance report and related examination of the compliance report to determine the nature and extent of the procedures for the surprise examination. PCAOB attestation standards require an independent public accountant ''to obtain an understanding of internal control over compliance sufficient to plan the engagement and to assess control risk for compliance with specified requirements.'' [497] The Commission agrees that the independent public accountant's understanding of internal controls related to custody at the broker-dealer acting as a qualified custodian, as well as other facts and circumstances, may affect the nature and extent of procedures performed for the annual surprise examination.[498] The Commission has provided interpretive guidance on the relationship between the annual surprise examination and the internal control report for engagements performed pursuant to Rule 206(4)–2.[499]

III. Access to Accountant and Audit Documentation

The Commission proposed amending paragraph (f)(2) of Rule 17a–5 to require that each clearing broker-dealer [500] include a representation in its statement regarding its independent public accountant that the broker-dealer agrees to allow Commission and DEA examination staff to review the audit documentation associated with its annual audit reports required under Rule 17a–5 and to allow its independent public accountant to discuss findings relating to the audit reports with Commission and DEA examination staff if requested for the purposes of an examination of the broker-dealer.[501] This proposed requirement was intended to facilitate examinations of clearing broker-dealers by Commission and DEA examination staff.[502] Access to information obtained from audit documentation and discussions with a clearing broker-dealer's independent public accountant would enhance the efficiency and effectiveness of Commission and DEA examinations by providing examiners with access to additional relevant information to plan their examinations.[503]

The Commission proposed to limit this requirement to clearing broker-dealers, which generally have more complex business operations than non-carrying firms.[504] Thus, access to accountants and audit documentation was considered of substantially greater value when preparing for regulatory examinations of these types of broker-dealers, as compared to firms with more limited business models.

To facilitate Commission and DEA examination staff access to a clearing broker-dealer's independent public accountant and the accountant's audit documentation, the Commission proposed amending paragraph (f)(2) of

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[492] *See Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)–2 Under the Investment Advisers Act of 1940,* 75 FR at 1494; *Broker-Dealer Reports,* 76 FR at 37579–37580. As discussed above in section II.D.3. of this release, the independent public accountant must examine the compliance report in accordance with attestation standards promulgated by the PCAOB. Consequently, the PCAOB's attestation standards are integral to the Commission's determination that the independent public accountant's report based on an examination of the compliance report satisfies the internal control report requirement under Rule 206(4)–2. The Commission could revisit this determination if the PCAOB's attestation standards do not support the determination.

[493] *See* paragraphs (d)(3)(i)(A)(*1*) and (d)(3)(ii) of Rule 17a–5.

[494] *See* 17 CFR 240.17a–13. As discussed above in section II.D.3. of this release, the PCAOB proposed attestation standards related to the compliance report. The PCAOB's proposed attestation standards include a requirement that the independent public accountant must perform procedures to obtain evidence about the existence of customer funds or securities held for customers, *e.g.,* confirmation of customer security positions directly with depositories and clearing organizations. *See PCAOB Proposing Release* app. 1, at ¶ 26. This procedure would be consistent with the tests of the qualified custodian's reconciliation that the Commission specified in the guidance on Rule 206(4)–2. *See Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)–2 Under the Investment Advisers Act of 1940,* 75 FR 1494.

[495] *See, e.g.,* CBOE Rule 9.12; NASD Rule 2340. *See also Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)–2 Under the Investment Advisers Act of 1940,* Advisers Act Release No. 2969 (Dec. 30, 2009), 75 FR 1494 (Jan. 11, 2010), which describes as a control objective for qualified custodians (including broker-dealer qualified custodians) that account statements reflecting cash and security positions are provided to clients in a complete, accurate and timely manner.

[496] *See supra* notes 299, 300.

[497] *See* PCAOB Interim Attestation Standard, *AT Section 601. AT Section 601* requires an independent public accountant ''to obtain an understanding of internal control over compliance sufficient to plan the engagement and to assess control risk for compliance with specified requirements. In planning the examination, such knowledge should be used to identify types of potential non-compliance, to consider factors that affect the risk of material noncompliance, and to design appropriate tests of compliance.'' *Id.* at ¶ .45.

[498] *Id.*

[499] *See Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)–2 Under the Investment Advisers Act of 1940,* Advisers Act Release No. 2969 (Dec. 30, 2009), 75 FR 1492 (Jan. 11, 2010).

[500] For the purpose of this release, a ''clearing broker-dealer'' is a broker-dealer that clears transactions or carries customer accounts.

[501] *See Broker-Dealer Reports,* 76 FR at 37583–37584.

[502] *Id.*

[503] For example, where an independent public accountant has performed extensive testing of a carrying broker-dealer's custody of funds and securities by confirming holdings at custodians and sub-custodians, examiners could focus their efforts on other matters that had not been the subject of prior testing and review.

[504] *See Broker-Dealer Reports,* 76 FR at 37583.

Rule 17a–5 to require that a clearing broker-dealer's notice designating its independent public accountant include, among other things, representations: (1) That the broker-dealer agrees to allow representatives of the Commission or the broker-dealer's DEA, if requested for purposes of an examination of the broker-dealer, to review the documentation associated with the reports of its independent public accountant prepared pursuant to paragraph (g) of Rule 17a–5; and (2) that the broker-dealer agrees to permit its independent public accountant to discuss with representatives of the Commission and the DEA, if requested for the purposes of an examination of the broker-dealer, the findings associated with the reports of the accountant prepared pursuant to paragraph (g) of Rule 17a–5.[505] Proposed paragraph (f)(2)(iii) of Rule 17a–5 provided that a broker-dealer that does not clear transactions or carry customer accounts would not be required to include these representations in its notice.[506]

Eight commenters addressed the proposed changes to paragraph (f)(2) of Rule 17a–5.[507] Generally, commenters requested that the Commission do one or more of the following: (1) Clarify the type of documentation that the Commission and DEA examiners would seek to access [508]; (2) grant confidential treatment to documentation obtained by the Commission under this provision [509]; (3) clarify the process by which Commission and DEA examiners would seek access to a broker-dealer's independent public accountant and its audit documentation [510]; and (4) limit the use of information and documentation obtained from a broker-dealer's independent public accountant.[511] In addition, one commenter raised general concerns that providing Commission and DEA examiners with access to a broker-dealer's auditor and audit documentation will discourage communications between broker-dealers and their auditors and may require auditors to produce documentation protected by attorney-client and/or accountant-client privilege.[512] Finally, one commenter asserted that it is reasonable for securities regulators to be able to validate any concerns promptly with a broker-dealer's accountant.[513]

In response to requests for clarity as to the types of audit documentation that Commission and DEA examiners would seek to access under the proposal, the Commission revised proposed paragraph (f)(2)(ii)(F) of Rule 17a–5 to clarify that ''audit documentation'' has the meaning established by PCAOB standards.[514] This revision, which was specifically suggested by two commenters,[515] is not intended to alter an independent public accountant's obligations with respect to audit documentation; rather, it is intended to clarify the types of audit documentation that the Commission and DEA examiners may ask to review in connection with a broker-dealer examination.

In response to questions regarding the process by which Commission and DEA examiners might seek to access audit documentation, the Commission agrees with a commenter that suggested that these requests be in writing because that will provide independent public accountants with a record of requests for information and specify the documentation the Commission or DEA examination staff would like to access.[516] Therefore, the Commission has modified the rule from the proposal to provide that a request to a broker-dealer's independent public accountant for the accountant to discuss audit findings or for access to audit documentation be made in writing.

Independent public accountants can seek to protect information obtained by examiners from being disclosed to Freedom of Information Act (''FOIA'') requestors by specifically requesting confidential treatment of audit documentation following the process described in Rule 83 of the Commission's Rules on Information and Requests.[517] The Commission anticipates that it will accord confidential treatment to such documents to the extent permitted by law.[518]

Two commenters requested that the Commission clarify the intended use of information and documents obtained from an independent public accountant.[519] One recommended that the Commission clarify that the information obtained from the independent public accountant not be used for any purpose other than in connection with a regulatory examination of the broker-dealer.[520] The other suggested that the rule text state that the requests for information should be solely for the purposes of conducting a regulatory examination of the clearing broker-dealer.[521] The Commission does not believe that it is necessary to modify the proposed rule text in response to these comments. The Commission stated that it did not propose that examiners would use the requested information for the purpose of inspecting independent public accountants.[522] As the Commission stated in the proposing release, the purpose of this access requirement is to enhance and improve the efficiency and effectiveness of Commission and DEA examinations of broker-dealers.[523] The PCAOB is responsible for inspections of independent public accountants that audit broker-dealers.[524] In response to these comments, the Commission reiterates its intention, as stated in the proposing release, that any requests for

[505] *Id.*

[506] *Id.*

[507] *See CAI Letter; CAQ Letter; CFP Letter; Deloitte Letter; E&Y Letter; KPMG Letter; PWC Letter; SIFMA Letter.*

[508] *See CAQ Letter; Deloitte Letter; E&Y Letter; KPMG Letter.*

[509] *See CAI Letter; KPMG Letter; PWC Letter; SIFMA Letter.*

[510] *See Deloitte Letter; E&Y Letter; KPMG Letter.*

[511] *See E&Y Letter; PWC Letter.*

[512] *See CAI Letter.*

[513] *See CFP Letter.*

[514] PCAOB Auditing Standard 3 defines ''Audit documentation'' as the ''written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise. Audit documentation also facilitates the planning, performance, and supervision of the engagement, and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. Among other things, audit documentation includes records of the planning and performance of the work, the procedures performed, evidence obtained, and conclusions reached by the auditor. Audit documentation also may be referred to as *work papers* or *working papers*.''

[515] *See CAQ Letter; KPMG Letter.*

[516] *See KPMG Letter. See also Deloitte Letter,* which suggests that Commission and DEA examiners first provide notice to the broker-dealer, in writing, of plans to request access to the broker-dealer's audit documentation and then make a written request to the accountant. Although, in practice, Commission and DEA examiners may provide advance or simultaneous notice to a broker-dealer of requests to access audit documentation from the broker-dealer's accountant, the Commission is not adopting a requirement that examiners so notify broker-dealers of such requests. This additional notification would likely delay an examiner's ability to gain access to the broker-dealer's audit documentation and is not necessary given the broker-dealer's prior consent. In addition, a broker-dealer can request that its accountant provide notice when examiners request audit documentation, and, expects that, in practice, accountants will provide such notice. *See also E&Y Letter.*

[517] 17 CFR 200.83. Generally, persons who submit information to the Commission may request that the Commission accord confidential treatment to the information for any reason permitted by federal law.

[518] The Commission believes that this audit documentation likely would fall under exemptions (b)(8) and/or (b)(4) of FOIA. *See* 5 U.S.C. 522(b)(8); 5 U.S.C. 522(b)(4).

[519] *See E&Y Letter; PWC Letter.*

[520] *See PWC Letter.*

[521] *See E&Y Letter.*

[522] *See Broker-Dealer Reports,* 76 FR at 37583.

[523] *Id.*

[524] *Id.*

audit documentation under this provision would be made exclusively in connection with conducting a regulatory examination of a broker-dealer.[525]

One commenter stated that Commission and DEA examiners should be limited to inspecting audit documentation relating to a broker-dealer in the offices of the broker-dealer's independent public accountant and that the broker-dealer should be permitted to be present during conversations between Commission or DEA staff and the accountant.[526] The Commission has considered these comments and decided not to modify the proposal in response to these comments. However, Commission and DEA examiners may exercise discretion in determining whether to review audit documentation in the offices of the broker-dealer's accountant and whether to permit the broker-dealer to be present during conversations with the accountant. This commenter also requested that the Commission establish a process by which broker-dealers can object to overly broad or unduly burdensome requests.[527] The rule will not be modified in response to this comment and the Commission recommends that any concerns regarding the scope of audit documentation requests be directed to the examiner from whom the request was received. The examiner will consider the concerns and determine whether and how to limit the scope of the audit documentation request, if appropriate. The independent public accountant also can express concerns to senior examination staff if the scope of the audit documentation request remains a concern after discussions with the examiner.

Another commenter stated that the Commission must be responsible for returning all audit work papers that it receives for purposes of an examination of the broker-dealer to either the broker-dealer or its accountant.[528] The purpose of requesting access to audit documentation is to assist examiners in conducting a regulatory examination of the clearing broker-dealer. Upon completion of the examination, if the Commission and DEA, and any offices and divisions thereof, no longer need the audit documentation, the Commission and DEA will, upon the request of the independent public accountant and in the absence of unusual circumstances, return audit documentation to the independent public accountant or the broker-dealer within a reasonable time after the examination is complete.

One commenter stated that, if adopted, this requirement will discourage or ''chill'' communications between a broker-dealer and its auditor because ''the broker-dealer knows that regardless of the nature of an auditing issue and how it was discovered . . . it cannot freely seek advice from, or discuss the issue openly with[] the auditor[] without fear of the auditor misunderstanding the broker-dealer's response or simply drawing a conclusion that a broker-dealer's questions indicate the broker-dealer's lack of knowledge or admission of an issue.'' [529] Presumably, this ''chilling effect'' would result from a broker-dealer's desire to avoid the creation of audit documentation memorializing misunderstandings and miscommunications, which, when accessed by Commission and DEA examiners, could result in regulatory scrutiny. The Commission is not persuaded by this comment; while it is possible for miscommunications to occur between representatives of a broker-dealer and its auditor, potential misunderstandings or miscommunications should not limit the ability of the Commission or a DEA to have access to audit documentation or a broker-dealer's independent public accountant. Further, to the extent a misunderstanding or miscommunication between a broker-dealer and its accountant is reflected in the accountant's audit documentation relating to the broker-dealer, the broker-dealer could clarify the nature of the misunderstanding or miscommunication to examiners and explain how it was rectified if such clarification and rectification is not already described in subsequent audit documentation.

The same commenter also asserted that the requirement that broker-dealers allow regulators to access audit documentation may, in effect, require auditors to produce documentation protected by attorney-client privilege or accountant-client privilege.[530] The rule language providing Commission and DEA examiners with access to a broker-dealer's auditor and audit documentation is not designed to affect the circumstances in which privilege can be asserted. Any claims of privilege can be addressed on a case-by-case basis by appropriate Commission and DEA staff as those claims arise.

IV. Form Custody

A. Background

Proposed Form Custody was comprised of nine line items (each, an ''Item'') designed to elicit information about a broker-dealer's custodial activities.[531] As is discussed below, several Items on the proposed form contained multiple questions, and some required the completion of charts and the disclosure of custody-related information specific to the broker-dealer completing the form.[532]

The Commission received nine comment letters on proposed Form Custody.[533] While commenters generally supported the proposed form, the Commission received several comments on the timing of, exemptions from, and the compliance date for filing the form and whether a broker-dealer also would be required to file an accountant's attestation covering the form.[534] In addition, several commenters suggested that the Commission make certain revisions to the form and address certain technical interpretative questions.[535] One commenter, who agreed ''in concept'' that Form Custody is appropriate for custodial broker-dealers, also stated that the aggregate cost estimate of the proposed form was ''staggering.'' [536]

The Commission is adopting the requirement that broker-dealers file Form Custody with their DEAs, subject to modifications that, in part, respond to issues raised by commenters. A description of the comments on the proposed process for filing Form Custody is set forth below in section IV.B. of this release, together with a discussion of the final rule amendments that the Commission is adopting today. A description of the comments on the proposed form is set forth below in section IV.C. of this release, together with a discussion of the final form the Commission is adopting today.

B. Filing of Form Custody

1. Requirement to File Form Custody with FOCUS Reports

Under paragraph (a) of Rule 17a–5, a broker-dealer is required to file periodic

[525] *Id.*

[526] *See SIFMA Letter.*

[527] *Id.*

[528] *See CAI Letter.*

[529] *Id.*

[530] *Id.*

[531] *See Broker-Dealer Reports,* 76 FR at 37584–37592.

[532] *Id.*

[533] *See Angel Letter; Barnard Letter; CAI Letter; CFP Letter; E&Y Letter; IMS Letter; KPMG Letter; Shatto Letter; SIFMA Letter.*

[534] *See CAI Letter; E&Y Letter; KPMG Letter; Shatto Letter; SIFMA Letter.*

[535] *See Angel Letter; CFP Letter; SIFMA Letter.*

[536] *See IMS Letter.* This commenter, however, did not provide any suggestion for reducing the costs associated with Form Custody. *See* section VII. below for an economic analysis of the costs and benefits relating to Form Custody.

FOCUS Reports with the Commission and the broker-dealer's DEA.[537] In the proposing release, the Commission proposed adding paragraph (a)(5) to Rule 17a–5 to require the filing of Form Custody, which was designed to elicit information concerning whether a broker-dealer maintained custody of customer and non-customer assets, and, if so, how such assets were maintained.[538] Under this proposed amendment, a broker-dealer would be required to file Form Custody with its DEA at the same time it filed its periodic FOCUS Report with its DEA under paragraph (a) of Rule 17a–5.[539] The DEA, in turn, would be required to maintain the information obtained through the filing of Form Custody and to transmit such information to the Commission at such time as it transmits FOCUS Report data to the Commission under paragraph (a)(4) of Rule 17a–5.[540]

A broker-dealer's FOCUS Report provides the Commission and a broker-dealer's DEA with information relating to the broker-dealer's financial and operational condition but does not solicit detailed information on how a broker-dealer maintains custody of assets.[541] Proposed Form Custody was intended to provide additional information about a broker-dealer's custodial activities and to make it easier for examiners to identify risks and possible violations of laws and regulations concerning the broker-dealer's custody of assets.[542] If, upon reviewing Form Custody, regulatory authorities were to become aware of inconsistencies or other red flags in information contained on the form, they could initiate a more focused and detailed analysis of the broker-dealer's custodial activities. Such an analysis could, in turn, identify potential abuses related to customer assets. Moreover, proposed Form Custody was intended to expedite the examination of a broker-dealer's custodial activities and reduce examination costs, as examiners would no longer need to request basic custody-related information already disclosed on the form.[543]

The Commission proposed that a broker-dealer file Form Custody with its DEA within 17 business days after the end of each calendar quarter and within 17 business days after the date selected for the broker-dealer's annual report where that date was other than the end of a calendar quarter.[544] The Commission received one comment regarding proposed paragraph (a)(5) of Rule 17a–5, which supported the Commission's proposal as to when a broker-dealer should be required to file Form Custody.[545]

The Commission is adopting paragraph (a)(5) of Rule 17a–5 substantially as proposed. As to when a broker-dealer must file its Form Custody with its DEA, the Commission is adopting its proposal that a broker-dealer file Form Custody with its DEA within 17 business days after the end of each calendar quarter.[546] However, for year end filings of Form Custody by a broker-dealer that has selected a fiscal year end date that is not the end of a calendar year, the Commission has modified its proposal to provide that a broker-dealer also must file Form Custody with its DEA within 17 business days after the end of the broker-dealer's fiscal year.[547]

The Commission did not receive any comments relating to when DEAs are required to transmit Form Custody information to the Commission and is adopting this requirement as proposed.

2. Requests for Exemption From Filing Form Custody

One commenter recommended that the Commission include a provision in Rule 17a–5 that would enable the Commission to exempt broker-dealers from the requirement to file Form Custody if the Commission determined that receiving the form for a particular firm, or type of firm, would serve no useful purpose.[548] For example, the commenter stated that no useful purpose would be served by receiving Form Custody from a firm that has no customer or non-customer accounts.[549]

The Commission intends for all broker-dealers to file Form Custody without exception. The Commission is concerned about circumstances where broker-dealers falsely represent to regulators and others that they do not handle funds or securities or issue trade confirmations or account statements. One of the purposes of Form Custody is to assist Commission and DEA examiners in identifying potential misrepresentations relating to broker-dealers' custody of assets. Through Form Custody, examiners will be in a position to better understand a broker-dealer's custody profile and identify custody-related violations and misconduct. For example, if a broker-dealer represents on Form Custody that it does not issue account statements, but an examiner receives an account statement issued by the broker-dealer (*e.g.,* in connection with a customer complaint or in the course of an examination of the broker-dealer), the examiner will be able to react more quickly to the misrepresentation. Further, the requirements to file the form will promote greater focus and attention to custody practices by requiring that broker-dealers make specific representations in this regard.

In addition, although the Commission does not currently contemplate any circumstance in which it would exempt a broker-dealer from having to file Form Custody, if the Commission subsequently determines that it is appropriate to exempt a broker-dealer, or type of broker-dealer, from such requirements, the Commission can act under existing authority. In particular, under section 36 of the Exchange Act, the Commission, by rule, regulation, or order, may exempt any person, or any class or classes of persons, from any rule under the Exchange Act to the extent that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors.[550]

Nonetheless, the Commission understands that a number of Items on Form Custody may not apply to certain types of broker-dealers (*e.g.,* broker-

[537] *See* 17 CFR 240.17a–5(a); 17 CFR 249.617. FOCUS Reports are one of the primary means of monitoring the financial and operational condition of broker-dealers and enforcing the broker-dealer financial responsibility rules. The completed forms also are used to determine which firms are engaged in various securities-related activities and how economic events and government policies might affect various segments of the securities industry. The FOCUS Report was designed to eliminate overlapping regulatory reports required by various SROs and the Commission and to reduce reporting burdens as much as possible. FOCUS Reports and Form Custody are deemed confidential under paragraph (a)(3) of Rule 17a–5.

[538] *See Broker-Dealer Reports,* 76 FR at 37592. For purposes of Form Custody, the term ''customer'' means a person that is a ''customer'' for purposes of Rule 15c3–3(a), and a ''non-customer'' means a person other than a ''customer'' as that term is defined in Rule 15c3–3(a). *See* 17 CFR 240.15c3–3(a); FINRA, *Interpretations of Financial and Operational Rules,* Rule 15c3–3(a)(1)/01, *available at http://www.finra.org/Industry/Regulation/Guidance/FOR/.*

[539] *See Broker-Dealer Reports,* 76 FR at 37592.

[540] *Id.*

[541] *See* Form X–17A–5 Schedule I, Part II, Part IIa, Part IIb, and Part III.

[542] *See Broker-Dealer Reports,* 76 FR at 37585.

[543] *Id.*

[544] *Id.* at 37592.

[545] *See Shatto Letter.*

[546] *See* paragraph (a)(5) of Rule 17a–5.

[547] *Id.* Consistent with the proposal, a broker-dealer must file Form Custody with its DEA at the same time that the broker-dealer files its FOCUS Report with its DEA. However, since the final rule changes the date for the filing of the year end FOCUS Report to ''within 17 business days after the end of the fiscal year where that date is not the end of a calendar quarter,'' the deadline for the year end filing of Form Custody is correspondingly changed to ''within 17 business days after the end of the fiscal year of the broker or dealer where that date is not the end of a calendar quarter.''

[548] *See CAI Letter.*

[549] *Id.*

[550] 15 U.S.C. 78mm.

dealers that do not carry customer, non-customer, or proprietary securities accounts) and has modified the form's instructions to make clear that questions on the form that cannot be answered because the broker-dealer does not engage in a particular activity do not need to be answered.[551]

3. Attest Engagement Not Required for Form Custody

In response to a question posed by the Commission in the proposing release, one commenter stated that the Commission should not require a broker-dealer to engage a PCAOB-registered independent public accountant to audit Form Custody.[552] This commenter stated that an audit of Form Custody is not necessary since the intent of the form is to gather custody-related information, which in some cases may not be derived from the broker-dealer's books and records.[553] This commenter also does not believe that the benefits of performing an audit of the information included on Form Custody would outweigh the costs or that an audit is necessary for the Commission to achieve its principal objective of using the information in the examination of a broker-dealer's custody activities.[554]

The Commission did not propose to require that a broker-dealer engage an independent public accountant to review Form Custody, and agrees that such a requirement should not be imposed. Accordingly, under today's amendments, broker-dealers are not required to enter into an attestation engagement with an independent public accountant for purposes of reviewing Form Custody.

C. Form Custody

As is discussed above, proposed Form Custody was comprised of nine Items designed to elicit information about a broker-dealer's custodial activities. Set forth below is a description of each of the Items.

1. Item 1—Accounts Introduced on a Fully Disclosed Basis

Item 1 consists of two subparts. Item 1.A, as proposed, would have elicited information concerning whether the broker-dealer introduced customer accounts to another broker-dealer on a fully disclosed basis by requiring the broker-dealer to check the appropriate ''Yes'' or ''No'' box.[555] Item 1.B of Form Custody would require broker-dealers that check ''Yes'' on Item 1.A to identify each broker-dealer to which customer accounts are introduced on a fully disclosed basis.[556] The Commission did not receive any comments on Item 1.A or 1.B and is adopting this Item as proposed.

As is discussed in the proposing release, many broker-dealers enter into agreements (''carrying agreements'') with another broker-dealer in which the two firms allocate certain responsibilities with respect to the handling of accounts.[557] These carrying agreements are governed by applicable SRO rules, which require a broker-dealer entering into a carrying agreement to allocate certain responsibilities associated with introduced accounts.[558]

Typically, under a carrying agreement, one broker-dealer (''introducing broker-dealer'') agrees to act as the customer's account representative (*e.g.,* by providing the customer with account opening documents, ascertaining the customer's investment objectives, and making investment recommendations). The carrying broker-dealer typically agrees to receive and hold the customer's cash and securities, clear transactions, make and retain records relating to the transactions and the receipt and holding of assets, and extend credit to the customer in connection with the customer's securities transactions.

Item 1.A, as adopted, elicits information concerning whether the broker-dealer introduces customer accounts to another broker-dealer on a fully disclosed basis, rather than asking whether the broker-dealer is an ''introducing broker-dealer.'' The Commission is presenting the question in this manner because some broker-dealers operate as carrying broker-dealers (*i.e.,* they hold cash and securities) for one group of customers but also introduce the accounts of a second group of customers on a fully disclosed basis to another broker-dealer. For example, a broker-dealer may incur the capital expense and cost of acting as a carrying broker-dealer for certain products (*e.g.,* equities) but not for other products (*e.g.,* options). In this case, the firm operates as a hybrid introducing/carrying broker-dealer by introducing on a fully disclosed basis to a carrying broker-dealer those customers that trade securities for which the broker-dealer is not prepared to provide a full range of services. Broker-dealers also may introduce customer accounts on an omnibus basis, as is discussed below in section IV.C.2. of this release.

If the broker-dealer answers Item 1.A by checking the ''Yes'' box, the broker-dealer will be required under Item 1.B to identify each broker-dealer to which customer accounts are introduced on a fully disclosed basis. The carrying broker-dealer in such an arrangement maintains the cash and securities of the introduced customers and is therefore obligated to return cash and securities to the introduced customers. Commission and DEA examiners could use the identification information provided by a broker-dealer in response to Item 1.B to confirm the existence of an introducing/carrying relationship.

2. Item 2—Accounts Introduced on an Omnibus Basis

Item 2 of Form Custody consists of two subparts. Item 2.A, as proposed, would have elicited information concerning whether the broker-dealer introduced customer accounts to another broker-dealer on an omnibus basis by requiring the broker-dealer to check the appropriate ''Yes'' or ''No'' box.[559] Item 2.B, as proposed, would require a broker-dealer that checks ''Yes'' in response to Item 2.A to identify each broker-dealer to which customer accounts are introduced on an omnibus basis.[560] The Commission did not receive any comments on Items 2.A or 2.B and is adopting this Item as proposed.

An omnibus account is an account carried and cleared by another broker-dealer that contains accounts of undisclosed customers on a commingled basis and that are carried individually on the books of the broker-dealer introducing the accounts.[561] Disclosure of this information is important because when a broker-dealer introduces customer accounts to another broker-dealer on an omnibus basis, the introducing broker-dealer (in addition to the broker-dealer carrying the omnibus account) is considered to be a carrying broker-dealer with respect to those accounts under the Commission's broker-dealer financial responsibility

[551] *See* General Instruction A to Form Custody.

[552] *See KPMG Letter. See also Broker-Dealer Reports,* 76 FR at 37592.

[553] *See KPMG Letter.*

[554] *Id.*

[555] *See Broker-Dealer Reports,* 76 FR at 37585. *See AICPA Broker-Dealer Audit Guide* glossary (defining the term *fully disclosed basis* as a ''situation in which a nonclearing broker introduces a customer to a clearing broker and the customer's name and statement are carried by, and disclosed to, that clearing broker.'').

[556] *See Broker-Dealer Reports,* 76 FR at 37585.

[557] *Id.*

[558] *See, e.g.,* FINRA Rule 4311.

[559] *See Broker-Dealer Reports,* 76 FR at 37585–37586.

[560] *Id.* at 37586.

[561] *See AICPA Broker-Dealer Audit Guide* at ¶¶ 5.144–5.145.

rules.[562] Thus, in these arrangements, the broker-dealer introducing the omnibus account is obligated to return cash and securities in the account to customers.[563]

If the broker-dealer checks the ''Yes'' box in Item 2.A, it will be required to identify in Item 2.B each broker-dealer to which accounts are introduced on an omnibus basis. Commission and DEA examiners could use this information to confirm whether the cash and securities introduced to the carrying broker-dealer are in fact being held in an omnibus account at the carrying broker-dealer and that the books and records of the broker-dealer that introduced the customer accounts to the carrying broker-dealer reflect the correct amounts of customer cash and securities held in the omnibus account.

3. Item 3—Carrying Broker-Dealers

Item 3 of Form Custody, as proposed, would have elicited information concerning how a carrying broker-dealer held cash and securities.[564] Proposed Item 3 was comprised of five subparts, as described below.[565] Two commenters specifically addressed this Item, in particular regarding subparts 3.C., 3.D, and 3.E, which also are discussed below.[566]

i. Items 3.A and 3.B

The first question of Item 3 of proposed Form Custody—Item 3.A—would have elicited information concerning whether the broker-dealer carried securities accounts for customers by requiring the broker-dealer to check the appropriate ''Yes'' or ''No'' box.[567] The General Instructions to Form Custody specify that the term ''customer'' as used in the Form means a ''customer'' as defined in Rule 15c3–3.

The next question of Item 3—Item 3.B—would have elicited information concerning whether the broker-dealer carried securities accounts for persons that are not ''customers'' under the definition in Rule 15c3–3.[568] For example, under Rule 15c3–3, persons that are not ''customers'' include an accountholder that is a general partner, director, or principal officer of the carrying broker-dealer, and accountholders that are themselves broker-dealers.[569] The Commission did not receive any comments on Item 3.A or 3.B and is adopting these questions as proposed.

ii. Item 3.C

a. Background

Item 3.C, as proposed, would have required the broker-dealer to identify in three charts the types of locations where it held securities and the frequency with which it performed reconciliations between the information on its stock record and information on the records of those locations.[570] Each of these charts, which are set forth in Items 3.C.i through 3.C.iii, is discussed in more detail below.

b. General Comments to Item 3.C

One commenter suggested that it would be helpful to require the broker-dealer to disclose the identities of specific entities at which it custodies securities.[571] This commenter stated that such disclosure would allow regulators to identify potential discrepancies more easily, as well as changes in custody relationships that may warrant further investigations.[572]

The Commission has considered this suggestion and determined that providing the identities of a broker-dealer's custodians instead of the types of locations would significantly increase the burden on broker-dealers in preparing the form, which is intended to be a starting point for Commission and DEA examiners in assessing a broker-dealer's compliance with its custody requirements. Large broker-dealers often maintain custody of customers' securities in many locations, which can total in the hundreds, particularly if the broker-dealer carries a large number of uncertificated investments for customers, such as alternative investments. Requiring broker-dealers to disclose this level of detail on Form Custody could significantly increase the costs of preparing the form for a number of broker-dealers. Although the Commission acknowledges that requiring the additional information the commenter suggested would enhance the ability of regulators to identify discrepancies, the Commission believes that the information on Form Custody provides sufficient information to allow examiners to determine whether it is appropriate to seek additional information from a particular broker-dealer. To the extent a Commission or DEA examiner believes that it is appropriate to obtain this information from a particular broker-dealer, the examiner could do so in a document request to that firm, a method that the Commission expects would be less costly than requiring this information from all broker-dealers on Form Custody. Accordingly, the Commission has determined not to require that broker-dealers identify on the form the specific identities of all of their custodians.

Another commenter to Item 3.C requested that the Commission clarify the distinction between ''locations where the broker-dealer holds securities directly in the name of the broker-dealer'' and ''locations where the broker-dealer holds securities only through an intermediary.'' [573] In making this distinction, the Commission intended to distinguish between locations that are aware of the identity of the broker-dealer and act directly upon the broker-dealer's instructions and locations that are not aware of the identity of the broker-dealer or that will not act on instructions directly from the broker-dealer. In the latter scenario, the location holding securities for the broker-dealer would act only on instructions relating to the broker-dealer's securities from the broker-dealer's intermediary. The Commission has modified the instructions to Item 3.C of Form Custody to reflect this clarification.

c. Item 3.C.i

The first chart in Item 3.C—set forth in Item 3.C.i—identifies the most common locations where broker-dealers hold securities. Many of the locations identified on the first chart, and described below, are locations deemed to be satisfactory control locations under paragraph (c) of Rule 15c3–3.[574] The Commission did not receive any comments on Item 3.C.i of proposed Form Custody and is adopting it as proposed.

The first location identified in the chart is the broker-dealer's vault. Broker-dealers primarily hold securities in fungible bulk at other institutions. In some cases, however, broker-dealers may physically hold securities certificates (*e.g.,* in the case of restricted securities).

The second location identified in the chart is another U.S. registered broker-dealer. For example, a broker-dealer may hold customers' foreign securities at another U.S. broker-dealer, or may

[562] *See Net Capital Rule,* Exchange Act Release No. 31511 (Nov. 24, 1992), 57 FR 56973, 56978 n.16 (Dec. 2, 1992).

[563] *Id.*

[564] *See Broker-Dealer Reports,* 76 FR at 37586.

[565] *Id.* at 37586–37589.

[566] *See CFP Letter; SIFMA Letter.*

[567] *See Broker-Dealer Reports,* 76 FR at 37586.

[568] *Id.*

[569] *See* 17 CFR 240.15c3–3(a)(1).

[570] *See Broker-Dealer Reports,* 76 FR at 37586–37587.

[571] *See CFP Letter.*

[572] *Id.*

[573] *See SIFMA Letter.*

[574] *See* 17 CFR 240.15c3–3(c).

hold securities in an omnibus account at another broker-dealer.

The third and fourth locations identified in the chart are the Depository Trust Company and the Options Clearing Corporation. These are the two most common securities clearing and depository organizations for equities and options in the U.S. and, consequently, are identified by name rather than by type of location.

The fifth location identified in the chart is a U.S. bank. Broker-dealers may have arrangements with U.S. banks to receive and hold securities for the accounts of the broker-dealer's customers and non-customers, as well as for the broker-dealer's own account. Obtaining information about a broker-dealer's relationships with U.S. banks could enable examiners to test and confirm the accuracy of the broker-dealer's representations on Form Custody (*i.e.,* that a U.S. bank holds securities for the broker-dealer), and, in addition, facilitate the collection of information regarding the relationship between the broker-dealer and the bank. For instance, customer fully paid and excess margin securities must be in the possession or control of the broker-dealer and therefore cannot be pledged as collateral for a loan to the broker-dealer, among other things, and customer margin securities may not be commingled with proprietary securities that are pledged as collateral for a bank loan. Form Custody could, for example, lead examiners to seek account statements and documentation governing the broker-dealer's relationship with the U.S. bank to ensure customer fully paid and excess margin securities are not pledged as collateral for a loan to the broker-dealer.

The sixth location identified in the chart is the transfer agent of an open-end investment management company registered under the Investment Company Act of 1940 (*i.e.,* a mutual fund). Generally, mutual funds issue securities only in book-entry form. This means that the ownership of securities is not reflected on a certificate that can be transferred but rather through a journal entry on the books of the issuer maintained by the issuer's transfer agent. A broker-dealer that holds mutual funds for customers generally holds them in the broker-dealer's name on the books of the mutual fund.

d. Item 3.C.ii

The second chart in Item 3.C—set forth in Item 3.C.ii—is intended to capture all other types of U.S. locations where a broker-dealer may hold securities that are not specified in the chart included in Item 3.C.i. This category would include, for example, securities held in book-entry form by the issuer of the securities or the issuer's transfer agent. A broker-dealer that holds securities at such locations must list the types of locations in the spaces provided in the chart and indicate the frequency with which the broker-dealer performs asset reconciliations with those locations. The Commission did not receive any comments on Item 3.C.ii of proposed Form Custody and is adopting it as proposed.

e. Item 3.C.iii

The third chart in Item 3.C—set forth in Item 3.C.iii—pertains to foreign locations where the broker-dealer maintains securities. Under the proposal, the Commission did not list categories of foreign locations because terminology used to identify certain locations may differ by jurisdiction.[575] For example, in some foreign jurisdictions, banks may operate a securities business, making it difficult to classify whether securities are held at a bank or a broker-dealer. A broker-dealer that holds securities in a foreign location must list the types of foreign locations where it maintains securities in the spaces provided in the chart and indicate the frequency with which reconciliations are performed with the location. The Commission did not receive any comments on Item 3.C.iii of proposed Form Custody and is adopting it as proposed.

iii. Items 3.D and 3.E

Items 3.D and 3.E of proposed Form Custody each contained three identical subparts (discussed in more detail below) designed to elicit information about the types and amounts of securities and cash the broker-dealer held, whether those securities were recorded on the broker-dealer's stock record and, if not, why they were not recorded, and where the broker-dealer held free credit balances.[576] The General Instructions to proposed Form Custody defined ''free credit balances'' as liabilities of a broker-dealer to customers or non-customers which are subject to immediate cash payment to customers or non-customers on demand, whether resulting from sales of securities, dividends, interest, deposits, or otherwise.[577]

The difference between proposed Item 3.D and proposed Item 3.E is that the former would have elicited information with respect to securities and free credit balances held for the accounts of customers, whereas the latter would have elicited information with respect to securities and free credit balances held for the accounts of persons who are not customers.[578] Accordingly, the proposed form asked two sets of identical questions to elicit information about each category of accountholder—customer and non-customer.[579]

a. Items 3.D.i and 3.E.i

Items 3.D.i and 3.E.i of proposed Form Custody would have elicited information about the types and dollar amounts of the securities the broker-dealer carried for the accounts of customers and non-customers, respectively.[580] Specifically, for each Item, the broker-dealer would have been required to complete information on a chart to the extent applicable.[581] The proposed charts were comprised of twelve rows, with each row representing a category of security. These categories included: (1) U.S. Equity Securities; (2) Foreign Equity Securities; (3) U.S. Listed Options; (4) Foreign Listed Options; (5) Domestic Corporate Debt; (6) Foreign Corporate Debt; (7) U.S. Public Finance Debt; (8) Foreign Public Finance Debt; (9) U.S. Government Debt; (10) Foreign Sovereign Debt; (11) U.S. Structured Debt; and (12) Foreign Structured Debt. A thirteenth row was included in each chart to identify any securities not specifically listed in the first twelve rows. The types of securities were categorized this way because the various categories ordinarily are associated with certain types of locations. Thus, as examiners review the form, they could assess whether the types of securities held by the broker-dealer were maintained at locations generally known to hold such securities. If a broker-dealer's completed form indicated that some types of securities were held at a location atypical for such securities, the examiner could refine the focus of the examination to evaluate whether customer assets were properly safeguarded. The Commission is adopting these requirements, with modifications, as discussed below.

