August 25, 2011

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: File No. S7-23-11 Broker-Dealer Reports

Dear Ms. Murphy:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants.

The CAQ appreciates the opportunity to provide feedback to the Securities and Exchange Commission's (the "SEC" or "Commission") File No. S7-23-11 Broker-Dealer Reports (the "proposed rule"). This letter represents the views of the CAQ, but not necessarily the views of any specific firm, individual or CAQ Governing Board member.

OVERALL COMMENT

The proposed rule is intended to enhance the annual audits of broker-dealers, and includes amendments that, among other things:

- Update the existing requirements of the Securities Exchange Act of 1934 Rule 17a-5
- Facilitate the ability of the Public Company Accounting Oversight Board (the "PCAOB") to implement oversight of registered public accountants of broker-dealers as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act

- Require broker-dealers that either clear transactions or carry customer accounts to consent to allow the Commission and designated examining authorities ("DEAs") to have access to independent registered public accountants ("auditors" or "audit firms") to discuss findings and to review related audit documentation
- Enhance the ability of the Commission and examiners of DEAs to oversee broker-dealers' custody practices by requiring broker-dealers to file a new Form Custody

In general, the CAQ supports the Commission's proposed rule. We believe the reporting amendments will improve broker-dealers' compliance with the Financial Responsibility Rules and enhance safeguarding of investors' assets. However, we recommend that the Commission consider the following observations that we believe will enhance the effectiveness of the proposed rule.

SPECIFIC COMMENTS

We have organized these observations around the following topical areas:

- Transition Timelines and Effective Dates
- Clarification of "Material Non-Compliance"
- Internal Control over Compliance with the Financial Responsibility Rules
- Access to Audit Documentation
- Non-Compliance Notification Requirements
- Exemption Report
- "Clean Up" Amendments
- Interaction with Other Regulatory Rules

TRANSITION TIMELINES AND EFFECTIVE DATES

The effective date for the Commission's proposed rule is for annual reports filed with the SEC for fiscal years ending on or after December 15, 2011. The proposed rule also includes a transition period for carrying broker-dealers subject to the Compliance Report requirement with fiscal years ending on or after December 15, 2011, but before September 15, 2012.[1]

This effective date is less than four months after the close of the comment period (August 26, 2011) and provides little time for broker-dealers to prepare the additional reports and the documentation to support their assertions.

This effective date also provides little time for auditors to review and evaluate the full body of PCAOB auditing standards (excluding those specifically required for integrated audits) including PCAOB Auditing Standard No. 3 (Audit Documentation Requirements) and PCAOB Auditing Standard No. 7 (Engagement Quality Review) among others, in order to identify all required changes to audit procedures, update auditing guidance, and provide any required training.

Additionally, for December 31, 2011 broker-dealer audit engagements, planning and interim procedures may have already begun. Engagement plans designed under GAAS would need to be

[1] Proposed Rule, Section II. B. 7.

revised, and related audit procedures would need to be re-performed in order for these audits to comply with PCAOB auditing standards. These changes may require audit plans (and engagement fees) to be re-approved by Audit Committees and other governing bodies. Further, many registered audit firms that do not have issuer audit clients will need to quickly develop an Engagement Quality Review (EQR) process that is consistent with PCAOB auditing standards.

Lastly, we are concerned that the effective date of the proposed rule does not align with the effective dates of the following related standards proposed by the PCAOB:

1) Examination Engagements Regarding Compliance Reports of Brokers and Dealers
2) Review Engagements Regarding Exemption Reports of Brokers and Dealers
3) Auditing Supplemental Information Accompanying Audited Financial Statements

These proposed standards are effective for fiscal years ending on or after September 15, 2012, which is consistent with the end of the transition period for carrying broker-dealers under the Commission's proposed rule, but which is not consistent with the proposed rule's effective date of December 15, 2011.

Based on these proposed effective dates, audit firms would be required to adopt a new set of auditing standards (existing PCAOB standards) during the transition period, and another set after the transition period (proposed PCAOB standards), which could create unnecessary costs for broker-dealers and their auditors.

