KPMG LLP
757 Third Avenue
New York, NY 10017

Telephone 212 909 5600
Fax 212 909 5699
Internet www.us.kpmg.com

August 25, 2011

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

Re: SEC Release No. 34-64676; File No. S7-23-11, Broker-Dealer Reports

Dear Ms. Murphy:

We appreciate the opportunity to respond to the Securities and Exchange Commission's ("SEC" or "Commission") proposed amendments to Exchange Act Rule 17a-5 (the "Proposal" or the "Proposed Rule"). We support the regulatory efforts of the Commission to strengthen the oversight of broker-dealer audits. We have structured our comments to provide insights as to those aspects of the Proposal that we believe: 1) may prove challenging for management and independent registered public accountants; 2) would benefit from additional guidance; and/or 3) should be revised in order to achieve the Commission's stated objectives in a more cost-effective manner. Our comments and observations relate to the following areas:

- Material Non-Compliance
- Internal Control over Compliance with the Financial Responsibility Rules
- Non-Compliance Notification Requirements
- Exemption Report
- Form Custody
- Access to Audit Documentation
- Interaction with Commodity Futures Trading Commission Regulation 1.16
- "Clean Up" Amendments
- Transition Timelines and Effective Dates

Material Non-Compliance

The Commission has raised the question whether the proposed definition of the term "material non-compliance" is understandable in the context of broker-dealer audits. The Proposal defines an instance of "material non-compliance" as a failure to comply with any of the requirements of the Financial Responsibility Rules in all material respects.[1]

The Proposal requires that an independent registered public accountant examine a broker-dealer's assertions in its Compliance Report and issue an Examination Report thereon. As the scope of the proposed examination is a compliance attestation engagement, we suggest that the definition of "material non-compliance" as used in AT §601.64-67 of the Public Company Accounting Oversight Board's (the "PCAOB") Standards and Related Rules also be used for purposes of the Proposed Rule, *i.e.*, "noncompliance with the applicable requirements that the practitioner believes have a material effect on the entity's compliance."[2] In addition, we believe that the Commission should provide guidance with respect to qualitative and quantitative factors that may impact the determination of "materiality" consistent with the objectives of a compliance attestation engagement.[3]

We agree with the Commission in not proposing that the effectiveness of internal control over financial reporting be included as one of the assertions made in a broker-dealer's Compliance Report. We believe however, that broker-dealers and their independent registered public accountants would benefit from additional clarification related to the interaction between material weaknesses in internal control over financial reporting and material weaknesses in internal control over compliance with the Financial Responsibility Rules. For example, under what circumstances would a material weakness in internal control over financial reporting also constitute a material weakness in internal control over compliance with the Financial Responsibility Rules? Further, do all instances of a material weakness in internal control over compliance with the Financial Responsibility Rules constitute a material weakness in internal control over financial reporting?

We also suggest the Commission consider further guidance concerning the reporting of material weaknesses in internal control over financial reporting identified as part of a financial statement audit. For example, would the Commission expect that all material weaknesses in internal control over financial reporting identified as part of a financial statement audit (whether or not they are related to the Financial Responsibility Rules) be disclosed in the broker-dealer's Compliance Report?

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[1] See Rule 15c3-1, Rule 15c3-3, Rule 17a-13, or the Account Statement Rule (Proposed Rule, Section II. B.1.)
[2] See AT §601.64 in the PCAOB Standards and Related Rules.
[3] See AT §601.36 of the PCAOB Standards and Related Rules.

Additionally, we also suggest the Commission consider further guidance with respect to the interrelationship between material errors discovered during the audit of the financial statements and the determination of instances of "material non-compliance". For example, assume that during the audit of the financial statements, a broker-dealer or an independent registered public accountant determines that an allowable asset is materially misstated, and that an adjustment was necessary to both the balance sheet and net capital in the Rule 15c3-1 calculation. If this adjustment does not cause a net capital deficiency (*i.e.*, the broker-dealer continued to have adequate net capital notwithstanding the adjustment), would this be considered an instance of "material non-compliance"? Conversely, if an adjustment for a material error to the financial statements *does* result in a net capital deficiency, would that be considered an instance of "material non-compliance," even though the error related to internal control over financial reporting and not internal control over compliance with the Financial Responsibility Rules?