One commenter requested that the Commission clarify whether alternative investments, mutual funds, and exchange traded funds fall within the

[575] *See Broker-Dealer Reports,* 76 FR at 37587.

[576] *Id.* at 37587–37589.

[577] This definition is similar to the definition of the term *free credit balance* in Rule 15c3–3, except that the definition in the rule is limited to liabilities to *customers* whereas the definition in the Form contemplates liabilities to customers and non-customers. *See* 17 CFR 240.15c3–3(a)(8).

[578] *See Broker-Dealer Reports,* 76 FR at 37587–37589.

[579] *Id.*

[580] *Id.* at 37587.

[581] *Id.*

scope of ''Other'' securities within the thirteenth row of Items 3.D.i and 3.E.i.[582] The Commission has considered this comment and determined that those investments are other types of securities that should be part of Items 3.D.i and 3.E.i, but that it would be useful to separately identify each of these categories of securities in Items 3.D.i and 3.E.i, rather than group them together in the ''Other'' category. By identifying these types of investments separately on Form Custody, Commission and DEA examiners will have a better understanding of a broker-dealer's business activities and a more refined understanding of the types of securities held by the broker-dealer. This information, in turn, could facilitate more focused examinations by Commission and DEA examiners. Accordingly, Items 3.D.i and 3.E.i of Form Custody, as adopted, will contain six additional rows to account for both domestic and foreign alternative investments (referred to on the form as ''private funds''), mutual funds, and exchange traded funds. The Commission is referring to the term ''private funds'' on the form, rather than the term ''alternative investments,'' for purposes of clarity; while both terms are often used interchangeably in practice, the term ''private fund'' is a regulatory term defined in other contexts of the securities laws (*e.g.,* on Form ADV), whereas the term ''alternative investments'' is not. For purposes of Form Custody, the term ''private fund'' is given the same meaning as is used by the Commission on Form ADV—that is, an investment company as defined in section 3 of the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of that Act. Items 3.D.i and 3.E.i of Form Custody and the related Instructions to those Items, as adopted, reflect these changes.

The charts in Items 3.D.i and 3.E.i, as proposed, would have each had eight columns. The first column contained boxes for each category of security specified in the Item (and identified in the second column), as discussed above.[583] The broker-dealer would have been required to check the box in each chart for every applicable category of security it holds for the accounts of customers and non-customers, respectively. The second column would have identified the category of security. The third through eighth columns represented ranges of dollar values: (1) Up to $50 million; (2) greater than $50 million up to $100 million; (3) greater than $100 million up to $500 million; (4) greater than $500 million up to $1 billion; (5) greater than $1 billion up to $5 billion; and (6) greater than $5 billion. In each chart, the broker-dealer would have been required to check the box in the column reflecting the approximate dollar value for every category of security that the broker-dealer carried for the accounts of customers and non-customers, respectively.[584]

The Commission proposed identifying dollar ranges for the values of the securities, as opposed to actual values, to ease compliance burdens.[585] The intent was to elicit information about the relative dollar value of securities the broker-dealer held for customers and non-customers in each category of security. Values would be reported as of the date specified in the broker-dealer's accompanying quarterly FOCUS Report.

One commenter noted that the charts set forth in Items 3.D.i and 3.E.i of proposed Form Custody did not include boxes to check to reflect the approximate dollar values for the categories of securities the broker-dealer carried for the accounts of customers and non-customers.[586] This commenter requested guidance on whether broker-dealers would be required to populate the chart with checkmarks or more precise estimates of market value.[587] The Commission intended to include boxes to check to reflect approximate dollar values in the charts set forth in Items 3.D.i and 3.E.i of proposed Form Custody, and the form, as adopted, includes these boxes.

b. Items 3.D.ii and 3.E.ii

Items 3.D.ii and 3.E.ii of proposed Form Custody would have elicited information concerning whether the broker-dealer had recorded all the securities it carried for the accounts of customers and non-customers, respectively, on its stock record by requiring the broker-dealer to check the appropriate ''Yes'' or ''No'' box.[588] If the broker-dealer checked ''No,'' it would have been required to explain in the space provided why it had not recorded such securities on its stock record and indicate the type of securities and approximate U.S. dollar market value of such unrecorded securities.[589] The Commission did not receive any comments on Items 3.D.ii and 3.E.ii of proposed Form Custody and is adopting these Items as proposed.

The Commission anticipates that a broker-dealer ordinarily would answer ''Yes'' in response to Items 3.D.ii and 3.E.ii because the stock record—which a broker-dealer is required to create pursuant to Rule 17a–3 [590]—is a record of custody of securities. A long position in the stock record indicates ownership of the security or a right to the possession of the security. Thus, the ''long side'' of the stock record indicates the person to whom the broker-dealer owes the securities. Common examples of ''long side'' positions are securities received from customers (*e.g.,* fully paid or excess margin securities), securities owned by the firm (*i.e.,* securities held in the broker-dealer's inventory for its own account), securities borrowed, and fails-to-deliver (*i.e.,* securities sold to or through another broker-dealer but not delivered).

A short position in the stock record indicates either the location of the securities or the responsibility of other parties to deliver the securities to the broker-dealer. Every security owned or held by the broker-dealer must be accounted for by its location. Since securities are fungible, the short side of the stock record does not in fact designate where particular securities are located. Rather, it indicates the total amount of securities, on a security-by-security basis, held at each location, which could include, for example, securities depositories. Common short-side stock record locations also include banks (*e.g.,* when a broker-dealer pledges securities to a bank as collateral for a loan), stock loan counterparties (*e.g.,* when a broker-dealer lends securities to another firm as part of a securities lending transaction), and counterparties failing to deliver securities to the broker-dealer (*e.g.,* when the broker-dealer has purchased securities that have not yet been received from the counterparty).

The Commission's goals in asking this question were twofold. First, the question would elicit the disclosure of the unusual circumstance in which a broker-dealer carries securities for the account of a customer or non-customer but does not reflect them on its stock record.[591] The Commission and other securities regulators could use this information to assess whether the broker-dealer is properly accounting for securities. Second, this question could prompt a broker-dealer to identify, and self-correct, circumstances in which it

[582] *See SIFMA Letter.*

[583] *See Broker-Dealer Reports,* 76 FR at 37587.

[584] *Id.*

[585] *Id.*

[586] *See SIFMA Letter.*

[587] *Id.*

[588] *See Broker-Dealer Reports,* 76 FR at 37587.

[589] *Id.*

[590] *See* 17 CFR 240.17a–3(a)(5).

[591] *See Broker-Dealer Reports,* 76 FR at 37588.

did not include securities on its stock record as required by Rule 17a-3.[592]

c. Items 3.D.iii and 3.E.iii

Items 3.D.iii and 3.E.iii of proposed Form Custody would have elicited information as to how the broker-dealer treated free credit balances in securities accounts of customers and non-customers, respectively.[593] The information would have been elicited through a chart the broker-dealer would be required to complete. The chart in Item 3.D.iii of proposed Form Custody had five rows with each row representing a different process for treating free credit balances. The chart would have disclosed whether free credit balances were: (1) Included in a computation under Rule 15c3–3(e); (2) held in a bank account under Rule 15c3–3(k)(2)(i); (3) swept to a U.S. bank; (4) swept to a U.S. money market fund; and/or (5) ''other,'' with a space to describe such other treatment. The options were not intended to be mutually exclusive in that a broker-dealer may treat free credit balances in several different ways (*e.g.,* a broker-dealer may be instructed by certain customers to sweep their free credit balances to a bank, and by other customers to sweep their free credit balances to a U.S. money market fund). The Commission did not receive any comments on Items 3.D.iii and 3.E.iii of proposed Form Custody and is adopting these Items as proposed.

A broker-dealer will be required to check the box in the first column of the chart for every process that applies to the broker-dealer's treatment of free credit balances in customer and non-customer accounts, respectively. The first process identified on each chart is that the broker-dealer treats customer and non-customer free credit balances in accordance with the customer reserve computation required under paragraph (e) of Rule 15c3–3. Paragraph (e) of Rule 15c3–3 requires a broker-dealer to maintain a special reserve bank account for the exclusive benefit of its customers and maintain deposits in that account (to the extent a deposit is required) in amounts computed in accordance with Exhibit A to Rule 15c3–3.[594] Rule 15c3–3 requires that a broker-dealer comply with these reserve account provisions only with respect to customer-related credit balances. The Commission has, however, proposed amendments to Rule 15c3–3 that would require a broker-dealer to maintain a reserve account and perform a reserve computation for non-customer accountholders that are domestic and foreign broker-dealers.[595]

The second process identified on the chart is that the broker-dealer handles free credit balances by placing funds in a ''bank account under Rule 15c3–3(k)(2)(i).'' Paragraph (k)(2)(i) of Rule 15c3–3 prescribes a process by which a broker-dealer can qualify for an exemption from the requirements of Rule 15c3–3. Specifically, the exemption applies to a broker-dealer that does not carry margin accounts, promptly transmits all customer funds and delivers all securities received in connection with its activities, does not otherwise hold funds or securities for, or owe money or securities to, customers and effectuates all financial transactions between the broker-dealer and its customers through one or more bank accounts that are each designated as a ''Special Account for the Exclusive Benefit of Customers of (the name of broker or dealer).'' [596]

The third process identified in the chart—''swept to a U.S. bank''—is included because some broker-dealers engage in ''bank sweep programs.'' Rather than hold customer funds in securities accounts, some broker-dealers require or offer the option to transfer free credit balances in securities accounts to a specific money market fund or interest bearing bank account (''Sweep Programs''). The customer earns dividends on the money market fund or interest on the bank account until such time as the customer chooses to liquidate the position in order to use the cash, for example, to purchase securities.[597] Customers must make a request to the broker-dealer for the return of funds swept from their securities accounts to the bank.

The fourth option identified in the chart is that the broker-dealer sweeps free credit balances into a money market fund as part of a Sweep Program. In most cases when a broker-dealer sweeps free credit balances into a money market fund, the broker-dealer purchases shares in the money market fund, which are registered in the name of the broker-dealer. The money market fund understands that these shares are not proprietary positions of the broker-dealer, and any interest earned on the shares from the money market fund are payable to the customers.

Finally, the fifth option in the chart covers any other process that is not described in the other options.

4. Item 4—Carrying for Other Broker-Dealers

Item 4 of proposed Form Custody would have required a broker-dealer to disclose whether it acted as a carrying broker-dealer for other broker-dealers.[598] There were two sets of questions in Item 4—Item 4.A.i, ii, and iii and Item 4.B.i, ii, and iii. The first set of questions would have elicited information from a broker-dealer as to whether it carried transactions for other broker-dealers on a fully disclosed basis.[599] The second set of questions would have elicited information from a broker-dealer as to whether it carried transactions for other broker-dealers on an omnibus basis.[600] The Commission did not receive any comments to Item 4 of proposed Form Custody and is adopting this Item as proposed.

Items 4.A.i and 4.B.i require a broker-dealer to indicate by checking the appropriate ''Yes'' or ''No'' box whether it carries customer accounts for another broker-dealer on a fully disclosed basis and on an omnibus basis, respectively. Items 4.A.ii and 4.B.ii require a broker-dealer, if applicable, to indicate the number of broker-dealers with which it has an arrangement to carry accounts on a fully disclosed basis and on an omnibus basis, respectively. Items 4.A.iii and 4.B.iii require a broker-dealer, if applicable, to identify any affiliated broker-dealers that introduce accounts to the broker-dealer on a fully disclosed basis and on an omnibus basis, respectively.

As the Commission has noted, related person custody arrangements can present higher risks to ''advisory clients'' than maintaining assets with an independent custodian.[601] Consistent with the definition of the term in other contexts applicable to broker-dealers, including Form BD,[602] the General

[592] *Id.*

[593] *Id.*

[594] *See* Rule 15c3–3(e) and Rule 15c3–3a.

[595] *See Amendments to Financial Responsibility Rules for Broker-Dealers,* Exchange Act Release No. 55431 (Mar. 9, 2007), 72 FR 12862 (Mar. 19, 2007); *Amendments to Financial Responsibility Rules for Broker-Dealers* (Reopening of Comment Period), Exchange Act Release No. 34–66910 (May 3, 2012), 77 FR 27150 (May 9, 2012). *See also* letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, Commission, to Raymond J. Hennessy, Vice President, New York Stock Exchange (''NYSE''), and Thomas Cassella, Vice President, NASD Regulation, Inc. (Nov. 10, 1998).

[596] *See* 17 CFR240.15c3–3(k)(2)(i).

[597] *See Amendments to Financial Responsibility Rules for Broker-Dealers,* Exchange Act Release No. 55431 (Mar. 9, 2007), 72 FR 12862 (Mar. 19, 2007) at 12866.

[598] *See Broker-Dealer Reports,* 76 FR at 37589.

[599] *Id.*

[600] *Id.*

[601] *See Custody of Funds or Securities of Clients by Investment Advisers,* 75 FR at 1462.

[602] Form BD is the uniform application for broker-dealer registration with the Commission. Form BD states that a person is presumed to control a company if, among other things, that person has directly or indirectly the right to vote 25% or more

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Instructions for Form Custody define the term ''affiliate'' as any person who directly or indirectly controls the broker-dealer or any person who is directly or indirectly controlled by or under common control with the broker-dealer. The definition also specifies that ownership of 25% or more of the common stock of the broker-dealer introducing accounts to the broker-dealer submitting the Form Custody is deemed *prima facie* evidence of control; this provision also is consistent with the definition used in Form BD.[603]

Item 4 in Form Custody elicits information about broker-dealers' custodial responsibilities with respect to accounts held for the benefit of *other* broker-dealers, and requires broker-dealers to identify such broker-dealers that are affiliates of the broker-dealer.[604] The Commission believes that this information will provide the Commission with an enhanced understanding of, and useful and readily available information relating to, the scope of broker-dealer introducing/carrying relationships and activities, and the custodial practices of broker-dealers involved in such relationships.

5. Item 5—Trade Confirmations

Item 5 of Form Custody, as proposed, would have required broker-dealers to disclose whether they send transaction confirmations to customers and other accountholders by checking the appropriate ''Yes'' or ''No'' box.[605] Confirmations are important safeguards that enable customers to monitor transactions that occur in their securities accounts. Timely confirmations alert customers of unauthorized transactions and provide customers with an opportunity to object to the transactions. The Commission received one comment on Item 5 of proposed Form Custody. As discussed below, the Commission is modifying the instructions to Item 5 in response to this comment and is otherwise adopting Item 5 as proposed.

Exchange Act Rule 10b–10 specifies the information a broker-dealer must disclose to customers on a trade confirmation at or before completion of a securities transaction.[606] Generally, Rule 10b–10 requires a confirmation to include, among other things: (1) The date and time of the transaction and the identity, price, and number of shares or units (or principal amount) of such security purchased or sold by such customer; (2) the broker-dealer's capacity (agent or principal) and its compensation; (3) the source and amount of any third party remuneration it has received or will receive; and (4) other information, both general (*e.g.,* that the broker-dealer is not a SIPC member, if such is the case) and transaction-specific (*e.g.,* certain yield information in most transactions involving debt securities).[607]

The information contained on a trade confirmation should reconcile with customer statements and the broker-dealer's journal entries.[608] In this regard, there is a link between trade confirmations sent by a broker-dealer and the broker-dealer's records pertaining to custody of customer assets.[609] How a broker-dealer answers Item 5 could assist examiners in focusing their inspections. For example, if the form indicates that a third party is responsible for sending trade confirmations, the examiners can confirm with that third party that it is in fact sending confirmations.

With respect to Item 5.A, one commenter requested clarification as to whether a broker-dealer should indicate that it sends trade confirmations directly to customers (by checking ''yes'') where it employs a vendor to do so.[610] The Commission has considered this comment and determined that a broker-dealer should affirmatively respond to Item 5 of Form Custody, as adopted, by checking the ''yes'' box on the form if it employs a vendor to send trade confirmations to customers on its behalf because, in such an arrangement, the broker-dealer is ultimately responsible for complying with its trade confirmation obligations, not the vendor. The Commission has modified the instructions to Item 5 to reflect this clarification.

6. Item 6—Account Statements

Item 6 of proposed Form Custody would have required broker-dealers to disclose whether they send account statements directly to customers and other accountholders by checking the appropriate ''Yes'' or ''No'' box.[611] The Commission received one comment on Item 6 of proposed Form Custody.[612] As is discussed below, the Commission is modifying the instructions to Item 6 in response to this comment and is otherwise adopting Item 6 as proposed.

Account statements generally are sent to customers and other accountholders on a monthly or quarterly basis and typically set forth the assets held in the investor's securities account as of a specific date and the transactions that occurred in the account during the relevant period. SROs impose requirements on broker-dealers with respect to the statements they must send to their customers.[613] For example, FINRA generally requires any member that conducts a general securities business and also carries customer accounts or holds customer funds or securities, at least once each calendar quarter, to send an account statement to each customer whose account had a security position, money balance, or account activity since the last statement was sent.[614] The account statement

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of a class of a voting security or has the power to sell or direct the sale of 25% or more of a class of voting securities, or, in the case of a partnership, the right to receive upon dissolution, or has contributed, 25% or more of the firm's capital.

[603] This definition of the term *affiliate* is the same as the definition in Form BD, including the specification that ownership of 25% or more of the common stock is deemed *prima facie* evidence of control.

[604] Form Custody does not require a broker-dealer to identify unaffiliated broker-dealers for which it carries accounts, though, as discussed above, it would need to indicate that it carries accounts for such broker-dealers. The Commission believes that this approach provides the Commission and DEA examiners with access to useful information involving a broker-dealer's custody practices while alleviating potential time and cost burdens associated with completing Form Custody given that some broker-dealers carry accounts for hundreds of unaffiliated broker-dealers. The Commission notes that information about these broker-dealers would be part of the books and records of the carrying broker-dealer. Therefore, an affirmative answer to Item 4 could prompt the Commission and DEA examiners to request information about the identities of the unaffiliated broker-dealers. *See Broker-Dealer Reports,* 76 FR at 37589 n.143.

[605] *See Broker-Dealer Reports,* 76 FR at 37589–37590.

[606] 17 CFR 240.10b–10.

[607] *Id.*

[608] *See* 17 CFR 240.17a–3(a)(1), which requires the broker-dealer to make ''[b]lotters (or other records of original entry) containing an itemized daily record of all purchases and sales of securities, all receipts and deliveries of securities (including certificate numbers), all receipts and disbursements of cash and all other debits and credits. Such records shall show the account for which each such transaction was effected, the name and amount of securities, the unit and aggregate purchase or sale price (if any), the trade date, and the name or other designation of the person from whom purchased or received or to whom sold or delivered.''

[609] Although broker-dealers may allocate the function of sending confirmations to other broker-dealers or to service providers, the allocating broker-dealer retains the responsibility for sending confirmations. *See New York Stock Exchange, Inc.; Order Approving Proposed Rule Change,* Exchange Act Release No. 18497 (Feb. 19, 1982), 47 FR 8284 (Feb. 25, 1982) at n.2 (providing ''no contractual arrangement for the allocation of functions between an introducing and carrying organization can operate to relieve either organization from their respective responsibilities under the federal securities laws and applicable SRO rules'').

[610] *See SIFMA Letter.*

[611] *See Broker-Dealer Reports,* 76 FR at 37590–37591.

[612] *See SIFMA Letter.*

[613] *See, e.g.,* NASD Rule 2340.

[614] *See* NASD Rule 2340. NASD Rule 2340 defines a *general securities member* as any member that conducts a general securities business and is required to calculate its net capital pursuant to Rule 15c3–1. NASD Rule 2340(d)(2). Additionally, NASD Rule 2340 defines *account activity* broadly so that

must contain a description of any securities positions, money balances, or account activity in the account. In addition, the account statement must include a statement that advises the customer to report promptly any inaccuracy or discrepancy in that person's account to the brokerage firm.[615] The statement also is required to advise the customer that any oral communications made to the broker-dealer regarding inaccuracies or discrepancies should be re-confirmed in writing to further protect the customer's rights, including rights under SIPA.[616]

Like trade confirmations, account statements are important safeguards that allow investors to monitor transactions that occur in their securities accounts. If the account statements are sent by a broker-dealer other than the broker-dealer completing Form Custody, this fact will need to be disclosed on the Form in Item 6.B. Item 6.C asks whether the broker-dealer sends account statements to anyone other than the beneficial owner of the account.[617] In response to a request for clarification raised by one commenter to proposed Item 6.C,[618] a broker-dealer also would check ''Yes'' to Item 6.C if the broker-dealer sends account statements to the beneficial owner of an account and duplicate account statements to persons other than the beneficial owner of the account. The Commission has modified the instructions to Item 6 to reflect this clarification.

The Commission is requiring broker-dealers to answer the questions in Item 6 to enhance its understanding of a broker-dealer's relationship with customers, particularly in the context of the broker-dealer's custodial responsibilities. Broker-dealers do not currently disclose to the Commission whether they send account statements directly to customers. Collecting this information on Form Custody will provide examiners with additional background information that could be used to refine the focus of their inspections. Further, the Commission anticipates that examiners would make further inquiries to the extent the Form reveals answers that are inconsistent with industry practice.

A review of Item 6 also may facilitate an examiner's preparation for an inspection. For example, if a broker-dealer indicates on Form Custody that it holds customer accounts and sends account statements to customers, the examiner could prepare a more targeted document request to the broker-dealer. In this regard, an examiner could request customer account statements from the broker-dealer, as well as statements from the custodian(s) of the broker-dealer's customer securities and cash.[619] Examiners could then review and reconcile these documents to verify whether customer securities and cash are held at the custodian(s) identified by the broker-dealer.

7. Item 7—Electronic Access to Account Information

Item 7 of proposed Form Custody would have required broker-dealers to indicate whether they provided customers and other accountholders with electronic access to information about the securities and cash positions in their accounts by checking the appropriate ''Yes'' or ''No'' box.[620] Electronic access to account information can provide investors with an efficient means of monitoring transactions that occur in their securities accounts. This inquiry would inform the Commission as to how readily customers are able to access and review their account information. The Commission did not receive any comments to Item 7 of proposed Form Custody and is adopting this Item as proposed.

The Commission believes that electronic access to account information is beneficial to customers, who can more easily monitor the performance of their accounts and perhaps more quickly identify any discrepancies or inaccuracies. The Commission is including this Item in Form Custody because it will help to inform examiners as to how readily customers can access and review account information.

8. Item 8—Broker-Dealers Registered as Investment Advisers

Item 8 of Form Custody, as proposed, would have elicited information, if applicable, as to whether and how the broker-dealer operated as an investment adviser.[621] Proposed Item 8 was comprised of three subparts, as described below.

The first question of Item 8—Item 8.A—would have required the broker-dealer to indicate whether it was registered as an investment adviser with the Commission under the Advisers Act or with one or more states pursuant to the laws of a state.[622] If the broker-dealer indicated that it was registered with the Commission under the Advisers Act or pursuant to state law (or both), then it would have been required to respond to the remaining questions under Item 8.[623]

The next question of Item 8 of proposed Form Custody—Item 8.B—would have required the broker-dealer to disclose the number of its investment adviser clients.[624] This would provide the Commission with information about the scale of the broker-dealer's investment adviser activities.

The third question of Item 8 of proposed Form Custody—Item 8.C—would have required the broker-dealer to complete a chart, consisting of six columns, in which the broker-dealer would have provided information about the custodians where the assets of the investment adviser clients were held.[625]

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it includes, but is not limited to, purchases, sales, interest credits or debits, charges or credits, dividend payments, transfer activity, securities receipts or deliveries and/or journal entries relating to securities or funds in the possession or control of the member. NASD Rule 2340(d)(1). *See also Order Approving Proposed Rule Change Relating to Rule 2340 Concerning Customer Account Statements,* Exchange Act Release No. 54411 (Sept. 7, 2006), 71 FR 54105 (Sept. 13, 2006) (order granting approval of a proposed rule change relating to Rule 2340 concerning customer account statements).

[615] If the customer's account is serviced by both an introducing broker-dealer and a clearing broker-dealer, the statement must inform customers that such reports must be made to both firms. *See* NASD Rule 2340(a).

[616] *Id.*

[617] Generally, the beneficial owner of an account represents the person entitled to the economic benefits of ownership. With respect to securities, the term beneficial owner is defined in Rule 13d–3 under the Exchange Act. *See* 17 CFR 240.13d–3.

[618] *See SIFMA Letter.*

[619] As is discussed above in section IV.C.3. of this release, the fact that a broker-dealer uses a custodian to hold customer securities and cash, and the type of custodian, will be disclosed in response to Items 3.C and 3.D of Form Custody.

[620] *See Broker-Dealer Reports,* 76 FR at 37591.

[621] *Id.* at 37591–37592.

[622] *Id.* Section 203A of the Advisers Act prohibits certain investment advisers from registering with the Commission based on the advisers' assets under management, among other factors. *See* 17 CFR 275.203A.

[623] *See Broker-Dealer Reports,* 76 FR at 37591.

[624] *Id.*

[625] *Id.* Under Rule 206(4)–2, it is a ''fraudulent, deceptive, or manipulative act, practice or course of business'' for an investment adviser registered or required to be registered under section 203 of the Advisers Act (15 U.S.C. 80b–3) to have custody of client funds or securities unless, among other things, a qualified custodian maintains those funds or securities. *See* 17 CFR 275.206(4)–2(a)(1). A qualified custodian is: (1) A bank as defined in section 202(a)(2) of the Advisers Act or savings association as defined in section 3(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(b)(1)) that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act (2 U.S.C. 1811); (2) a broker-dealer registered under section 15(b)(1) of the Exchange Act holding the client assets in customer accounts; (3) an FCM registered under section 4f(a) of the Commodity Exchange Act (7 U.S.C. 6f(a)), holding the client assets in customer accounts, but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and (4) a foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory

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In the first column, the broker-dealer would have been required to disclose the name of the custodian, and in the second column, the broker-dealer would have been required to identify the custodian by either SEC file number or CRD number, as applicable.[626]

The third and fourth columns of the chart would have elicited information about the scope of the broker-dealer/investment adviser's authority over the accounts held at the custodian by requiring the broker-dealer/investment adviser to check the appropriate ''Yes'' or ''No'' box.[627] Specifically, in the third column, the broker-dealer/investment adviser would have been required to indicate whether it had the authority to effect transactions in the advisory client accounts at the custodian. In the fourth column, the broker-dealer/investment adviser would have been required to indicate whether it had the authority to withdraw funds and securities from those accounts.

In the fifth column, the broker-dealer/investment adviser would have been required to indicate whether the custodian sends account statements directly to the broker-dealer's investment adviser clients.[628] The Commission recently adopted amendments to Rule 206(4)–2 to require that investment advisers have a reasonable basis, after due inquiry, for believing that qualified custodians of advisory client assets send account statements to the investment advisers' clients. As stated in the release adopting that requirement, the Commission believes that the direct delivery of account statements by qualified custodians provides greater assurance of the integrity of account statements received by clients.[629]

In the sixth column, the broker-dealer/investment adviser would have been required to indicate whether investment adviser client assets were recorded on the broker-dealer's stock record.[630] If the broker-dealer was acting as custodian for such assets, the Commission anticipates that those assets would be recorded on the broker-dealer's stock record.[631]

The Commission received one comment in response to Item 8 of Form Custody, as proposed.[632] This commenter stated that the information sought in Item 8 was largely redundant with information collected from investment advisers on Form ADV. The Commission is aware that some overlap exists between the information collected from investment advisers on Form ADV and the information that would be collected from broker-dealers dually-registered as investment advisers in Item 8 of proposed Form Custody. However, these two forms also contain a significant amount of non-overlapping material, reflecting their different purposes and uses. Form Custody is intended to be a single source of readily-available information to assist Commission and DEA examiners in preparing for and performing focused custody exams, and it is particularly important that such information be readily available in the case of dually-registered firms. Accordingly, the Commission is adopting Item 8 of Form Custody substantially as proposed.[633]

9. Item 9—Broker-Dealers Affiliated With Investment Advisers

Item 9 of Form Custody consists of two subparts. Item 9.A, as proposed, would have elicited information concerning whether the broker-dealer was an affiliate of an investment adviser.[634] Item 9.B.i, as proposed, would have elicited information from a broker-dealer that checks ''Yes'' in response to Item 9.A to identify whether it has custody of client assets of the adviser, and, if Item 9.B.i is checked ''Yes,'' to indicate the approximate U.S. dollar market value of the adviser client assets of which the broker-dealer has custody.[635] The Commission did not receive any comments to Item 9 of proposed Form Custody and is adopting this Item as proposed. The additional information obtained from a broker-dealer in response to Item 9 will provide SEC and DEA examiners with a better understanding of a broker-dealer's custody profile and, in particular, custodial relationships with investment adviser affiliates.

For purposes of Item 9, an affiliate is any person who directly or indirectly controls the broker-dealer or any person who is directly or indirectly controlled by or under common control with the broker-dealer. Ownership of 25% or more of the common stock of the investment adviser is deemed *prima facie* evidence of control.[636]

V. Effective Dates

As discussed below, the Commission has established December 31, 2013 as the effective date for the requirement to file Form Custody and the requirement to file annual reports with SIPC. The Commission is delaying the effective date for the requirements relating to broker-dealer annual reports to June 1, 2014. These delayed effective dates are intended to provide time for broker-dealers, broker-dealer independent public accountants, and broker-dealer DEAs to prepare for the changes that will result from these new requirements. The amendments relating to broker-dealer annual reports and the other amendments to Rule 17a–5 (including the technical amendments) affect numerous paragraphs in that rule and two paragraphs in Rule 17a–11. Given the complexity and practical difficulty of having certain provisions become effective before others, the amendments to Rule 17a–5 and the amendments to Rule 17a–11 will become effective on June 1, 2014, regardless of whether they relate to the annual report requirements, except that there will be different effective dates for the amendments to paragraph (a) of Rule 17a–5 (which includes the filing requirement for Form Custody), Form Custody, the deletion of paragraph (e)(5) of Rule 17a–5 (which sets forth the requirement to file Form BD–Y2K), and the requirement to file annual reports with SIPC. The effective dates for the remaining paragraphs of Rule 17a–5 and Rule 17a–11 are discussed further below.

clients' assets in customer accounts segregated from its proprietary assets. *See* 17 CFR 275.206(4)–2(d)(6). A qualified custodian must maintain client funds and securities: (1) In a separate account for each client under that client's name; or (2) in accounts that contain only the clients' funds and securities, under the investment adviser's name as agent or trustee for the clients. *See* 17 CFR 275.206(4)–2(a)(1).

[626] *See Broker-Dealer Reports,* 76 FR at 37591.

[627] *Id.*

[628] *Id.*

[629] *See, e.g., Custody of Funds or Securities of Clients by Investment Advisers,* 75 FR at 1465.

[630] *See Broker-Dealer Reports,* 76 FR at 37591.

[631] If the broker-dealer acts as custodian for an investment adviser client's securities, and does not record those securities on its stock record, the broker-dealer would need to explain why those securities were not recorded on its stock record in response to the question in Item 3.D.ii of Form Custody.

[632] *See Angel Letter.*

[633] Column 2 of Item 8.C of Form Custody, as proposed, would have required a broker-dealer/investment adviser to identify the SEC File No. or CRD No. of each custodian where assets of investment adviser clients were held. However, not all custodians of investment adviser client assets have an SEC File No. or CRD No. Accordingly, the instructions applicable to Column 2 of Item 8.C, as adopted, have been modified to provide that a broker-dealer needs to identify custodians in the column by SEC File No. or CRD No., ''if applicable.'' Thus, a broker-dealer can leave Column 2 of Item 8.C blank if assets of its investment adviser clients are held at a custodian that does not have an SEC File No. or CRD No.

[634] *See Broker-Dealer Reports,* 76 FR at 37592.

[635] *Id.*

[636] *See supra* note 603 and corresponding text which specifies the same ownership percentage on Form BD.

A. Amendments Effective 60 Days After Publication in the ***Federal Register***

Before today's amendments, paragraph (e)(5) of Rule 17a–5 required a broker-dealer to file Form BD–Y2K, which elicits information with respect to a broker-dealer's readiness for the year 2000 and any potential problems that could arise with the advent of the new millennium. The Commission is deleting this paragraph from Rule 17a–5 as the requirement is no longer applicable. The amendment deleting paragraph (e)(5) of Rule 17a–5 will be effective 60 days after this release is published in the **Federal Register**.

B. Amendments Effective on December 31, 2013

The amendments to paragraph (a) of Rule 17a–5 and the rule establishing Form Custody (17 CFR 249.639) are effective on December 31, 2013. The amendments to paragraph (a) include the requirement for a broker-dealer to file Form Custody with its DEA.[637] Consequently, broker-dealers subject to this filing requirement must begin filing Form Custody with their DEAs 17 business days after the calendar quarter or fiscal year, as applicable, ended December 31, 2013.

Two commenters requested that the Commission provide broker-dealers with sufficient time to develop, test, and implement the systems that they will use to comply with the Form Custody filing requirements.[638] The Commission understands that broker-dealers will need to allocate personnel and systems resources to comply with the Form Custody filing requirements, particularly for a broker-dealer's initial filing. DEAs also will need to be prepared to receive the forms that are filed by broker-dealers. Establishing December 31, 2013 as the effective date of the Form Custody requirements is designed to accommodate the efforts that need to be undertaken by both broker-dealers and DEAs in connection with the filing and receipt of Form Custody.

Additionally, the amendment to paragraph (d)(6) of Rule 17a–5 is effective on December 31, 2013. Broker-dealer annual reports must be filed with SIPC for fiscal years ending on or after December 31, 2013.

C. Amendments Effective on June 1, 2014

The amendments to paragraphs (b), (c), (d)(1), (d)(2), (d)(3), (d)(4), (d)(5), (e)(1), (e)(2), (e)(3), (e)(4), (f), (g), (h), (i), (k), (l), (m) and (n) and the deletion of paragraph (j) of Rule 17a–5 and the amendments to Rule 17a–11 are effective on June 1, 2014. Consequently, all of the amendments to Rule 17a–5 not discussed above in sections V.A. and V.B. of this release and the amendments to Rule 17a–11 are effective on that date. This includes the amendments relating to the annual report requirements, with the exception of the requirement to file annual reports with SIPC, which is effective on December 31, 2013. In 2014, therefore, the annual report requirements will apply to all broker-dealers subject to these requirements that have a fiscal year ending on or after June 1, 2014.

The Commission proposed that the amendments would apply for fiscal years ending on or after December 15, 2011, with a first-year transition period for carrying broker-dealers required to file compliance reports with fiscal years ending on or after December 15, 2011 but before September 15, 2012.[639] The Commission received 14 comments concerning the compliance date of the amendments.[640] Most commenters recommended that the Commission delay the compliance date. One commenter, however, stated that broker-dealers should start working on compliance immediately.[641] Several stated that the compliance date of the amendments should be aligned with the effective date of the proposed PCAOB standards for engagements related to compliance reports and exemption reports.[642] One commenter suggested that the Commission postpone the assertion requirements until the rule has been in effect for one year.[643] Another commenter stated that the rules should be effective for fiscal years ending on or before December 15, 2012 ''to allow sufficient time to complete robust documentation and testing of the processes related to the Financial Responsibility Rules and the Financial Statements.'' [644] Similarly, another commenter stated that the effective date should be deferred to fiscal years ending on or before December 15, 2012 ''to give broker-dealers and their auditors time to adequately address the final rules,'' and that the effective date should be aligned with the effective date of PCAOB standards.[645] Another commenter stated that the rule amendments should apply only to annual reports filed on or after December 15, 2012, and that implementation of the proposal must be postponed until after the PCAOB establishes auditing and attestation standards and broker-dealers have had ample time to plan and budget for the new standards.[646] Finally, a commenter stated that broker-dealers should be required to file the first compliance report or exemption report no earlier than one quarter after the adoption of the final rule amendments and to report identified instances of material non-compliance or material weaknesses in annual reports filed no earlier than five quarters after the adoption of the final rule amendments, with a transition period as proposed of no less than five quarters after the adoption of the final rule amendments.[647] This commenter also suggested that the Commission require the filing of the first Form Custody no earlier than three quarters after the effective date of the final rule.[648]

The amendments, among other things, establish important new safeguards with respect to broker-dealer custody of customer funds and securities. However, the Commission recognizes that broker-dealers and other affected parties may need additional time to prepare to comply with the new requirements.

