

SEC Adopts Amendments to Broker-Dealer Financial Responsibility, Reporting and Audit Requirements

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The SEC recently adopted amendments to its financial responsibility, reporting and audit rules applicable to registered broker-dealers. While some of the amendments will affect all firms, the amendments are particularly significant for those that carry customer accounts or act as clearing brokers.¹

The amendments to the broker-dealer financial responsibility rules (the “**Financial Responsibility Rules Amendments**”) were originally proposed in March 2007,² prior to the financial crisis. The amendments address a number of technical issues, including protections associated with “sweep programs” for customer free credit balances, proprietary accounts of broker-dealers that are held at other broker-dealers and limitations on banks eligible to hold special reserve accounts.

The amendments to the broker-dealer financial reporting and audit rules (the “**Financial Reporting Rules Amendments**”) were proposed in June 2011,³ partly in response to the Madoff scandal. The final rules require registered broker-dealers to file new types of reports with the SEC. They also require clearing and carrying broker-dealers to permit their independent public accountants to make available to the SEC and their designated examining authority (“**DEA**”) the audit documentation associated with annual audit reports required under Rule 17a-5 of the Securities Exchange Act of 1934 (the “**Exchange Act**”).

The Financial Responsibility Rules Amendments become effective **60 days** from the date of publication of the rules in the *Federal Register*, which is expected to occur soon. The effective dates for the new requirements imposed by the Financial Reporting Rules Amendments vary by requirement and are described below.

Financial Responsibility Rules Amendments

The amendments make various changes to the broker-dealer customer protection and net capital rules as described further below.

Customer Protection Rules

PAB Accounts

The amendments require registered broker-dealers carrying proprietary accounts on behalf of other registered broker-dealers, foreign broker-dealers and foreign banks acting as broker-dealers (“**PAB accounts**”) to establish special bank accounts for the benefit of PAB account holders and to fund those accounts on the basis of calculations that are similar to those that broker-dealers are required to make in

¹ See “Financial Responsibility Rules for Broker-Dealers,” Exchange Act Release No. 34-70072 (July 31, 2013), available [here](#), and “Broker-Dealer Reports,” Exchange Act Release No. 34-70073, (July 31, 2013), available [here](#).

² The comment period for the proposal was reopened in May 2012. See Davis Polk Memorandum “SEC Reopens Comment Period for Proposed Amendments to Financial Responsibility Rules for Broker-Dealers” (May 8, 2012), available [here](#), for a summary of the proposed amendments.

³ See Davis Polk Memorandum “SEC Proposes New Custody-Related Reporting and Audit Requirements for Broker-Dealers” (July 21, 2011), available [here](#), for a summary of the proposed amendments.

relation to special reserve accounts for the benefit of customers under Exchange Act Rule 15c3-3.⁴ The final rules permit an account holder to have its proprietary account excluded from the new requirement if it agrees to having its claims relating to the account subordinated to the claims of creditors of the carrying broker-dealer. In large part, the amendment is intended to close the gap between the scope of the term “customer” in a liquidation proceeding under the Securities Investor Protection Act of 1970 (“SIPA”) and under Exchange Act Rule 15c3-3, which gap the SEC was concerned could potentially expose SIPA and customers to losses.

Under the final rules, broker-dealers will also be required to obtain and maintain the physical possession or control of non-margin securities carried for a PAB account, unless the carrying broker-dealer has given written notice to the account holder that the broker-dealer may use the securities in the ordinary course of its business and has provided an opportunity for the account holder to object.

Reserve Accounts

The amendments prohibit registered broker-dealers from maintaining customer or PAB reserve account cash deposits at any affiliated bank and limit the amount of reserve account cash deposits that the broker-dealer may maintain at any single unaffiliated bank to 15% of the bank’s equity capital, as reported by the bank in its most recent Call Report.

U.S. branches of foreign banks will not be eligible to hold customer or PAB reserve account cash deposits unless a specific exemptive order is obtained.