Internal Control over Compliance with the Financial Responsibility Rules

We note that the Proposal provides that the broker-dealer's assertions 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 assertion related to internal control over financial reporting, which pertains to an "as of" date. As to the former, we are unclear as to what period should be tested under the rules. Specifically, the Proposed Rule states that "[t]he broker-dealer is required to be in compliance with the Financial Responsibility Rules *at all times*" (emphasis added). However, the Proposed Rule also states that the assertions made by the broker-dealer for purposes of the Compliance Report are, in contrast, *as of a point in time*.[4] We suggest the Proposed Rule be clarified to align the time period covered by the broker-dealer's assertion on internal control over compliance with the time period covered by the independent registered public accountant's attestation to that assertion.

We recognize that the time periods set forth in the Proposal appear to be consistent with the time periods applicable to internal control reports prepared by an independent registered public accountant under the Investment Advisor Custody Rule. Nevertheless, we recommend that a broker-dealer's assertions related to the effectiveness of internal control over compliance with the Financial Responsibility Rules be made as of a point in time. Such a modification would not only eliminate ambiguity and confusion in the application of the Proposed Rule by preparers and their independent registered public accountants, but would also have the additional benefit of aligning the final rule with the guidance in Section 404 of the Sarbanes-Oxley Act of 2002, which requires public companies to report on the effectiveness of internal control over financial reporting as of a point in time.

[4] See footnote 51 in Section II, B. 1. (SEC Broker-Dealer Reports).

We also note that, under the Proposed Rule, "a broker-dealer could not assert that its internal control over compliance with the Financial Responsibility Rules during the fiscal year was effective if one or more material weaknesses exist with respect to internal control over compliance."[5] We recommend the Commission revise the Proposal to allow a broker-dealer to assert compliance with the Financial Responsibility Rules if it can identify deficiencies, implement effective controls, and test their operating effectiveness prior to year-end, and if the independent registered public accountant also can adequately test the operating effectiveness of the remediated controls. Such a revision would both allow for the opportunity of remediation and, as with the suggestion above, align the Proposed Rule with the requirements in Section 404 of the Sarbanes-Oxley Act of 2002.

Non-Compliance Notification Requirements

The Proposed Rule would require the independent registered public accountant to notify the Commission within one business day if the independent registered public accountant determines that an instance of "material non-compliance" exists with respect to any of the Financial Responsibility Rules during the course of the examination.[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 and others. 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 independent registered public accountant with a copy of its notification to the regulators within a 24-hour period. If the independent registered public accountant fails to receive such notice from the broker-dealer within the 24-hour period, or if the independent registered public accountant disagrees with the statements contained in the notice of the broker-dealer, the independent registered public accountant then has the responsibility to notify the SEC and the Designated Examining Authority ("DEA") within 24 hours thereafter as set forth in SEC Rule 17a-11.

Additionally, we believe that management of a broker-dealer is properly responsible for the assertions made in their Compliance Report and, accordingly, should have the primary responsibility for the determination and notification of instances of "material non-compliance." Such an approach would reinforce the Commission's expectation that the independent registered public accountant's examination engagement be performed under PCAOB Attestation Standards. Those standards currently provide that management is responsible for the subject matter of its assertions, not the independent registered public accountant. In particular, PCAOB Standards and Related Rules AT §101 provide that "[t]he practitioner's role in an attest engagement is that of an attester, the practitioner should not take on the role of the responsible party."[7]

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[5] See Section II, B. 1. (SEC Broker-Dealer Reports).
[6] See Section II, B. 1. (SEC Broker-Dealer Reports).
[7] See AT §101.13

AT §101 further states that "[t]he party wishing to engage the practitioner is responsible for the subject matter, or has a reasonable basis for providing a written assertion about the subject matter."[8]

We also note that the Proposed Rule indicates, "upon determining any 'material non-compliance' exists during the course of preparing the independent public accountant reports, the independent public accountant must notify the Commission within one business day of the determination."[9] However, the Proposed Rule is unclear whether this obligation would apply to an attestation review engagement of an Exemption Report. Therefore, we suggest that the Commission clarify this matter.

Exemption Report

The Proposed Rule would require broker-dealers that do not hold customer funds or securities to file a report (i.e., the Exemption Report) asserting an exemption from the requirements of Rule 15c3-3. 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.