Amendments to provisions regarding broker-dealer annual reports and the engagement of an independent public accountant in paragraphs (d)(1), (d)(2), (d)(3), (d)(4), (d)(5), (e)(1), (e)(2), (e)(3), (e)(4), (g), and (i) of Rule 17a–5 and the deletion of paragraph (j) of Rule 17a–5 generally will apply for broker-dealers with fiscal years ending on or after June 1, 2014. In particular, broker-dealers must file compliance reports or exemption reports, as applicable, and broker-dealers must file reports of independent public accountants covering compliance reports or exemption reports in accordance with Rule 17a–5 as amended, for fiscal years ending on or after June 1, 2014, with no transition period. Similarly, PCAOB standards, rather than GAAS, apply to examinations of financial reports for fiscal years ending on or after June 1, 2014. For broker-dealers with fiscal years that end before June 1, 2014,

[637] *See* paragraph (a)(5) of Rule 17a–5.

[638] *See E&Y Letter; SIFMA Letter.*

[639] *See Broker-Dealer Reports,* 76 FR at 37581. During the transition period, the statement in the compliance report as to whether internal control was effective would have been a point-in-time statement as of the date of the report, rather than covering the entire fiscal year.

[640] *See, e.g., ABA Letter; AICPA Letter; CAQ Letter; Citrin Letter; Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter; PWC Letter; SIFMA Letter; Shatto Letter; CAI Letter; Van Kampen/Invesco Letter.*

[641] *See Shatto Letter.*

[642] *See, e.g., CAQ Letter; Deloitte Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter.*

[643] *See ABA Letter.*

[644] *See Van Kampen/Invesco Letter.*

[645] *See E&Y Letter.*

[646] *See CAI Letter.*

[647] *See SIFMA Letter.*

[648] *Id.*

applicable reports must be filed in accordance with the provisions of Rule 17a–5 as they existed before today's amendments.

Amendments to the customer statement provisions of paragraph (c) of Rule 17a–5 apply for fiscal years ending on or after June 1, 2014, and in the interim broker-dealers must comply with those provisions as they existed before today's amendments.

Paragraph (f)(2) of Rule 17a–5 requires a broker-dealer to file a statement regarding its independent public accountant on December 10 of each year. As a result of today's amendments, all broker-dealers that are required by Rule 17a–5 to engage an independent public accountant must file a new statement by December 10, 2013 that contains the information and representations required under paragraph (f)(2) of Rule 17a–5 as amended. For example, after today's amendments, the statement must include a representation that the accountant has undertaken the engagement of the accountant provisions of paragraph (g) of Rule 17a–5 as amended. The statement also must include, if applicable, representations regarding access to the broker-dealer's independent public accountant and the audit documentation of the independent public accountant.

The amendments to the notification provisions in paragraph (h) of Rule 17a–5 and amendments to Rule 17a–11 are effective on June 1, 2014. In the interim, these provisions as they existed before today's amendments continue to apply.

Finally, the amendments to paragraphs (b), (c), (d)(1), (d)(2), (d)(3), (d)(4), (d)(5), (e)(1), (e)(2), (e)(3), (e)(4), (f), (g), (h), (i), (k), (l), (m), and (n) of Rule 17a–5 and the amendments to Rule 17a–11 not discussed above, including technical amendments, are effective on June 1, 2014.

With respect to the annual report requirements, the June 1, 2014 effective date should provide sufficient time for the PCAOB to finalize, and for the Commission to consider, proposed standards applicable to broker-dealer examinations and reviews and for broker-dealers and their accountants to become familiar with, and be prepared to comply with, those standards. The Commission has chosen a specific effective date, instead of aligning that date with the date of adoption of the rule amendments or the date that the Commission approves PCAOB standards applicable to broker-dealer examinations and reviews, as suggested by commenters, to provide certainty regarding the date by which broker-dealers and their accountants must comply with the new requirements. Certain commenters referenced AICPA guidance with respect to broker-dealer audits. However, this guidance will no longer be applicable for fiscal years ending on or after June 1, 2014, when standards of the PCAOB begin to apply.

One commenter suggested that the effective date for non-carrying and smaller broker-dealers to comply with amendments to the annual reporting requirements should be one year after the adoption of the amendments.[649] The Commission notes that most smaller broker-dealers are non-carrying firms and, therefore, will be required to file the exemption report and a report of the independent public accountant based on a review of the exemption report. As discussed in sections VI. and VII. of this release, the hour burdens and costs of the exemption report requirements will be substantially less than the hour burdens and costs of the compliance report requirements. Consequently, the Commission does not believe the effective date should be extended further for smaller broker-dealers.

As stated above, another commenter suggested that the Commission postpone the assertion requirements until the rule has been in effect for one year.[650] The Commission recognizes that all broker-dealers subject to these requirements and their independent public accountants will need time to prepare to comply with the requirements. The effective date the Commission is establishing should provide sufficient time for small or non-carrying firms, as well as larger carrying firms, to prepare for compliance with the new requirements.

VI. Paperwork Reduction Act

Certain provisions of the final rule amendments contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (''PRA'').[651] The Commission solicited comment on the estimated burden associated with the collection of information requirements in the proposed amendments.[652] The Commission submitted the proposed collection of information requirements to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507 and 5 CFR 1320.11.

The titles and OMB control numbers for the collections of information are:

(1) Rule 17a–5, Reports to be made by certain brokers and dealers (OMB Control Number 3235–0123);

(2) Rule 17a–11, Notification provisions for brokers and dealers (OMB Control Number 3235–0085); and

(3) Form Custody (OMB Control Number 3235–0691).

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information requirement unless it displays a currently valid OMB control number. As discussed above, the Commission received 27 comment letters on the proposed rulemaking. Some of these comments relate directly or indirectly to the PRA. These comments are addressed below. Finally, some initial burden estimates have been adjusted, as discussed below, to reflect updated information used to make the estimates.

A. Summary of the Collection of Information Requirements

As discussed in greater detail above in sections II., III., and IV. of this release, the Commission is adopting amendments to Rules 17a–5 and 17a–11 and is adopting new Form Custody for broker-dealers to file with their DEA.

Under the amendments to Rule 17a–5, broker-dealers must, among other things, file with the Commission annual reports consisting of a financial report and one of two new reports—either a compliance report or an exemption report that are prepared by the broker-dealer, and generally must also file reports prepared by an independent public accountant registered with the PCAOB covering those reports in accordance with PCAOB standards.[653] The financial report must contain the same types of financial statements that were required to be filed under Rule 17a–5 prior to these amendments (a statement of financial condition, a statement of income, a statement of cash flows, and certain other financial statements).[654] In addition, the financial report must contain, as applicable, the supporting schedules that were required to be filed under Rule 17a–5 prior to these amendments (a computation of net capital under Rule 15c3–1, a computation of the reserve requirements under Rule 15c3–3, and information relating to the possession or control requirements under Rule 15c3–3).

A broker-dealer that does not claim an exemption from Rule 15c3–3 through the most recent fiscal year—generally a carrying broker-dealer—must file the compliance report, and a broker-dealer that claimed an exemption from Rule 15c3–3 throughout the most recent

[649] *See Citrin Letter.*

[650] *See ABA Letter.*

[651] 44 U.S.C. 3501 *et seq.*

[652] *See Broker-Dealer Reports,* 76 FR at 37594–37598.

[653] *See* discussion above in sections II.B.1., II.B.2., II.B.3., and II.B.4. of this release.

[654] *See* discussion above in section II.B.2. of this release.

fiscal year must file the exemption report. In the compliance report and exemption report, a broker-dealer must make certain statements and provide certain information relating to the financial responsibility rules.

In addition to preparing and filing the financial report and the compliance report or exemption report, a broker-dealer must engage a PCAOB-registered independent public accountant to prepare a report based on an examination of the broker-dealer's financial report in accordance with PCAOB standards.[655] A broker-dealer that files a compliance report also must engage the PCAOB-registered independent public accountant to prepare a report based on an examination of certain statements in the compliance report.[656] A broker-dealer that files an exemption report must engage the PCAOB-registered independent public accountant to prepare a report based on a review of certain statements in the broker-dealer's exemption report. In each case, the examination or review must be conducted in accordance with PCAOB standards. A broker-dealer must file these reports of the independent public accountant with the Commission along with the financial report and the compliance report or exemption report prepared by the broker-dealer.

The amendments add a requirement that the annual reports also be filed with SIPC if the broker-dealer is a member of SIPC.[657] In addition, broker-dealers must generally file with SIPC a supplemental report on the status of the membership of the broker-dealer in SIPC.[658] The supplemental report must include a report of the independent public accountant based on certain procedures specified in the rule in accordance with PCAOB standards. In the future, SIPC may determine the format of this report by rule, subject to Commission approval.

Under the amendments, the PCAOB-registered independent public accountant must immediately notify the broker-dealer if the accountant determines during the course of preparing the accountant's reports that the broker-dealer was not in compliance at any time during the fiscal year with the financial responsibility rules or if the accountant determines that any material weakness existed in the broker-dealer's Internal Control Over Compliance during the fiscal year.[659] The broker-dealer, in turn, must file a notification with the Commission and its DEA under Rule 15c3–1, Rule 15c3–3, or Rule 17a–11 if the accountant's notice concerns an instance of non-compliance that would trigger notification under those rules. Under amendments to Rule 17a–11, a broker-dealer also must file a notification with the Commission and its DEA if the accountant's notice concerns (or if the broker-dealer discovers) a material weakness in the broker-dealer's Internal Control Over Compliance.

The amendments also require a broker-dealer that clears transactions or carries customer accounts to agree to allow representatives of the Commission or the broker-dealer's DEA to review the documentation associated with the reports of the broker-dealer's independent public accountant and to allow the accountant to discuss its findings with the representatives, if requested in writing for purposes of an examination of the broker-dealer.[660]

Finally, the amendments require broker-dealers to file a new Form Custody, which elicits information concerning the custody practices of the broker-dealer.[661] Form Custody must be filed with the DEA each quarter. The DEA must transmit the information obtained from Form Custody to the Commission at the same time that it transmits FOCUS Report data to the Commission under paragraph (a)(4) of Rule 17a–5.

The burdens associated with the collection of information requirements in the amendments are discussed below.

B. Use of Information

The proposed amendments relating to the reports to be filed by the broker-dealer are designed to enhance the ability of the Commission to oversee broker-dealer custody practices and, among other things, to: (1) Increase the focus of carrying broker-dealers and their independent public accountants on compliance, and internal control over compliance, with the financial responsibility rules; (2) facilitate the ability of the PCAOB to implement the explicit oversight authority of broker-dealer audits provided to the PCAOB by the Dodd-Frank Act; and (3) with respect to broker-dealers that are dually-registered as investment advisers, satisfy the internal control report requirement that was added by the amendment to Rule 206(4)–2 noted above with the accountant's report based on an examination of the compliance report. Securities regulators will use these reports to monitor the financial condition of broker-dealers. In addition, the components of the reports that are made public may be used by investors to review the financial condition of broker-dealers with which they have accounts or obtain other securities related services. SIPC can use the annual reports to monitor the financial strength of broker-dealers and to assess the adequacy of the SIPC Fund.

The amendment requiring a broker-dealer that clears transactions or carries customer accounts to allow Commission and DEA examination staff to review the audit documentation associated with its annual audit reports required under Rule 17a–5 and to allow its independent public accountant to discuss findings relating to the audit reports with Commission and DEA examination staff is intended to facilitate examinations of clearing broker-dealers by Commission and DEA examination staff. Commission and DEA examiners will use the information obtained from audit documentation and discussions with the broker-dealer's independent public accountant to plan their examinations.

Finally, Commission and DEA examiners will use Form Custody to understand a broker-dealer's custody profile and identify custody-related violations and misconduct. For example, if a broker-dealer represents on Form Custody that it does not issue account statements, but an examiner discovers that an account statement has been issued by the broker-dealer (*e.g.,* in connection with a customer complaint or in the course of an examination of the broker-dealer), the examiner will be able to react more quickly to the misrepresentation. Further, the requirement to prepare and file the form should motivate broker-dealers to focus more attention on their custody practices.

C. Respondents

The Commission estimated in the proposal that there were 5,063 registered broker-dealers that would be affected by the proposed amendments and that, of these, 305 were carrying broker-dealers, 528 were carrying or clearing broker-dealers, and 4,752 were broker-dealers that claimed exemptions from Rule 15c3–3.[662] The Commission did not receive comments regarding these estimates, but the Commission has

[655] *See* discussion above in section II.D.3. of this release.

[656] *See* paragraphs (f)(1) and (g)(2)(i) of Rule 17a–5.

[657] *See* discussion above in section II.B.6. of this release.

[658] *See* discussion above in section II.C.4. of this release.

[659] *See* discussion above in section II.F. of this release.

[660] *See* discussion above in section III. of this release.

[661] *See* discussion above in section IV. of this release.

[662] *See Broker-Dealer Reports,* 76 FR at 37595.

updated the estimates to reflect more recent information.[663]

As of December 31, 2011, 4,709 broker-dealers filed FOCUS Reports with the Commission. Of these, 4,417 broker-dealers claimed exemptions from Rule 15c3–3. Consequently, the Commission estimates that there are approximately 292 carrying broker-dealers (4,709 − 4,417 = 292). Based on FOCUS Report data, the Commission further estimates that there are approximately 513 carrying or clearing broker-dealers. According to SIPC, as of March 31, 2012, 217 broker-dealers claimed exemptions from SIPC membership. Therefore, the Commission estimates that 4,492 (4,709 − 217 = 4,492) broker-dealers are members of SIPC.

D. Total Initial and Annual Burdens

As discussed in detail below, the Commission estimates that the total PRA burden resulting from the amendments to Rules 17a–5 and 17a–11 and new Form Custody include an initial, one-time burden of approximately 13,522 hours [664] and an annual burden of approximately 276,717 hours.[665] There is significant variance between the largest broker-dealers and the smallest broker-dealers. Consequently, the estimates described below are averages across all types of broker-dealers expected to be affected by the amendments.

1. Annual Reports To Be Filed

i. The Financial Report

The Commission's amendments to Rule 17a–5 retain the current requirement that broker-dealers annually file financial statements and supporting schedules that must be audited by a PCAOB-registered accountant. As a result, the Commission's estimate of the hour burden for broker-dealers to prepare and file the financial report has not changed as a result of the amendments to Rule 17a–5.

ii. The Compliance Report

Under the amendments, a carrying broker-dealer must prepare and file with the Commission a new compliance report each year. The compliance report must contain statements as to whether: (1) The broker-dealer has established and maintained Internal Control Over Compliance; (2) the Internal Control Over Compliance of the broker-dealer was effective during the most recent fiscal year; (3) the Internal Control Over Compliance of the broker-dealer was effective as of the end of the most recent fiscal year; (4) the broker-dealer was in compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3 as of the end of the most recent fiscal year; and (5) the information the broker-dealer used to state whether it was in compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3 was derived from the books and records of the broker-dealer. In addition, if applicable, the compliance report must contain a description of: (1) Each identified material weakness in the broker-dealer's Internal Control Over Compliance during the most recent fiscal year, including those that were identified as of the end of the fiscal year; and (2) any instance of non-compliance with Rule 15c3–1 or paragraph (e) of Rule 15c3–3 as of the end of the most recent fiscal year.

The Commission estimated that, on average, carrying broker-dealers would spend approximately 60 hours each year to prepare the compliance report, as proposed.[666]

One commenter stated that the proposal did not ''address the additional costs broker-dealers would incur in preparing Compliance Reports.''[667] The commenter, however, did not comment directly on the estimated hour burden or provide specific examples of costs, in addition to the hour burdens, that broker-dealers would bear.[668] Another commenter also stated that the proposed estimate of 60 hours ''is not an accurate estimate of the time burden to complete the Compliance Report'' and that the burdens in the proposing release are understated.[669] The commenter stated that completing the compliance report will require extensive collaboration between management, internal audit and the independent public accountants resulting in added hours to perform the validation and evidence gathering of the existing processes necessary to make the assertions in the proposed compliance report.[670] The commenter, however, did not provide a different estimate of the number of hours it would take to complete the compliance report.

In response to these comments, the Commission notes that the final rule modifies the proposal in ways that may modestly reduce the time burden. For example, the final rule requires a statement as to whether the broker-dealer was in compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3 as of the end of the most recent fiscal year and, if applicable, a description of any instances of non-compliance with these rules as of the fiscal year end, rather than the proposed assertion that the broker-dealer is in compliance with the financial responsibility rules in all material respects and proposed description of any material non-compliance with the financial responsibility rules. This reflects two changes from the proposal: (1) Elimination of the concepts of ''material non-compliance'' and ''compliance in all material respects'' with Rule 15c3–1 and 15c3–3 for the purposes of reporting in the compliance report; and (2) a narrowing of these statements and description requirements from compliance with all of the financial responsibility rules to compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3.

As modified, the final rule no longer requires the broker-dealer to evaluate whether an instance of non-compliance with the financial responsibility rules was material, a component of the proposal that generated significant comment. In addition, the broker-dealer only needs to report instances of non-compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3. In this regard, broker-dealers currently are required to include supporting schedules to their financial statements containing a computation of net capital and the reserve requirement under paragraph (e) of Rule 15c3–3. Consequently, the work required under this pre-existing requirement should provide the broker-dealer with the information it needs to make the statement as to whether it is in compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3 as of the fiscal year end.

Given these modifications, the statements in the compliance report concerning the broker-dealer's Internal Control Over Compliance likely will be responsible for the bulk of the hour burden associated with preparing the

[663] The updated estimates are based on FOCUS Report data as of year end 2011. As discussed above, FOCUS Reports are deemed confidential pursuant to paragraph (a)(3) of Rule 17a–5.

[664] As discussed below, the total one-time burden relates to the requirement to draft and file a revised statement regarding the independent public accountant under Rule 17a–5(f)(2). The Commission estimated a total one-time burden of 10,214 hours in the proposing release for the statement regarding the independent public accountant and for SIPC forms. *See Broker-Dealer Reports,* 76 FR at 37595.

[665] As discussed below, the total annual hour burden relates to the compliance report (17,520 hours), the exemption report (30,919 hours), the filing of annual reports with SIPC (2,246 hours), and Form Custody (226,032 hours). The Commission estimated a total annual burden of 287,325 hours in the proposing release. *See Broker-Dealer Reports,* 76 at FR 37595.

[666] *See Broker-Dealer Reports,* 76 FR at 37596.

[667] *See SIFMA Letter.*

[668] *Id.*

[669] *See Van Kampen/Invesco Letter.*

[670] *Id.*

compliance report. For example, the broker-dealer will need to evaluate whether its Internal Control Over Compliance with the financial responsibility rules was effective during the most recent fiscal year.

The Commission believes that the modifications to the final rule discussed above may modestly reduce the hour burden of the final rule as compared to the hour burden that would have resulted from the proposed rule; namely, because a broker-dealer will not need to evaluate whether instances of non-compliance with the financial responsibility rules are material and will only need to report instances of non-compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3. In light of the comments suggesting that the proposing release underestimated the burden, the Commission is not reducing the hour burden estimate for the rule to reflect the potential reduction in hour burden associated with the requirement. Thus, to the extent the proposing release underestimated the burden associated with making the statements in the compliance report about the broker-dealer's Internal Control Over Compliance, the amount of the burden reduction realized through the modifications discussed above is now attributed to the burden associated with the statements about Internal Control Over Compliance.

For these reasons, the Commission is retaining the rule's overall hour burden estimate without revision. The Commission, however, is updating the number of carrying broker-dealers to reflect more recently available data from the broker-dealer FOCUS Reports. The Commission now estimates that there are 292 carrying broker-dealers. Consequently, the Commission estimates that the total annual reporting burden to prepare and file the compliance report is approximately 17,520 hours per year for all carrying broker-dealers.[671]

iii. The Exemption Report

Under the amendments, a non-carrying broker-dealer must file the exemption report.[672] In the exemption report, the broker-dealer must provide to its best knowledge and belief: (1) A statement that identifies the provisions in paragraph (k) of Rule 15c3–3 under which the broker-dealer claimed an exemption from Rule 15c3–3; (2) a statement that the broker-dealer met the identified exemption provisions in paragraph (k) throughout the most recent fiscal year without exception or that it met the identified exemption provisions in paragraph (k) throughout the most recent fiscal year except as described in the exemption report; and (3) if applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified provisions in paragraph (k) and that briefly describes the nature of each exception and the approximate date(s) on which the exception existed.

The Commission estimated that it would take a non-carrying broker-dealer approximately five hours to prepare and file the proposed exemption report.[673] The Commission did not receive any comments on this hour estimate. As discussed above in section II.B.4. of this release, the Commission is adopting, with modifications, the requirements regarding the exemption report. These provisions generally clarified the scope and application of the report. However, one modification provides that if the broker-dealer states that it met the identified exemption provisions in paragraph (k) of Rule 15c3–3 throughout the most recent fiscal year except as described in the report, the broker-dealer must identify each exception during the most recent fiscal year in meeting the identified provisions in paragraph (k) of Rule 15c3–3 and that briefly describes the nature of each exception and the approximate date(s) on which the exception existed. The Commission expects that non-carrying broker-dealers generally track exceptions as part of monitoring compliance with the exemption provisions in paragraph (k) of Rule 15c3–3. The requirement to identify and describe exceptions would create an incremental burden over the rule as proposed. Based on staff experience with the application of Rule 17a–5, the Commission estimates that the additional work associated with describing exceptions in the exemption report would take two hours. Therefore, the Commission is revising the hour estimate associated with the exemption report to seven hours.

The Commission now estimates that there are approximately 4,417 non-carrying broker-dealers that must file exemption reports. Therefore, the Commission estimates that the annual reporting burden for all non-carrying broker-dealers to prepare and file the exemption report is approximately 30,919 hours per year.[674]

iv. Additional Burden and Cost To File the Annual Reports

The filing requirements for the annual reports are being amended.[675] In particular, Rule 17a–5 previously provided that a broker-dealer must file two copies of its annual reports with the Commission's principal office in Washington, DC. The final rule no longer requires that two copies be filed, so that, in accordance with paragraph (d)(6) of Rule 17a–5, broker-dealers must file only one copy of the annual reports with the Commission's principal office. This change could reduce slightly the hour burden and cost associated with filing the annual reports with the Commission.[676]

Amendments to paragraph (d)(6) of Rule 17a–5 require that a broker-dealer also file a copy of its annual reports with SIPC. The Commission estimated that it would take 30 minutes to prepare an additional copy of the annual reports and mail it to SIPC as required by the proposed amendments.[677] The Commission did not receive comments regarding this estimate. In addition, the clarification to the final rule that only broker-dealers that are members of SIPC must file a copy of their annual reports with SIPC will not affect the final PRA hour burden estimate. Therefore, the Commission is retaining this estimate without revision. The Commission now estimates that 4,492 broker-dealers are members of SIPC.[678] Therefore, the Commission estimates that the annual industry-wide reporting burden associated with this amendment is approximately 2,246 hours per year.[679]

There would be postage costs associated with sending a copy of the annual reports to SIPC that are estimated to be, on average,[680] approximately $12.05 per broker-dealer

[671] 60 hours × 292 carrying broker-dealers = 17,520 hours. *See* the discussion below regarding the external costs associated with obtaining the accountant's report on the compliance report.

[672] *See* discussion above in sections II.B.1. and II.B.4. of this release.

[673] *See Broker-Dealer Reports,* 76 FR at 37596.

[674] 7 hours × 4,417 non-carrying broker-dealers = 30,919 hours. *See* the discussion below regarding the external costs associated with obtaining the accountant's report on the exemption report.

[675] *See* discussion above in section II.B.6. of this release.

[676] The Commission does not expect the compliance report, exemption report, and related reports of the independent public accountant to increase the mailing costs of the annual reports because these additional reports in the aggregate should not significantly increase the size and weight of the package of annual reports.

[677] *See Broker-Dealer Reports,* 76 FR at 37596.

[678] As discussed in subsection C. above, according to SIPC, as of March 31, 2012, 217 broker-dealers claimed exemptions from SIPC membership. The Commission therefore estimates that 4,492 (4,709 − 217 = 4,492) broker-dealers are members of SIPC.

[679] ½ hour × 4,492 broker-dealers = 2,246 hours.

[680] The number of pages of an annual report, and consequently the associated postage costs, likely will vary significantly based on the size of the broker-dealer and the types of business in which it engages.

per year.[681] Thus, the Commission estimates that the total annual postage costs associated with sending a copy of the annual reports to SIPC would be approximately $54,128 per year for all broker-dealers that are SIPC members.[682]

Finally, the Commission notes that paragraph (d)(1)(ii) of Rule 17a–5 of the final rule was amended to require that a copy of a DEA's written approval to change a broker-dealer's fiscal year end must be sent to the Commission's principal office in Washington DC, in addition to the regional office of the Commission for the region in which the broker-dealer has its principal place of business. Based on the number of copies of approvals received by the Commission and staff experience in the application of Rule 17a–5, the Commission estimates that approximately 75 broker-dealers will receive approval each year to change their fiscal year end. The Commission estimates that it would take 10 minutes to copy and send an additional copy of the approval to the Commission's principal office in Washington, DC for a total industry-wide annual hour burden of approximately 12.5 hours,[683] and a total industry-wide cost of approximately $33.75 per year to mail the approval.[684]

v. Supplemental Report on SIPC Membership

Prior to today's amendments, paragraph (e)(4) of Rule 17a–5 provided that a broker-dealer must file with its annual report a supplemental report on the status of the membership of the broker-dealer in SIPC, which was required to be ''covered by an opinion of the independent public accountant'' if the annual report of the broker-dealer was required to be audited. The Commission is adopting amendments to paragraph (e)(4) of Rule 17a–5 to provide that broker-dealers must file with SIPC—but no longer with the Commission after an interim period if SIPC adopts a rule under paragraph (e)(4)(i) that is approved by the Commission—a report of an independent public accountant designed to help administer the collection of assessments from broker-dealers for purposes of establishing and maintaining SIPC's broker-dealer liquidation fund.[685] The Commission is adopting the proposed amendments to paragraph (e)(4) of Rule 17a–5 substantially as proposed. One modification is that, as adopted, the final rule provides that the accountant must perform the procedures specified in the rule in accordance with PCAOB standards. SIPC may determine the format of this report by rule, subject to Commission approval.

Because broker-dealers are currently required to file these reports with both the Commission and SIPC, the final rule amendment does not result in any change to the Commission's current estimate of the hour burden for broker-dealers to comply with this requirement under the current PRA collection for Rule 17a–5. Although broker-dealers will file the supplemental report on SIPC membership only with SIPC if a SIPC rule change to implement this amendment is approved by the Commission, as noted in the current PRA collection, the variation in the size and complexity of broker-dealers subject to Rule 17a–5 makes it difficult to calculate the burden of the information collection of Rule 17a–5. Therefore, the Commission will determine whether it is appropriate to revise the PRA estimate for Rule 17a–5 after any SIPC rule filing is approved or after the end of the two-year sunset provision.

In the proposing release the Commission estimated, however, that SIPC would incur a one-time burden associated with filing a rule change with the Commission to implement this proposed amendment of approximately 100 hours.[686] The process and requirements for SIPC to file rule changes with the Commission, however, is set out in SIPA.[687] Any burden on SIPC to file a rule change with the Commission would be associated with the requirements under SIPA. Therefore, the Commission is deleting the proposed one-time 100 hours from the final rule amendments.

vi. Statement Regarding Independent Public Accountant

The Commission is amending paragraph (f)(2) of Rule 17a–5 to revise the statement regarding identification of a broker-dealer's independent public accountant that broker-dealers must file each year with the Commission and their DEA (except that if the engagement is of a continuing nature, no further filing is required).[688] The revised statement contains additional information that includes a representation that the independent public accountant has undertaken to provide a report regarding the broker-dealer's financial reports and a report regarding the broker-dealer's compliance report or exemption report, as applicable.[689] In addition, the statement provided by a clearing or carrying broker-dealer must include representations regarding the access to its accountant requirements described above.[690] Therefore, all broker-dealers will generally be required to file a new statement regarding their independent public accountant. The Commission estimated that the one-time hour burden associated with amending its existing statement and filing the new statement with the Commission, in order to comply with the proposed amendments, would be an average of approximately two hours on a one-time basis for each broker-dealer, as the statement can be continuing in nature.[691]

The Commission is revising this estimate for clearing and carrying broker-dealers, as these broker-dealers will likely need to renegotiate their agreements with their independent public accountants. The Commission estimates, based on staff experience, that it will take a carrying or clearing broker-dealer approximately ten hours on a one-time basis to renegotiate its agreement with its accountant, amend its statement regarding its accountant, and file the new statement with the Commission. The Commission estimates that the one-time burden for all carrying

[681] Based on Commission staff experience with annual report filings of broker-dealers under Rule 17a–5, the Commission staff estimates that approximately 50% of broker-dealers file their annual reports using an overnight mail delivery service. These broker-dealers would consequently incur higher postage costs than broker-dealers which choose to mail their annual reports using first class mail or delivery methods other than overnight mail. Therefore, postage costs will vary depending on the size of the annual report and method of delivery. The Commission estimates that the cost to mail the additional reports would be, on average, $12.05 per broker-dealer. As of October 2012, the $12.05 rate is an average rate of the cost of an Express Mail Flat Rate Envelope of $18.95 and a Priority Mail Flat Rate Envelope of $5.15, based on costs obtained on the Web site of the U.S. Postal Service at: *www.usps.gov.* ($18.95 + $5.15) = $24.10/2 = $12.05.

[682] 4,492 broker-dealers × $12.05 = $54,128.

[683] (75 approvals × 10 minutes)/60 = 12.5 hours.

[684] 75 approvals × $0.45 (current price of a letter sent first class) = $33.75.

[685] *See* discussion above in section II.C.4. of this release.

[686] *See Broker-Dealer Reports,* 76 FR at 37597.

[687] 15 U.S.C. 78ccc(e)(2). The statute generally requires that the Board of Directors of SIPC file with the Commission a copy of any proposed rule change accompanied by a concise general statement of the basis and purpose of such proposed rule change. In addition, the statute states that ''the Commission shall, upon the filing of any proposed rule change, publish notice thereof, together with the terms of substance of such proposed rule change or a description of the subjects and issues involved'' and that the ''Commission shall give interested persons an opportunity to submit written data, views, and arguments with respect to such proposed rule change.'' 15 U.S.C. 78ccc(e)(2)(A).

[688] *See* discussion above in section III. of this release.

[689] *See* Rule 17a–5(f)(2)(ii). 17 CFR 240.17a–5(f)(2)(ii).

[690] *See* Rule 17a–5(f)(2)(ii)(F) and (G).

[691] *See Broker-Dealer Reports,* 76 FR at 37596.

or clearing broker-dealers is approximately 5,130 hours[692] and the one-time burden for all broker-dealers that neither carry customer accounts nor clear transactions is approximately 8,392 hours,[693] for a total industry-wide reporting burden of approximately 13,522 hours on a one-time basis.

Finally, the Commission believes there will be postage costs associated with sending the amended statement regarding the accountant, which must be sent to the Commission's principal office in Washington, DC, the regional office of the Commission for the region in which the broker-dealer's principal place of business is located, and to its DEA. The Commission estimates that each mailing will cost approximately $0.45, for a total cost of approximately $6,357 for all broker-dealers on a one-time basis.[694]

vii. External Costs of Engagement of Accountant

The amendments to Rule 17a–5 retain the current requirement that broker-dealers annually file with the Commission a financial report and a report prepared by a PCAOB-registered accountant based on an audit of the financial report.[695] However, the financial report must be audited in accordance with standards of the PCAOB, instead of in accordance with GAAS, as previously required. The amendments also require a broker-dealer to file with the Commission either a compliance report or an exemption report and to obtain an independent accountant's report based on an examination or review of those reports, respectively.[696]

Broker-dealers incur annual external costs associated with the PRA burden in terms of hiring outside auditors and accountants to comply with the requirements of Rule 17a–5. Any external costs of accountants' reports included in the PRA collection of information for these final rule amendments are averages across all broker-dealers. The external PRA costs incurred by a broker-dealer to comply with the final rule amendments will generally depend on its size and the complexity of its business activities. Because the size and complexity of broker-dealers varies significantly, the Commission provides estimates of the average external cost per broker-dealer across all broker-dealers.[697]

The Commission received various comments regarding the costs of the proposed requirements and engagement of the accountant provisions. More specifically, the Commission received comments addressing: (1) The costs of the change from GAAS to PCAOB standards for the financial report; (2) the costs of the examination of the new compliance report; and (3) the costs of the review of the new exemption report. The comments received with respect to these three areas and the Commission's responses are addressed in detail in each subsection below.

a. Financial Report (Including Change From GAAS to PCAOB Standards)

Two commenters stated that the Commission did not address the costs associated with the change from GAAS to PCAOB standards.[698] These costs would affect the external costs of broker-dealers under the PRA burden to the extent the change in standards caused an increase in external accounting fees incurred by broker-dealers. One commenter also stated that the Commission may need to consider the PCAOB's proposed rules before it can make a reasonable estimate, and that transition to PCAOB standards may require substantial revisions to audit programs.[699] Another commenter stated that the economic analysis was ''inconclusive'' because the PCAOB has not yet established auditing and attestation standards for broker-dealers.[700] In response to this comment, the Commission estimates the costs of its rules using the best information available to it at the time.

Based on information currently available, including the proposed PCAOB standards, the Commission does not expect that the move to PCAOB standards for audits of broker-dealer financial reports will result in significant one-time implementation costs or recurring annual costs. The proposed PCAOB standards for audits of financial reports (financial statements and supporting schedules) generally incorporate concepts and requirements contained within GAAS, thereby minimizing the potential costs to broker-dealer auditors of this change. As such, the Commission is not including any additional external PRA costs related to the change from GAAS to PCAOB auditing standards.[701] However, in response to the comment, the Commission will examine the effect of any final PCAOB standards on the external costs associated with this collection of information in subsequent extensions of this collection of information and make any necessary cost adjustments.

b. Compliance Report

The Commission estimated that the incremental external cost to a carrying broker-dealer of obtaining the independent public accountant's report based on an examination of the proposed compliance report would be an average incremental cost of approximately $150,000 per carrying broker-dealer per year.[702] The Commission is including these external costs in this collection of information.

One commenter stated that the Commission underestimated the cost of examining the compliance report.[703] This commenter believed that the auditing costs associated with the compliance examinations were underestimated given that the proposing release contemplated a move from GAAS to PCAOB auditing standards.[704] This commenter stated that the transition may require substantial revisions to independent public accountant audit programs, including implementation of new auditing techniques and processes and the associated training programs and noted that the proposed PCAOB standards were not released until after the publication of the proposing release.[705] Another commenter stated that completing both the compliance reports and exemption reports ''will require extensive collaboration between management, internal audit, and the independent public accountants'' and that due to the ''significant increase in hours,'' the proposed amendments have ''the potential to double the total current audit fees and have a material impact'' on firms.[706] These commenters did not quantify their cost estimates in terms of dollars; nor did they provide data to support their conclusions.

As explained above in section II.D. of this release, before today's amendments, Rule 17a–5 required a broker-dealer to

[692] 10 hours × 513 carrying or clearing broker-dealers = 5,130 hours.

[693] 2 hours × 4,196 non-carrying and non-clearing broker-dealers = 8,392 hours.

[694] 4,709 broker-dealers × $0.45 cost for first class postage × 3 mailings = $6,357.15.

[695] *See* discussion above in section II.D.3. of this release.

[696] *Id.*

[697] In the proposing release, these costs were included in the Economic Analysis. The Commission is also including these costs in the PRA amendments to more accurately reflect external costs incurred by broker-dealers as a result of the PRA hour burdens imposed by the final rule amendments, and in response to comments.

[698] *See, e.g., McGladrey Letter; SIFMA Letter.*

[699] *See ABA Letter.*

[700] *See CAI Letter.*

[701] *See* section VII. of this release (discussing benefits and costs of changing from GAAS to PCAOB auditing standards).

[702] *See Broker-Dealer Reports,* 76 FR at 37599.

[703] *See ABA Letter.*

[704] *Id.*

[705] *Id.*

[706] *See Van Kampen/Invesco Letter.*

engage an independent public accountant to prepare a material inadequacy report based on, among other things, a review of the accounting system, internal accounting control, and procedures for safeguarding securities of the broker-dealer, including appropriate tests, for the period since the prior examination date. In addition, the accountant was required to review the practices and procedures followed by the broker-dealer in, among other things, (1) making periodic computations of net capital and under paragraph (e) of Rule 15c3–3, (2) making quarterly securities examinations, counts, verifications, and comparisons under Rule 17a–13, and (3) obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3–3.

Consequently, under requirements before today's amendments relating to a material inadequacy report that are being replaced by the examination of the compliance report, the broker-dealer was required to engage the independent public accountant to review the internal controls, practices, and procedures of the broker-dealer with respect to key elements of the financial responsibility rules.

For these reasons, the Commission continues to believe that the average incremental cost of $150,000 per carrying broker-dealer to obtain the accountant's report covering the compliance report is reasonable. Moreover, as stated above, the Commission is adopting the proposed amendments to Rule 17a–5 with respect to the compliance report with modifications. For example, the final rule requires a statement as to whether the broker-dealer was in compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3 as of the end of the most recent fiscal year and, if applicable, a description of any instances of non-compliance with these rules as of the fiscal year end, rather than the proposed assertion that the broker-dealer is in compliance with the financial responsibility rules in all material respects and the proposed description of any material non-compliance with the financial responsibility rules. This reflects two changes from the proposal: (1) Elimination of the concepts of ''material non-compliance'' and ''compliance in all material respects'' with Rule 15c3–1 and 15c3–3 for the purposes of reporting in the compliance report; and (2) a narrowing of these statements and description requirements from compliance with all of the financial responsibility rules to compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3.