In our view, the timing issues discussed above would be resolved by postponing the effective date of the proposed rule to align with the effective date of the PCAOB's proposed standards (i.e., September 15, 2012).

CLARIFICATION OF "MATERIAL NON-COMPLIANCE"

The proposed rule defines reportable "material non-compliance" as a failure to comply with any of the requirements of the Financial Responsibility Rules, in all material respects.[2] The proposed rule provides certain specific examples of deficiencies that would necessarily constitute instances of material non-compliance under rules 15c3-1 and 15c3-3.[3] Additionally, the proposed rule indicates that when determining whether an instance of non-compliance is material, a broker-dealer should consider, "(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."[3]

As detailed below, we request that the Commission provide guidance with respect to the following:

1) Additional Specific Examples
2) Qualitative and Quantitative Considerations
3) Interrelationship between Material Non-Compliance and the Financial Statement Audit

[2] Rule 15c3-1, Rule 15c3-3, Rule 17a-13, or the Account Statement Rule (Proposed Rule, Section II. B. 1).
[3] Proposed Rule, Section II. B. 1.

1) Additional Specific Examples

The proposed rule notes that the examples provided are not intended to be all inclusive. We believe that broker-dealers and audit firms would benefit from additional specific examples that would constitute instances of material non-compliance within the context of each of the Financial Responsibility Rules. For example, with respect to Rule 15c3-1, would an error in the calculation of net capital that did not result in a failure to maintain the required minimum amount of net capital constitute a material non-compliance? Further, would a failure to perform any of the required quarterly security counts in a manner consistent with the provisions of Rule 17a-13 represent material non-compliance? Would the failure to provide an account statement to any client constitute material non-compliance? Finally, apart from the failure to maintain the minimum deposit requirement noted in the proposed rule, are there any other specific violations of Rule 15c3-3 that would necessarily constitute material non-compliance?

2) Qualitative and Quantitative Considerations

We would appreciate further guidance as to how auditors would assess quantitative and qualitative considerations for items that may not be related directly to the financial statements. For example, consider an internal control deficiency that led to account statements not being provided to certain clients in a particular quarter. In making a materiality determination, what relative level of consideration should be given to quantitative factors such as the dollar value of account statements not provided relative to the total value of all statements, versus qualitative factors such as delays in processing name or address changes that gave rise to customer statements not being provided?

Further, in instances where non-compliance is quantifiable, such as an error in the calculation of net capital, is it considered reasonable to align this materiality judgment with financial statement materiality, or should this materiality judgment be made only in relation to net capital?

3) Interrelationship Between Material Non-Compliance and the Financial Statement Audit

We believe that broker-dealers and audit firms would benefit from guidance regarding the impact of material errors and/or misstatements discovered during the audit of the financial statements, on the determination of material non-compliance. For example, if a broker-dealer or an auditor identified an allowable asset that was materially misstated during the audit of the financial statements, and the adjustment needed to be made to both the balance sheet as well as net capital in the Rule 15c3-1 calculation, would this be considered an instance of material non-compliance, regardless of whether the broker-dealer continues to have adequate net capital after the adjustment is made?

Additionally, we believe that broker-dealers and audit firms would benefit from additional guidance related to the interaction between material weaknesses in internal control over financial reporting ("ICFR") and material weakness in internal control over compliance with the Financial Responsibility Rules. For example, would a material weakness in ICFR also constitute a material weakness in internal control over compliance with the Financial Responsibility Rules? Further, do all instances of material weaknesses in internal control over compliance with the Financial Responsibility Rules indicate a material weakness in ICFR?

INTERNAL CONTROL OVER COMPLIANCE WITH THE FINANCIAL RESPONSIBILITY RULES

As noted in the proposed rule, the Commission is not proposing that broker-dealers provide an assertion regarding the effectiveness of ICFR or for auditors to perform procedures related to such an assertion. However, we note that many of the aspects of the Financial Responsibility Rules (specifically Rule 15c3-1 and 15c3-3) are derived from the financial statements. For example, the accuracy of a specific haircut charge in the Rule 15c3-1 calculation is based, in part, on whether the value of a security is fairly stated in the broker-dealer's balance sheet. We believe that audit firms would benefit from clarification as to the interaction between ICFR and the auditors' attestation on compliance with the Financial Responsibility Rules, particularly as it relates to non-issuer broker-dealers.

