

SEC Proposes New Custody-Related Reporting and Audit Requirements for Broker-Dealers

The SEC recently proposed amendments to Rule 17a-5 under the Securities Exchange Act of 1934—the broker-dealer financial reporting rule—that would significantly increase the reporting, compliance and audit requirements for broker-dealers that custody client assets. The proposal reflects the SEC’s continued efforts to deal with difficult issues raised by the massive fraud in the Madoff securities matter. The following is an overview of the key aspects of the proposed amendments to Rule 17a-5. The comment period for the proposed amendments is open until August 26, 2011.

Annual Reports and Audit Standards

The proposed amendments to Rule 17a-5 would require broker-dealers subject to the custody requirements of Rule 15c3-3 regarding customer funds or securities (carrying broker-dealers) as well as non-carrying broker-dealers to file new types of reports with the SEC. These reports would supplement the existing requirements under Rule 17a-5 for a broker-dealer to file its audited financial statements and specified supporting materials with the SEC.

Carrying Broker-Dealers

Under the proposed amendments, a carrying broker-dealer would need to file on an annual basis a “Compliance Report” that would include specified assertions and information about its compliance with Exchange Act Rules 15c3-1, 15c3-3, 17a-13 and rules of the broker-dealer’s designated examining authorities (DEAs) that require the broker-dealer to send account statements to customers (the “Financial Responsibility Rules”). The Compliance Report would contain the following information:

- A statement whether the broker-dealer has established and maintained a system of internal control to provide it with reasonable assurance that any instances of material non-compliance¹ with the Financial Responsibility Rules will be prevented or detected on a timely basis;
- An assertion whether the broker-dealer was in compliance in all material respects with the Financial Responsibility Rules as of its fiscal year end. A broker-dealer could not make this assertion affirmatively if it identified one or more instances of material non-compliance within the covered fiscal year;
- An assertion whether the information used to assert compliance with the Financial Responsibility Rules was derived from the books and records of the broker-dealer;
- An assertion whether the 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; and
- A description of each identified instance of material non-compliance and material weakness in internal control over compliance with the Financial Responsibility Rules.

A carrying broker-dealer would also have to file an Examination Report with the SEC. The Examination Report would be obtained by a broker-dealer from an independent public accountant² and would contain

¹ The proposed rules would replace the standard of “material inadequacies” in current Rule 17a-5 with one of “material non-compliance.” The proposed rules define material non-compliance broadly to mean the failure by a broker-dealer to comply with the requirements of the Financial Responsibility Rules “in all material aspects.” See Proposed Rule 17a-5(d)(3)(ii).

² The proposed rule would clarify that an independent public accountant also must be registered with the PCAOB.

the accountant's assessment of the information contained in its Compliance Report.³ A broker-dealer that is dually registered as an investment adviser under the Investment Advisers Act of 1940 could also use its Examination Report to satisfy the internal control requirements of Advisers Act Rule 206(4)-2.

Non-Carrying Broker-Dealers

A non-carrying broker-dealer would need to file two new reports with the SEC on an annual basis. A non-carrying broker-dealer would need to file an Exemption Report that would specify the particular exemption from Rule 15c3-3 under the Exchange Act on which the broker-dealer is relying. The broker-dealer would also be required to file an Examination Report containing the results of a review by the broker-dealer's independent public accountant of the basis for the exemption contained in the broker-dealer's Exemption Report.

Audit Standards

Currently under Rule 17a-5, broker-dealer audits must be conducted in accordance with generally accepted auditing standards (GAAS). The proposed amendments instead would require that the Examination Reports for both carrying and non-carrying broker-dealers be conducted in accordance with PCAOB standards.⁴ The SEC states that in addition to applying PCAOB standards, the amended auditing standards are designed to assure that independent auditors provide an opinion on the broker-dealer's compliance and internal controls with respect to what the SEC considers to be key regulatory requirements. The PCAOB held an open meeting on July 12 at which it proposed audit and attestation standards for broker-dealer and public company engagements for purposes of the Rule 17a-5 requirements.⁵

SEC and DEA Access to Audit Documentation for Clearing Brokers

The proposed rules would require a clearing broker-dealer (that is, a broker-dealer that clears transactions for itself or other broker-dealers)⁶ to permit its independent public accountant to make available to the SEC and relevant DEA auditing staffs the audit documentation associated with the annual audit reports required under Rule 17a-5. The SEC states that it intends, at least preliminarily, that requests for audit documentation would be made "exclusively in connection with conducting a regulatory examination of a clearing broker-dealer" and would be used to determine the scope and focus of a pending examination.⁷ The SEC does not expect to use the information to examine an independent public accountant.

³ The SEC noted that the Examination Report is designed to replace the current practice of an independent public accountant issuing a report for purposes of the audit requirements of Rule 17a-5(g). Broker-Dealer Reports, Securities Exchange Act Release No. 64676, 76 Fed. Reg. 37572, 37573 (Jun. 15, 2011).

⁴ This change is designed to effectuate the Dodd-Frank Act's grant of authority to the PCAOB to establish auditing, attestation, and related standards for broker-dealer audit reports to be included in SEC filings. Dodd-Frank Act § 982.

⁵ 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 (Jul. 12, 2011).

⁶ Many carrying broker-dealers are also clearing broker-dealers. The SEC estimates that there are 305 carrying broker-dealers and 528 clearing broker-dealers.

⁷ Broker-Dealer Reports, Securities Exchange Act Release No. 64676, 76 Fed. Reg. 37572, 37583 (Jun. 15, 2011).

SEC and DEA Access to Audit Documentation for Clearing Brokers

Citing concerns raised in recent SEC enforcement actions against broker-dealers and investment advisers relating to the misuse or misappropriation of customer assets, the SEC proposes to require a broker-dealer to file a new form, called Form Custody, with the SEC on a quarterly basis with its FOCUS report. Form Custody would require information about how a broker-dealer maintains customer and non-customer assets. Form Custody would include nine items, each relating to a particular aspect of a broker-dealer's custodial activities including whether the broker-dealer:

- serves as an introducing broker;
- introduces customers to another broker-dealer on an omnibus basis;
- acts as a carrying broker-dealer (and if so, what types of customer assets it maintains and how it maintains them);
- acts as a carrying broker-dealer for other broker-dealers;
- sends trade confirmations to customers;
- sends account statements to customers;
- provides customers with electronic access to information;
- is registered as an investment advisers under the Advisers Act; and
- is affiliated with an SEC-registered investment adviser.

The SEC expects to use the information provided in Form Custody to aid it in its examinations of broker-dealers and, to that end, to alert the SEC and its staff to inconsistencies and red-flags in information provided by a broker-dealer to the SEC.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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