As modified, the final rule no longer requires the independent public accountant to evaluate whether an instance of non-compliance with the financial responsibility rules was material. While there may be an increase in the number of reported instances of non-compliance than under the proposal, the independent public accountant will not be required to determine whether an instance of non-compliance is material. Consequently, the reporting of instances of non-compliance (as compared to instances of material non-compliance) is not expected to increase costs of the engagement of the accountant from those estimated for the proposal and may decrease costs.

In addition, the final rule has been modified from the proposal so that the independent public accountant will not be required to examine a broker-dealer statement that encompassed compliance with all the financial responsibility rules. Instead, the independent public accountant must examine a statement about compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3. In this regard, the Commission has not amended the requirement, which existed before today's amendments, that the independent public accountant examine the supporting schedules to the broker-dealer's financial statements, which contain a computation of net capital under Rule 15c3–1 and the reserve requirement under paragraph (e) of Rule 15c3–3.

Given these modifications, the statements in the compliance report concerning the broker-dealer's Internal Control Over Compliance will likely account for the bulk of the work of the independent public accountant and, as noted above, before today's amendments, the independent public accountant was required to include internal control within the scope of the audit.

The Commission believes that the modifications to the final rule discussed above should modestly reduce the external cost of the final rule as compared to the cost that would have resulted from the proposed rule. Further, elimination of the requirement that the accountant prepare a material inadequacy report will result in some cost savings.[707] While these modifications to the final rule may result in reduced costs, the Commission continues to believe that the average estimated incremental cost of $150,000 per carrying broker-dealer, which may be at the high end of the range of estimated costs, is reasonable.

For these reasons, the Commission has not changed its average estimate of the incremental cost of the accountants' reports covering the compliance report. The Commission therefore estimates that the average industry-wide annual external reporting incremental cost of this requirement is approximately $43,800,000 per year ($150,000 × 292 carrying broker-dealers = $43,800,000).

c. Exemption Report

The Commission estimated that the external cost to a non-carrying broker-dealer of obtaining the independent public accountant's report based on a review of the proposed exemption report would be an average of approximately $3,000 per non-carrying broker-dealer per year, for a total estimated annual cost associated with this proposal of $14,256,000.[708] The Commission did not receive any specific comments regarding this cost estimate.

In the proposing release, the Commission stated its belief that an independent public accountant's review of the exemption assertion would add an incremental cost to that incurred as a result of the annual financial audit.[709] As discussed above, independent public accountants engaged by broker-dealers were required, before today's amendments, to ''ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to [the independent public accountant's] attention to indicate that the exemption had not been complied with during the period since [the independent public accountant's] last examination.'' [710]

The Commission continues to believe that $3,000 is a reasonable estimate of the cost of obtaining the accountant's report covering the exemption report. The Commission now estimates that

[707] The Commission also stated in the proposing release that the Commission estimated that amendments to the IA Custody Rule would impose external costs of $250,000 per investment adviser, and that the Commission estimated that the examination of the compliance report would incrementally cost $150,000 because the IA Custody Rule imposed new requirements on investment advisers, and, unlike the final rule amendments being adopted today, was not based on existing obligations. *See Broker-Dealer Reports,* 76 FR at 37599. Based on this comparison, the Commission continues to believe that the average estimated incremental cost of $150,000 per carrying broker-dealer is reasonable and that the changes discussed above generally should not materially impact the cost estimate as they may, in some cases, result in a modest reduction in burden.

[708] *See Broker-Dealer Reports,* 76 FR at 37599–37600. The Commission estimated that there were 4,752 non-carrying broker-dealers. 4,752 × $3,000 = $14,256,000.

[709] *Id.* at 37599.

[710] *See* 17 CFR 240.17a–5(g)(2).

there are approximately 4,417 non-carrying broker-dealers. The Commission therefore estimates that the total industry-wide external annual reporting cost of this requirement is approximately $13,251,000 per year (4,417 non-carrying broker-dealers × $3,000 = $13,251,000).

d. Access to Accountant and Audit Documentation

The amendments to Rule 17a–5 require that carrying or clearing broker-dealers agree to allow Commission and DEA staff, if requested in writing for purposes of an examination of the broker-dealer, to review the work papers of the independent public accountant and to allow the accountant to discuss its findings with the examiners.

In the proposing release, the Commission estimated that a carrying or clearing broker-dealer's accountant would charge the broker-dealer for time its personnel spend speaking with the Commission or the broker-dealer's DEA and providing them with audit documentation.[711] Thus, the Commission estimated that the additional cost of accountant time associated with this amendment to all clearing and carrying broker-dealers would be approximately $660,000 annually.[712] As the Commission now estimates that the number of carrying or clearing broker-dealers is 513, the new estimate is approximately $641,250.[713]

2. Conforming and Technical Amendments to Rule 17a–11

The Commission proposed technical amendments to Rule 17a–5 and proposed amending paragraph (e) of Rule 17a–11 to eliminate a reference to Rule 17a–5.[714] The Commission stated that these changes should not result in an additional hour burden for the Rule 17a–11 collection of information. As discussed above in section II.F.2. of this release, in response to a comment, paragraph (e) of Rule 17a–11, as adopted, retains a reference to Rule 17a–5. In addition, the Commission is adopting conforming amendments to substitute the term *material weakness* as defined in paragraph (d)(3)(iii) of Rule 17a–5 for the term material inadequacy with respect to Rule 17a–5. Specifically, the final rule provides that whenever a broker-dealer discovers, or is notified by its accountant under paragraph (h) of Rule 17a–5 of the existence of any material weakness, the broker-dealer must: (1) Give notice of the material weakness within 24 hours of the discovery or notification; and (2) transmit a report within 48 hours of the notice stating what the broker-dealer has done or is doing to correct the situation.[715]

The Commission does not expect any change in the number of notices filed per year as a result of the final amendments because the material inadequacy notification requirement is being replaced by a material weakness notification requirement. Therefore, the final amendments to Rule 17a–11 should not result in a change in the current PRA burden for Rule 17a–11. However, the Commission will take into account any changes in the number of notices associated with this collection of information in subsequent extensions of this collection of information and make any necessary adjustments, as appropriate.

3. Form Custody

As described more fully above, the amendments require that all broker-dealers registered with the Commission file Form Custody quarterly with their DEA. The Commission estimated that the hour burden associated with completing and filing proposed Form Custody would be approximately 12 hours per quarter, or 48 hours per year, on average, for each broker-dealer.[716]

In section IV. of this release, in adopting the final amendments to Form Custody, the Commission received one comment in response to Item 8 of Form Custody, as proposed, noting that the information sought in Item 8 was largely the same as information collected from investment advisers on Form ADV.[717] As stated above in section IV. of this release, the Commission is aware that some overlap exists between the information collected from investment advisers on Form ADV and the information that would be collected from broker-dealers dually-registered as investment advisers in Item 8 of proposed Form Custody. However, these two forms also contain a significant amount of non-overlapping material, reflecting their different purposes and uses. Form Custody is intended to be a single source of readily-available information to assist Commission and DEA examiners in preparing for and performing focused custody exams, and it is particularly important that such information be readily available in the case of dually-registered firms. Consequently, the Commission believes that the PRA burden for Form Custody is reasonable in light of its intended purpose, as discussed above in section IV. of this release. Additionally, the commenter did not indicate disagreement with the hour burden estimate as proposed. Therefore, the Commission is retaining the hour burden estimate without revision.

The Commission now estimates that there are approximately 4,709 broker-dealers that must file Form Custody. The Commission therefore estimates that the total annual burden associated with completing and filing Form Custody for all 4,709 broker-dealers is approximately 226,032 hours per year (4,709 broker-dealer times 4 responses per year times 12 hours = 226,032 hours).

One commenter stated that the estimated costs to the industry of $69,179,670 is ''staggering,'' and that such costs would likely indirectly be passed on to customers.[718] The commenter did not disagree with the PRA estimate in the proposing release; rather, the commenter focused on size of the total estimated costs. The Commission recognizes that the requirement to file Form Custody will increase compliance costs for broker-dealers and, consequently, the PRA estimates reflect these costs. The PRA hour burden estimates (and associated internal burden costs), however, are averages across all broker-dealers. The costs incurred by a broker-dealer to comply with the requirement to file Form Custody will depend on its size and the complexity of its business activities. Because the size and complexity of broker-dealers varies significantly, the Commission provides estimates of the average cost per broker-dealer across all broker-dealers.

For these reasons, the Commission believes the internal costs related to the PRA for this hour burden are reasonable and, therefore, the Commission is not adjusting the final cost estimate, except to reflect updated data with respect to

[711] In the proposing release, the Commission estimated that a broker-dealer's accountant would spend approximately 5 hours per year speaking with Commission or DEA staff and providing them with audit documentation.

[712] In the proposing release, the Commission multiplied 528 clearing and carrying broker-dealers × 5 hours × $250/hour = $660,000.

[713] 513 clearing and carrying broker-dealers × $1,250 in increased costs per clearing broker-dealer = $641,250.

[714] *See Broker-Dealer Reports,* 76 FR at 37597.

[715] *See* paragraph (e) of Rule 17a–11. This provision retains references to material inadequacy with respect to Rule 17a–12.

[716] *See Broker-Dealer Reports,* 76 FR at 37597.

[717] *See Angel Letter.*

[718] *See IMS Letter.* The cost of $69,179,670 was reflected in the Economic Analysis in the proposing release. *See Broker-Dealer Reports,* 76 FR at 37601. This cost was calculated as an internal cost of the estimated PRA hours and is the total cost divided among 5,057 firms. *Id.* at 37601 n.215. This internal cost would amount to an average of $13,680 per broker-dealer.

the number of broker-dealers and compensation.[719]

E. Collection of Information Is Mandatory

The collection of information obligations imposed by the rule amendments are mandatory for broker-dealers that are registered with the Commission.

F. Confidentiality

The Commission expects to receive confidential information in connection with the proposed collections of information. Paragraph (e)(3) of Rule 17a–5, as amended, provides that broker-dealer annual reports filed with the Commission are not confidential, except that if the Statement of Financial Condition is bound separately from the balance of the annual reports, and each page of the balance of the annual reports is stamped ''confidential,'' then the balance of the annual reports shall be deemed confidential to the extent permitted by law.[720] However, under paragraph (c)(2)(iv) of Rule 17a–5, if there are material weaknesses, the accountant's report on the compliance report must be made available for customers' inspection and, consequently, it would not be deemed confidential. In addition, paragraph (c)(2)(i) of Rule 17a–5 requires a broker-dealer to furnish to its customers annually a balance sheet with appropriate notes prepared in accordance with GAAP and which must be audited if the broker-dealer is required to file audited financial statements with the Commission.[721] With respect to the other information collected under the amendments, a broker-dealer can request the confidential treatment of the information.[722] If such a confidential treatment request is made, the Commission anticipates that it will keep the information confidential to the extent permitted by law.[723]

VII. Economic Analysis

The Commission is sensitive to the costs and benefits of its rules. When engaging in rulemaking that requires the Commission to consider or determine whether an action is necessary or appropriate in the public interest, section 3(f) of the Exchange Act requires that the Commission consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[724] In addition, section 23(a)(2) of the Exchange Act requires that the Commission consider the effects on competition of any rules the Commission adopts under the Exchange Act, and prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[725]

In the proposing release, the Commission solicited comment on the costs and benefits of the proposed amendments and new form, including whether estimates of the costs and benefits were accurate and comprehensive.[726] The Commission further encouraged commenters to provide specific data and analysis in support of their views.[727] The Commission also requested comment on whether the proposed amendments would place a burden on competition, and promote efficiency, competition, and capital formation.[728]

The Commission received 27 comment letters on the proposed amendments. A number of commenters addressed the Commission's estimates of the cost and benefits of the proposed amendments.[729] Generally, these commenters stated that the Commission's cost and benefit estimates failed to include all of the costs associated with the proposed amendments and that the costs that the Commission did include in its analysis were underestimated. For example, one commenter stated that the proposed amendments ''place unnecessary regulatory burdens and costs on industry, in general, and smaller firms, in particular'' and that ''broker-dealers compete against investment advisers who are not burdened by the same regulatory requirements,'' including the requirements in the proposed amendments.[730] While commenters stated that the Commission underestimated costs, they did not provide alternative quantified estimates of the costs.[731]

As discussed throughout this release, in part in response to comments, the Commission has modified the proposed rules to reduce compliance burdens where consistent with investor protection. In addition, as discussed below, where commenters identified costs the Commission did not consider, the Commission has revised its economic analysis of the final rules to take these costs into account.

In adopting the rule amendments and new form, the Commission has been mindful of the associated costs and benefits. The costs and benefits that the Commission has considered in adopting these amendments and new form are discussed below. The discussion focuses on the Commission's reasons for adopting these amendments and new form, the affected parties, and the costs and benefits of the amendments and new form compared to the baseline, described below, and to alternative courses of action.

Many of the benefits and costs discussed below are difficult to quantify, in particular when discussing increases in investor confidence and improvements in investor protection. For example, the extent to which the increased ability of the Commission and DEAs to oversee compliance with the financial responsibility rules will help limit future violations of the rules is unknown. Similarly, it is unknown how much increasing the focus of broker-dealers on the financial responsibility rules will result in enhanced compliance with those rules. Moreover, limited public data exists to study the costs of broker-dealer audits. Therefore, much of the discussion is qualitative in nature but, where possible, the Commission attempted to quantify the costs.

A. Motivation for the Amendments

The rule amendments and new form being adopted today are designed to provide additional safeguards with respect to broker-dealer custody of customer securities and funds. The motivation for these amendments, which are discussed throughout this release, are summarized below.

[719] *Id.*

[720] *See* paragraph (e)(3) of Rule 17a–5.

[721] *See* 17 CFR 240.17a–5(c)(2)(i).

[722] *See* 17 CFR 200.83. Information regarding requests for confidential treatment of information submitted to the Commission is *available at http://www.sec.gov/foia/howfo2.htm#privacy.*

[723] *See, e.g.,* 15 U.S.C. 78x (governing the public availability of information obtained by the Commission); 5 U.S.C. 552 *et seq.*

[724] 15 U.S.C. 78c(f).

[725] 15 U.S.C. 78w(a)(2).

[726] *See Broker-Dealer Reports,* 76 FR at 37598. An economic analysis was included in the proposing release. *Id.* at 37598–37601.

[727] *Id.* at 37598.

[728] *Id.*

[729] *See ABA Letter; AICPA Letter; Angel Letter; CAI Letter; Citrin Letter; IMS Letter; KPMG Letter; McGladrey Letter; SIFMA Letter; Van Kampen/ Invesco Letter.*

[730] *See IMS Letter.*

[731] For example, one commenter stated that the Commission's estimate of the costs of the compliance report have ''the potential to double the total current audit fees and have a material impact'' on firms. *See Van Kampen/Invesco Letter.* The commenter, however, did not provide a quantified baseline estimate of current audit fees incurred by broker-dealers with which to compare the Commission's estimate of the incremental cost that the compliance report amendments will have on audit fees.

First, as mentioned above in section I.A. of this release, over the last several years, the Commission has brought several cases alleging fraudulent conduct by investment advisers and broker-dealers, including among other things, alleged misappropriation or other misuse of customer securities and funds.[732] These cases highlight the need for enhancements to the rules governing broker-dealer custody of customer assets. Such enhancements include both increased focus on compliance and internal compliance controls by broker-dealers and their auditors, as well as measures to increase the ability of the Commission and broker-dealer DEAs to oversee broker-dealer custody practices by requiring broker-dealers to provide more information about these practices.

Second, as discussed above in section II.D. of this release, certain provisions of Rule 17a–5 before today's amendments were inconsistent with current audit practices, standards, and terminology, which have evolved since these provisions were adopted. This inconsistency has resulted in disparate audit practices and inconsistent compliance with the rule. As discussed above in section II.D.3.iii. of this release, the PCAOB has published a report containing observations from inspections of portions of 23 broker-dealer audits conducted by ten accounting firms.[733] According to the report, PCAOB inspections staff identified deficiencies in all of the audits inspected.[734] The deficiencies noted in the report provide support for the need to strengthen and clarify broker-dealer audit and reporting requirements in order to facilitate consistent compliance with these requirements.

Third, as discussed in section II.D. of this release, prior to today's amendments, Rule 17a–5 required that broker-dealer audits be conducted in accordance with GAAS, which are established by the Auditing Standards Board of the AICPA. The amendments—by requiring that the audits be conducted in accordance with PCAOB standards—recognize the PCAOB's explicit oversight authority over broker-dealer audits as provided by the Dodd-Frank Act, including the authority to establish (subject to Commission approval) and enforce auditing and related attestation, quality control, ethics, and independence standards.[735] In addition, the Commission has direct oversight authority over the PCAOB, including the authority to approve or disapprove the PCAOB's rules and standards.[736] Consequently, requiring that broker-dealer audits be conducted in accordance with standards the Commission has approved will better ensure alignment between broker-dealer audits and the regulatory policy objectives reflected in the Commission's financial responsibility rules.

Fourth, as discussed in section II.B.6. of this release, because broker-dealers have not been required to file with SIPC their annual audited financial statements, SIPC has received limited information regarding the financial condition of its broker-dealer members. SIPC can use this information, among other things, to assess whether the SIPC Fund is appropriately sized to the risks of a large broker-dealer failure. In addition, at least one court, the New York Court of Appeals, has held that in cases where SIPC is required to fund the liquidation of a broker-dealer, SIPC could not maintain a claim against the auditor of the broker-dealer based on an alleged failure to comply with auditing standards because SIPC did not receive the audited financial statements and therefore could not have relied upon them.

Fifth, as discussed in section III. of this release, the audit work performed by independent public accountants with respect to audits of carrying and clearing broker-dealers can provide useful information to Commission and DEA examiners in terms of planning the scope and focus of the examination of the broker-dealer. Providing Commission and DEA examiners with access to the independent public accountant that audited the broker-dealer and audit documentation related to the audit will allow the examiners to gain an understanding of the work the accountant did in auditing the broker-dealer and any areas of concern highlighted by the auditor. This will enable the examiners to conduct risk-based examinations of carrying and clearing broker-dealers and assist the examiners in determining areas of focus for their examinations. Furthermore, the amendments will make it clear to the independent public accountant that the broker-dealer has agreed that the accountant can provide this information and, consequently, eliminate uncertainty as to whether the broker-dealer consents to the disclosure of the information.

Sixth, as discussed in section IV. of this release, because broker-dealers were not required to provide comprehensive or consolidated information about their custody practices to the Commission or their DEA, the Commission and the broker-dealer's DEA had a fragmented and incomplete picture of whether a broker-dealer maintained custody of customer and non-customer assets, and if so, how such assets were maintained. This hindered the ability of the Commission and DEAs to efficiently plan, prioritize, and perform examinations.

B. Economic Baseline

The regulatory changes adopted today amend requirements that apply to broker-dealers registered with the Commission and independent public accountants that audit or attest to broker-dealer annual reports. The discussion below includes approximate numbers of broker-dealers and accountants that would be affected by today's amendments and a description of the economic baseline against which the costs and benefits, as well as the impact on efficiency, competition, and capital formation, of today's amendments and new form are measured.

1. Broker-Dealers

The broker-dealers registered with the Commission vary significantly in terms of their size, business activities, and the complexity of their operations. For example, carrying broker-dealers hold customer securities and funds.[737]

[732] *See, e.g., SEC* v. *Donald Anthony Walker Young, et al.,* Litigation Release No. 21006 (Apr. 20, 2009); *SEC* v. *Isaac I. Ovid, et al.,* Litigation Release No. 20998 (Apr. 14, 2009); *SEC* v. *The Nutmeg Group, LLC, et al.,* Litigation Release No. 20972 (Mar. 25, 2009); *SEC* v. *WG Trading Investors, L.P., et al.,* Litigation Release No. 20912 (Feb. 25, 2009); *SEC* v. *Stanford International Bank, et al.,* Litigation Release No. 20901 (Feb. 17, 2009); *SEC* v. *Bernard L. Madoff, et al.,* Litigation Release No. 20889 (Feb. 9, 2009). The Commission also has brought an enforcement action against an accountant that purported to audit financial statements and disclosures of one of these broker-dealers. *See SEC* v. *David G. Friehling, C.P.A., et al.,* Litigation Release No. 20959 (Mar. 18, 2009).

[733] *See PCAOB Inspection Report* at p. ii.

[734] *Id.*

[735] *See* discussion in section II.D.3. of this release.

[736] Section 107(a) of the Sarbanes-Oxley Act provides that the Commission ''shall have oversight and enforcement authority over the [PCAOB] as provided by the [Sarbanes-Oxley Act].'' Section 107(b) of the Sarbanes-Oxley act provides that ''[n]o rule of the [PCAOB] shall become effective without prior approval of the Commission'' other than certain initial or transitional standards. Section 107(c) of the Sarbanes-Oxley Act provides for Commission review of disciplinary action taken by the PCAOB. Section 107(d) of the Sarbanes-Oxley Act provides that the Commission may censure and impose other sanctions on the PCAOB in certain circumstances.

[737] Rule 15c3–1, the Commission's net capital rule, specifies that a broker-dealer shall be deemed to carry customer or broker-dealer accounts ''if, in connection with its activities as a broker or dealer, it receives checks, drafts, or other evidences of indebtedness made payable to itself or persons other than the requisite registered broker or dealer carrying the account of a customer, escrow agent, issuer, underwriter, sponsor, or other distributor of

Continued

Clearing broker-dealers clear transactions as members of security exchanges and the Depository Trust & Clearing Corporation and the Options Clearing Corporation.[738] Many clearing broker-dealers are carrying broker-dealers, but some clearing broker-dealers clear only their own transactions and do not hold customer securities and cash.

As stated in section I.B.1. above, a broker-dealer that claims an exemption from Rule 15c3–3 is generally referred to as ''non-carrying broker-dealer.'' Non-carrying broker-dealers include ''introducing brokers.'' [739] These non-carrying broker-dealers accept customer orders and introduce their customers to a carrying broker-dealer that will hold the customers' securities and cash along with the securities and cash of customers of other introducing broker-dealers and those of direct customers of the carrying broker-dealer. The carrying broker-dealer generally receives and executes the orders of the introducing broker-dealer's customers.[740] Carrying broker-dealers also prepare trade confirmations, settle trades, and organize book entries of the securities.[741] Introducing broker-dealers also may use carrying broker-dealers to clear the firm's proprietary trades and carry the firm's securities. Another group of non-carrying broker-dealers effects transactions in securities such as mutual funds on a subscription-way basis, where customers purchase the securities by providing the funds directly to the issuer. [742] Finally, some non-carrying broker-dealers act as finders by referring prospective purchasers of securities to issuers.[743]

The broker-dealer industry is the primary industry affected by the rule amendments and the new form. In some cases, the amendments impose different requirements on different types of broker-dealers. For example, carrying broker-dealers must file the compliance report and an independent public accountant's report covering the compliance report, while non-carrying broker-dealers must file the exemption report and an independent public accountant's report covering the exemption report. Only carrying and clearing broker-dealers must agree to allow Commission and DEA examiners to review the audit documentation of their independent public accountants and to allow accountants to discuss their findings with the examiners. All broker-dealers must file Form Custody, but many of the line items on the form apply only to carrying broker-dealers.

To establish a baseline for competition among broker-dealers, the Commission looks at the status of the broker-dealer industry detailed below. In terms of size, the following tables illustrate the variance among broker-dealers with respect to total capital. The information in the table is based on FOCUS Report data for calendar year 2011.

BROKER-DEALER CAPITAL AT CALENDAR YEAR END 2011[744]

[$ millions]

Capital	Number of firms	Aggregate total capital
Less than $500,000	2,506	$347
Greater than or equal to $500,000 and less than $5 million	1,320	2,212
Greater than or equal to $5 million and less than $50 million	608	10,520
Greater than or equal to $50 million and less than $100 million	80	5,672
Greater than or equal to $100 million and less than $500 million	125	26,655
Greater than or equal to $500 million and less than $1 billion	28	19,248
Greater than or equal to $1 billion and less than $5 billion	27	61,284
Greater than or equal to $5 billion and less than $10 billion	6	41,175
Greater than or equal to $10 billion	9	175,585
Total	4,709	342,698

According to FOCUS Report data, as of December 31, 2011, there were approximately 4,709 broker-dealers registered with the Commission.[745] Nine broker-dealers dominate the broker-dealer industry, holding over half of all capital held by broker-dealers. Of the 4,709 registered broker-dealers, 4,417 firms claimed exemptions from Rule 15c3–3 on their FOCUS Reports. Accordingly, the Commission estimates that there are approximately 292

securities'' or ''if it does not promptly forward or promptly deliver all of the securities of customers or of other brokers or dealers received by the firm in connection with its activities as a broker or dealer.'' 17 CFR 240.15c3–11(a)(2)(i). Further, Rule 15c3–3, the Commission's customer protection rule governing reserves and custody of securities, defines the term ''securities carried for the account of a customer'' to mean ''securities received by or on behalf of a broker or dealer for the account of any customer and securities carried long by a broker or dealer for the account of any customer,'' as well as securities sold to, or bought for, a customer by a broker-dealer. 17 CFR 240.15c3–3(a)(2).

[738] *See Definitions of Terms and Exemptions Relating to the ''Broker'' Exceptions for Banks,* Final Rule, Exchange Act Release No. 56501 (Sept. 24, 2007), 72 FR 56514, 56541 n.269 (Oct. 3, 2007).

[739] *Id.* at ¶ 1.15; *see also* Exchange Act Release No. 31511 (Nov. 24, 1992), 57 FR 56973 (Dec. 2, 1992) (describing role of introducing broker-dealers).

[740] Exchange Act Release No. 31511 (Nov. 24, 1992), 57 FR 56973 (Dec. 2, 1992).

[741] *See, e.g.,* FINRA Rule 4311 (Carrying Agreements). This FINRA rule governs the requirements applicable to FINRA members when entering into agreements for the carrying of any customer accounts in which securities transactions can be effected. Historically, the purpose of this rule has been to ensure that certain functions and responsibilities are clearly allocated to either the introducing or carrying firm, consistent with the requirements of the SRO's and Commission's financial responsibility and other rules and regulations, as applicable. *See also Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change Adopting, as Modified by Amendment No. 1, Rules Governing Guarantees, Carrying Agreements, Security Counts and Supervision of General Ledger Accounts in the Consolidated FINRA Rulebook,* Exchange Act Release 34–63999 (Mar. 7, 2011), 76 FR 12380 (Mar. 7, 2011).

[742] *See Books and Records Requirement for Brokers and Dealers Under the Securities Exchange Act of 1934,* Exchange Act Release 34–44992 (Nov. 2, 2001) (''[T]he Commission recognizes that for some types of transactions, such as purchases of mutual funds or variable annuities, the customer may simply fill out an application or a subscription agreement that the broker-dealer then forwards directly to the issuer.'').

[743] *See* American Bar Association, *Report and Recommendations of the Task Force on Private Placement Broker-Dealers* 23–24 (2005); *see also* Exchange Act Release No. 31511 (Nov. 24, 1992), 57 FR 56973 (Dec. 2, 1992).

[744] The information in this chart is based on FOCUS Report data filed by broker-dealers in 2011.

[745] Not all broker-dealers registered with the Commission are SIPC members. According to SIPC, as of March 31, 2012, 217 broker-dealers claimed exemptions from SIPC membership. The Commission therefore estimates that 4,492 (4,709 − 217 = 4,492) broker-dealers are members of SIPC.

carrying broker-dealers (4,709 − 4,417 = 292). Further, based on FOCUS Report data, the Commission also estimates that there are approximately 513 broker-dealers that are clearing or carrying firms. The Commission staff has estimated that approximately 18% of broker-dealers registered with FINRA [746] also are registered as investment advisers with the Commission or with a state.[747]

2. Independent Public Accountants That Audit Broker-Dealer Reports

Independent public accountants that audit broker-dealer reports also will be impacted by the rule amendments. Based on the audit reports filed by broker-dealers in 2011, approximately 900 accounting firms audited broker-dealer reports that were filed with the Commission. However, six large accounting firms dominate the market performing audits for approximately 20% of all broker-dealers registered with the Commission, and those broker-dealers audited by the six large accounting firms had total capital that was more than 90% of the total capital of all broker-dealers registered with the Commission.[748] These statistics highlight the current baseline for competition under which the accountants are operating.

Prior to today's amendments, the AICPA established the auditing and attestation standards to be followed by the independent public accountants of broker-dealers (*i.e.,* GAAS). The AICPA's auditing standards are revised and updated from time to time. For example, the AICPA recently revised GAAS (including audit standards that apply to audits of broker-dealer financial statements), and the revised standards were generally effective for fiscal years that ended on or after December 31, 2012.[749] Consequently, the independent public accountants of broker-dealers have from time to time had to familiarize themselves with updates and revisions to GAAS.

3. SIPC Lawsuits Against Accountants

SIPC was established in 1971. In the period from 1971 to 2011, SIPC initiated 324 proceedings under SIPA to liquidate a failed broker-dealer.[750] This results in an average of approximately 8 SIPA proceedings per year, though 109 of the 324 proceedings were initiated in the period from 1971 to 1974, which was the immediate aftermath of the financial crisis of 1968–1970.[751] According to SIPC staff, SIPC has brought 9 lawsuits against accountants since 1971, which is one lawsuit for every 36 SIPA proceedings.[752] The SIPC staff reports that two of these lawsuits were brought after the 2001 New York decision discussed in section II.B.6.iii. of this release and three lawsuits were brought in liquidation proceedings that were active at or about the same time as the 2001 New York decision. The suits initiated around the time of the 2001 decision and thereafter were brought in jurisdictions other than New York.

4. Overview of Broker-Dealer Reporting, Auditing, and Notification Requirements Before Today's Amendments

i. Broker-Dealer Reporting

Before today's amendments, Rule 17a–5 generally required broker-dealers to prepare and file a financial report with the Commission and the broker-dealer's DEA, as well as a report of a PCAOB-registered independent public accountant covering the financial report. Brokers-dealers also were required to file concurrently with the audited financial report a material inadequacy report prepared by the independent public accountant.

With regard to the material inadequacy report, broker-dealers generally made representations to their independent public accountants about their compliance with certain financial responsibility rules in a representation letter.[753] However, broker-dealers did not file reports with the Commission or their DEA containing such representations. GAAS does not prescribe specific or standardized representations to be made by a broker-dealer to its accountant with regard to an attestation engagement performed under Rule 17a–5.[754] Therefore, broker-dealers' representations to their independent public accountant relating to compliance with certain financial responsibility rules varied depending on what was required by the terms of the individual engagements.

ii. Engagement of the Accountant

As noted above, prior to today's amendments, broker-dealers generally were required to file with the Commission: (1) A report of an independent public accountant based on an audit of the broker-dealer's financial statements and supporting schedules; and (2) a material inadequacy report prepared by the accountant, based on, among other things, a review of a broker-dealer's accounting system, internal accounting control, and procedures for safeguarding securities. The accountant was required to be registered with the PCAOB. However, Rule 17a–5 required that the audit be performed in accordance with GAAS, which are issued by the AICPA. Consequently, the standard setting body for broker-dealer audits has been the AICPA (rather than the PCAOB) notwithstanding the requirement that broker-dealers be audited by a PCAOB-registered independent public accountant.[755]

With regard to the independent public accountant's preparation of the material inadequacy report, Rule 17a–5 required that the scope of the accountant's review be sufficient to provide ''reasonable assurance'' that any material inadequacies[756] existing at the

[746] Per FINRA's Web site, there were 4,456 FINRA member firms at year end 2011. *See http://www.finra.org/Newsroom/Statistics/.*

[747] *See* Commission staff, *Study on Investment Advisers and Broker-Dealers, as required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Jan. 2011).

[748] This data is based on audited reports filed by broker-dealers in 2011 and FOCUS Report data.

[749] *See* AICPA, *Improving the Clarity of Auditing Standards, available at http://www.aicpa.org/InterestAreas/FRC/AuditAttest/Pages/ImprovingClarityASBStandards.aspx.* The AICPA announced the clarification and convergence project in July 2008. *See http://www.aicpa.org/InterestAreas/FRC/AuditAttest/DownloadableDocuments/Clarity/Archive/ASB_Clarity_%20and_Convergence_(8.5x11).pdf.*

[750] *See* SIPC, *Annual Report 2011,* at 6.

[751] *Id. See also* Commission, *Study of Unsafe and Unsound Practices of Brokers and Dealers: Report and Recommendations of the Securities and Exchange Commission* (December 1971) (discussing the financial crisis of 1968–1970). Since its inception through 2001, SIPC initiated 299 proceedings under SIPA.

[752] *See* discussion above in section II.B.6. of this release.

[753] *See, e.g., AICPA Broker-Dealer Audit Guide* app. H (sample representation letter).

[754] According to GAAS, auditors ''should consider obtaining a representation letter'' in an examination or review engagement, and ''specific written representations will depend on the circumstances of the engagement and the nature of the subject matter and the criteria.'' *See* AICPA, *AT Section 101* at ¶ .60. Further, while the *AICPA Broker-Dealer Audit Guide* contains a sample representation letter, publications such as this guide ''are not auditing standards'' but are ''recommendations on the application of the [auditing standards] in specific circumstances, including engagements for entities in specialized industries.'' *See* AICPA, *AU Section 150,* at ¶ .05.

[755] *See* below discussion in section VII.C.1.i. of this release.

[756] Prior to today's amendments, paragraph (g)(3) of Rule 17a–5 describes a ''material inadequacy'' in a broker-dealer's accounting system, internal accounting controls, procedures for safeguarding securities, and practices and procedures to include ''any condition which has contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to: (i) inhibit a broker or dealer from promptly completing securities transactions or promptly discharging his responsibilities to customers, other brokers or dealers or creditors; (ii) result in material financial loss; (iii) result in material misstatements in the broker's or dealer's financial statements; or (iv) result in violations of the Commission's recordkeeping or financial responsibility rules to an

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date of examination would be disclosed. As discussed above in section II.D.3. of this release, the *AICPA Broker-Dealer Audit Guide* provided guidance regarding preparation of the material inadequacy report. Specifically, AICPA guidance stated that the material inadequacy report should address what the independent public accountant concluded in its ''study'' of the adequacy of the broker-dealer's practices and procedures in complying with the financial responsibility rules in relation to the definition of material inadequacy as stated in Rule 17a–5. The requirement to issue a ''study'' does not generally exist outside the context of broker-dealer audits, however, and, while auditing standards at one time referred to the performance of a study, current auditing standards no longer contain such references.

If the broker-dealer was exempt from Rule 15c3–3, Rule 17a–5 required the independent public accountant to ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to the independent public accountant's attention to indicate that the exemption had not been complied with during the period since the last examination.

iii. Filing of Annual Reports With SIPC

Prior to today's amendments, broker-dealers that are members of SIPC were required to file only limited information with SIPC. This information is elicited on Form SIPC–6, the ''General Assessment Payment Form'' and Form SIPC–7, the ''Annual General Assessment Reconciliation.'' In addition, for any period during which the SIPC assessment was not a minimum assessment as provided for in section 4(d)(1)(c) of SIPA, paragraph (e)(4) of Rule 17a–5 generally required broker-dealers to submit to SIPC a supplemental report on the status of the membership of the broker-dealer in SIPC. The supplemental report, among other things, had to include a comparison of the amounts reflected in the annual financial report the broker-dealer filed with the Commission with amounts reported on Form SIPC–7. Form SIPC–6 is filed for the first half of the fiscal year and Form SIPC–7 is filed at the end of the fiscal year with a place to deduct the assessment due and paid as reflected on Form SIPC–6. These forms elicit information from a broker-dealer that is a SIPC member about the broker-dealer's sources of revenue attributable to its securities business.

Prior to today's amendments, broker-dealers did not file with SIPC the annual audited financial statements and accompanying schedules and reports they filed with the Commission and their DEA under Rule 17a–5. Therefore, for example, broker-dealers did not file their balance sheets, which contain information concerning their assets, liabilities, and net worth, or notes to their financial statements with SIPC. This information is necessary to understand the financial conditions of the broker-dealer and, therefore, in order for SIPC to determine whether the SIPC Fund is appropriately sized to the risks of the broker-dealer industry.

iv. Notification Requirements

Prior to today's amendments, the reporting provisions of Rule 17a–5 included references to the term ''material inadequacy.'' [757] The term also was used in the Rule 17a–5 and Rule 17a–11 notification provisions discussed below.

Rule 17a–5 required that if, during the course of the audit, the independent public accountant determined that any material inadequacies existed, the independent public accountant was required to inform the CFO of the broker-dealer, who was required to give notice to the Commission and the broker-dealer's DEA within 24 hours. The rule also provided that the broker-dealer must furnish the independent public accountant with the notice. If the independent public accountant failed to receive the notice within the 24-hour period, or if the accountant disagreed with the statements contained in the notice, the accountant was required to inform the Commission and the DEA within the next 24 hours and describe any material inadequacies found to exist or, if the broker-dealer filed a notice, detail the aspects of the broker-dealer's notice with which the accountant did not agree.

In addition, Rule 17a–11 required that when a broker-dealer discovers a material inadequacy, or is notified by its independent public accountant under Rule 17a–5 that a material inadequacy exists, the broker-dealer must notify the Commission and its DEA and must transmit a report stating what the broker-dealer has done or is doing to correct the situation.

v. Information Provided to Customers

Prior to today's amendments, Rule 17a–5 provided that, if the independent public accountant commented on any material inadequacies, the financial information a broker-dealer was required to send to customers annually must include a statement that a copy of the accountant's report and comments was available for customers' inspection. In addition, Rule 17a–5 provided a conditional exemption from the requirement that a broker-dealer send paper copies of financial information to customers, if the broker-dealer was not required during the prior year to give notice of a material inadequacy.

vi. Access to Accountants

Prior to today's amendments, carrying and clearing broker-dealers were not required to provide Commission and DEA examination staff access to their independent public accountants and accountant work papers. Such access would enable Commission and DEA examiners to obtain information, for example, regarding areas on which the accountants focused in order to plan and conduct risk-based examinations of carrying and clearing broker-dealers.

vii. Form Custody

Generally, prior to today's amendments, broker-dealers were not required to provide comprehensive or consolidated information about their custody practices to the Commission or their DEA. Some information relating to a broker-dealer's custody practices is included in a broker-dealer's exchange membership agreements and clearing agreements, and in the books and records of the broker-dealer. In addition, some information is included on Form ADV and, therefore, if the broker-dealer also is a registered investment adviser, the information is available to the Commission. Although Commission and DEA examiners could obtain the information provided on Form Custody through detailed examinations of the broker-dealer's books and records and by requesting information from other sources, the Commission and the broker-dealer's DEA did not have a profile of a broker-dealer's custodial activities that could serve as a starting point to perform more focused examinations.