Additionally, the second assertion in the Compliance Report requires the broker-dealer to affirm that the information used to assert compliance with the Financial Responsibility Rules was derived from the books and records of the broker-dealer.[4] However, the proposed rule is unclear as to whether the term "books and records" is intended to mean the records maintained by the broker-dealer under Rule 17a-3, *Records to be made by Certain Exchange Members, Brokers and Dealers.* We request that the Commission include a cross-reference to these specific rules or clarify its definition of "books and records" in the proposed rule.

Lastly, the broker-dealer's assertion related to the effectiveness of internal control over compliance with the Financial Responsibility Rules would cover the entire fiscal year (except during the transition period), in contrast to an issuer's report on ICFR, which pertains to the end of the issuer's reporting period. Because the compliance assertion would cover the entire fiscal year (except during the transition period), any material weaknesses identified during the period would preclude management from asserting that its internal controls were effective for the period under audit, even if the material weakness were remediated during the period. We acknowledge that the period covered by the proposed rule is consistent with the Investment Adviser Custody Rule, but we believe that broker-dealers should have the opportunity to remediate material weaknesses identified during the compliance period and thus be able to assert (and auditors opine on) effectiveness of internal control over compliance with the Financial Responsibility Rules at the end of the compliance period. We believe this approach would better align the proposed rule with guidance related to an issuer's report on ICFR.

ACCESS TO AUDIT DOCUMENTATION

The proposed rule requires certain broker-dealers to consent to allow the Commission and the DEAs' examination staff access to their audit firms, to discuss findings with respect to annual audits of the broker-dealers and to review related audit documentation.[5]

We believe both broker-dealers and audit firms would benefit from clarification as to whether the word "documentation" as used in the proposed rule is intended to have the same meaning as the

[4] Proposed Rule, Section II. B. 1.
[5] Proposed Rule, Section III.

phrase "audit documentation" in PCAOB Auditing Standard No. 3 (Audit Documentation Requirements), as suggested by footnote 3 of the proposed rule and the accompanying text. It would be helpful if the proposed rule were amended to explicitly incorporate the definition established by Auditing Standard No. 3.

The Commission also stated in its proposed rule that it "preliminarily believes that it is appropriate to limit these requirements to broker-dealers that maintain customer funds and securities or self-custody their proprietary securities because these firms generally have more complex business operations than other broker-dealers."[5] It is not clear from the proposed rule what types of broker-dealers the Commission is referring to when discussing clearing broker-dealers or broker dealers which self-custody proprietary securities. As proposed, this could indicate an inclusion of broker-dealers that clear transactions but do not carry customer accounts. For example, would broker-dealers that are exempt under Rule 15c3-3(k)(2)(i) be subject to audit documentation access if they self-custody their proprietary securities? We believe the Commission should clarify which types of clearing broker-dealers are intended - and not intended - to be included in this requirement.

NON-COMPLIANCE NOTIFICATION REQUIREMENTS

The proposed rule would require audit firms to notify the Commission within one business day if the audit firm determines that during the course of the examination an instance of "material non-compliance" exists with respect to any of the Financial Responsibility Rules.[6]

We concur with the Commission that timely and effective notification of a broker-dealer's material non-compliance with the Financial Responsibility Rules enables the Commission to react promptly in protecting investors. However, we believe compliance with the existing process for notification under SEC Rule 17a-5(h)(2) satisfies the objective of timely notification. SEC Rule 17a-5(h)(2) requires broker-dealers to furnish the auditor with a copy of its notification to the regulators within a 24-hour period. If the auditor fails to receive such notice from the broker-dealer within this 24-hour period, or if the auditor disagrees with the statements contained in the notice of the broker-dealer, the auditor then has the responsibility to notify the SEC and DEA(s) within 24 hours thereafter, as set forth in SEC Rule 17a-11.