The Proposed Rule also would require broker-dealers claiming an exemption from Rule 15c3-3 (*i.e.*, non-carrying broker-dealers) to have their independent registered public accountants ''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'' (emphasis added).[10] However, the Proposed Rule does not specify whether the Commission intends to have broker-dealers make that assertion, and have the independent registered public accountants report upon that assertion, for an annual period or an "as of" date.

To facilitate the broker-dealer's assertion in its Exemption Report and the independent registered public accountant's review thereof, we suggest that the Commission clarify whether it intends for broker-dealers to assess their compliance with the exemptive provisions of Rule 15c3-3 as of a period-end date (*e.g.* as of December 31) or for a specific period of time (*e.g.* for the year ending December 31).

Finally, we recommend that the Commission make available illustrative examples of Compliance and Exemption Reports to be used by carrying and exempt broker-dealers to provide a better sense as to each report's form and content.

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[8] See AT §101.13.a
[9] See Proposed Rule, subparagraph (g), *Engagement of Independent Public Accountant*, page 131.
[10] See Section II. B. 5. (SEC Broker-Dealer Reports).

Form Custody

The Commission has requested comments as to whether it should require the broker-dealer to engage an independent registered public accountant to audit proposed Form Custody. The Commission has noted that the intent of Form Custody is to assist in expediting the Commission's examination of a broker-dealer.

We do not believe such an audit is 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. We also do not believe that the benefits of performing an audit of the information included in 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 custodial activities.

Access to Audit Documentation

Under the Proposed Rule, every clearing broker-dealer would be required to consent to "permitting its independent public accountant to make available to Commission and DEA examination staff the audit documentation associated with its annual audit reports required under Rule 17a-5 and to discuss findings relating to the audit reports with Commission and DEA examination staff."[11] The stated purpose of these proposed amendments is to provide the Commission and DEA staff with information that will assist them in "establish[ing] the scope and focus of a pending examination of a clearing broker-dealer."[12] The Commission has observed that, "in cases in which such information is obtained, it would enhance and improve the efficiency and effectiveness of Commission and DEA examinations of clearing broker-dealers by providing examiners with access to additional relevant information to plan their examinations."[13] While we support the objectives sought to be achieved by the Commission through the Proposal, we set forth below a number of observations and recommendations that we hope will help clarify the scope, and limit certain unintended consequences, of the Proposed Rule.

Procedures and Logistics

We note that the Proposed Rule does not address the procedures that would govern a request for access (a "Request") from the Commission or DEA. We believe it would be helpful if the Commission elaborates on the procedures applicable to both making and responding to Requests, including, as described below, the format and content of a Request.

[11] See Section III (SEC Broker-Dealer Reports), page 41.
[12] See Section III (SEC Broker-Dealer Reports), page 42.
[13] *Ibid.*

As a threshold matter, the Commission has inquired about the format for Requests. We believe the Commission should require all Requests to be made in writing. A written Request would minimize the risk of ambiguity concerning the scope of information sought by examiners. It would also provide the receiving party with clear instructions for complying with the Request, including where, when and how access to the requested information should be provided to the Commission or DEA staff.

To increase the efficiencies associated with these procedures and to encourage a more streamlined process, we suggest that the Commission consider a final rule that would require the Commission to solicit, from each independent registered public accountant of a clearing broker-dealer, the name of a designated representative who would function as a centralized point of contact within the firm for all matters relating to Requests from the Commission or DEA staff. The final rule should also provide that the Commission or DEA staff send any Requests to that designated representative.

Content of the Request

As to the content of a Request, we believe that the overall efficiency of the process would be enhanced, and the burden imposed on independent registered public accountants minimized, if the final rule were to require the Commission staff to specify in each Request the areas of inquiry that are intended to be covered in the examination of the clearing broker-dealer. Requests should also identify the specific categories (and time periods) of audit documentation to which access is being sought.

We further believe that both broker-dealers and independent registered public accountants 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 phrase "audit documentation" in PCAOB Auditing Standard No. 3, "Audit Documentation", as suggested by footnote 3 of the Proposal and the accompanying text. It would be helpful if the Proposed Rule were amended to explicitly incorporate the definition of Auditing Standard No. 3 as "Audit Documentation" for the purposes of a final rule.