C. Costs and Benefits of the Rule Amendments

This section discusses costs and benefits of the rule amendments and new forms for the affected parties against the economic baseline identified above, both in terms of each of the specific changes from the baseline, as well as in terms of the overall impact. In considering these costs, benefits, and impacts, this discussion addresses, among other things, comments received,

extent that could reasonably be expected to result in the conditions described in [(i) through (iii) above].'' 17 CFR 240.17a–5.

[757] *See supra* note 756, at 216.

modifications made to the proposed amendments and form, and reasonable alternatives, where applicable.

The costs incurred by a broker-dealer to comply with the rule amendments and new form generally will depend on its size and the complexity of its business activities. Because the size and complexity of broker-dealers vary significantly as indicated in the economic baseline, their costs could vary significantly. In some cases, the Commission is providing estimates of the average cost per broker-dealer across all broker-dealers, taking into consideration the variance in the size of broker-dealers and the complexity of their business activities.

1. Broker-Dealer Annual Reporting Amendments

i. Changing the Broker-Dealer Audit Standard Setter From the AICPA to the PCAOB and the Standards From GAAS to PCAOB Standards

Today's amendments require that audits of broker-dealer financial statements and schedules be conducted in accordance with the standards of the PCAOB, thereby replacing the AICPA as the standard setter. The amendments also require that broker-dealers file one of two new reports—either a compliance report or an exemption report—and a report of an independent public accountant based on an examination of the compliance report or a review of the exemption report. This section discusses the costs and benefits of the change from the AICPA to the PCAOB as the standard setter for broker-dealer audits and the corresponding change from GAAS to PCAOB standards with respect to the audit of the financial statements and schedules. The costs and benefits of requiring the use of PCAOB standards with respect to examinations and reviews of the new compliance report and exemption report are discussed separately below in section VII.C.1.iii. of this economic analysis regarding the engagement of the accountant.

The change from the AICPA to the PCAOB as standard setter for broker-dealer audits and the corresponding change from GAAS to PCAOB auditing standards for audits of broker-dealer financial reports and supporting schedules provides several benefits. By requiring that these audits be conducted in accordance with PCAOB standards, the amendments align Rule 17a–5 with statutory provisions. As discussed above, the Sarbanes-Oxley Act amended the Exchange Act to require that certain broker-dealer financial reports filed with the Commission be audited by an accounting firm registered with the PCAOB. The Dodd-Frank Act, enacted in July 2010, amended the Sarbanes-Oxley Act to provide the PCAOB with explicit authority to, among other things, establish (subject to Commission approval) auditing and related attestation, quality control, ethics, and independence standards for registered public accounting firms with respect to their preparation of audit reports to be included in broker-dealer filings with the Commission, and the authority to conduct an inspection program of registered public accounting firms that audit broker-dealers.[758] However, Rule 17a–5 provided that broker-dealer audits be performed in accordance with GAAS; namely, auditing standards issued by the AICPA.

After today's amendments, the PCAOB will be the standard setter for two types of entities: issuers that are public companies and broker-dealers. Given this mandate, the PCAOB can focus on establishing standards tailored to these types of entities. For example, with respect to the audit of the financial report, the PCAOB has proposed a standard for auditing supplemental information accompanying audited financial statements filed with the Commission, including supporting schedules broker-dealers must file with the Commission and the broker-dealer's DEA, such as schedules regarding the computation of net capital and the customer reserve requirement and information related to the broker-dealer's possession or control of customer securities.[759] In addition, the PCAOB included the Commission's proposal to amend Rule 17a–5 as one of the factors that led the PCAOB to ''reexamine its requirements regarding supplemental information.'' [760] Consequently, the PCAOB has proposed a standard that would be used for the supplemental reports to the broker-dealer's financial report.[761] The PCAOB stated that ''[t]he proposed standard enhances existing PCAOB standards by: (1) [R]equiring the auditor to perform certain audit procedures to test and evaluate the supplemental information, and (2) [e]stablishing requirements that promote enhanced coordination between the work performed on the supplemental information with work performed on the financial statement audit and other engagements, such as a compliance attestation engagement for brokers and dealers.'' [762]

The change to the PCAOB as the audit standard setter for broker-dealers should facilitate the development of the PCAOB's permanent inspection program as contemplated by the Dodd-Frank Act, because audits of broker-dealers will be inspected by the PCAOB in accordance with its own standards, and not those of another standard setter, and because of feedback that can be obtained through the inspections process regarding gaps and areas that may need improvement. Further, the Commission has direct oversight authority over the PCAOB, including the ability to approve or disapprove the PCAOB's rules.[763] This may help to increase investor confidence in the independent public accountants that audit broker-dealers. In addition, as previously stated, the Commission has greater confidence in the quality of audits conducted by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.[764]

As an alternative approach, one commenter argued that GAAS should apply for audits of non-carrying broker-dealers.[765] Another commenter stated that PCAOB standards should apply only for broker-dealers ''permanently subject to PCAOB inspection,'' and that the Commission should not require that audits of broker-dealers be performed in accordance with PCAOB standards for non-issuer broker-dealers until the PCAOB determines which non-issuer

[758] *See* Public Law 111–203 § 982.

[759] *See Proposed Auditing Standard, Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards,* PCAOB Release No. 2011–05, PCAOB Rulemaking Docket Matter No. 036, 3 (July 12, 2011) (''*PCAOB Proposed Auditing Standard for Supplemental Information*''). As discussed above, the PCAOB has also proposed standards for attestation engagements related to broker-dealer compliance or exemption reports. *See PCAOB Proposing Release.*

[760] *See PCAOB Proposed Auditing Standard for Supplemental Information* at 2–3.

[761] *Id.* at 2 (''The proposed standard would benefit investors and other users of financial statements by updating and enhancing the required audit procedures when the auditor of the financial statements is engaged to audit and report on whether supplemental information accompanying the financial statements is fairly stated, in all material respects, in relation to the financial statements as a whole.'').

[762] *Id.* at 4–5.

[763] Section 107 of the Sarbanes-Oxley Act states that no rule of the PCAOB ''shall become effective without prior approval of the Commission in accordance with this section, other than as provided in section 103(a)(3)(B) with respect to initial or transitional standards.'' *See* Public Law 107–204 § 107. This section also states that the Commission ''shall approve a proposed rule, if it finds that the rule is consistent with the requirements of this Act and the securities laws, or is necessary or appropriate in the public interest or for the protection of investors'', and generally provides that the proposed rule procedures follow the same rule filing procedure for SROs under section 19(b) of the Exchange Act. *Id.*

[764] *See Custody of Funds or Securities of Clients by Investment Advisers,* 75 FR at 1456.

[765] *See Citrin Letter.*

broker-dealers will be subject to its permanent inspection program.[766]

The Commission has determined that all audits of broker-dealer financial statements and supporting schedules should be performed in accordance with PCAOB standards for several reasons. First, allowing the use of more than one auditing standard would introduce inconsistencies in audits of broker-dealer financial reports. Second, allowing the use of non-PCAOB auditing standards for certain broker-dealer audits would reduce the benefits discussed above of requiring that all audits of broker-dealer financial reports be conducted in accordance with PCAOB standards. Third, as discussed in more detail below, the switch from GAAS to PCAOB standards should not result in significant incremental costs.

Independent public accountants that audit issuers are already familiar with PCAOB audit standards, which should ease any transition to PCAOB standards for their audits of broker-dealers. Although the retention of two standards could reduce the incremental costs of switching from GAAS to PCAOB standards for some independent public accountants that do not audit issuers, it would not reduce the incremental costs for all such independent public accountants. For example, a requirement that the financial statements of one class of broker-dealer be audited in accordance with GAAS and the financial statements of another class of broker-dealer be audited in accordance with PCAOB standards would avoid the incremental costs only for independent public accountants that limit their audit engagements to the former class of broker-dealer. These independent public accountants would not need to stay current with PCAOB standards and adopt their procedures to those standards. However, independent public accountants that were engaged to audit broker-dealers in both classes would need to stay current with both sets of standards and adopt their procedures to both sets of standards, which could increase their incremental costs. Further, the PCAOB may determine, subject to Commission approval, to adopt specific auditing standards for certain types of broker-dealers (for example, carrying and non-carrying broker-dealers). This could decrease costs for certain broker-dealer audits.

The Commission received several comments on the costs of its proposal to replace GAAS with PCAOB standards with respect to audits of broker-dealer financial reports. Several commenters stated that the Commission did not address the costs associated with the change from GAAS to PCAOB standards.[767] One commenter also stated that the transition to PCAOB standards from GAAS may require substantial revisions to broker-dealer audit programs.[768]

Current PCAOB standards for audits of financial information generally incorporate concepts and requirements contained within GAAS, thereby minimizing the potential costs of this change to independent public accountants that audit broker-dealers. For example, in April 2003, the PCAOB adopted interim auditing standards consisting of GAAS then in existence, to the extent not superseded or amended by the PCAOB.[769] The PCAOB's Web site lists 50 such standards, including, for example, a standard relating to auditing accounting estimates (AU 342) and a standard relating to auditing fair value measurements and disclosures (AU 328).[770] The PCAOB has adopted, and the Commission has approved, 16 PCAOB auditing standards, beginning with a standard relating to references in audit reports to PCAOB standards.[771]

While some independent public accountants of broker-dealers may incur one-time implementation costs to update their broker-dealer audit programs to reflect PCAOB standards, the costs should not be significant. As stated above, most of the PCAOB's current standards for audits of financial reports incorporate concepts and requirements contained within GAAS. Thus, the independent public accountants of broker-dealers already should be familiar with many of the PCAOB's standards. In addition, as discussed in the economic baseline, the AICPA from time-to-time updates and revises its standards. On such an occurrence, an independent public accountant would need to take steps to become familiar with the updates and revisions and change its broker-dealer audit program accordingly. This need for continuing education presumably already is priced into the audit fees independent public accountants charge broker-dealers.

In contrast to the views expressed by some commenters, the Commission does not expect that a requirement that an audit of financial statements and supporting schedules be conducted in accordance with standards of the PCAOB instead of with GAAS will result in substantial changes for broker-dealer audit programs and therefore the Commission does not anticipate that this change will result in significant costs to broker-dealers in the form of increased audit fees.[772]

ii. Requirement To File New Reports

Under the amendments, a broker-dealer will need to file one of two new reports: a compliance report or an exemption report.[773] A carrying broker-dealer (*i.e.,* one that does not claim an exemption from Rule 15c3–3) must file the compliance report, and a broker-dealer that claimed an exemption from Rule 15c3–3 throughout the most recent fiscal year must file the exemption report. In the reports, a broker-dealer must make certain statements and provide certain information relating to the financial responsibility rules. In addition to preparing and filing the compliance report, a carrying broker-dealer must engage the PCAOB-registered independent public accountant to prepare a report based on an examination of certain statements in the broker-dealer's compliance report.[774] A broker-dealer that claimed an exemption from Rule 15c3–3 throughout the most recently ended fiscal year must engage the PCAOB-registered independent public accountant to prepare a report based on a review of certain statements in the broker-dealer's exemption report. In each case, the examination or review must be conducted in accordance with PCAOB standards.

a. Compliance Report

Under the amendments, a carrying broker-dealer must prepare and file with the Commission a new compliance report each year, along with a report prepared by a PCAOB-registered independent public accountant based on an examination of certain statements made in the compliance report in accordance with PCAOB standards.[775] The compliance report must contain statements as to whether: (1) The broker-dealer has established and

[766] *See AICPA Letter.*

[767] *See, e.g., McGladrey Letter; SIFMA Letter.*

[768] *See ABA Letter.*

[769] *See* PCAOB Auditing Standards (AS) and Interim Auditing Standards (AU) (2013), *available at www.pcaobus.org/standards/auditing.*

[770] *Id.*

[771] *See* PCAOB Auditing Standard No. 1 (AS No. 1). At least one of these audit standards would not apply to audits of broker-dealer financial reports. *See* PCAOB Auditing Standard No. 5, ''An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements.''

[772] As discussed in section V. of this release, the Commission has delayed the compliance date for this requirement to provide sufficient time for broker-dealers and their accountants to prepare to comply with the new requirement.

[773] *See* discussion above in sections II.B.1., II.B.3., and II.B.4. of this release.

[774] *See* paragraphs (f)(1) and (g)(2)(i) of Rule 17a–5.

[775] *See* discussion above in sections II.B.1., II.B.3., and II.D.3. of this release.

maintained Internal Control Over Compliance; (2) the Internal Control Over Compliance of the broker-dealer was effective during the most recent fiscal year; (3) the Internal Control Over Compliance of the broker-dealer was effective as of the end of the most recent fiscal year; (4) the broker-dealer was in compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3 as of the end of the most recent fiscal year; and (5) the information the broker-dealer used to state whether it was in compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3 was derived from the books and records of the broker-dealer. In addition, if applicable, the compliance report must contain a description of: (1) Each identified material weakness in the Internal Control Over Compliance during the most recent fiscal year, including those that were identified as of the end of the fiscal year; and (2) any instance of non-compliance with Rule 15c3–1 or paragraph (e) of Rule 15c3–3 as of the end of the most recent fiscal year.

The compliance report requirements provide a number of benefits. For example, specifying and standardizing the statements required in the compliance report should promote consistent compliance with Rule 17a–5 and should ensure that the Commission receives information relating to aspects of a carrying broker-dealer's compliance with the financial responsibility rules that are of particular concern. Although, as discussed above in section II.D.3. of this release, current auditing standards require that independent public accountants obtain written representations from management as part of the audits of financial statements and attestation engagements, GAAS only provide examples of management representations and do not mandate that specific management representations be made. By clearly specifying and standardizing the statements, the compliance report should increase consistency with respect to the matters examined by the independent public accountants as part of the examination of the compliance report.

The specification and standardization of the statements also should facilitate Commission and DEA oversight of broker-dealer compliance with the financial responsibility rules to the benefit of broker-dealer customers, by helping the Commission and DEAs to more quickly identify broker-dealers with potential problems. Moreover, as adopted, the final rule requires a broker-dealer's compliance report to include information regarding whether the broker-dealer's internal control was effective as of the end of the fiscal year, in addition to information regarding whether there were material weaknesses in the Internal Control Over Compliance during the fiscal year. This will provide the Commission and the DEA with information on whether the broker-dealer has taken action by the end of the fiscal year to cure any material weaknesses in the Internal Control Over Compliance that existed during the fiscal year.

Requiring the compliance report to be filed with the Commission and the broker-dealer's DEA also should increase broker-dealers' focus on ensuring the accuracy of the statements being made and enhance compliance with the financial responsibility rules given the penalties for false filings. For example, filers are subject to penalties for willfully making false statements in any application, report, or document filed with the Commission.[776]

One commenter stated that incremental benefits of having the assertion in the compliance report with respect to internal controls pertain to the whole year rather than the fiscal year end does not justify the costs.[777] In response, the Commission notes that key requirements in the financial responsibility rules must be complied with on an on-going basis throughout the year. Therefore, it is critical to have internal controls over compliance with these rules that are effective throughout the year rather than just at fiscal year end. Therefore, the Commission believes that there are benefits to having a carrying broker-dealer state that its Internal Control Over Compliance was effective throughout the year.

Broker-dealers will incur costs associated with preparing the compliance report. The level of effort required by carrying broker-dealers to prepare a compliance report will depend on the nature of the activities of the broker-dealer. For example, the controls necessary for a carrying broker-dealer that engages in limited custodial activities generally should be less complex than the controls necessary for a carrying broker-dealer that engages in more extensive custodial activities. Therefore, a carrying broker-dealer with limited custodial activities should have to expend less effort to make its statements in the compliance report relating to the effectiveness of its Internal Control Over Compliance. To the extent that the amount of custodial activity is related to the size of a broker-dealer, the cost of preparing the compliance report should be lower for smaller carrying broker-dealers.

The Commission estimated in the proposing release that, on average, carrying broker-dealers would spend approximately 60 hours each year to prepare the proposed compliance report.[778] One commenter stated that the proposal did not ''address the additional costs broker-dealers would incur in preparing Compliance Reports.''[779] However, the commenter did not comment on the estimated hour burden or provide specific data and analysis on the additional costs that broker-dealers would incur in preparing compliance reports. Another commenter stated that the proposed estimate of 60 hours ''is not an accurate estimate of the time burden to complete the Compliance Report'' and that the burdens in the proposing release are understated.[780] This commenter, however, did not provide a quantified alternative estimate of the costs or specific data to support its statement.

The Commission is retaining the 60-hour estimate for the reasons discussed below. The final rules contain two changes from the proposal that could result in lower costs than if the rules had been adopted as proposed: (1) Elimination of the concepts of ''material non-compliance'' and ''compliance in all material respects'' with Rule 15c3–1 and 15c3–3 for the purposes of reporting in the compliance report; and (2) a narrowing of these statements and description requirements from compliance with all of the financial responsibility rules to compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3.

As previously discussed, many commenters raised concerns about how firms would determine whether an instance of non-compliance constitutes material non-compliance.[781] Commenters urged the Commission to provide guidance with additional specific examples or quantitative and qualitative factors to be considered when determining whether non-compliance was material,[782] or proposing alternate definitions or examples of non-compliance that should not be regarded as material.[783] Under the rules as adopted, broker-dealers will not be required to conduct

[776] *See, e.g.,* 15 U.S.C. 78ff(a).

[777] *See E&Y Letter.*

[778] *See Broker-Dealer Reports,* 76 FR 37596.

[779] *See SIFMA Letter.*

[780] *See Van Kampen/Invesco Letter.*

[781] *See ABA Letter; CAI Letter; CAQ Letter; Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter; PWC Letter; SIFMA Letter; Van Kampen/Invesco Letter.*

[782] *See ABA Letter; CAQ Letter; E&Y Letter; KPMG Letter; McGladrey Letter; PWC Letter.*

[783] *See SIFMA Letter.*

a separate evaluation of materiality when determining instances of non-compliance that must be reported. This should reduce the likelihood that inconsistent approaches be taken both among broker-dealers and between broker-dealers and their independent public accountants.

The ''material non-compliance'' and ''compliance in all material respects'' concepts were designed to limit the types of instances of non-compliance that would need to be identified in the report. To retain a limiting principle, the final rule focuses on provisions that trigger notification requirements when they are not complied with, namely, Rule 15c3–1 and the customer reserve requirement in paragraph (e) of Rule 15c3–3.[784] Any instances of non-compliance with these requirements as of the fiscal year end must be described in the compliance report. As stated in the proposing release, failing to maintain the required minimum amount of net capital under Rule 15c3–1 or failing to maintain the minimum deposit requirement in a special reserve bank account under Rule 15c3–3 would have been instances of material non-compliance under the proposed rule.[785] Accordingly, under the proposal, a broker-dealer would have been required to describe all instances of non-compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3. Under the proposal, a broker-dealer also would have been required to describe instances of material non-compliance with Rule 17a–13 and the Account Statement Rules. The final rule is narrower in that a broker-dealer only is required to describe instances of non-compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3. While the final rules increase costs relative to the baseline, they should result in modestly lower costs to broker-dealers relative to the proposal.

The final rule also retains the proposed requirement that the carrying broker-dealer provide a description of each identified material weakness in the internal control of the broker-dealer over compliance with the financial responsibility rules, but, in conformity with other modifications to the proposal, the final rule specifies that the material weaknesses include those identified during the most recent fiscal year as well as those that were identified as of the end of the fiscal year.[786] The Commission believes that the modifications to the final rule discussed above may modestly reduce the hour burden of the final rule as compared to the hour burden that would have resulted from the proposed rule; namely, because a broker-dealer will not need to evaluate whether instances of non-compliance with the financial responsibility rules are material and will only need to report instances of non-compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3. While these modifications will result in additional costs to broker-dealers over the baseline, they are not expected to increase costs over those estimated for the proposed rule. This is because the proposed statement as to whether the broker-dealer's Internal Control Over Compliance was effective during the most recent fiscal year, and the related statement about material weakness, would also cover the fiscal year end. As noted above, the modification to require two statements (one covering the fiscal year and one covering the fiscal year end) was prompted by commenter suggestions that broker-dealers be permitted to report the remediation of a material weakness, or whether a material weakness still exists, at the end of the fiscal year. These changes will provide information to the Commission and DEAs as to whether material weaknesses during the year have been remediated as of the fiscal year end. They also afford the broker-dealer the opportunity to state in the report that a material weakness has been remediated, if applicable.

The changes discussed above, in some cases, may result in a modest reduction in burden relative to the proposal. However, while some commenters suggested that the proposing release underestimated the burden, the Commission is not changing its estimate of the time required for a broker-dealer to prepare the compliance report. The Commission notes that, while commenters questioned the estimate, they did not provide data that would enable the Commission to revise its estimate.

The Commission, however, is updating its estimates of the number of broker-dealers that would be required to file the compliance report, which affects the cost estimates. The Commission now estimates that there are approximately 292 carrying broker-dealers. Therefore, the Commission estimates that the time required for all 292 carrying broker-dealers to prepare the report is approximately 17,520 hours per year.[787] Further, the Commission estimates that the total cost[788] associated with this requirement is approximately $5.6 million per year.[789]

b. Exemption Report

Broker-dealers that claim an exemption from Rule 15c3–3 are required to file an exemption report and a report of the independent public accountant based on a review of the exemption report. The exemption report must contain the following statements made to the best knowledge and belief of the broker-dealer: (1) A statement that identifies the provisions in paragraph (k) of Rule 15c3–3 under which the broker-dealer claimed an exemption from Rule 15c3–3; (2) a statement the broker-dealer met the identified exemption provisions in paragraph (k) of Rule 15c3–3 throughout the most recent fiscal year without exception or that it met the identified exemption provisions in paragraph (k) of Rule 15c3–3 throughout the most recent fiscal year except as described in the exemption report; and (3) if applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified provisions in paragraph (k) of Rule 15c3–3 and that briefly describes the

[784] *See* 17 CFR 240.15c3–1(a)(6)(iv)(B), (a)(6)(v), (a)(7)(ii), (a)(7)(iii), (c)(2)(x)(B)(*1*), (c)(2)(x)(F)(*3*); 17 CFR 240.17a –11(b)–(c); 17 CFR 240.15c3–3(i).

[785] *See Broker-Dealer Reports,* 76 FR at 37577.

[786] *See* 17 CFR 240.17a–5(d)(3)(i)(B).

[787] *See* discussion above in section VI.D.1.ii. of this release. 60 hours × 292 carrying broker-dealers = 17,520 hours per year.

[788] For purposes of this economic analysis, salary data is from the Securities Industry and Financial Markets Association (''SIFMA'') Report on Management and Professional Earnings in the Securities Industry 2011 (''SIFMA Report on Management and Professional Earnings in the Securities Industry''), which provides base salary and bonus information for middle-management and professional positions within the securities industry. The salary costs derived from the report and referenced in this cost benefit section are modified to account for an 1800-hour work year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead.

[789] *See* discussion above in section VI.D.1.ii. of this release. Based on staff experience, the Commission believes that a carrying broker-dealer likely would have a Compliance Manager gather information necessary to validate the statements to be provided and that it would take the Compliance Manager approximately 45 hours to perform this task. In addition, the Commission believes that a carrying broker-dealer likely would have a Chief Compliance Officer review the information and make the attestation and that it would take the Chief Compliance Officer approximately 15 hours per year to perform this task. According to the SIFMA Report on Management and Professional Earnings in the Securities Industry, as modified by Commission staff 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 hourly cost of a Compliance Manager is approximately $279/hour, and the hourly cost of a Chief Compliance Officer is approximately $433/hour. 292 carrying broker-dealers × 45 hours × $279 = $3,666,060. 292 carrying broker-dealers × 15 hours × $433 = $1,896,540. $3,666,060 + $1,896,540 = $5,562,600 per year.

nature of each exception and the approximate date(s) on which the exception existed.

The preparation of exemption reports by broker-dealers that claim an exemption from Rule 15c3–3 throughout the most recent fiscal year, as well as reviews of certain statements in the exemption reports by independent public accountants, should strengthen and facilitate consistent compliance with the Commission's financial responsibility rules, for many of the same reasons identified above with respect to the compliance report. Among other things, these reports should enhance compliance with the exemption provisions in Rule 15c3–3, thereby providing better protection of customer assets. This increased focus is enhanced further by requiring the direct filing of the exemption report with the Commission and the broker-dealer's DEA because of the potential penalties for false statements. In addition, the Commission and the broker-dealer's DEA will benefit from the information provided in the exemption report in conducting their supervisory oversight of the broker-dealer.

The Commission considered an alternative suggested by one commenter to replace the exemption report with a box to check on the FOCUS Report.[790] After careful consideration of this alternative, the Commission determined that it is not an appropriate alternative to the exemption report. As discussed above in section II.B.4.iii. of this release, a broker-dealer claiming an exemption from Rule 15c3–3 already is required to indicate the basis for the exemption on its FOCUS Report.[791] Second, the exemption report requires the broker-dealer to make certain statements that the independent public accountant must review. Thus, the exemption report will provide a standardized statement across all broker-dealers claiming an exemption from Rule 15c3–3 for the independent public accountant to review. Third, the exemption report will provide the Commission and the broker-dealer's DEA with more information than currently is reported by non-carrying broker-dealer's in the FOCUS Report. Specifically, it requires the broker-dealer to, among other things, state either that it met the identified exemption provisions in paragraph (k) throughout the most recent fiscal year without exception or that it met the identified exemption provisions throughout the most recent fiscal year except as described in the report. This will provide the Commission and the broker-dealer's DEA with information as to whether a broker-dealer is meeting the exemption provisions of paragraph (k) of Rule 15c3–3 (not simply that the broker-dealer is claiming the exemption as is reported in the FOCUS Report). The Commission expects that non-carrying broker-dealers generally track exceptions as part of monitoring compliance with the exemption provisions in paragraph (k) of Rule 15c3–3. Fourth, requiring that the exemption report be filed with the Commission should increase broker-dealers' focus on the statements being made, facilitating consistent compliance with the exemption provisions in Rule 15c3–3, and therefore, providing better protection of customer assets. Further, employing a ''check the box'' alternative would not substantially reduce compliance costs because the broker-dealer would need to take steps to ascertain that it has a valid basis for claiming the exemption, whether or not these steps result in an exemption report or ''check the box.''

The Commission estimated that it would take a non-carrying broker-dealer approximately five hours to prepare and file the proposed exemption report.[792] The Commission did not receive comments specifically addressing this estimate. However, because the rule was modified from the proposal to also require the identification of exceptions to the exemption provisions, the Commission is increasing the estimate to seven hours.[793] The Commission now estimates that there are approximately 4,417 non-carrying broker-dealers that must file exemption reports. Therefore, the Commission estimates that the annual reporting burden for all non-carrying broker-dealers to prepare and file the exemption report is approximately 30,919 hours per year.[794] The Commission estimates that the total industry-wide cost to prepare the exemption report is approximately $9.3 million per year.[795]

iii. Engagement of the Accountant

As discussed above, the amendments to Rule 17a–5 eliminate the requirement that the broker-dealer's independent public accountant prepare, and the broker-dealer file with the Commission and its DEA concurrently with its annual audited financial statements, a material inadequacy report, based on, among other things, a review of a broker-dealer's accounting system, internal accounting control, and procedures for safeguarding securities. The amendments replace this requirement with a requirement, among other things, that the broker-dealer file with its annual reports a report prepared by an accountant covering either the broker-dealer's compliance report or exemption report, as applicable. The accountant engaged by the broker-dealer must, as part of the engagement, undertake to prepare its reports based on an examination of certain statements in the compliance report or a review of certain statements in the exemption report, as applicable, in accordance with PCAOB standards.

With regard to the independent public accountant's preparation of the material inadequacy report, Rule 17a–5 required that the scope of the accountant's review be sufficient to provide ''reasonable assurance'' that any material inadequacies existing at the date of examination would be disclosed. If the broker-dealer was exempt from Rule 15c3–3, Rule 17a–5 provided that the accountant must ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to the accountant's attention to indicate that the conditions of the exemption had not been complied with since the last examination. As discussed above, AICPA guidance provided that the material inadequacy report should address what the independent public accountant concluded in its ''study'' of the adequacy of the broker-dealer's practices and procedures in complying with the financial responsibility rules in

[790] *See Angel Letter.*

[791] *See* Item 24 of Part IIa of the FOCUS Report.

[792] *See Broker-Dealer Reports,* 76 FR at 37596.

[793] *See* discussion above in section VI.D.1.iii. of this release.

[794] *See* discussion above in section VI.D.1.iii. of this release. 7 hours × 4,417 non-carrying broker-dealers = 30,919 hours per year. *See* the discussion below regarding the external costs associated with obtaining the accountant's report on the exemption report.

[795] *See* discussion above in section VI.D.1.iii. of this release. Based on staff experience, a non-carrying broker-dealer likely would have a Compliance Manager gather information necessary to validate the information to be provided in the exemption report, and it would take the Compliance Manager approximately six hours to perform this task. In addition, a non-carrying broker-dealer likely would have a Chief Compliance Officer review the information and make the attestation, and it would take the Chief Compliance Officer approximately one hour to perform this task. According to the SIFMA Report on Management and Professional Earnings in the Securities Industry, as modified by Commission staff 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 hourly cost of a Compliance Manager is approximately $279/hour, and the hourly cost of a Chief Compliance Officer is approximately $433/hour. 4,417 non-carrying broker-dealers × 6 hours × $279 = $7,394,058 per year. 4,417 non-carrying broker-dealers × 1 hour × $433 = $1,912,561 per year. $7,394,058 + $1,912,561 = $9,306,619 per year.

relation to the definition of material inadequacy as stated in Rule 17a–5.[796]

However, in the PCAOB's first report on the progress of its interim inspection program of broker-dealer audits, the PCAOB stated that as to 21 of the 23 audits inspected, the accountant ''failed to perform sufficient audit procedures to obtain reasonable assurance that any material inadequacies found to exist since the date of the last examination . . . would have been disclosed in the accountant's supplement report.'' [797] Further, for all of the 14 audits of broker-dealers that claimed an exemption from Rule 15c3–3, the PCAOB stated that the accountant ''did not perform sufficient procedures to ascertain that the broker or dealer complied with the conditions of the exemption.'' [798] The deficiencies noted in the PCAOB's report on the progress of the interim inspection program provide further support for the amendments that the Commission is adopting today to establish the foundation for the PCAOB's development of standards that are tailored to Rule 17a–5, and to strengthen and facilitate consistent compliance with broker-dealer audit and reporting requirements.

Generally, the engagement of accountant amendments should result in higher levels of compliance with the Commission's financial responsibility rules by increasing the focus of carrying broker-dealers and their independent public accountants on specific statements made in the compliance report relating to the broker-dealer's compliance, and internal control over compliance, with the financial responsibility rules and increasing the focus of non-carrying broker-dealers and their independent public accountants on whether the broker-dealer meets the exemption provisions in paragraph (k) of Rule 15c3–3. These amendments also clarify the scope and the standards that apply to broker-dealer audits and conform language in the rule with terminology in existing audit literature, which should reduce inconsistencies in broker-dealer compliance with Rule 17a–5. The replacement of the material inadequacy report with the report based on an examination of the compliance report or review of the exemption report facilitates the Commission's objective to provide clear and consistent terminology focused separately on compliance with the financial responsibility rules and internal control over compliance with the financial responsibility rules.

With regard to the examination of the compliance report, the amendments are intended to encourage greater focus by the independent public accountant on Internal Control Over Compliance, including, in particular, broker-dealer custody practices. By specifying the statements that must be made by a broker-dealer to the Commission, and hence, examined by the auditor, the compliance report should provide clarity and facilitate consistent compliance with Rule 17a–5 by independent public accountants. Additionally, the focus of independent public accountants on internal control over the custody practices of broker-dealers should better identify broker-dealers that have weak internal controls for safeguarding investor securities and cash. Similarly, with regard to the review of the exemption report, the amendments encourage greater focus by the accountant on whether the broker-dealer has appropriately claimed an exemption from Rule 15c3–3 by, among other things, reviewing whether the broker-dealer's statements in the exemption report as to meeting the exemption provisions without or with exceptions, and, if applicable, identifying exceptions to meeting those provisions, were fairly stated.[799] As stated above, the terminology in Rule 17a–5 with regard to the material inadequacy report was outdated and inconsistent with current audit practices.

The PCAOB stated that its proposed attestation standards for examining compliance reports and reviewing exemption reports were ''tailored'' to the proposed amendments to Rule 17a–5.[800] These standards, if adopted, are expected to establish a single and broker-dealer-specific approach to examining compliance reports and reviewing exemption reports and are expected to enable the accountant to scale the engagement based on the broker-dealer's size and complexity.

Based on its estimates of the costs associated with the cost of an internal control report under Rule 206(4)–2, the Commission estimated that the external cost to a carrying broker-dealer of obtaining the independent public accountant's report based on an examination of the proposed compliance report would be an average incremental cost of approximately $150,000 per carrying broker-dealer per year.[801] Based on staff experience, including communications with broker-dealers, broker-dealer independent public accountants, and independent public accountant industry groups, the Commission estimated that the external cost to a non-carrying broker-dealer of obtaining the independent public accountant's report based on a review of the proposed exemption report would cost an average of approximately $3,000 per non-carrying broker-dealer per year.[802] Before today's amendments, independent public accountants of broker-dealers were required to prepare a material inadequacy report. As that report is no longer required, the costs associated with engaging the independent public accountant to prepare a material inadequacy report have been eliminated and replaced by the costs associated with engaging the independent public accountant to prepare a report covering the compliance report or the exemption report. Therefore, the incremental cost of today's amendments related to the engagement of the independent public accountant is the amount that the cost exceeds the cost of engaging the independent public accountant to prepare the material inadequacy report. However, the Commission has not previously estimated the average cost of preparing the material inadequacy report. Consequently, the Commission is retaining the cost estimates set forth in the proposing release, while recognizing that costs could be lower as a result of cost savings attributable to the elimination of the material inadequacy report requirements.

The Commission received various comments regarding the engagement of accountant provisions as they relate to examining or reviewing the proposed compliance reports and exemption reports, respectively. One commenter stated that the Commission underestimated the cost of examining the compliance report and that the Commission may need to consider the

[796] *See AICPA Broker-Dealer Audit Guide* at ¶ 3.77.

[797] *See PCAOB Inspection Report* at iii.

[798] *Id.*

[799] As stated above, a review engagement is designed to provide a moderate level of assurance, and the accountant's conclusion could state, for example, that no information came to the accountant's attention that indicates that the exemption report is not fairly stated in all material respects.

[800] *See PCAOB Proposing Release* at 5.

[801] *See Broker-Dealer Reports,* 76 FR at 37599. *See also* discussion above in section VI.D.1.vii.b. of this release.

[802] *See Broker-Dealer Reports,* 76 FR at 37600. The Commission estimated that the average cost of an audit of a non-carrying broker-dealer's financial report was approximately $30,000 per year, based on a weighted average of estimates of that cost for broker-dealers with varying levels of net income. The Commission further estimated that the additional cost for a review of the exemption report would be an average of approximately $3,000 per non-carrying broker-dealer per year. *Id. See also* discussion above in section VI.D.1.vii.c. of this release.

PCAOB's proposed rules before it can reasonably estimate this cost.[803] Another commenter stated that the proposed amendments have ''the potential to double the total current audit fees and have a material impact'' on firms.[804] A third commenter stated that the economic analysis was ''inconclusive'' because the PCAOB has not yet established auditing and attestation standards for broker-dealers.[805] The commenters, however, did not provide quantified alternative cost estimates.

The Commission acknowledges that the total costs associated with these requirements will depend on the final PCAOB standards for attestation engagements to examine compliance reports or review exemption reports. However, as the PCAOB's proposed standards were tailored to the proposed amendments, nothing in those standards causes the Commission to change its estimates of the costs associated with these requirements, or to question that the benefits will justify the costs.

Before today's amendments, Rule 17a–5 required the independent public accountant to, among other things, review the accounting system, internal accounting control, and procedures for safeguarding securities of the broker-dealer, including appropriate tests, for the period since the prior examination date. The scope of the independent public accountant's review was required to be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the auditor examination would be disclosed. Similarly, an examination of a compliance report performed under the PCAOB's attestation standard for examination engagements would require that the auditor obtain reasonable assurance to express an opinion on whether the broker-dealer's statements in the compliance report are fairly stated, in all material respects.[806]

Moreover, before today's amendments, if a broker-dealer was exempt from Rule15c3–3, Rule 17a–5 required the independent public accountant to ''ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to [the independent public accountant's] attention to indicate that the exemption had not been complied with during the period since [the independent public accountant's] last examination.'' [807] The PCAOB's proposed review standard for the exemption report would require that the independent public accountant make inquiries and perform other procedures that are commensurate with the auditor's responsibility to obtain moderate assurance that the broker-dealer meets the identified conditions for an exemption from Rule 15c3–3.[808] These procedures would include evaluating relevant evidence obtained from the audit of the financial statements and supporting schedules and are designed to enable the auditor to scale the review engagement based on the broker-dealer's size and complexity.[809]

The compliance report as adopted includes an additional statement (relative to the proposal) as to whether the broker-dealer's Internal Control Over Compliance was effective as of the end of the most recent fiscal year. Therefore, costs of compliance with the final rules may be higher than costs of compliance with the proposed rules to the extent Internal Control Over Compliance has changed near or as of the fiscal year end. However, this increased cost is not expected to be significant, since the procedures needed to opine on these matters as of the fiscal year end should not be materially different from the procedures employed to opine as to the effectiveness of internal control over the course of the fiscal year.