Sweep Programs

The amendments provide that a broker-dealer must not convert, invest or transfer to another account or institution customer free credit balances, except (i) upon the customer’s specific order, authorization or draft or (ii) pursuant to a “sweep program” that sweeps free credit balances into money market funds or a bank deposit account that is insured by the Federal Deposit Insurance Corporation (“FDIC”), but only if the broker-dealer has satisfied specified disclosure and notification requirements. In addition, for accounts opened after the effective date of the Financial Responsibility Rules Amendments, the broker-dealer must obtain affirmative written consent of the customer to participate in a sweep program.

A broker-dealer must also provide written notice to the customer at least 30 calendar days before making changes to terms and conditions of the sweep program, changing the terms and conditions of a product currently available through the sweep program, changing products available through the sweep program, or changing the customer’s investment from one product to another in the sweep program. The written notice must describe the new terms and conditions or product and the options available to the customer if the customer does not accept the new terms and conditions or product.

Futures Positions in Portfolio Margin Accounts

The amendments clarify the treatment of futures positions held in securities portfolio margin accounts for purposes of Exchange Act Rule 15c3-3.

Net Capital Requirements

Securities Loans and Repurchase Agreements

The amendments create a presumption, for net capital purposes, that broker-dealers providing securities lending and borrowing services are deemed to be acting as principal, rather than as an agent, unless specified procedures are followed.

⁴ This change would essentially broaden and codify many provisions of a no-action letter regarding PAB accounts issued by SEC staff in 1998. Significantly, the no-action letter will be superseded and withdrawn as of the effective date of the Financial Responsibility Rules Amendments.

The amendments also require new SEC reporting by any registered broker-dealer having principal positions in securities loans and repurchase agreements on nongovernment securities exceeding 2,500 percent of their tentative net capital, unless the broker-dealer reports to its DEA on a monthly basis its securities lending and borrowing and repurchase activity.

Expense-Sharing Agreements

A registered broker-dealer must deduct from net worth liabilities assumed by third parties (such as those under expense-sharing arrangements) if it cannot demonstrate the ability of the third party to repay the obligations. Significantly, prior SEC staff guidance on this topic will not be withdrawn.⁵

Treatment of Temporary Capital Contributions

The amendments will require a registered broker-dealer to treat as a liability (rather than as part of its net worth) (i) any capital that is contributed under an agreement giving the investor the option to withdraw it, and (ii) any capital contribution that is intended to be withdrawn within one year. Importantly, any capital withdrawn within one year of contribution will be retroactively deemed to have been intended to be withdrawn within one year, unless the withdrawal was approved in writing by the broker-dealer's DEA.

Other Net Capital Changes

The final rules make a number of additional technical changes to net capital requirements, including, among others, amendments relating to broker-dealer solvency requirements.

Other Noteworthy Points

Under the final rules, large broker-dealers must document their risk-management controls and retain those records for three years after termination of the documented risk-management control.

Noting its pending money market fund reforms, the SEC declined to adopt proposals that would have expanded the definition of "qualified securities" eligible for reserve account deposits to include certain money market securities and decreased the net capital haircuts applicable to holdings of money market fund securities.

The adopting release summarizes comments received concerning a number of questions as to which the SEC solicited comments, including whether to reduce the Exchange Act Rule 17a-11 early warning threshold for broker-dealers that carry more than \$10 billion in debits and whether to harmonize the net capital treatment of securities lending and borrowing transactions and repurchase agreements. However, the SEC declined to take action with respect to any of these items.

Financial Reporting Rules Amendments

New Annual Reports

The Financial Reporting Rules Amendments require the filing of new types of annual reports as described below. The new reports must be filed with respect to fiscal years ending on or after **June 1, 2014**, and are due 60 calendar days after the end of each fiscal year.

- ***Annual Compliance Report or Exemption Report.*** A broker-dealer subject to the customer protection requirements of Exchange Act Rule 15c3-3 (a "**carrying broker-dealer**") must file on an annual basis a "**Compliance Report**" that would include specified information about its compliance with Exchange Act Rules 15c3-1, 15c3-3 and 17a-13 and customer account

⁵ See Letter from Michael A. Macchiaroli, Associate Director, SEC Division of Market Regulation, to Elaine Michitsch, Member Firm Regulation, New York Stock Exchange, Inc., and Susan DeMando, Director, Financial Operations, NASD Regulation, Inc. (July 11, 2003), available [here](#).

statement rules of the broker-dealer's DEA. A non-carrying broker-dealer must file an "**Exemption Report**" that would specify the particular exemption from Exchange Act Rule 15c3-3 on which the broker-dealer is relying.