Lastly, the proposed rule indicates, "upon determining any material non-compliance exists during the course of preparing the independent public accountant's reports, the independent public accountant must notify the Commission within one business day of the determination."[7] It is unclear whether this would also pertain to reports resulting from review engagements and financial statement audits. In addition, it is unclear when during an engagement an auditor would be considered to be preparing the independent public accountant's report. Therefore, we request that the Commission clarify which independent public accountant's reports are subject to the proposed rule's notification requirements, as well as provide clarity around what activities would constitute preparation of the independent public accountant's report.

[6] Proposed Rule, Section II. B. 3.
[7] Proposed Rule, (h) Notification of material non-compliance, page 131.

EXEMPTION REPORT

The Exemption Report would require broker-dealers to assert that they are exempt from Rule 15c3-3 and identify the provision of the rule that they are relying on to qualify for the exemption. Does the Commission intend to have broker-dealers make these assertions (and to have the auditor report upon these assertions) for an annual period (e.g., for the year ending December 31) or an 'as of date' (e.g., as of December 31)?

"CLEAN UP" AMENDMENTS

The proposed rule includes various "clean up" amendments intended to delete unnecessary or outdated provisions. Included within these "clean up" amendments is a proposal requiring broker-dealers to file their annual reports with the Securities Investor Protection Corporation ("SIPC").[8]

While this may seem innocuous on its face, the stated reason for the change is to enable SIPC to assert that it "relied" on the accountant's report and thereby overcome judicial authority that limits SIPC's ability to assert claims for monetary damages against the auditing profession. This change would increase the auditing profession's exposure to litigation in certain instances where SIPC is required to fund the liquidation of a broker-dealer. Furthermore, the proposed rule does not address any of the federal policies impacted by the amendment or acknowledge the authority of the United States Supreme Court on this subject. An additional concern is that the proposed amendment does not identify the potential costs of the amendment, nor weigh those costs against any potential benefits. We would suggest that if SIPC's ability to assert such claims is to be revisited, it should be done through a robust analysis with careful consideration of the relevant federal policies and limitations at issue and not through a "clean up" amendment in this proposed rule.

INTERACTION WITH OTHER REGULATORY RULES

Below we highlight selected regulatory rules that are impacted by the Commission's proposed rule:

1) **Rule 206(4)-2 of the Investment Advisers Act of 1940 ('Rule 206')**

Certain broker-dealers that are also registered investment advisers ("dual registrants") are subject to the annual surprise examination of client assets under Rule 206, which requires the auditor to obtain a copy of the most recent internal control report and determine whether there are any findings that would affect the nature and extent of the surprise count procedures (e.g., confirmation with depositories). Since Rule 206 allows for reliance on internal control reports in determining the surprise count procedures, we request that the Commission clarify whether the auditor can also rely on the proposed rule's Compliance Report in determining the nature and extent of the surprise count procedures.

[8] Proposed Rule, Section V, A.

2) Commodity Futures Trading Commission (CFTC) Regulation 1.16

Auditors of certain broker-dealers who are also registered as Futures Commission Merchants with the CFTC, are required to file a report under CFTC Regulation 1.16, related to their review of the broker-dealers' practices and procedures in complying with CFTC Regulation 1.16. Certain broker-dealers will be required to provide the management assertion required by the proposed rule, as well as the compliance report required by CFTC Regulation 1.16. We believe this may create unnecessary costs for certain broker-dealers.

*** * * * * ***

We appreciate the opportunity to comment on the Commission's proposed rule and would welcome the opportunity to respond to any questions you may have regarding any of our comments and recommendations.

Sincerely,

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc:

SEC
Chairman Mary L. Schapiro
Commissioner Luis A. Aguilar
Commissioner Troy A. Paredes
Commissioner Elisse B. Walter
James L. Kroeker, Chief Accountant
Paul Beswick, Deputy Chief Accountant
Mike Starr, Deputy Chief Accountant
Brian Croteau, Deputy Chief Accountant
Michael A. Macchiaroli, Associate Director

PCAOB
James R. Doty, Chairman
Daniel L. Goelzer, Board Member
Steven B. Harris, Board Member
Jay D. Hanson, Board Member
Lewis H. Ferguson, Board Member
Martin F. Baumann, Chief Auditor