As proposed, the broker-dealer would have been required to assert whether it was in compliance, in all material respects, with all of the financial responsibility rules as of its fiscal year end. As adopted, the broker-dealer must assert whether it is in compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3 (*i.e.,* a narrower range of rule compliance than proposed). This modification of the broker-dealer's assertion could result in lower costs for accountants' reports on the compliance report as compared to the proposal as the scope of the matters to be covered by accountants' examinations will be narrower.

Although these modifications could modestly lower costs associated with the accountant's report covering the compliance report as compared to the proposal, the Commission is not changing its estimate of costs associated with accountants' reports covering compliance reports and exemption reports. Based on updated data, the Commission now estimates that there are approximately 292 carrying broker-dealers. The Commission therefore estimates that the industry-wide annual average incremental external reporting cost of accountants' reports based on examinations of compliance reports is approximately $44 million per year ($150,000 times 292 carrying broker-dealers = $43,800,000).[810] Based on updated data, the Commission now estimates that there are approximately 4,417 non-carrying broker-dealers. The Commission therefore estimates that the total industry-wide annual reporting cost of accountant's reports based on reviews of exemption reports is approximately $13.3 million per year (4,417 non-carrying broker-dealers times $3,000 = $13,251,000).[811] The Commission therefore estimates that the total industry-wide incremental external annual reporting cost to broker-dealers associated with the accountants' reports covering the compliance report and exemption report is approximately $57.3 million per year.

Finally, one commenter suggested that the Commission use an ''agreed-upon procedures'' engagement for the exemption report.[812] This alternative was considered. The final rule, however, requires a review engagement as proposed. Under an ''agreed-upon procedures'' engagement, the independent public accountant is engaged by a client to issue a report of findings based on specific procedures performed on subject matter that the specified parties believe are appropriate.[813] Additionally, in an ''agreed-upon procedures'' engagement, the independent public accountant does not perform an examination or a review, and does not provide an opinion or negative assurance. Thus, no conclusion would be rendered as to the broker-dealer's statements in the exemption report.

Another commenter stated that the benefit of receiving an audit report covering the exemption report would not justify the cost [814] and, similarly, a second commenter did not see a benefit from the auditor attestation of the

[803] *See ABA Letter.*

[804] *See Van Kampen/Invesco Letter.*

[805] *See CAI Letter.*

[806] *See PCAOB Proposing Release* at 5. An examination engagement is designed to provide a high level of assurance. *See, e.g.,* PCAOB Interim Attestation Standard, *AT Section 101* at ¶ .54. In this case, the accountant's conclusion will be expressed in the form of an opinion. For example, the accountant's conclusion based on an examination of an assertion could state that in the accountant's opinion, [the assertion] is fairly stated in all material respects. *See, e.g.,* PCAOB Interim Attestation Standard, *AT Section 101* at ¶ .84.

[807] *See* 17 CFR 240.17a–5(g)(2).

[808] *See PCAOB Proposing Release* at 8.

[809] *Id.* at 9.

[810] *See* discussion above in section VI.D.1.vii.b. of this release.

[811] *See* discussion above in section VI.D.1.vii.c. of this release.

[812] *See E&Y Letter.*

[813] *See* PCAOB Interim Attestation Standard, *AT Section 201* at ¶ .03.

[814] *See Citrin Letter.*

exemption report.[815] As noted above, before today's amendments, if a broker-dealer was exempt from Rule15c3–3, Rule 17a–5 required the independent public accountant to ''ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to [the independent public accountant's] attention to indicate that the exemption had not been complied with during the period since [the independent public accountant's] last examination.'' [816] Consequently, the current rule requires the independent public accountant to reach a conclusion with respect to a broker-dealer's claimed exemption from Rule 15c3–3.

The Commission believes the rule should continue to require a conclusion from the independent public accountant on the broker-dealer's claimed exemption from Rule 15c3–3 because of the importance of safeguarding customer securities and cash. While the Commission anticipates there will be costs related to the audit of the exemption report, the Commission does not believe it would be appropriate to use a lower standard (*i.e.,* the agreed-upon procedures standard) or have no requirement for the independent public accountant to perform any work with respect to the exemption report.

iv. Filing of Annual Reports With SIPC

The amendments to Rule 17a–5 require broker-dealers that are SIPC members to file their annual reports with SIPC. SIPC plays an important role in the securities markets by serving as a backstop to protect customers of a failed broker-dealer that cannot promptly return customer securities and funds. In this capacity, SIPC has a legitimate interest in receiving the annual reports of its broker-dealer members to assist it with its maintenance of the SIPC Fund and to monitor trends in the broker-dealer industry. For example, SIPC presently obtains revenue information from broker-dealers, through Form SIPC–7, to determine how best to structure broker-dealer assessments to maintain the SIPC Fund at an appropriate level. However, the information collected in the form is limited and may not assist SIPC in assessing whether the SIPC Fund is appropriately sized to the risks of a large broker-dealer failure. The annual reports contain much more detailed information about the assets, liabilities, income, net capital, and Rule 15c3–3 customer reserve requirements of broker-dealers, and also include, for carrying broker-dealers, a compliance report containing information about the broker-dealer's compliance with, and controls over compliance with, the broker-dealer financial responsibility rules. The annual reports also generally include the independent public accountant's reports covering the financial report and compliance report or exemption report, as applicable, prepared by the broker-dealer. This information also will assist SIPC in monitoring the financial strength of broker-dealers and, therefore, in assessing the adequacy of the SIPC Fund.

In addition, by receiving the annual reports, SIPC may be able to overcome a potential legal hurdle to pursuing claims against a broker-dealer's accountant where the accountant's failure to adhere to professional standards in auditing a broker-dealer causes a loss to the SIPC Fund. As discussed in section II.B.6. of this release, SIPC has sought to recover money damages from the broker-dealer's independent public accountant based on an alleged failure to comply with auditing standards, but at least one court has held under New York law that SIPC could not maintain a claim because it was not a recipient of the annual audit filing and could not have relied on it.[817]

SIPC's improved ability to maintain the SIPC Fund will benefit investors. First, if the SIPC Fund is appropriately sized, customers of a failed broker-dealer in a SIPA liquidation should be able to recover their assets more quickly through advances from the fund than if the fund is not adequate. Also, to the extent the amendments overcome a potential legal hurdle to pursuing claims against a broker-dealer's accountant, the ability to recover damages from the broker-dealer's accountant in the context of a SIPA liquidation proceeding could increase the size of the estate of a failed broker-dealer. Increasing the size of the estate could benefit customers with claims that cannot be fully satisfied through distributions of customer property held by the failed broker-dealer and the SIPC advances.

The new requirement that broker-dealers that are members of SIPC file their annual reports with SIPC will increase these broker-dealers' compliance costs.[818] In the proposing release, the Commission estimated that it would take broker-dealers approximately 30 minutes to prepare and file the annual reports with SIPC, and commenters did not disagree with this estimate. Thus, the Commission estimates that the annual industry-wide reporting burden associated with this amendment is approximately 2,246 hours per year (½ hour times 4,492 SIPC members = 2,246 hours) and that the total annual cost is approximately $694,000.[819] There would be postage costs associated with sending a copy of the annual report to SIPC that are estimated to be, on average,[820] approximately $12.05 per broker-dealer per year.[821] Thus, the Commission estimates that the total annual postage costs associated with sending a copy of the annual report to SIPC would be approximately $54,128 per year for all broker-dealers that are SIPC members.[822]

While they did not provide estimates of potential litigation costs, several commenters stated that the Commission did not address the potential costs and benefits of requiring broker-dealers to file copies of their annual reports with SIPC, including potential litigation costs for independent public accountants.[823] The Commission recognizes that there may be increased litigation costs (or reserves for potential litigation costs) for accountants as a result of the amendment and that to the extent that there are such costs, some of them may be passed on to broker-dealers in the

[815] *See Angel Letter.*

[816] *See* 17 CFR 240.17a–5(g)(2).

[817] *See SIPC* v. *BDO Seidman, LLP,* 746 NE.2d 1042 (N.Y. 2001); aff'd, 245 F.3d 174 (2d Cir. 2001).

[818] *See Broker-Dealer Reports,* 76 FR at 37596.

[819] Based on staff experience, a broker-dealer likely would have a Financial Reporting Manager prepare an additional copy of its annual report and mail it to SIPC. According to the SIFMA Report on Management and Professional Earnings in the Securities Industry, as modified by Commission staff 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 hourly cost of a Financial Reporting Manager is approximately $309/hour. 4,492 SIPC-member broker-dealers × ½ hour × $309 = $694,014.

[820] The number of pages of an annual report, and consequently the associated postage costs, likely will vary significantly based on the size of the broker-dealer and the types of business in which it engages.

[821] Based on Commission staff experience with annual report filings of broker-dealers under Rule 17a–5, the Commission staff estimates that approximately 50% of broker-dealers file their annual reports using an overnight mail delivery service. These broker-dealers would consequently incur higher postage costs than broker-dealers which choose to mail their annual reports using first class mail or delivery methods other than overnight mail. Therefore, postages costs will vary depending on the size of the annual report and method of delivery. The Commission estimates that the cost to mail the additional reports would be, on average, $12.05 per broker-dealer. As of October 2012, the $12.05 rate is an average rate of the cost of an Express Mail Flat Rate Envelope of $18.95 and a Priority Mail Flat Rate Envelope of $5.15, based on costs obtained on the Web site of the U.S. Postal Service, *available at www.usps.gov.* ($18.95 + $5.15) = $24.10/2 = $12.05.

[822] 4,492 broker-dealers × $12.05 = $54,128.

[823] *See, e.g., CAQ Letter; Deloitte Letter; KPMG Letter.*

form of increased fees charged by broker-dealers' independent public accountants. However, commenters did not provide estimates of potential litigation costs, and Commission staff were unable to find readily-available public information from which to estimate specific costs of possible litigation. To the extent that SIPC does bring an individual lawsuit as a direct result of this amendment (*e.g.,* a suit brought in New York), there would be costs in terms of legal fees. Based on staff experience, depending on the complexity, scope, and length of the litigation, the costs to defend an individual case could be quite signficant given the hourly fees charged by outside counsel. However, the Commission does not believe these costs would be significant in the aggregate. As indicated in the economic baseline, SIPC initiates a small number of proceedings each year, and most of these proceedings have not involved litigation by SIPC against the firm's independent public accountant. Moreover, SIPC continued to bring lawsuits against broker-dealer accountants after the 2001 New York decision in jurisdictions other than New York.[824] Consequently, while the amendment removes one potential legal hurdle to such suits, it may not significantly increase the frequency with which SIPC brings such lawsuits. Moreover, the other elements of any relevant cause of action would be unaffected. Accordingly, the Commission continues to believe that the requirement to file copies of the annual reports with SIPC is appropriate.

v. Notification Requirements

As discussed above in section II.F. of this release, the Commission is amending the notification provisions in Rule 17a–5 and is making conforming amendments to Rule 17a–11. Prior to today's amendments, paragraph (h)(2) of Rule 17a–5 provided that if, during the course of the audit or interim work, the independent public accountant determined that any ''material inadequacies'' existed, the independent public accountant was required to inform the CFO of the broker-dealer, who, in turn, was required to give notice to the Commission and the broker-dealer's DEA within 24 hours in accordance with the provisions of Rule 17a–11.[825]

Under Rule 17a–11, a broker-dealer must provide notice to the Commission and its DEA in certain circumstances.[826] For example, paragraph (b)(1) of Rule 17a–11 requires a broker-dealer to give notice if its net capital declines below the minimum amount required under Rule 15c3–1.[827] Before today's amendments, Rule 17a–11 required that whenever a broker-dealer discovered, or was notified by an independent public accountant of the existence of any material inadequacy, the broker-dealer must give notice to the Commission and transmit a report to the Commission stating what the broker or dealer has done or is doing to correct the situation. Rule 15c3–1 and Rule 15c3–3 also require broker-dealers to provide notification in certain circumstances.[828] For example, paragraph (i) of Rule 15c3–3 requires a carrying broker-dealer to immediately notify the Commission and its DEA if it fails to make a deposit into its customer reserve account as required by paragraph (e) of Rule 15c3–3.[829]

a. Amendments to Rule 17a–5

The Commission proposed amending the notification provisions in Rule 17a–5 to replace the term ''material inadequacy'' with the term ''material non-compliance.'' The term ''material non-compliance'' was defined in the context of the compliance report, which was required to be prepared and filed by carrying broker-dealers. This provision would therefore have applied to broker-dealers that filed compliance reports with the Commission. The Commission also proposed amending the notification process. Under the proposed new process, the accountant would be required to notify the Commission and the broker-dealer's DEA directly.

The Commission received numerous comments in response to this proposal.[830] Most of these commenters objected to the proposed notification process.[831] Among the reasons given were that it would be inappropriate to require the accountant to notify the Commission and the DEA directly, because, among other things, the broker-dealer is principally responsible for compliance with the securities laws, including timely notification;[832] that PCAOB standards provide that ''the practitioner should not take on the role of the responsible party'' [833]; and that PCAOB attestation standards (which were referenced in the proposing release) clearly provide that management is responsible for the subject matter to which it is asserting, and not the accountant.[834] In addition to suggestions that the notification process that existed prior to today's amendments should not be changed,[835] one commenter stated that the rule should require simultaneous notice by the accountant to the Commission and to the firm's management.[836] In addition, one commenter asked whether the notification provisions apply to a review of the exemption report.[837] Another commenter stated that non-compliance also will trigger a Rule 17a–11 notice, which would be duplicative and create confusion.[838]

The final rule requires that if the accountant determines that there are any instances of non-compliance (as opposed to an instance of material non-compliance, as proposed) with the financial responsibility rules during the course of preparing the accountant's reports, the accountant must immediately notify the CFO of the broker-dealer of the nature of the non-compliance. If the accountant provides notice of an instance of non-compliance, the broker-dealer must notify the Commission and its DEA, but only if required to do so by existing provisions of Rule 15c3–1, Rule 15c3–3, or Rule 17a–11 that require such notification.[839]

[824] *See SIPC* v. *BDO Seidman, LLP,* 746 NE.2d 1042 (N.Y. 2001); aff'd, 245 F.3d 174 (2d Cir. 2001).

[825] *See* 17 CFR 240.17a–5(h)(2).

[826] *See* 17 CFR 240.17a–11.

[827] *See* 17 CFR 240.17a–11(b)(1).

[828] *See, e.g.,* 17 CFR 240.15c3–1(a)(6)(iv)(B); 17 CFR 240.15c3–1(a)(6)(v); 17 CFR 240.15c3–1(a)(7)(ii); 17 CFR 240.15c3–1(c)(2)(x)(C)(*1*); 17 CFR 240.15c3–1(e); 17 CFR 240.15c3–1d(c)(2); 17 CFR 240.15c3–3(i).

[829] *See* 17 CFR 240.15c3–3(i).

[830] *See ABA Letter; CAI Letter; CAQ Letter; Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter; PWC Letter; SIFMA Letter; Van Kampen/Invesco Letter.*

[831] *See ABA Letter; CAI Letter; CAQ Letter; Deloitte Letter; E&Y Letter; Grant Thornton Letter; KPMG Letter; McGladrey Letter; PWC Letter; Van Kampen/Invesco Letter.*

[832] *See Deloitte Letter.*

[833] *See KPMG Letter. See also PCAOB Interim Attestation Standard, AT Section 101 at ¶ 13.*

[834] *See PWC Letter. See also PCAOB Interim Attestation Standard, AT Section 101 at ¶¶ 11–13.*

[835] *See, e.g., ABA Letter; E&Y Letter; McGladrey Letter.*

[836] *See Van Kampen/Invesco Letter.*

[837] *See KPMG Letter.*

[838] *See ABA Letter.*

[839] Under Rule 17a–11, a broker-dealer must provide notice to the Commission and its DEA in certain circumstances. For example, paragraph (b)(1) of Rule 17a–11 requires a broker-dealer to give notice if its net capital declines below the minimum amount required under Rule 15c3–1. In addition, Rule 15c3–1 and Rule 15c3–3 require broker-dealers to provide notifications in certain circumstances. For example, paragraph (a)(6)(iv) of Rule 15c3–1 requires a broker-dealer that operates as a specialist or market-maker and that operates under the provisions of paragraph (a)(6) of Rule 15c3–1 to obtain certain representations from the broker-dealer that carries its market maker or specialist account. The representations include that the broker-dealer carrying the account will provide a notification under Rule 17a–11 if the market maker or specialist fails to deposit the required amount of equity into the account within the required time frame as prescribed in paragraph (a)(6) of Rule 15c3–1. In addition, under paragraph

Continued

Consequently, the final rule requires that any instance of non-compliance identified by the accountant will trigger a notification by the broker-dealer to the Commission and the firm's DEA to the same extent that notification is required if discovered by the broker-dealer other than in connection with its annual audit. Therefore, under the final rule, if the accountant determines that an instance of non-compliance with the financial responsibility rules exists, the accountant is not required to make a determination of whether that instance of non-compliance is material. This modification likely will result in a lower burden relative to the proposal on the independent public accountant as the accountant will not need to analyze whether an instance of non-compliance is material to determine whether the notification requirement has been triggered. On the other hand, the independent public accountant will need to provide notice to the broker-dealer of all instances of non-compliance rather than only instances of material non-compliance. Therefore, the modification will result in more required notifications from the independent public accountant to the broker-dealer.

Under the final rule, the independent public accountant also will be required to provide notice to the broker-dealer if the accountant determines that any material weaknesses exist. As in the proposal, *material weakness* is defined with regard to the compliance report and therefore applies only to broker-dealers that file compliance reports. In that report, a carrying broker-dealer must state whether its internal controls were effective during the fiscal year as well as at the end of the fiscal year. Internal controls are not effective if there are one or more material weaknesses in the controls. The broker-dealer also is required to describe any identified material weaknesses. The independent public accountant must undertake to prepare a report based on an examination of certain statements in the compliance report, including the statements as to whether the carrying broker-dealer's internal controls were effective.

As stated above, before today's amendments, Rule 17a–5 required the accountant to notify the broker-dealer if the accountant determined that any material inadequacies existed. The concept of material inadequacy generally applied to all broker-dealers and, therefore, the notification requirement applied with respect to independent public accountant engagements for non-carrying as well as carrying broker-dealers under Rule 17a–5. This requirement, however, may not have produced the intended benefits.

As discussed in section II.D.3. above, PCAOB inspection staff found that in 21 of 23 broker-dealer audits inspected, the accountant ''failed to perform sufficient audit procedures to obtain reasonable assurance that any material inadequacies found to exist since the date of the last examination . . . would have been disclosed in the accountant's supplemental report.'' [840] Material inadequacies which were expected to be reported by the accountant included any condition which contributed substantially to or, if appropriate corrective action was not taken, could reasonably be expected to: (1) Inhibit a broker-dealer from promptly completing securities transactions or promptly discharging its responsibilities to customers, other broker-dealers, or creditors; (2) result in material financial loss; (3) result in material misstatements of the broker-dealer's financial statements; or (4) result in violations of the Commission's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in (1) through (3) above. The definition of *material weakness* is more specific: a *material weakness* includes a deficiency in internal control such that there is a reasonable possibility that non-compliance with Rule 15c3–1 and paragraph (e) of Rule 15c3–3 will not be prevented or detected on a timely basis or that non-compliance to a material extent with Rule 15c3–3, except paragraph (e), Rule 17a–13, or the Account Statement Rules will not be prevented or detected on a timely basis.

As discussed above, today's amendments generally replace the term material inadequacy and separate it into two components—a compliance component (non-compliance with the financial responsibility rules) and, for carrying broker-dealers, an internal control component (material weakness in Internal Control Over Compliance). The change is consistent with one of the objectives of the amendments: to provide clear and consistent terminology focused separately on compliance with key financial responsibility rules and internal control over compliance with the financial responsibility rules. The amended notification provisions in Rule 17a–5 reflect this change in terminology.

The Commission proposed amending the notification process so that the accountant would be required to notify the Commission and the broker-dealer's DEA directly. However, the Commission is not adopting this alternative because it agrees with the comments, discussed above, that the notification process in place before today's amendments should be retained.

As stated above, Rule 17a–5 before today's amendments required the accountant to notify the broker-dealer, and the broker-dealer to notify the Commission, if the accountant determined during the course of the audit or interim work that a material inadequacy existed. This requirement generally applied to all broker-dealer audits. The notification provisions in themselves did not direct the accountant to perform specific procedures with respect to the audit—those requirements were contained in other provisions of Rule 17a–5. The notification provisions in Rule 17a–5 were intended to require notification if, during the course of the audit, the accountant became aware of any material inadequacies. As amended, the notification provisions in Rule 17a–5 likewise do not in themselves require the accountant to perform specific procedures with respect to the examination of the financial report or an examination of a compliance report or review of an exemption report. Instead, the notification provisions are triggered when the accountant becomes aware, during the course of preparing the reports of the accountant required under Rule 17a–5, that the broker-dealer is not in compliance with the financial responsibility rules or, during the course of preparing a report based on an examination of a compliance report, that a material weakness exists. These notification requirements are designed to put the broker-dealer in a position to correct controls, processes, and systems that have caused or potentially could cause the firm to not comply with the financial responsibility rules. As discussed throughout this release, the financial responsibility rules serve an important investor protection function by requiring broker-dealers to maintain prudent levels of net capital and take steps to safeguard customer securities and cash.

The requirement to notify the broker-dealer when the independent public accountant determines that the broker-dealer is not in compliance with the financial responsibility rules or that any material weaknesses exist is not expected to increase costs for broker-dealers when compared to the baseline requirement to provide the broker-

(i) of Rule 15c3–3, a carrying broker-dealer must immediately notify the Commission and its DEA if it fails to make a deposit into its customer reserve account as required by paragraph (e) of Rule 15c3–3.

[840] *See PCAOB Inspection Report,* at ii.

dealer with notice when the independent public accountant determines that a material inadequacy exists. As discussed above, the notice requirements under today's amendments do not require the independent public accountant to perform specific procedures. Instead, they are triggered when the independent public accountant determines that any non-compliance or material weakness exists during the course of performing procedures to examine the financial report and to examine the compliance report or review the exemption report, as applicable. To the extent the obligation to provide the broker-dealer with notice is factored into the fee charged by the accountant, the Commission notes that before today's amendments the independent public accountant was required to give notice of a material inadequacy. This notification requirement has been eliminated and, therefore, to the extent it was factored into the fee, that cost has been eliminated. The Commission does not believe that the component of the independent public accountants' fee associated with the new notification requirements would be materially different than the component of the fee associated with the material inadequacy notification requirements. Therefore, the Commission believes these requirements would not result in increased compliance costs relative to the requirements in place before today's amendments.

b. Conforming and Technical Amendments to Rule 17a–11

As discussed above in section II.F.2., prior to today's amendments, paragraph (e) of Rule 17a–11 required that whenever a broker-dealer discovered, or was notified by an independent public accountant, pursuant to paragraph (h)(2) of Rule 17a–5 or paragraph (f)(2) of Rule 17a–12, of the existence of any material inadequacy, the broker-dealer was required to give notice to the Commission and transmit a report to the Commission stating what the broker-dealer has done or is doing to correct the situation.

The Commission is adopting conforming amendments to paragraph (e) of Rule 17a–11 to substitute a notice of the existence of any material weakness as defined in paragraph (d)(3)(iii) of Rule 17a–5 for a notice of the existence of any material inadequacy and to replace a reference to paragraph (h)(2) of Rule 17a–5 with a reference to paragraph (h) of Rule 17a–5.[841] Specifically, the final rule provides that whenever a broker-dealer discovers, or is notified by its accountant under paragraph (h) of Rule 17a–5 of the existence of any material weakness, the broker-dealer must: (1) Give notice of the material weakness within 24 hours of the discovery or notification; and (2) transmit a report within 48 hours of the notice stating what the broker-dealer has done or is doing to correct the situation.[842]

The notification requirements, among other things, alert the Commission and the DEA of the need to increase their monitoring of a broker-dealer and to obtain additional information when appropriate in order to address any concerns the Commission or the DEA may have as a result of the notification. A notification of a material weakness will alert the Commission and the broker-dealer's DEA to the existence of a condition that could impact the broker-dealer's ability to remain in compliance with the financial responsibility rules, which serve an important investor protection function by requiring broker-dealers to maintain prudent levels of net capital and take steps to safeguard customer securities and cash. Once alerted, the Commission and the DEA can respond to the situation through, for example, heightened monitoring of the broker-dealer to assess whether it has corrected the problem and whether it is properly safeguarding customer securities and cash.

The Commission believes these amendments will not result in increased compliance costs to broker-dealers. *Material weakness* is defined with regard to the compliance report and therefore applies only to broker-dealers that file compliance reports (*i.e.,* carrying broker-dealers). In contrast, the concept of material inadequacy generally applied to all broker-dealers and, therefore, the notification requirement applied with respect to independent public accountant engagements under Rule 17a–5 for non-carrying as well as carrying broker-dealers. As discussed above in section VII.B.1. of this release, the Commission estimates that there are approximately 4,709 broker-dealers registered with the Commission and that of those firms, approximately 292 are carrying broker-dealers. Consequently, before today's amendments, the notification requirements with respect to material inadequacy applied to approximately 4,709 broker-dealers, whereas after today's amendments the notification requirement with respect to material weakness will apply to approximately 292 broker-dealers.

The Commission proposed amending paragraph (e) of Rule 17a–11 to delete the references to Rule 17a–5. However, the Commission is not adopting this alternative because it agrees with a commenter that notification should be provided to the Commission when a deficiency in internal control is discovered by the broker-dealer. [843]

vi. Information Provided to Customers

Prior to today's amendments, paragraph (c)(2)(iii) of Rule 17a–5 provided that if, in conjunction with a broker-dealer's most recent audit report, the broker-dealer's independent public accountant commented on any material inadequacies in the broker-dealer's internal controls, its accounting system, or certain of its practices and procedures[844] under paragraphs (g) and (h) of Rule 17a–5, and paragraph (e) of Rule 17a–11, the broker-dealer's audited statements sent to customers were required to include a statement that a copy of the auditor's comments were available for inspection at the Commission's principal office in Washington, DC, and the regional office of the Commission in which the broker-dealer had its principal place of business.[845]

The Commission is revising its proposal with respect to amending paragraph (c)(2) of Rule 17a–5 to be consistent with the new notification provisions in paragraph (h) described above relating to the identification by a broker-dealer's accountant of a material weakness rather than an instance of material non-compliance.[846] Specifically, if, in connection with the most recent annual reports, the report of the independent public accountant on the broker-dealer's compliance report identifies a material weakness, the broker-dealer must include a statement that one or more material weaknesses have been identified and that a copy of the report of the independent public accountant is currently available for the customer's inspection at the principal office of the Commission in Washington, DC, and the regional office of the Commission for the region in

[841] The final rule retains a reference to material inadequacy as defined in paragraph (h)(2) of Rule 17a–12, but amendments correct citations to that rule.

[842] *See* paragraph (e) of Rule 17a–11. The rule retains provisions referencing the term *material inadequacy* as defined in Rule 17a–12.

[843] *See Deloitte Letter.*

[844] These practices and procedures include, for example, periodic net capital computations under Rule 15c3–1 and periodic counts of securities under Rule 17a–13.

[845] *See* 17 CFR 240.17a–5(c)(2)(iii).

[846] *See* paragraph (c)(2)(iv) of Rule 17a–5.

which the broker-dealer has its principal place of business.[847]

The Commission does not believe these amendments will result in incremental costs to broker-dealers over the baseline. *Material weakness* is defined with regard to the compliance report and therefore applies only to broker-dealers that file compliance reports (*i.e.,* carrying broker-dealers). In contrast, the concept of material inadequacy generally applied to all broker-dealers and, therefore, the customer notification requirement applied with respect to independent public accountant engagements under Rule 17a–5 for non-carrying as well as carrying broker-dealers. As discussed above in section VII.B.1. of this release, the Commission estimates that there are approximately 4,709 broker-dealers registered with the Commission and that of those firms, approximately 292 are carrying broker-dealers. Consequently, before today's amendments, the notification requirements with respect to material inadequacy applied to approximately 4,709 broker-dealers, whereas after today's amendments the notification requirement with respect to material weakness will apply to approximately 292 broker-dealers.

Rule 17a–5 also provides a conditional exemption from the requirement to send paper copies of financial information to customers if the broker-dealer mails a financial disclosure statement with summary information and an Internet link to the balance sheet and other information on the broker-dealer's Web site. Before today's amendments, one of the conditions of the exemption was that the broker-dealer was not required during the prior year to give notice of a material inadequacy. The Commission proposed revising this condition for using Web site disclosure to provide that the broker-dealer's financial statements must receive an unqualified opinion from the accountant and that neither the broker-dealer nor the accountant identified a material weakness or an instance of material non-compliance.

One commenter stated that a broker-dealer should be able to deliver the financial information available to customers via its Web site regardless of whether an instance of material non-compliance or material weakness was identified.[848] Another commenter stated that the rule should not require a 100% rate of compliance with the financial responsibility rules to qualify for the exemption.[849] A third commenter stated that the proposed amendment should be eliminated, or replaced with the requirement that broker-dealers include a notice of the material weakness or non-compliance on customer account statements for a year following its identification.[850]

The Commission has decided not to adopt the proposed condition for qualifying for the conditional exemption. The decision not to adopt should result in lower costs than would have been incurred had the Commission adopted the proposal without modification. Using the Internet to disclose information should be less costly and more efficient for the broker-dealer than mailing paper copies to all customers. It also will benefit customers, since they will be able to access relevant broker-dealer information more efficiently through the Internet (alternatively, customers can request a paper copy by phone at no cost to the customer).[851]

vii. Coordination With Investment Advisers Act Rule 206(4)–2

Advisers Act Rule 206(4)–2 provides that when a registered investment adviser or its related person maintains client funds and securities as a qualified custodian in connection with advisory services provided to clients, the adviser annually must obtain, or receive from its related person, a written internal control report prepared by an independent public accountant registered with, and subject to regular inspection by, the PCAOB. This report must be supported by the accountant's examination of the qualified custodian's custody controls. Under the amendments, a broker-dealer that also acts as a qualified custodian for itself as an investment adviser or for its related investment advisers may use the report of the independent public accountant based on an examination of its compliance report to meet the reporting obligations under Rule 206(4)–2. Therefore, such a broker-dealer will not be required to obtain an internal control report under Rule 206(4)–2 in addition to a report covering the compliance report from its independent public accountant. It also will result in efficiencies as a single audit will be able to address two audit requirements.

2. Access to Accountant and Audit Documentation

The amendments to Rule 17a–5 require that carrying or clearing broker-dealers agree to allow Commission and DEA staff, if requested in writing for purposes of an examination of the broker-dealer, to review the work papers of the independent public accountant and to allow the accountant to discuss the its findings with the examiners.

This requirement will enable the Commission and DEAs to more efficiently deploy examination resources.[852] Examiners reviewing the accountant's work papers will be able to tailor the scope of their examinations by identifying areas where extensive audit work was performed by the independent public accountant and focusing their examinations on other areas, allowing for more efficient oversight of broker-dealers by the Commission and DEA examination staff. Enabling Commission and DEA examination staff to conduct more focused and efficient examinations of broker-dealers could, in turn, allow for examination resources to be allocated more strategically.

The Commission is amending paragraph (f)(2) of Rule 17a–5 to revise the statement regarding identification of a broker-dealer's independent public accountant that broker-dealers must file each year with the Commission and their DEA (except that if the engagement is of a continuing nature, no further filing is required).[853] The revised statement contains additional information that includes a representation that the independent public accountant has undertaken to provide a report regarding the broker-dealer's financial reports and a report regarding the broker-dealer's compliance or exemption report, as applicable.[854] In addition, the statement provided by a clearing or carrying broker-dealer must include representations regarding the access to accountant requirements described above.[855] Therefore, all broker-dealers will generally be required to file a new

[847] *Id.*

[848] *See ABA Letter.*

[849] *See CAI Letter.* This commenter stated that FINRA has proposed that broker-dealers send customer account statements monthly instead of quarterly, broker-dealers are already potentially facing ''extremely high'' costs of sending information to customers. FINRA withdrew its proposals to send customer account statements monthly instead of quarterly on July 30, 2012. *See SR–FINRA–2009–028, Proposed Rule Change to Adopt FINRA Rule 2231 (Customer Account Statements) in the Consolidated FINRA Rulebook,* Withdrawal of Proposed Rule Change (July 30, 2012), *available at http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p143262.pdf.*

[850] *See SIFMA Letter.*

[851] *See* 17 CFR 240.17a–5(c)(5)(ii), (iv), and (v).

[852] As discussed previously, where an independent public accountant has performed extensive testing of a carrying broker-dealer's custody of securities and cash by confirming holdings at subcustodians, examiners could focus their efforts on matters that had not been the subject of prior testing and review.

[853] *See* discussion above in section III. of this release.

[854] *See* 17 CFR 240. 17a–5(f)(2)(ii).

[855] *See* 17 CFR 17a–5(f)(2)(ii)(F)–(G).

statement regarding their independent public accountant.

As discussed above in section III. of this release, one commenter stated that, the amendments would discourage or ''chill'' communications between a broker-dealer and its auditor because of the possibility that an auditor may misconstrue communications from representatives of the broker-dealer and wrongly conclude that the representatives lack knowledge or admit to an issue.[856] Presumably, this ''chilling effect'' would result from a broker-dealer's desire to avoid the creation of audit documentation memorializing misunderstandings and miscommunications, which when accessed by Commission and DEA examiners could result in regulatory scrutiny. As stated in section III. of this release, the Commission is not persuaded by this comment; while it is possible for miscommunications to occur between representatives of a broker-dealer and its auditor, potential misunderstandings or miscommunications should not limit the ability of the Commission or a DEA to have access to audit documentation or a broker-dealer's independent public accountant. Further, to the extent a misunderstanding or miscommunication between a broker-dealer and its accountant is reflected in the accountant's audit documentation relating to the broker-dealer, the broker-dealer could clarify the nature of the misunderstanding or miscommunication to examiners and how it was rectified if such clarification and rectification is not already described in subsequent audit documentation.

The Commission estimated that the one-time hour burden associated with amending its existing statement and filing the new statement with the Commission, in order to comply with the proposed amendments, would be an average of approximately two hours on a one-time basis for each broker-dealer, as the statement can be continuing in nature.[857]

As discussed in the PRA, the Commission is revising this estimate for clearing and carrying broker-dealers, as these broker-dealers will likely be required to renegotiate their agreements with their independent public accountants. The Commission estimates that the total one-time cost associated with this burden is approximately $5.2 million.[858] Additionally, the Commission believes there will be postage costs associated with sending the amended statement regarding the accountant and estimates that each mailing will cost approximately $0.45, for a total cost of approximately $6,357 for all broker-dealers on a one-time basis.[859]

In addition, in the proposing release, the Commission estimated that a carrying or clearing broker-dealer's accountant would charge the broker-dealer for time its personnel spend speaking with the Commission or the broker-dealer's DEA or providing them with audit documents and that, on average, the Commission or the broker-dealer's DEA may speak with each accountant for approximately five hours per year. Thus, the Commission estimated that the additional cost of accountant time associated with this amendment to all clearing and carrying broker-dealers would be approximately $660,000 annually.[860] As the Commission now estimates that the number of carrying or clearing broker-dealers is 513, the new estimate is approximately $641,250.[861]

3. Form Custody

The newly adopted Form Custody is to be filed quarterly at the same time that a broker-dealer is required to file its FOCUS Reports. The form elicits information concerning whether, and if so, how, a broker-dealer maintains custody of customer assets and, as discussed above, consolidates information about the broker-dealer's custodial responsibility and relationships with other custodians in one report so that the Commission and other securities regulators will be provided with a comprehensive profile of the broker-dealer's custody practices and arrangements. This should reduce the likelihood that fraudulent conduct, including misappropriation or other misuse of investor assets, can continue undetected. Further, the information provided in Form Custody should aid in the examination of broker-dealers, because the examination staff can use the information provided as another tool to prioritize and plan examinations.

The Form Custody amendments also should enhance investor confidence in the ability of the securities regulators to oversee broker-dealers and broker-dealer custody of investor assets. By establishing a discipline under which broker-dealers are required to report greater detail as to their custodial functions, investor perception as to the safety of their funds and securities held by broker-dealers should improve. Investors may be more willing to provide capital for investment. Further, the requirement by broker-dealers to provide detail as to their custodial practices may prompt them to identify and correct deficiencies. For example, if a broker-dealer preparing the information to be disclosed on the form discovers a discrepancy between its own records and the records of a custodian as to the nature or quantity of assets held by the custodian, the broker-dealer can act to resolve the discrepancy before filing the form.

The Commission estimated that the time required to complete and file Form Custody would be approximately 12 hours per quarter, or 48 hours per year, on average, for each broker-dealer.[862] The Commission did not receive comments regarding this estimate. The Commission now estimates that there are approximately 4,709 broker-dealers that must file Form Custody. The Commission therefore estimates that the total time required to complete and file Form Custody for all 4,709 broker-dealers is approximately 226,032 hours per year (4,709 broker-dealer times four responses per year times 12 hours = 226,032 hours). Further, the Commission estimates that the total cost associated with completing and filing Form Custody is approximately $69.8 million.[863]

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[856] *See CAI Letter.*

[857] *See Broker-Dealer Reports,* 76 FR at 37596.