The Compliance Report must include:

- a statement as to whether the broker-dealer has established and maintained "**Internal Control Over Compliance**," defined to mean internal controls that have the objective of providing a broker-dealer with reasonable assurance that non-compliance with the rules covered by the report will be prevented or detected on a timely basis;
- a statement as to whether the broker-dealer was in compliance with Exchange Act Rule 15c3-1 and paragraph (e) of Exchange Act Rule 15c3-3 (pertaining to special reserve account requirements for customers and PAB accounts) as of the end of the most recent fiscal year and, if applicable, a description of *any* instances of non-compliance with those rules; and
- a statement as to whether the broker-dealer's Internal Control Over Compliance was "effective" during, and as of the end of, the most recent fiscal year and, if applicable, a description of each identified "material weakness" in its Internal Control Over Compliance during the most recent fiscal year;
 - to be considered "effective," there must not have been a "material weakness" in the broker-dealer's Internal Control Over Compliance;
 - a "material weakness" is defined as a deficiency that creates a reasonable possibility that *any* non-compliance with Exchange Act Rule 15c3-1 or 15c3-3(e) will not be prevented or detected on a timely basis, or that creates a reasonable possibility that non-compliance *to a material extent* with the remaining rules covered by the report will not be prevented or detected on a timely basis.

Annual Examination Report. A broker-dealer must file with its Compliance Report or Exemption Report (as applicable) an "**Examination Report**" prepared by its independent public accountant, which must contain the accountant's assessment of certain information in the Compliance Report or Exemption Report, as the case may be. A broker-dealer that is dually registered as an investment adviser under the Investment Advisers Act of 1940 (the "**Advisers Act**") may use the Examination Report covering a Compliance Report to satisfy the internal control requirements of Advisers Act Rule 206(4)-2.

During the course of preparing the Examination Report of the Compliance Report, if the accountant determines that (i) the broker-dealer is not in compliance with the financial responsibility rules or DEA customer account statement rules, or (ii) a material weakness exists, the accountant must immediately notify the broker-dealer. In certain cases where the broker-dealer is required to notify the SEC under specified rules, then the broker-dealer must provide a copy of such notice to the accountant. If the accountant does not receive the broker-dealer's notice to the SEC within one business day or disagrees with the broker-dealer's statements in such notice, the accountant is required report this to the SEC, with specificity.

While the rule sets forth a procedure to maintain the confidentiality of certain parts of Compliance Reports, if there are material weaknesses, Examination Reports covering Compliance Reports will be made available for customers' inspection and will not be accorded confidential treatment.

Audit Standards and SEC and DEA Access to Audit Documentation of Clearing Brokers

The amendments require that, as of **December 31, 2013**, the Examination Reports for both carrying and non-carrying broker-dealers be made in accordance with standards of the Public Company Accounting Oversight Board (“**PCAOB**”).

The amendments also require carrying and clearing broker-dealers to permit their independent public accountant to make available to the SEC and DEA the audit documentation associated with the annual audit reports required under Exchange Act Rule 17a-5.

Form Custody

The amendments require all registered broker-dealers to file a new form, called **Form Custody**, with their DEA, generally within 17 business days after the end of each calendar quarter and at the same time that they file their FOCUS reports with their DEA. The rule requiring the filing of Form Custody is effective on **December 31, 2013**. Therefore, a broker-dealer must begin filing Form Custody with its DEA by January 17, 2014.

Form Custody, which was adopted in substantially the same form as previously proposed, is comprised of nine categories of questions generally designed to elicit information about a broker-dealer’s custodial activities.

SIPC Filings

Effective **December 31, 2013**, a broker-dealer that is a member of the Securities Investor Protection Corporation (“**SIPC**”) must file its annual reports with SIPC concurrently with their filing with the SEC.

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