[858] *See* Section VI.D.1.vi. Based on staff experience, a broker-dealer that carries customer accounts or clears transactions likely would have its Controller and an Assistant General Counsel involved in renegotiating the agreement with auditors, and that those discussions would take, on average, approximately four hours. Broker-dealers would likely have an attorney prepare a new notification of designation of accountant, and that task would take the attorney, on average, approximately two hours. According to the SIFMA Report on Management and Professional Earnings in the Securities Industry, as modified by Commission staff 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 hourly cost of a Controller is approximately $409/hour, the hourly cost of an Assistant General Counsel is approximately $407/hour, and the hourly cost of an Attorney is approximately $378/hour. 513 broker-dealers that carry customer accounts or clear transactions × 4 hours × $409 = $839,268. 513 broker-dealers that carry customer accounts or clear transactions × 4 hours × $407 = $835,164. 4,709 broker-dealers × 2 hours × $378 = $3,560,004. $839,268 + $835,164 + $3,560,004 = $5,234,436.

[859] *See* Section VI.D.1.vi. 4,709 broker-dealers × $0.45 cost for first class postage × 3 mailings = $6,375.15.

[860] *See* Section VI.D.1.vii.d. In the proposing release the Commission multiplied 528 clearing and carrying broker-dealers × 5 hours × $250/hour = $660,000.

[861] *See* Section VI.D.1.vii.d. 513 clearing and carrying broker-dealers × $1,250 in increased costs per clearing broker-dealer = $641,250.

[862] *See Broker-Dealer Reports,* 76 FR at 37597.

[863] Based on staff experience, a broker-dealer likely would have a Financial Reporting Manager complete and file Form Custody. According to the

Continued

One commenter stated that the estimated costs to the industry of $69,179,670 in the proposing release was ''staggering,'' and that such costs would likely indirectly be passed on to customers.[864] The commenter did not disagree with the estimated cost in the proposing release; rather, the commenter focused on the size of the total estimated costs. The Commission notes that the $69 million estimate in the proposing release and the $69.8 million estimate in this release are estimates of the aggregate cost to the industry. The average cost to an individual broker-dealer would be approximately $15,000 per year.[865] As an average, the costs incurred by a broker-dealer to comply with the requirement to file Form Custody will depend on its size and the complexity of its business activities.

The Commission recognizes that the requirement to file Form Custody will increase compliance costs for broker-dealers and that these costs may be passed on to customers. The Commission, however, believes the investor protection benefits of the Form Custody requirements outweigh these costs. As noted above, Form Custody is designed to assist Commission and DEA examiners in identifying potential misrepresentations relating to broker-dealers' custody of assets. Further, the requirements to file the form will promote greater focus and attention to custody practices by requiring that broker-dealers make specific representations in this regard. The safeguarding of customer securities and cash held by broker-dealers is of paramount importance as demonstrated by recent cases where broker-dealers failed to protect customer securities and cash.[866]

4. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

As discussed above, incremental costs will result from the annual reporting requirement amendments, the access to accountant amendments, and the Form Custody amendments. These incremental costs could result in higher barriers to entry for broker-dealers as compared with the baseline that existed prior to the amendments. This could be the case particularly for carrying broker-dealers given the incremental costs associated with the compliance report requirements, the applicability of the access to accountant amendments to carrying and clearing broker-dealers, and that most of the information elicited in Form Custody relates to carrying broker-dealer activities.

The annual reporting requirements have a mixed effect on competition across broker-dealers. The requirement to prepare and file a compliance report or exemption report may impose a burden on competition for smaller carrying broker-dealers to the extent that it imposes relatively high fixed costs, which would represent a greater amount of net income for smaller broker-dealers. On the other hand, as previously noted, a carrying broker-dealer with limited custodial activities should have to expend less effort to support its statements in the compliance report than a broker-dealer with more extensive custodial activities, and the attendant costs should similarly be lower. While the incremental costs of the annual reporting requirements may be lower for non-carrying broker-dealers (which generally are smaller broker-dealers), the costs could disproportionately impact smaller broker-dealers due to fixed cost components of the cost of compliance with these requirements.

The access to accountant amendments may place a burden on carrying and clearing broker dealers. To the extent that addressing contracts between auditors and broker-dealers is a fixed cost, the rule may impact smaller broker-dealers to a greater extent than it will larger broker-dealers. The amendments should not place a burden on competition for non-carrying broker-dealers.

The requirement to file Form Custody could have a burden on competition because it will increase compliance costs for broker-dealers. However, the requirement should not have a disproportionate effect on smaller broker-dealers. Smaller firms will incur fewer costs to complete Form Custody because less information is required to be disclosed. For example, broker-dealers that introduce customers on a fully disclosed basis and do not have custody of customer funds or assets would leave much of the form blank.

In sum, the costs of compliance resulting from the requirements in these amendments should not impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act and in light of the benefits discussed above.

Today's amendments are designed to reduce the likelihood that fraudulent conduct, or lack of appropriate custody procedures or other internal controls, will jeopardize customer securities and funds held by broker-dealers. To the extent that the amendments achieve that goal, investors should be more confident that the customer assets held by broker-dealers are safe. This in turn may promote capital formation as investor assets are able to be allocated more efficiently across the opportunity set.

One commenter asserted that the proposed amendments ''place unnecessary regulatory burdens and costs on industry, in general, and smaller firms, in particular'' and that ''broker-dealers compete against investment advisers who are not burdened by the same regulatory requirements,'' including the requirements in the proposed amendments.[867] The Commission recognizes, as explained above, that the amendments adopted today impose costs on broker-dealers that could result in higher barriers to entry. However, the Commission is of the opinion that these costs are justified by the numerous and significant benefits, in particular with respect to protection of customer assets, described in this economic analysis.

With respect to the commenter's statement about broker-dealers competing with investment advisers, recent Commission amendments to investment adviser rules are ''designed to provide additional safeguards . . . when a registered adviser has custody of client funds or securities'' including a requirement to undergo an annual surprise examination by an independent public accountant to verify client assets and a requirement to have a report of the internal controls relating to the custody of client assets from an accountant registered with, and subject to inspection by, the PCAOB unless client assets are maintained by an independent custodian.[868] Consequently, the regulations governing

SIFMA Report on Management and Professional Earnings in the Securities Industry, as modified by Commission staff 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 hourly cost of a Financial Reporting Manager is approximately $309/hour. 4,709 broker-dealers × 48 hours × $309 = $69,843,888.

[864] *See IMS Letter.* The cost of $69,179,670 was reflected in the economic analysis in the proposing release. *See Broker-Dealer Reports,* 76 FR at 37601. This cost was calculated as an internal cost of the estimated PRA hours and is the total cost divided among 5,057 firms. *Id.* at 37601 n.215. This internal cost would amount to an average of $13,680 per broker-dealer. *Id.*

[865] 1 broker-dealer × 48 hours × $309 = $14,832.

[866] *See, e.g., SEC* v. *Bernard L. Madoff, et al.,* Litigation Release No. 20889 (Feb. 9, 2009).

[867] *See IMS Letter.*

[868] *See Custody of Funds or Securities of Clients by Investment Advisers,* 75 FR at 1456.

investment advisers have been strengthened in recent years through new requirements aimed at safeguarding customer assets. Today's amendments also are aimed at safeguarding customer assets. As both investment advisers and broker-dealers are now subject to new requirements, today's amendments should not create a competitive advantage for either class of registrant. Moreover, the recently adopted requirements for investment advisers and the amendments adopted today are, among other things, part of an effort to strengthen the Commission's rules regarding the safekeeping of customer assets, in part in response to several fraud cases brought by the Commission involving investment advisers and broker-dealers.[869]

If the amendments increase investor confidence in broker-dealers, they will promote capital formation. Moreover, for the reasons discussed above, today's amendments should not unduly restrict competition and should promote capital formation.[870]

The amendments also should increase efficiencies. With respect to the annual reporting amendments, updating the language of Rule 17a–5 to replace outdated or inconsistent audit terminology is designed to ensure that the requirements of the rule are better aligned with applicable current audit standards. Further, the amendments facilitate PCAOB oversight authority, including its ability to inspect audits of broker-dealers, by providing that examinations or reviews of broker-dealer annual reports be made in accordance with PCAOB standards. In addition, the amendments strengthen and promote consistent compliance with the financial responsibility rules for broker-dealers that maintain custody of customer securities and funds by increasing the focus of these broker-dealers and their independent public accountants on compliance, and internal control over compliance, with the financial responsibility rules. This, in turn, should help the Commission and the broker-dealer's DEA identify broker-dealers that have weak internal controls for safeguarding investor assets and improve the financial and operational condition of broker-dealers and thereby provide more protection for investor assets held by broker-dealers.

The access to accountant amendments should increase efficiencies by promoting more risk-based examinations by Commission and DEA staff. For example, the examiners in some cases may be able to leverage the work performed by the independent public accountants and, therefore, focus on areas the accountants did not review. Similarly, the Form Custody amendments should increase efficiencies by promoting more risk-based examinations by Commission and DEA staff as they will be able to use the profile of the broker-dealer's custody practices documented in Form Custody to focus their reviews. For this reason, examinations may also place fewer time demands on broker-dealer personnel.

In significant part, the effect of these rules on efficiency and capital formation are linked to the effect of these rules on competition. For example, markets that are competitive and trusted may be expected to promote the efficient allocation of capital. Similarly, rules that promote, or do not unduly restrict, trust in broker-dealers can be accompanied by regulatory benefits that minimize the risk of market failure and thus promote efficiency within the market. Such competitive markets would increase the efficiency by which market participants could transact with broker-dealers.

VIII. Final Regulatory Flexibility Analysis

The Regulatory Flexibility Act (''RFA'')[871] requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a)[872] of the Administrative Procedure Act,[873] as amended by the RFA, generally requires the Commission to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to determine the impact of such rulemaking on small entities.[874] Section 605(b) of the RFA provides that this requirement does not apply to any proposed rule or proposed rule amendment, which if adopted, would not ''have a significant economic impact on a substantial number of small entities.''[875]

The Commission proposed amendments to Rules 17a-5 and 17a-11 and proposed new Form Custody. An Initial Regulatory Flexibility Analysis (''IRFA'') was included in the proposing release.[876] This Final Regulatory Flexibility Analysis has been prepared in accordance with the provisions of the RFA.

A. Need for and Objectives of the Amendments and New Form

The final rules amend certain broker-dealer annual reporting, audit, and notification requirements. The amendments include a requirement that broker-dealer audits be conducted in accordance with standards of the PCAOB, that broker-dealers file either a compliance report or an exemption report covered by a report prepared by an independent public accountant, and that clearing broker-dealers allow representatives of the Commission or the broker-dealer's DEA to review the documentation associated with certain reports of the broker-dealer's independent public accountant and to allow the accountant to discuss its findings with the representatives when requested in connection with a regulatory examination of the broker-dealer. The amendments also require a broker-dealer to file a new form with its DEA that elicits information about the broker-dealer's practices with respect to the custody of securities and funds of customers and others.

The amendments and new form are designed, among other things, to provide additional safeguards with respect to broker-dealer custody of customer securities and funds, to enhance the ability of the Commission to oversee broker-dealer custody practices, to increase the focus of carrying broker-dealers and their independent public accountants on compliance, and internal control over compliance, with certain financial and custodial requirements, to facilitate the ability of the PCAOB to implement the explicit oversight authority over broker-dealer audits provided to the PCAOB by the Dodd-Frank Act, and to satisfy the internal control report requirement in Rule 206(4)–2 for certain broker-dealers affiliated with, or dually-registered as, investment advisers.

[869] *Id.*

[870] The Commission stated in the proposing release that its preliminary view was that the proposed rule amendments promote efficiency, competition, and capital formation and that any burden on competition is justified by the benefits provided by the amendments. *See Broker-Dealer Reports,* 76 FR at 37598.

[871] 5 U.S.C. 601 *et seq.*

[872] 5 U.S.C. 603(a).

[873] 5 U.S.C. 551 *et seq.*

[874] Although section 601(b) of the RFA defines the term *small entity,* the statute permits agencies to formulate their own definitions. The Commission has adopted definitions for the term ''small entity'' for the purposes of Commission rulemaking in accordance with the RFA. Those definitions, as relevant to this rulemaking, are set forth in Rule 0–10. *See* 17 CFR 240.0–10. *See Statement of Management on Internal Accounting Control,* Exchange Act Release No. 18451 (Jan. 28, 1982), 47 FR 5215 (Feb. 4, 1982).

[875] *See* 5 U.S.C. 605(b).

[876] *See Broker-Dealer Reports,* 76 FR at 37601–37602.

B. Significant Issues Raised by Public Comments

The Commission requested comment with regard to matters discussed in the IRFA, including comments with respect to the number of small entities that may be affected by the proposed rule amendments and whether the effect on small entities would be economically significant.[877]

The Commission did not receive any comments specifically addressing the IRFA. However, several commenters discussed the impact of the proposal on small broker-dealers. One commenter stated that the proposed amendments ''place unnecessary regulatory burdens and costs on the industry, in general, and smaller firms in particular.'' [878] Another commenter stated that small broker-dealers may find the timing of the transition to be a ''burden,'' and requested that the Commission provide a longer transition period.[879] A third commenter suggested that the exemption report and the accountant's report on the exemption report be replaced with a ''check box on the FOCUS report'' and that with regard to these reports ''[t]he amount of paperwork involved for small firms that do not carry customer securities seems rather excessive.'' [880] A fourth commenter stated that the proposed transition period may burden smaller broker-dealers, and suggested that to facilitate the transition, the Commission should provide examples of best practices and deficiencies, with the cooperation of the AICPA.[881] This commenter also suggested that the effective date for the annual reporting requirements should be one year after publication of the final rule.[882]

The Commission is sensitive to the burdens the rule amendments and new form will have on small broker-dealers. To remove unnecessary burdens, the final rule amendments contain certain modifications from the proposal designed to alleviate some of the concerns regarding small broker-dealers.[883] The modifications are discussed in the following paragraphs.

As is discussed above, the Commission has modified the proposed amendments with respect to the exemption report in a manner that will likely result in lower costs for small broker-dealers than would have been the case if the Commission had adopted the proposed amendments without the modifications. In particular, the final rule provides that a broker-dealer can file the exemption report if it ''claimed that it was exempt'' from Rule 15c3–3 throughout the most recent fiscal year. This modification from the proposal—which provided that a broker-dealer could file the exemption report if the broker-dealer ''is exempt from Rule 15c3–3''—is designed to address concerns raised by commenters that a non-carrying broker-dealer might be required to file the compliance report because of an instance during the year in which it did not meet the relied on exemption provision in paragraph (k) of Rule 15c3–3.[884] As discussed in the economic analysis, the compliance report costs are significantly greater than the exemption report costs. The final rule clarifies that a non-carrying broker-dealer that has an exception to meeting the exemption provisions in paragraph (k) of Rule 15c3–3 need not file the compliance report; however, the broker-dealer would be required to identify, to its best knowledge and belief, in its exemption report each exception during the most recent fiscal year, if applicable, including a brief description of the exception and the approximate date on which the exception existed.

In addition, only clearing broker-dealers will be subject to the requirements that the Commission is adopting today that provide Commission and DEA examination staff with the ability to review audit documentation associated with broker-dealers' annual audit reports and allow their independent public accountants to discuss findings relating to the audit reports with Commission and DEA examination staff.

To alleviate burdens associated with Form Custody, the Commission has modified the form's instructions to make clear that questions on the form that cannot be answered because the broker-dealer does not engage in a particular activity do not need to be answered.

In response to comments, the Commission also has delayed the effective dates associated with the proposed reporting and attestation amendments, which will provide all broker-dealers, including smaller broker-dealers, with a longer transition period to prepare for the new requirements.

As is discussed above, the Commission considered the comment that it should replace the exemption report with a box to check on the FOCUS Report as the amount of paperwork for small firms ''seems rather excessive.'' [885] After careful consideration of this and other alternatives, the Commission determined that of the alternatives considered, none are appropriate alternatives to the exemption report. Requiring the broker-dealer to (1) create a separate written report stating that it is claiming the exemption and identifying the basis for the exemption, including any identified exceptions in meeting the conditions set forth in § 240.15c3–3(k) and (2) file this report with the Commission and the broker-dealer's DEA should increase broker-dealers' focus on the accuracy of its compliance with the statements being made because of the potential for liability for false statements, enhance compliance with the exemption conditions in Rule 15c3–3, and therefore provide better protection of customer assets.

Finally, with respect to the comment that the Commission should provide examples of best practices and deficiencies with the cooperation of the AICPA, the Commission notes that the question of whether further guidance is necessary is best answered after the requirements become effective and practical compliance questions arise. In addition, the Commission will publish a Small Entity Compliance Guide relating to these amendments.

C. Small Entities Subject to the Rules

Paragraph (c) of Rule 0–10 provides that, for purposes of the RFA, a small entity when used with reference to a broker-dealer (''small broker-dealer'') means a broker-dealer that: (1) Had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a–5(d) or, if not required to file such statements, a broker-dealer that had total capital (net worth plus subordinated liabilities)

[877] *Id.* at 37602.

[878] *See IMS Letter.*

[879] *See Citrin Letter.*

[880] *See Angel Letter.*

[881] *See Citrin Letter.*

[882] *Id.* The commenter also specifically suggested that if non-carrying and smaller broker-dealers must use PCAOB standards, that the Commission should defer the effective date for one year after the approval of the amendments. *Id.*

[883] As is discussed below, small broker-dealers are in most instances not carrying broker-dealers. *See* section VIII.C. of this release.

[884] *See SIFMA Letter.* As discussed above in section II.B.1. of this release, there will be cases where a broker-dealer changes its business model to convert from a carrying broker-dealer to a non-carrying broker-dealer during the fiscal year. In this case, the broker-dealer could seek exemptive relief under section 36 of the Exchange Act (15 U.S.C. 78mm) from the requirement to file the compliance report and to instead file the exemption report. In analyzing such a request, the period of time the broker-dealer operated as a carrying broker-dealer would be a relevant consideration.

[885] *See* section II.B.4.iii. of this release.

of less than $500,000 on the last business day of the preceding fiscal year (or in the time that it has been in business if shorter); and (2) is not affiliated with any person (other than a natural person) that is not a small business or small organization.[886] Based on December 31, 2011 FOCUS Report data, the Commission estimates that there are approximately 812 broker-dealers that are classified as ''small'' entities for purposes of the RFA. Of these, the Commission estimates that there are approximately eight broker-dealers that are carrying broker-dealers. The Commission estimated for purposes of the IRFA that there were approximately 871 broker-dealers that were classified as small entities for purposes of the RFA and that there were no broker-dealers that were carrying firms that satisfied the definition of a small broker-dealer.[887]

D. Reporting, Recordkeeping, and Other Compliance Requirements

The Commission's amendments to Rule 17a–5 retain the current requirement that broker-dealers annually file financial statements and supporting schedules (''financial report'') that must be audited by a PCAOB-registered accountant. Under the amendments, the financial report must be audited in accordance with standards of the PCAOB, instead of in accordance with GAAS, as previously required.

In addition to the financial report, the amendments require broker-dealers to file one of two new reports: either a compliance report or an exemption report. If a broker-dealer did not claim that it was exempt from Rule 15c3–3 throughout the most recent fiscal year, the broker-dealer must prepare and file with the Commission a compliance report containing certain statements regarding the broker-dealer's internal control over compliance with the financial responsibility rules and compliance with certain of those rules. Alternatively, if the broker-dealer claimed that it was exempt from Rule 15c3–3 throughout the most recent fiscal year, the broker-dealer must prepare and file with the Commission an exemption report containing a statement that it claimed that it was exempt from Rule 15c3–3 during that period and identify the provisions under which it claimed that it was exempt from Rule 15c3–3.

The amendments to Rule 17a–5 also eliminate the ''material inadequacy'' concept and, among other things, replace the requirement that the broker-dealer's independent public accountant prepare, and the broker-dealer file with the Commission, a material inadequacy report with a requirement for the accountant to prepare a new report covering either the compliance report or the exemption report, as applicable. If the broker-dealer is a carrying broker-dealer, the accountant must prepare a report based on an examination, in accordance with PCAOB standards, of certain statements by the broker-dealer in the compliance report. If the broker-dealer claimed an exemption from Rule 15c3–3, the accountant must prepare a report based on a review, in accordance with PCAOB standards, of the exemption report. Broker-dealers must file these reports of the accountant with the Commission along with the financial report and either the compliance report or the exemption report.

Together, the financial report and the compliance report or the exemption report and the accountant's reports covering those reports comprise the annual reports that the broker-dealer must file each fiscal year with the Commission and the broker-dealer's DEA. The amendments require that the broker-dealer also file the annual reports with SIPC if the broker-dealer is a member of SIPC.

Amendments to Rule 17a–5 also require that if, during the course of an audit, a broker-dealer's independent public accountant determines that the broker-dealer is not in compliance with the financial responsibility rules, or that any material weaknesses exist, the accountant must immediately notify the broker-dealer. The broker-dealer must notify the Commission and its DEA of the material weakness and must notify the Commission and the DEA of the non-compliance if that non-compliance would otherwise trigger a notification requirement.

Amendments to Rule 17a–11 require that when a broker-dealer discovers, or is notified by its independent public accountant, of the existence of any material weakness under Rule 17a–5, the broker-dealer must notify the Commission and transmit a report to the Commission stating what the broker-dealer has done or is doing to correct the situation. The amendments substituted the term material weakness for the term material inadequacy with regard to Rule 17a–5.

Under the amendments, carrying broker-dealers or those that clear transactions must agree to allow Commission or DEA examination staff, if requested in writing for purposes of an examination of the broker-dealer, to review ''the documentation associated with the reports of the accountant'' and to discuss the accountant's findings with the accountant.

The amendments require broker-dealers to file a new ''Form Custody'' each quarter to elicit information concerning whether a broker-dealer maintains custody of customer and non-customer assets, and, if so, how such assets are maintained. Form Custody must be filed with the broker-dealer's DEA. The DEA must transmit the information obtained from Form Custody to the Commission at the same time that it transmits FOCUS Report data to the Commission under paragraph (a)(4) of Rule 17a–5.

The impact of the amendments on small broker-dealers will be substantially less than on larger firms. Most small broker-dealers are exempt from Rule 15c3–3 and therefore must file the exemption report. As discussed above, the exemption report must be reviewed by the independent public accountant, in lieu of the compliance report, which must be examined by the accountant. In addition, Form Custody would elicit less information from broker-dealers that do not maintain custody of customer assets, and therefore the form should be less burdensome for these broker-dealers.

E. Agency Action To Minimize Effect on Small Entities

Pursuant to section 3(a) of the RFA,[888] the Commission must consider significant alternatives that would accomplish the Commission's stated objectives, while minimizing any significant adverse impact on small entities. In connection with the final rules, the Commission considered the following alternatives: (1) Establishing differing compliance or reporting requirements or timetables that take into account the resources available to smaller entities; (2) clarifying, consolidating, or simplifying compliance and reporting requirements for smaller entities; (3) the use of performance standards rather than design standards; and (4) exempting smaller entities from coverage of the rules, or any part of the rules.

The Commission considered differing compliance and reporting requirements and timetables in adopting the amendments discussed in this release, which took into account the resources available to smaller entities. For

[886] 17 CFR 240.0–10(c).

[887] *See Broker-Dealer Reports,* 76 FR at 37602. Although the Commission received no comments regarding the its initial estimate that there were no small carrying broker-dealers, the estimate is nonetheless being revised based on additional analysis of available information.

[888] 5 U.S.C. 603(c).

example, as is discussed above, the Commission considered alternatives to the exemption report requirements, which resulted in modifications to the final rule that make clear that broker-dealers claiming exemptions from Rule 15c3–3 will remain subject to those requirements even if certain exceptions arise.[889] This reduces the burden on small broker-dealers that would otherwise be subject to the more resource-intensive compliance and examination report requirements applicable to carrying broker-dealers.

In addition, the Commission, in establishing effective dates for these amendments, considered the resources available to small broker-dealers. In this regard, the Commission is delaying the effective dates for the audit and reporting requirements, which will provide small broker-dealers with greater flexibility in allocating their resources while preparing to comply with applicable amendments.

The Commission also clarified, consolidated, and simplified compliance and reporting requirements for broker-dealers in connection with the amendments. As discussed above, the Commission clarified and simplified requirements applicable to Form Custody by specifying in the final form that broker-dealers are not required to answer questions that do not apply to their business activities. Further, in terms of consolidating regulatory requirements applicable to broker-dealers, a broker-dealer affiliated with, or dually-registered as, an investment adviser that is subject to the compliance report requirement can use the independent public accountant's examination of the compliance report to satisfy reporting obligations under Advisers Act Rule 206(4)–2.

The Commission generally used design standards rather than performance standards in connection with the final rule amendments because the Commission believes design standards will better accomplish its objectives of enhancing safeguards with respect to broker-dealer custody of securities and funds. The specific disclosure requirements in the final rule will promote comparable and consistent types of disclosures by broker-dealers, which will facilitate the ability of Commission and DEA staff to assess broker-dealer compliance with applicable requirements.

The Commission also considered, and is adopting, amendments that exempt certain types of broker-dealers from certain requirements. For example, broker-dealers that are not clearing broker-dealers, which include most small broker-dealers, do not need to comply with the access to accountant and audit documentation amendments. Most small broker-dealers also will not be subject to the new compliance and examination report requirements, as small broker-dealers are in most instances not carrying broker-dealers.

In addition, if the Commission subsequently determines that it is appropriate to exempt a broker-dealer, or type of broker-dealer, from such requirements, the Commission has existing authority under which it can act. In particular, under Exchange Act section 36, the Commission, by rule, regulation, or order, may exempt any person, or any class or classes of persons, from any rule under the Exchange Act to the extent that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors.[890]

IX. Statutory Authority

The Commission is amending Rule 17a–5 and Rule 17a–11 under the Exchange Act (17 CFR 240.17a–5 and 17 CFR 240.17a–11) and adopting new Form Custody (17 CFR 249.639) pursuant to the authority conferred by the Exchange Act, including sections 15, 17, 23(a) and 36.[891]

List of Subjects in 17 CFR Parts 240 and 249

Brokers, Confidential business information, Fraud, Reporting and recordkeeping requirements, Securities.

Text of the Amendments

For the reasons set out in the preamble, the Commission is amending Title 17, Chapter II, of the Code of Federal Regulations as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

■ 1. The authority citation for part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c–3, 78c–5, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78*l,* 78m, 78n, 78n–1, 78o, 78o–4, 78o–10, 78p, 78q, 78q–1, 78s, 78u–5, 78w, 78x, 78*ll,* 78mm, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, 7201 *et seq.,* and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350; and Pub. L. 111–203, 939A, 124 Stat. 1376, (2010), unless otherwise noted.

* * * * *

■ 2. Section 240.17a–5 is amended by:

■ a. In paragraph (a)(2)(i), adding the word ''transactions'' after the word ''clears'' and removing the words ''shall file'' and adding in their place ''must file with the Commission.''

■ b. In paragraph (a)(2)(ii), removing the words ''shall file'' and adding in their place ''must file with the Commission'' and removing the phrase ''date selected for the annual audit of financial statements where said date is other than a calendar quarter'' and adding in its place ''end of the fiscal year of the broker or dealer where that date is not the end of a calendar quarter.'';

■ c. In paragraph (a)(2)(iii), removing the phrase ''who does not carry nor clear transactions nor carry customer accounts shall file'' and adding in its place ''that neither clears transactions nor carries customer accounts must file with the Commission'' and removing the phrase ''date selected for the annual audit of financial statements where said date is other than the end of the calendar quarter.'' and adding in its place ''end of the fiscal year of the broker or dealer where that date is not the end of a calendar quarter.'';

■ d. In paragraph (a)(2)(iv), removing the words ''shall file'' and adding in their place ''must file with the Commission'' and adding the phrase ''(''designated examining authority'')'' after the phrase ''section 17(d) of the Act'';

■ e. In paragraph (a)(3), in the first sentence, adding the words ''that must be filed with the Commission'' after the words ''provided for in this paragraph (a)'';

■ f. Redesignating paragraphs (a)(5) and (6) as paragraphs (a)(6) and (7);

■ g. In newly redesignated paragraph (a)(6)(ii)(A), removing the phrase ''(a)(5)(i)'' and adding in its place ''(a)(6)(i)'';

■ h. Adding new paragraph (a)(5);

■ i. Revising paragraph (b)(2);

■ j. In paragraph (b)(4), removing the word ''he'' and adding in its place ''the broker or dealer''.

■ k. Removing paragraph (b)(6);

■ l. In paragraph (c)(1)(i), removing the phrase ''his customers'' and adding in its place ''customers of the introducing broker or dealer'';

■ m. In paragraph (c)(1)(iii), removing the phrase ''in the manner contemplated by the $2,500 minimum net capital requirement of § 240.15c3–1'' and adding in its place ''and otherwise qualified to maintain net capital of no less than what is required under § 240.15c3–1(a)(2)(iv)'';

■ n. In paragraph (c)(2) introductory text, in the first sentence, removing the phrase ''date of the audited financial statements required by paragraph (d) of

[889] *See* sections II.B.4.iii. and VII.C.1.ii.b. of this release.

[890] 15 U.S.C. 78mm.

[891] 15 U.S.C. 78o, 78q, 78w(a) and 78mm.

this section'' and adding in its place ''end of the fiscal year of the broker or dealer'';

■ o. In paragraph (c)(2)(i) removing the phrase ''balance sheet with appropriate notes prepared in accordance with'' and adding in its place ''Statement of Financial Condition with appropriate notes prepared in accordance with U.S.'';

■ p. Removing paragraph (c)(2)(iii);

■ q. Redesignating paragraph (c)(2)(iv) as (c)(2)(iii);

■ r. In newly redesignated paragraph (c)(2)(iii), removing the phrase ''annual audit report of the broker or dealer pursuant to § 240.17a-5'' and adding in its place ''financial report of the broker or dealer under paragraph (d)(1)(i)(A) of this section'' and adding at the end the word ''and'';

■ s. Adding new paragraph (c)(2)(iv);

■ t. In paragraph (c)(4) introductory text removing the word '''customer''' and adding in its place ''*customer'';*

■ u. In paragraphs (c)(5)(ii)(A) and (c)(5)(iii) introductory text, removing the phrases ''Web site'' and ''Web sites'' and adding in their place ''website'' and ''websites'';

■ v. Removing paragraph (c)(5)(vi);

■ w. Revising paragraph (d);

■ x. In paragraph (e) introductory text, removing the phrase ''financial statements'' and adding in its place ''annual reports'' and removing the word ''shall'' and adding in its place ''must'';

■ y. Revising paragraphs (e)(1) through (4);

■ z. Removing paragraph (e)(5);

■ aa. Revising paragraphs (f) through (i);

■ bb. Removing and reserving paragraph (j);

■ cc. In paragraph (m)(1), removing the word ''audit'' after the word ''annual''; and

■ dd. In paragraph (n)(2) removing the phrase ''audit report'' and adding in its place ''annual reports''; adding the phrase ''in writing'' after the word ''approved'' and removing the phrase ''pursuant to paragraph (d)(1)(i) of this section'' and adding in its place ''of the broker or dealer''.

The revisions and additions read as follows:

§ 240.17a–5 Reports to be made by certain brokers and dealers.

(a) * * *

(5) Every broker or dealer subject to this paragraph (a) must file Form Custody (§ 249.639 of this chapter) with its designated examining authority within 17 business days after the end of each calendar quarter and within 17 business days after the end of the fiscal year of the broker or dealer where that date is not the end of a calendar quarter. The designated examining authority must maintain the information obtained through the filing of Form Custody and transmit the information to the Commission, at such time as it transmits the applicable part of Form X–17A–5 (§ 249.617 of this chapter) as required in paragraph (a)(4) of this section.

* * * * *

(b) * * *

(2) The broker or dealer must attach to the report required by paragraph (b)(1) of this section an oath or affirmation that to the best knowledge and belief of the person making the oath or affirmation the information contained in the report is true and correct. The oath or affirmation must be made before a person duly authorized to administer such oaths or affirmations. If the broker or dealer is a sole proprietorship, the oath or affirmation must be made by the proprietor; if a partnership, by a general partner; if a corporation, by a duly authorized officer; or if a limited liability company or limited liability partnership, by the chief executive officer, chief financial officer, manager, managing member, or those members vested with management authority for the limited liability company or limited liability partnership.

* * * * *

(c) * * *

(2) * * *

(iv) If, in connection with the most recent annual reports required under paragraph (d) of this section, the report of the independent public accountant required under paragraph (d)(1)(i)(C) of this section covering the report of the broker or dealer required under paragraph (d)(1)(i)(B)(*1*) of this section identifies one or more *material weaknesses,* a statement by the broker or dealer that one or more *material weaknesses* have been identified and that a copy of the report of the independent public accountant required under paragraph (d)(1)(i)(C) of this section is currently available for the customer's inspection at the principal office of the Commission in Washington, DC, and the regional office of the Commission for the region in which the broker or dealer has its principal place of business.

* * * * *

(d) *Annual reports.* (1)(i) Except as provided in paragraphs (d)(1)(iii) and (d)(1)(iv) of this section, every broker or dealer registered under section 15 of the Act must file annually:

(A) A financial report as described in paragraph (d)(2) of this section; and

(B)(*1*) If the broker or dealer did not claim it was exempt from § 240.15c3–3 throughout the most recent fiscal year, a compliance report as described in paragraph (d)(3) of this section executed by the person who makes the oath or affirmation under paragraph (e)(2) of this section; or

(*2*) If the broker or dealer did claim that it was exempt from § 240.15c3–3 throughout the most recent fiscal year, an exemption report as described in paragraph (d)(4) of this section executed by the person who makes the oath or affirmation under paragraph (e)(2) of this section;

(C) Except as provided in paragraph (e)(1)(i) of this section, a report prepared by an independent public accountant, under the engagement provisions in paragraph (g) of this section, covering each report required to be filed under paragraphs (d)(1)(i)(A) and (B) of this section.

(ii) The reports required to be filed under this paragraph (d) must be as of the same fiscal year end each year, unless a change is approved in writing by the designated examining authority for the broker or dealer under paragraph (n) of this section. A copy of the written approval must be sent to the Commission's principal office in Washington, DC, and the regional office of the Commission for the region in which the broker or dealer has its principal place of business.

(iii) A broker or dealer succeeding to and continuing the business of another broker or dealer need not file the reports under this paragraph (d) as of a date in the fiscal year in which the succession occurs if the predecessor broker or dealer has filed reports in compliance with this paragraph (d) as of a date in such fiscal year.

(iv) A broker or dealer that is a member of a national securities exchange, has transacted a business in securities solely with or for other members of a national securities exchange, and has not carried any margin account, credit balance, or security for any person who is defined as a *customer* in paragraph (c)(4) of this section, is not required to file reports under this paragraph (d).

(2) *Financial report.* The financial report must contain:

(i) A Statement of Financial Condition, a Statement of Income, a Statement of Cash Flows, a Statement of Changes in Stockholders' or Partners' or Sole Proprietor's Equity, and a Statement of Changes in Liabilities Subordinated to Claims of General Creditors. The statements must be prepared in accordance with U.S. generally accepted accounting principles and must be in a format that is consistent with the statements

contained in Form X–17A–5 (§ 249.617 of this chapter) Part II or Part IIA. If the Statement of Financial Condition filed in accordance with instructions to Form X–17A–5, Part II or Part IIA, is not consolidated, a summary of financial data, including the assets, liabilities, and net worth or stockholders' equity, for subsidiaries not consolidated in the Part II or Part IIA Statement of Financial Condition as filed by the broker or dealer must be included in the notes to the financial statements reported on by the independent public accountant.

(ii) Supporting schedules that include, from Part II or Part IIA of Form X–17A–5 (§ 249.617 of this chapter), a Computation of Net Capital Under § 240.15c3–1, a Computation for Determination of the Reserve Requirements under Exhibit A of § 240.15c3–3, and Information Relating to the Possession or Control Requirements Under § 240.15c3–3.

(iii) If either the Computation of Net Capital under § 240.15c3–1 or the Computation for Determination of the Reserve Requirements Under Exhibit A of § 240.15c3–3 in the financial report is materially different from the corresponding computation in the most recent Part II or Part IIA of Form X–17A–5 (§ 249.617 of this chapter) filed by the broker or dealer pursuant to paragraph (a) of this section, a reconciliation, including appropriate explanations, between the computation in the financial report and the computation in the most recent Part II or Part IIA of Form X–17A–5 filed by the broker or dealer. If no material differences exist, a statement so indicating must be included in the financial report.

(3) *Compliance report.* (i) The compliance report must contain:

(A) Statements as to whether:

(*1*) The broker or dealer has established and maintained *Internal Control Over Compliance* as that term is defined in paragraph (d)(3)(ii) of this section;

(*2*) The Internal Control Over Compliance of the broker or dealer was effective during the most recent fiscal year;

(*3*) The Internal Control Over Compliance of the broker or dealer was effective as of the end of the most recent fiscal year;

(*4*) The broker or dealer was in compliance with §§ 240.15c3–1 and 240.15c3–3(e) as of the end of the most recent fiscal year; and

(*5*) The information the broker or dealer used to state whether it was in compliance with §§ 240.15c3–1 and 240.15c3–3(e) was derived from the books and records of the broker or dealer.

(B) If applicable, a description of each material weakness in the Internal Control Over Compliance of the broker or dealer during the most recent fiscal year.

(C) If applicable, a description of any instance of non-compliance with §§ 240.15c3–1 or 240.15c3–3(e) as of the end of the most recent fiscal year.

(ii) The term *Internal Control Over Compliance* means internal controls that have the objective of providing the broker or dealer with reasonable assurance that non-compliance with § 240.15c3–1, § 240.15c3–3, § 240.17a–13, or any rule of the designated examining authority of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer (an ''Account Statement Rule'') will be prevented or detected on a timely basis.

(iii) The broker or dealer is not permitted to conclude that its Internal Control Over Compliance was effective during the most recent fiscal year if there were one or more material weaknesses in its Internal Control Over Compliance during the most recent fiscal year. The broker or dealer is not permitted to conclude that its Internal Control Over Compliance was effective as of the end of the most recent fiscal year if there were one or more material weaknesses in its internal control as of the end of the most recent fiscal year. A *material weakness* is a deficiency, or a combination of deficiencies, in Internal Control Over Compliance such that there is a reasonable possibility that non-compliance with §§ 240.15c3–1 or 240.15c3–3(e) will not be prevented or detected on a timely basis or that non-compliance to a material extent with § 240.15c3–3, except for paragraph (e), § 240.17a–13, or any Account Statement Rule will not be prevented or detected on a timely basis. A *deficiency in Internal Control Over Compliance* exists when the design or operation of a control does not allow the management or employees of the broker or dealer, in the normal course of performing their assigned functions, to prevent or detect on a timely basis non-compliance with § 240.15c3–1, § 240.15c3–3, § 240.17a–13, or any Account Statement Rule.

(4) *Exemption report.* The exemption report must contain the following statements made to the best knowledge and belief of the broker or dealer:

(i) A statement that identifies the provisions in § 240.15c3–3(k) under which the broker or dealer claimed an exemption from § 240.15c3–3;

(ii) A statement that the broker or dealer met the identified exemption provisions in § 240.15c3–3(k) throughout the most recent fiscal year without exception or that it met the identified exemption provisions in § 240.15c3–3(k) throughout the most recent fiscal year except as described under paragraph (d)(4)(iii) of this section; and

(iii) If applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified exemption provisions in § 240.15c3–3(k) and that briefly describes the nature of each exception and the approximate date(s) on which the exception existed.

(5) The annual reports must be filed not more than sixty (60) calendar days after the end of the fiscal year of the broker or dealer.

(6) The annual reports must be filed at the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the Commission's principal office in Washington, DC, the principal office of the designated examining authority for the broker or dealer, and with the Securities Investor Protection Corporation (''SIPC'') if the broker or dealer is a member of SIPC. Copies of the reports must be provided to all self-regulatory organizations of which the broker or dealer is a member, unless the self-regulatory organization by rule waives this requirement.

(e) * * *

(1)(i) The broker or dealer is not required to engage an independent public accountant to provide the reports required under paragraph (d)(1)(i)(C) of this section if, since the date of the registration of the broker or dealer under section 15 of the Act (15 U.S.C. 78o) or of the previous annual reports filed under paragraph (d) of this section:

(A) The securities business of the broker or dealer has been limited to acting as broker (agent) for the issuer in soliciting subscriptions for securities of the issuer, the broker has promptly transmitted to the issuer all funds and promptly delivered to the subscriber all securities received in connection with the transaction, and the broker has not otherwise held funds or securities for or owed money or securities to customers; or

(B) The securities business of the broker or dealer has been limited to buying and selling evidences of indebtedness secured by mortgage, deed of trust, or other lien upon real estate or leasehold interests, and the broker or dealer has not carried any margin account, credit balance, or security for any securities customer.

(ii) A broker or dealer that files annual reports under paragraph (d) of this

section that are not covered by reports prepared by an independent public accountant must include in the oath or affirmation required by paragraph (e)(2) of this section a statement of the facts and circumstances relied upon as a basis for exemption from the requirement that the annual reports filed under paragraph (d) of this section be covered by reports prepared by an independent public accountant.

(2) The broker or dealer must attach to the financial report an oath or affirmation that, to the best knowledge and belief of the person making the oath or affirmation,

(i) The financial report is true and correct; and

(ii) Neither the broker or dealer, nor any partner, officer, director, or equivalent person, as the case may be, has any proprietary interest in any account classified solely as that of a customer.

The oath or affirmation must be made before a person duly authorized to administer such oaths or affirmations. If the broker or dealer is a sole proprietorship, the oath or affirmation must be made by the proprietor; if a partnership, by a general partner; if a corporation, by a duly authorized officer; or if a limited liability company or limited liability partnership, by the chief executive officer, chief financial officer, manager, managing member, or those members vested with management authority for the limited liability company or limited liability partnership.

* * * * *

(3) The annual reports filed under paragraph (d) of this section are not confidential, except that, if the Statement of Financial Condition in a format that is consistent with Form X–17A–5 (§ 249.617 of this chapter), Part II, or Part IIA, is bound separately from the balance of the annual reports filed under paragraph (d) of this section, and each page of the balance of the annual reports is stamped ''confidential,'' then the balance of the annual reports shall be deemed confidential to the extent permitted by law. However, the annual reports, including the confidential portions, will be available for official use by any official or employee of the U.S. or any State, by national securities exchanges and registered national securities associations of which the broker or dealer filing such a report is a member, by the Public Company Accounting Oversight Board, and by any other person if the Commission authorizes disclosure of the annual reports to that person as being in the public interest. Nothing contained in this paragraph may be construed to be in derogation of the rules of any registered national securities association or national securities exchange that give to customers of a member broker or dealer the right, upon request to the member broker or dealer, to obtain information relative to its financial condition.

(4)(i) The broker or dealer must file with SIPC a report on the SIPC annual general assessment reconciliation or exclusion from membership forms that contains such information and is in such format as determined by SIPC by rule and approved by the Commission.

(ii) Until the earlier of two years after the date paragraph (e)(4)(i) of this section is effective or SIPC adopts a rule under paragraph (e)(4)(i) of this section and the rule is approved by the Commission, the broker or dealer must file with SIPC a supplemental report on the status of the membership of the broker or dealer in SIPC if, under paragraph (d)(1)(i)(C) of this section, the broker or dealer is required to file reports prepared by an independent public accountant. The supplemental report must include the independent public accountant's report on applying agreed-upon procedures based on the performance of the procedures enumerated in paragraph (e)(4)(ii)(C) of this section. The supplemental report must cover the SIPC annual general assessment reconciliation or exclusion from membership forms not previously reported on under this paragraph (e)(4) that were required to be filed on or prior to the date of the annual reports required by paragraph (d) of this section: Provided, that the broker or dealer is not required to file the supplemental report on the SIPC annual general assessment reconciliation or exclusion from membership form for any period during which the SIPC assessment is a specified dollar value as provided for in section 4(d)(1)(c) of the Securities Investor Protection Act of 1970, as amended. The supplemental report must be filed with the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the Commission's principal office in Washington, DC, the principal office of the designated examining authority for the broker or dealer, and the principal office of SIPC. The supplemental report must include the following:

(A) A schedule of assessment payments showing any overpayments applied and overpayments carried forward including: payment dates, amounts, and name of SIPC collection agent to whom mailed; or

(B) If exclusion from membership was claimed, a statement that the broker or dealer qualified for exclusion from membership under the Securities Investor Protection Act of 1970, as amended; and

(C) *An independent public accountant's report.* The independent public accountant must be engaged to perform the following procedures:

(*1*) Comparison of listed assessment payments with respective cash disbursements record entries;

(*2*) For all or any portion of a fiscal year, comparison of amounts reflected in the annual reports required by paragraph (d) of this section with amounts reported in the Annual General Assessment Reconciliation (Form SIPC–7);

(*3*) Comparison of adjustments reported in Form SIPC–7 with supporting schedules and working papers supporting the adjustments;

(*4*) Proof of the arithmetical accuracy of the calculations reflected in Form SIPC–7 and in the schedules and working papers supporting any adjustments; and

(*5*) Comparison of the amount of any overpayment applied with the Form SIPC–7 on which it was computed; or

(*6*) If exclusion from membership is claimed, a comparison of the income or loss reported in the financial report required by paragraph (d)(2) of this section with the Certification of Exclusion from Membership (Form SIPC–3).

(f)(1) *Qualifications of independent public accountant.* The independent public accountant must be qualified and independent in accordance with § 210.2–01 of this chapter and the independent public accountant must be registered with the Public Company Accounting Oversight Board if required by the Sarbanes-Oxley Act of 2002.

(2) *Statement regarding independent public accountant.* (i) Every broker or dealer that is required to file annual reports under paragraph (d) of this section must file no later than December 10 of each year (or 30 calendar days after the effective date of its registration as a broker or dealer, if earlier) a statement as prescribed in paragraph (f)(2)(ii) of this section with the Commission's principal office in Washington, DC, the regional office of the Commission for the region in which its principal place of business is located, and the principal office of the designated examining authority for the broker or dealer. The statement must be dated no later than December 1 (or 20 calendar days after the effective date of its registration as a broker or dealer, if earlier). If the engagement of an

independent public accountant is of a continuing nature, providing for successive engagements, no further filing is required. If the engagement is for a single year, or if the most recent engagement has been terminated or amended, a new statement must be filed by the required date.

(ii) The statement must be headed ''Statement regarding independent public accountant under Rule 17a–5(f)(2)'' and must contain the following information and representations:

(A) Name, address, telephone number, and registration number of the broker or dealer.

(B) Name, address, and telephone number of the independent public accountant.

(C) The date of the fiscal year of the annual reports of the broker or dealer covered by the engagement.

(D) Whether the engagement is for a single year or is of a continuing nature.

(E) A representation that the independent public accountant has undertaken the items enumerated in paragraphs (g)(1) and (2) of this section.

(F) Except as provided in paragraph (f)(2)(iii) of this section, a representation that the broker or dealer agrees to allow representatives of the Commission or its designated examining authority, if requested in writing for purposes of an examination of the broker or dealer, to review the audit documentation associated with the reports of the independent public accountant filed under paragraph (d)(1)(i)(C) of this section. For purposes of this paragraph, ''audit documentation'' has the meaning provided in standards of the Public Company Accounting Oversight Board. The Commission anticipates that, if requested, it will accord confidential treatment to all documents it may obtain from an independent public accountant under this paragraph to the extent permitted by law.

(G) Except as provided in paragraph (f)(2)(iii) of this section, a representation that the broker or dealer agrees to allow the independent public accountant to discuss with representatives of the Commission and its designated examining authority, if requested in writing for purposes of an examination of the broker or dealer, the findings associated with the reports of the independent public accountant filed under paragraph (d)(1)(i)(C) of this section.

(iii) If a broker or dealer neither clears transactions nor carries customer accounts, the broker or dealer is not required to include the representations in paragraphs (f)(2)(ii)(F) and (G) of this section.

(iv) Any broker or dealer that is not required to file reports prepared by an independent public accountant under paragraph (d)(1)(i)(C) of this section must file a statement required under paragraph (f)(2)(i) of this section indicating the date as of which the unaudited reports will be prepared.

(3) *Replacement of accountant.* A broker or dealer must file a notice that must be received by the Commission's principal office in Washington, DC, the regional office of the Commission for the region in which its principal place of business is located, and the principal office of the designated examining authority for the broker or dealer not more than 15 business days after:

(i) The broker or dealer has notified the independent public accountant that provided the reports the broker or dealer filed under paragraph (d)(1)(i)(C) of this section for the most recent fiscal year that the independent public accountant's services will not be used in future engagements; or

(ii) The broker or dealer has notified an independent public accountant that was engaged to provide the reports required under paragraph (d)(1)(i)(C) of this section that the engagement has been terminated; or

(iii) An independent public accountant has notified the broker or dealer that the independent public accountant would not continue under an engagement to provide the reports required under paragraph (d)(1)(i)(C) of this section; or

(iv) A new independent public accountant has been engaged to provide the reports required under paragraph (d)(1)(i)(C) of this section without any notice of termination having been given to or by the previously engaged independent public accountant.

(v) The notice must include:

(A) The date of notification of the termination of the engagement or of the engagement of the new independent public accountant, as applicable; and

(B) The details of any issues arising during the 24 months (or the period of the engagement, if less than 24 months) preceding the termination or new engagement relating to any matter of accounting principles or practices, financial statement disclosure, auditing scope or procedure, or compliance with applicable rules of the Commission, which issues, if not resolved to the satisfaction of the former independent public accountant, would have caused the independent public accountant to make reference to them in the report of the independent public accountant. The issues required to be reported include both those resolved to the former independent public accountant's satisfaction and those not resolved to the former accountant's satisfaction. Issues contemplated by this section are those that occur at the decision-making level—that is, between principal financial officers of the broker or dealer and personnel of the accounting firm responsible for rendering its report. The notice must also state whether the accountant's report filed under paragraph (d)(1)(i)(C) of this section for any of the past two fiscal years contained an adverse opinion or a disclaimer of opinion or was qualified as to uncertainties, audit scope, or accounting principles, and must describe the nature of each such adverse opinion, disclaimer of opinion, or qualification. The broker or dealer must also request the former independent public accountant to furnish the broker or dealer with a letter addressed to the Commission stating whether the independent public accountant agrees with the statements contained in the notice of the broker or dealer and, if not, stating the respects in which independent public accountant does not agree. The broker or dealer must file three copies of the notice and the accountant's letter, one copy of which must be manually signed by the sole proprietor, a general partner, or a duly authorized corporate, limited liability company, or limited liability partnership officer or member, as appropriate, and by the independent public accountant, respectively.

(g) *Engagement of independent public accountant.* The independent public accountant engaged by the broker or dealer to provide the reports required under paragraph (d)(1)(i)(C) of this section must, as part of the engagement, undertake the following, as applicable:

(1) To prepare an independent public accountant's report based on an examination of the financial report required to be filed by the broker or dealer under paragraph (d)(1)(i)(A) of this section in accordance with standards of the Public Company Accounting Oversight Board; and

(2)(i) To prepare an independent public accountant's report based on an examination of the statements required under paragraphs (d)(3)(i)(A)(*2*) through (*5*) of this section in the compliance report required to be filed by the broker or dealer under paragraph (d)(1)(i)(B)(*1*) of this section in accordance with standards of the Public Company Accounting Oversight Board; or

(ii) To prepare an independent public accountant's report based on a review of the statements required under paragraphs (d)(4)(i) through (iii) of this section in the exemption report required to be filed by the broker or dealer under

paragraph (d)(1)(i)(B)(*2*) of this section in accordance with standards of the Public Company Accounting Oversight Board.

(h) *Notification of non-compliance or material weakness.* If, during the course of preparing the independent public accountant's reports required under paragraph (d)(1)(i)(C) of this section, the independent public accountant determines that the broker or dealer is not in compliance with § 240.15c3–1, § 240.15c3–3, or § 240.17a–13 or any rule of the designated examining authority of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer, as applicable, or the independent public accountant determines that any material weaknesses (as defined in paragraph (d)(3)(iii) of this section) exist, the independent public accountant must immediately notify the chief financial officer of the broker or dealer of the nature of the non-compliance or material weakness. If the notice from the accountant concerns an instance of non-compliance that would require a broker or dealer to provide a notification under § 240.15c3–1, § 240.15c3–3, or § 240.17a–11, or if the notice concerns a material weakness, the broker or dealer must provide a notification in accordance with § 240.15c3–1, § 240.15c3–3, or § 240.17a–11, as applicable, and provide a copy of the notification to the independent public accountant. If the independent public accountant does not receive the notification within one business day, or if the independent public accountant does not agree with the statements in the notification, then the independent public accountant must notify the Commission and the designated examining authority within one business day. The report from the accountant must, if the broker or dealer failed to file a notification, describe any instances of non-compliance that required a notification under § 240.15c3–1, § 240.15c3–3, or § 240.17a–11, or any material weaknesses. If the broker or dealer filed a notification, the report from the accountant must detail the aspects of the notification of the broker or dealer with which the accountant does not agree.

Note to paragraph (h): The attention of the broker or dealer and the independent public accountant is called to the fact that under § 240.17a–11(b)(1), among other things, a broker or dealer whose net capital declines below the minimum required pursuant to § 240.15c3–1 shall give notice of such deficiency that same day in accordance with § 240.17a–11(g) and the notice shall specify the broker or dealer's net capital requirement and its current amount of net capital. The attention of the broker or dealer and accountant also is called to the fact that under § 240.15c3–3(i), if a broker or dealer shall fail to make a reserve bank account or special account deposit, as required by § 240.15c3–3, the broker or dealer shall by telegram immediately notify the Commission and the regulatory authority for the broker or dealer, which examines such broker or dealer as to financial responsibility and shall promptly thereafter confirm such notification in writing.

(i) *Reports of the independent public accountant required under paragraph (d)(1)(i)(C) of this section*—(1) *Technical requirements.* The independent public accountant's reports must:

(i) Be dated;

(ii) Be signed manually;

(iii) Indicate the city and state where issued; and

(iv) Identify without detailed enumeration the items covered by the reports.

(2) *Representations.* The independent public accountant's reports must:

(i) State whether the examinations or review, as applicable, were made in accordance with standards of the Public Company Accounting Oversight Board;

(ii) Identify any examination and, if applicable, review procedures deemed necessary by the independent public accountant under the circumstances of the particular case that have been omitted and the reason for their omission.

(iii) Nothing in this section may be construed to imply authority for the omission of any procedure that independent public accountants would ordinarily employ in the course of an examination or review made for the purpose of expressing the opinions or conclusions required under this section.

(3) *Opinion or conclusion to be expressed.* The independent public accountant's reports must state clearly:

(i) The opinion of the independent public accountant with respect to the financial report required under paragraph (d)(1)(i)(A) of this section and the accounting principles and practices reflected in that report;

(ii) The opinion of the independent public accountant with respect to the financial report required under paragraph (d)(1)(i)(A) of this section, as to the consistency of the application of the accounting principles, or as to any changes in those principles, that have a material effect on the financial statements; and

(iii)(A) The opinion of the independent public accountant with respect to the statements required under paragraphs (d)(3)(i)(A)(*2*) through (*5*) of this section in the compliance report required under paragraph (d)(1)(i)(B)(*1*) of this section; or

(B) The conclusion of the independent public accountant with respect to the statements required under paragraphs (d)(4)(i) through (iii) of this section in the exemption report required under paragraph (d)(1)(i)(B)(*2*) of this section.

(4) *Exceptions.* Any matters to which the independent public accountant takes exception must be clearly identified, the exceptions must be specifically and clearly stated, and, to the extent practicable, the effect of each such exception on any related items contained in the annual reports required under paragraph (d) of this section must be given.

* * * * *

■ 3. Section 240.17a–11 is amended by:

■ a. Revising paragraph (e); and

■ b. In paragraph (h), removing the citation ''17a–5(h)(2)'' and adding in its place the citation ''17a–5(h)'' and removing the citation ''17a–12(f)(2)'' and adding in its place the citation ''17a–12(i)(2).''

The revision reads as follows:

§ 240.17a–11 Notification provision for brokers and dealers.

* * * * *

(e) Whenever any broker or dealer discovers, or is notified by an independent public accountant under § 240.17a–12(i)(2), of the existence of any material inadequacy as defined in § 240.17a–12(h)(2), or whenever any broker or dealer discovers, or is notified by an independent public accountant under § 240.17a–5(h), of the existence of any material weakness as defined in § 240.17a–5(d)(3)(iii), the broker or dealer must:

(1) Give notice, in accordance with paragraph (g) of this section, of the material inadequacy or material weakness within 24 hours of the discovery or notification of the material inadequacy or the material weakness; and

(2) Transmit a report, in accordance with paragraph (g) of this section, within 48 hours of the notice stating what the broker or dealer has done or is doing to correct the situation.

* * * * *

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

■ 4. The authority citation for part 249 continues to read, in part, as follows:

Authority: 15 U.S.C. 78a *et seq.* and 7201 *et seq.;* 12 U.S.C. 5461 *et seq.;* and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

Subpart G—Forms for Reports To Be Made by Certain Exchange Members, Brokers, and Dealers

■ 5. Add Form Custody (referenced in § 249.639) to subpart G to read as follows:

§ 249.639 Form custody.

This form shall be used for reports of information required by § 240.17a–5 of this chapter.

Note: The text of Form Custody will not appear in the Code of Federal Regulations.

BILLING CODE 8011–01–P

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM CUSTODY
For Broker-Dealers

(Please read instructions before preparing Form.)

Name of Broker/Dealer | As of (Month/Day/Year)

_8-_____
SEC File No. | CRD No.

Address of Principal Place of Business

(No. and Street) (City) (State) (Zip Code)

INSTRUCTIONS

GENERAL INSTRUCTIONS

A. Answer questions applicable to the broker-dealer's business activities and all "Yes" or "No" questions. Questions that cannot be answered because the broker-dealer does not engage in a particular activity do not need to be answered. For example, a broker-dealer that does not hold customer and non-customer funds or securities does not need to answer Items 3.C-3.E.

B. Definitions: for purposes of this Form:

1. "Affiliate" means any person who directly or indirectly controls the broker-dealer or any person who is directly or indirectly controlled by or under common control with the broker-dealer. Ownership of 25% or more of the common stock of an entity is deemed prima facie evidence of control.

2. "Bank" has the same meaning as in 15 U.S.C. 78c(a)(6).

3. "Broker" has the same meaning as in 15 U.S.C. 78c(a)(4).

4. "Dealer" has the same meaning as in 15 U.S.C. 78c(a)(5).

5. "Carrying broker-dealer" means a broker-dealer that carries customer or broker or dealer accounts and receives or holds funds or securities for those customers.

6. "Clearing broker-dealer" means a broker-dealer that clears transactions for itself or accounts of other broker-dealers either on a fully disclosed or omnibus basis.

7. "Customer" has the same meaning as in 17 CFR 240.15c3-3(a)(1).

8. "Free credit balance" means any liabilities of a broker-dealer to customers and non-customers that are subject to immediate cash payment to customers and non-customers on demand, whether resulting from sales of securities, dividends, interest, deposits, or otherwise, excluding, however, funds in commodity accounts that are segregated in accordance with the Commodity Exchange Act or in a similar manner.

9. "Money Market Fund" means any security issued by an investment company registered under section 8 of the Investment Company Act of 1940 that is considered a money market fund under Investment Company Act Rule 2a-7.

10. "Omnibus account" means an account carried and cleared by another broker-dealer and containing accounts of undisclosed customers on a commingled basis that are carried individually on the books of the broker-dealer introducing the accounts.

11. "Private Fund" means an issuer that would be an investment company as defined in section 3 of the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of that Act.

12. "Structured debt" means any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction. Structured debt is a broad category of financial instrument and includes, but is not limited to, asset-backed securities such as residential mortgage-backed securities ("RMBS") and other types of structured debt instruments such as collateralized debt obligations ("CDOs"), including synthetic and hybrid CDOs, or collateralized loan obligations ("CLOs").

INSTRUCTIONS FOR SPECIFIC LINE ITEMS

Item 1.A — Answer the question by checking the appropriate box. A broker-dealer must check "Yes" if it introduces any customer accounts to another broker-dealer on a fully disclosed basis. A broker-dealer that carries customer accounts and/or introduces customer accounts on an omnibus basis must check "Yes" if it also introduces one or more customer accounts to another broker-dealer on a fully disclosed basis.

Item 1.B — Item 1.B applies to broker-dealers that introduce customer accounts on a fully disclosed basis to one or more other broker-dealers. If Item 1.B applies, identify each broker-dealer to which customer accounts are introduced on a fully disclosed basis.

Item 2.A — Answer the question by checking the appropriate box. A broker-dealer must check "Yes" if it introduces any customer accounts to another broker-dealer on an omnibus basis. A broker-dealer that carries customer accounts (other than those introduced on an omnibus basis) and/or introduces customer accounts on a fully disclosed basis must check "Yes" if it also introduces one or more customer accounts to another broker-dealer on an omnibus basis.

Item 2.B — Item 2.B applies to broker-dealers that introduce customer accounts on an omnibus basis to one or more other broker-dealers. If Item 2.B applies, identify each broker-dealer to which customer accounts are introduced on an omnibus basis.

Item 3.A — Answer the question by checking the appropriate box. A broker-dealer that introduces customer accounts to another broker-dealer on an omnibus basis is a carrying broker-dealer with respect to those accounts under the Commission's broker-dealer financial responsibility rules. If those accounts are the only accounts carried by the broker-dealer, check "No" in Item 3.A, as those accounts are addressed in Items 2.A and 2.B.

Item 3.B — Answer the question by checking the appropriate box. Answer "Yes" if accounts are carried by the broker-dealer for persons that are not "customers" as that term is defined in Rule 15c3-3 under the Securities Exchange Act of 1934. Examples of persons that are not customers of a broker-dealer include general partners, directors, or principal officers – such as the president, executive vice presidents, treasurer, secretary or any person performing similar functions – of the broker-

dealer and accountholders that are themselves broker-dealers (unless such broker-dealer accountholders are required to be treated as customers under Rule 15c3-3).

Item 3.C — Identify the types of locations where the broker-dealer holds securities. Only identify types of locations where the broker-dealer holds securities directly in the name of the broker-dealer (*i.e.*, do not identify a type of location if the broker-dealer only holds securities at the location through an intermediary). A location holds securities directly in the name of the broker-dealer if the location is aware of the identity of the broker-dealer and acts directly upon the broker-dealer's instructions. A location holds securities through an intermediary if the location is not aware of the identity of the broker-dealer or will not act on instructions directly from the broker-dealer (*i.e.,* the location holding securities for the broker-dealer would only act on instructions relating to the broker-dealer's securities from the broker-dealer's intermediary). The information required by Items 3.C.i-iii is intended to identify all locations used by the broker-dealer to hold securities listed on the broker-dealer's stock record, and to elicit information concerning the frequency with which the broker-dealer performs reconciliations between the information on its stock record and information about the securities provided by the location. In Item 3.C.i, check all applicable boxes, and in Items 3.C.i-iii provide all applicable information as specified for each Item.

Item 3.D — Answer the questions in Items 3.D.i-iii by checking appropriate boxes and entering appropriate financial information, where applicable, and by providing explanations as requested. In Item 3.D.i, check "Other" if a type of security carried by the broker-dealer for customers is not listed on the chart, and for each category of security, indicate by checking the approximate box for the approximate U.S. dollar market value of the securities.

Item 3.E — Answer the questions in Items 3.E.i-iii by checking appropriate boxes and entering appropriate financial information, where applicable, and by providing explanations as requested. In Item 3.E.i, check "Other" if a type of security carried by the broker-dealer for persons that are not customers is not listed on the chart, and for each category of security, indicate by checking the appropriate box the approximate U.S. dollar market value of the securities.

Item 4 — Answer the questions in Items 4.A.i-iii and 4.B.i-iii by checking appropriate boxes and, if applicable, providing requested information.

Item 5 — Answer the questions in Items 5.A and 5.B by checking the appropriate box and, if applicable, providing requested information. A broker-dealer should respond to Item 5.A by checking "Yes" if it employs a vendor to send trade confirmations to customers on its behalf because the broker-dealer is ultimately responsible for complying with its trade confirmation obligations, not the vendor.

Item 6 — Answer the questions by checking the appropriate boxes and, if applicable, providing requested information. In Item 6.C, check "Yes" if (i) a broker-dealer sends account statements to persons other than the beneficial owner of the account; or (ii) if a broker-dealer sends account statements to the beneficial owner of an account and duplicate account statements to persons other than the beneficial owner of the account.

Item 7 — Answer the question by checking the appropriate box.

Item 8 — Answer the questions in Item 8 by checking appropriate boxes and, if applicable, providing requested information.

Item 9 — Answer the questions in Item 9 by checking appropriate boxes and, if applicable, providing requested information.

Item 1. A. Does the broker-dealer introduce customer accounts on a fully disclosed basis to another broker-dealer?

Yes ☐ No ☐

B. If the answer to question 1.A is "yes," identify below the broker-dealer(s) (by name, SEC No., and CRD No.) to which the customer accounts are introduced on a fully disclosed basis:

_____

_____

_____

Item 2. A. Does the broker-dealer introduce customer accounts to another broker-dealer on an omnibus basis?

Yes ☐ No ☐

B. If the answer to question 2.A is "yes," identify below the broker-dealer(s) (by name, SEC No., and CRD No.) to which the customer accounts are introduced on an omnibus basis:

_____

_____

_____

Item 3. A. Does the broker-dealer carry securities accounts (*i.e.*, accounts that are not introduced on a fully disclosed basis to another broker-dealer) for customers?

Yes ☐ No ☐

B. Does the broker-dealer carry securities accounts (*i.e.*, accounts that are not introduced on a fully disclosed basis to another broker-dealer) for non-customers?

Yes ☐ No ☐

C. Location of Securities (if the answer to question 3.A and/or 3.B is "yes")

i. Indicate in the chart below the types of U.S. locations used by the broker-dealer to hold securities that it carries by checking each box in the first column that applies. For each type of location selected, indicate in the third column the frequency (*e.g.*, daily, weekly, monthly, quarterly, semi-annually, annually) with which the broker-dealer performs a reconciliation between the information on its stock record and information about the securities provided by the location:

	Location	**Reconciliation Frequency**
☐	**The broker-dealer's vault**	
☐	**U.S. broker-dealer(s)**	
☐	**The Depository Trust Company**	
☐	**The Options Clearing Corporation**	
☐	**U.S. bank(s)**	
☐	**Transfer agents of mutual fund(s) under the Investment Company Act**	

ii. Indicate in the chart below the types of U.S. locations not identified in Item 3.C.i used by the broker-dealer to hold securities that it carries by describing the type of entity in the first column. For each type of location, indicate in the second column the frequency (*e.g.*, daily, weekly, monthly, quarterly, semi-annually, annually) with which the broker-dealer performs a reconciliation between the information on its stock record and information about the securities provided by location:

Other Types of U.S. Locations	Reconciliation Frequency

iii. Indicate in the chart below the types of foreign locations used by the broker-dealer to hold securities that it carries by describing the type of location in the first column. For each type of location indicate in the second column the frequency (*e.g.*, daily, weekly, monthly, quarterly, semi-annually, annually) with which the broker-dealer performs a reconciliation between the information on its stock record and information about the securities provided by the location:

Non-U.S. Locations	Reconciliation Frequency

D. Securities and Cash Carried for the Accounts of Customers (if the answer to question 3.A is "yes")

i. Indicate by checking the appropriate boxes on the chart below the types and approximate market value of securities that are carried by the broker-dealer for the accounts of customers:

	Type of Securities	$50 million or less	Greater than $50 million to $100 million	Greater than $100 million to $500 million	Greater than $500 million to $1 billion	Greater than $1 billion to $5 billion	Greater than $5 billion
☐	U.S. Equity Securities	☐	☐	☐	☐	☐	☐
☐	Foreign Equity Securities	☐	☐	☐	☐	☐	☐
☐	U.S. Listed Options	☐	☐	☐	☐	☐	☐
☐	Foreign Listed Options	☐	☐	☐	☐	☐	☐
☐	Domestic Corporate Debt	☐	☐	☐	☐	☐	☐
☐	Foreign Corporate Debt	☐	☐	☐	☐	☐	☐
☐	U.S. Public Finance Debt	☐	☐	☐	☐	☐	☐
☐	Foreign Public Finance Debt	☐	☐	☐	☐	☐	☐
☐	U.S. Government Debt	☐	☐	☐	☐	☐	☐
☐	Foreign Sovereign Debt	☐	☐	☐	☐	☐	☐
☐	U.S. Structured Debt	☐	☐	☐	☐	☐	☐
☐	Foreign Structured Debt	☐	☐	☐	☐	☐	☐
☐	U.S. Mutual Funds	☐	☐	☐	☐	☐	☐
☐	Foreign Mutual Funds	☐	☐	☐	☐	☐	☐
☐	U.S. Exchange Traded Funds	☐	☐	☐	☐	☐	☐
☐	Foreign Exchange Traded Funds	☐	☐	☐	☐	☐	☐
☐	U.S. Private Funds	☐	☐	☐	☐	☐	☐
☐	Foreign Private Funds	☐	☐	☐	☐	☐	☐
☐	Other	☐	☐	☐	☐	☐	☐

ii. Has the broker-dealer recorded all securities it carries for the accounts of customers on its stock record?

Yes ☐ No ☐

If the answer is "no," explain in the space provided why the broker-dealer has not recorded such securities on its stock record and provide the approximate U.S. dollar market value of such unrecorded securities:

_____
_____
_____

iii. Indicate in the chart below each process used by the broker-dealer with respect to free credit balances in cash accounts it holds for customers by checking all the boxes that apply and providing applicable information:

	Process
☐	Included in a computation under Rule 15c3-3(e)
☐	Held in a bank account under Rule 15c3-3(k)(2)(i)
☐	Swept to a U.S. bank
☐	Swept to a U.S. money market fund
☐	Other (Briefly describe in the space provided below) _____ _____ _____ _____ _____ _____ _____

E. Securities and Cash Carried for the Accounts of Non-customers (if the answer to question 3.B is "yes")

i. Indicate by checking the appropriate boxes on the chart below the types and approximate market value of securities that are carried by the broker-dealer for the accounts of non-customers:

	Type of Securities	**$50 million or less**	**Greater than $50 million to $100 million**	**Greater than $100 million to $500 million**	**Greater than $500 million to $1 billion**	**Greater than $1 billion to $5 billion**	**Greater than $5 billion**
☐	**U.S. Equity Securities**	☐	☐	☐	☐	☐	☐
☐	**Foreign Equity Securities**	☐	☐	☐	☐	☐	☐
☐	**U.S. Listed Options**	☐	☐	☐	☐	☐	☐
☐	**Foreign Listed Options**	☐	☐	☐	☐	☐	☐
☐	**Domestic Corporate Debt**	☐	☐	☐	☐	☐	☐
☐	**Foreign Corporate Debt**	☐	☐	☐	☐	☐	☐
☐	**U.S. Public Finance Debt**	☐	☐	☐	☐	☐	☐
☐	**Foreign Public Finance Debt**	☐	☐	☐	☐	☐	☐
☐	**U.S. Government Debt**	☐	☐	☐	☐	☐	☐
☐	**Foreign Sovereign Debt**	☐	☐	☐	☐	☐	☐
☐	**U.S. Structured Debt**	☐	☐	☐	☐	☐	☐

☐	**Foreign Structured Debt**	☐	☐	☐	☐	☐	☐
☐	**U.S. Mutual Funds**	☐	☐	☐	☐	☐	☐
☐	**Foreign Mutual Funds**	☐	☐	☐	☐	☐	☐
☐	**U.S. Exchange Traded Funds**	☐	☐	☐	☐	☐	☐
☐	**Foreign Exchange Traded Funds**	☐	☐	☐	☐	☐	☐
☐	**U.S. Private Funds**	☐	☐	☐	☐	☐	☐
☐	**Foreign Private Funds**	☐	☐	☐	☐	☐	☐
☐	**Other**	☐	☐	☐	☐	☐	☐

ii. Has the broker-dealer recorded all securities it carries for the accounts of non-customers on its stock record?

Yes ☐ No ☐

If the answer is "no," explain in the space provided why the broker-dealer has not recorded such securities on its stock record and provide the approximate total U.S. dollar market value of such unrecorded securities:

_____

_____

_____

iii. Indicate in the chart below each process used by the broker-dealer with respect to free credit balances in the securities accounts of non-customers by checking all the boxes that apply and providing applicable information:

	Process
☐	Included in a reserve computation
☐	Swept to a U.S. bank
☐	Swept to a U.S. money market fund
☐	Other (Briefly describe in space provided below) _____ _____ _____ _____ _____ _____ _____

Item 4. Acting as a Carrying Broker-Dealer for Other Broker-Dealers

A. On a fully disclosed basis

i. Does the broker-dealer carry customer accounts for another broker-dealer(s) on a fully disclosed basis?

Yes ☐ No ☐

ii. If the answer to question 4.A.i is "yes," indicate the number of broker-dealers: _____.

iii. If the answer to question 4.A.i is "yes," identify any of these broker-dealers that are affiliates of the broker-dealer by name and "SEC File No.":

_____
_____
_____

B. On an omnibus basis

i. Does the broker-dealer carry customer accounts for another broker-dealer(s) on an omnibus basis?

Yes ☐ No ☐

ii. If the answer to question 4.B.i is "yes," indicate the number of broker-dealers: _____.

iii. If the answer to question 4.B.i is "yes," identify any of these broker-dealers that are affiliates of the broker-dealer by name and "SEC File No.":

_____
_____
_____

Item 5. A. Does the broker-dealer send trade confirmations directly to customers and other accountholders?

Yes ☐ No ☐

B. If the answer to question 5.A is "no," who sends the trade confirmations to customers and other accountholders? :_____.

Item 6. A. Does the broker-dealer send account statements directly to customers and other accountholders?

Yes ☐ No ☐

B. If the answer to question 6.A is "no," who sends the account statements to customers and other accountholders? :_____.

C. Does the broker-dealer send account statements to anyone other than the beneficial owner of the account?

Yes ☐ No ☐

Item 7. Does the broker-dealer provide customers and other accountholders with electronic access to information about the securities and cash positions in their accounts?

Yes ☐ No ☐

Item 8. A. Is the broker-dealer also registered as an investment adviser:

i. With the SEC under the Investment Advisers Act of 1940?

Yes ☐ No ☐

ii. With one or more U.S. states under the laws of the state?

Yes ☐ No ☐

If the answer to question 8.A.i or 8.A.ii is "yes," answer each of the following items:

B. Provide the number of investment adviser clients:_________________.

C. Complete the following chart concerning the custodians of investment adviser client assets if any (including, if applicable, the broker-dealer):

Column 1: The name of the custodian
Column 2: The identity of the custodian by SEC File No. or CRD No. (if applicable)
Column 3: Whether the broker-dealer/investment adviser has the authority to effect transactions in these advisory client accounts at the custodian
Column 4: Whether the broker-dealer/investment adviser has the authority to withdraw funds and securities out of any accounts at the custodian
Column 5: Whether the custodian sends account statements directly to the investment adviser clients
Column 6: Whether the investment adviser client assets are on the broker-dealer's stock record

1	**2**	**3**	**4**	**5**	**6**
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐
		Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐	Yes ☐ No ☐

Item 9. A. Is the broker-dealer an affiliate of an investment adviser?

Yes ☐ No ☐

B.i. If the answer to Item 9.A is "yes," does the broker-dealer have custody of client assets of the adviser?

Yes ☐ No ☐

B.ii. If the answer to Item 9.B.i is "yes" indicate the approximate U.S. dollar market value of the adviser client assets of which the broker-dealer has custody: _______________________.

By the Commission.

Dated: July 30, 2013.

Elizabeth M. Murphy,

Secretary.

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