Use of Audit Documentation and Findings

We view as important the Commission's express acknowledgement that it "is *not* proposing that the Commission or DEA staff would use any audit documentation they may request, or discuss findings related to the audit reports, for purposes of examining independent public accountants" and its recognition that "the PCAOB carries out that function."[14] Instead, the Commission has made clear that the Requests contemplated by the Proposed Rule "would be made exclusively in connection with conducting a regulatory examination of the clearing broker-dealer."[15]

[14] See Section III (SEC Broker-Dealer Reports), page 41 (emphasis added).
[15] *Ibid*.

We recommend that the final rule provide that every Request contain an express recitation that the information obtained by the Commission and DEA examination staff from the independent public accountant will be used "exclusively in connection with conducting a regulatory examination of the clearing broker-dealer."

Access to Information Provided to Commission and DEA Examination Staff

Given the precise parameters governing the use of audit documentation and findings provided by an independent registered public accountant, we believe it is appropriate that restrictions be placed on access to such information that is inconsistent with the statutorily permitted use.

We would therefore suggest that information provided to the Commission and DEA examination staffs pursuant to a Request be subject to, at a minimum, the Commission's existing FOIA confidential treatment procedures as set forth in the Commission's Rule 83 (17 C.F.R. 200.83).

Interaction with Commodity Futures Trading Commission ("CFTC") Regulation 1.16

Independent registered public accountants of certain broker-dealers who are also registered as Futures Commission Merchants ("FCM") with the CFTC are required to file a report under CFTC Rule 1.16 related to their review of the broker-dealer's practices and procedures in complying with CFTC Regulation 1.16.

As compliance with CFTC Regulation 1.16 is not within the scope of the Proposed Rule, certain broker-dealers will be required to provide both the management assertion and related independent registered public accountants attestation required by the Proposed Rule, as well as the existing report by the independent registered public accountants as to broker-dealers' compliance with CFTC Regulation 1.16, which may be duplicative and unnecessarily burdensome for both the broker-dealer and independent registered public accountant.

We believe it would benefit both broker-dealers and independent registered public accountants if the Commission were to work with the CFTC to resolve issues impacting broker-dealers that are also registered as a FCM.

"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").[16]

[16] See Section V.A ("Requirement to File Annual Reports").

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 independent registered public accountants's report and therefore overcome judicial authority that limited 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. 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.

Transition Timelines and Effective Dates

The effective date for the 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.

With this effective date approximately four months after the end of the Proposed Rule comment period (August 26, 2011), we have concerns about the time available for broker-dealers to prepare the additional reports and documentation needed to support their assertions. Additionally, this schedule would leave minimal time for independent registered public accountants to review, assess and comply with the new attestation and reporting requirements.

Further, by the end of the comment period, planning and interim procedures for December 31, 2011 audit engagements may have already begun. A change in the rules and procedures at that point in time would require the revision of already-established audit plans thereby creating both inefficiencies and unnecessary costs.

We also have concerns that the Proposed Rule's effective date is not aligned with the PCAOB's recent proposals for:

- Examination Engagements Regarding Compliance Reports of Brokers and Dealers,
- Review Engagements Regarding Exemption Reports of Brokers and Dealers, and
- Auditing Supplemental Information Accompanying Audited Financial Statements.

The PCAOB proposals have an effective date 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 does not coincide with the Proposed Rule's effective date of fiscal years ending on or after December 15, 2011. We believe a transition to the new rules could be accomplished more effectively and efficiently if they were to take effect at the same time as the new standards proposed by the PCAOB, September 15, 2012.

Additionally, the effective dates of proposed Form Custody and the *Access to Audit Documentation* amendments are not clear. We suggest that the SEC clarify these effective dates in its final rule.

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In closing, we would like to reiterate our support of the regulatory efforts undertaken by the Commission to improve the oversight of broker-dealer audits. We trust that our comments and observations will assist the Commission to that end.

If you have any questions regarding our comments or other information included in this letter, please do not hesitate to contact Sam Ranzilla, (212) 909-5837, sranzilla@kpmg.com, or Karl E. Ruhry, (212) 872-3133, kruhry@kpmg.com.

Very truly yours,

KPMG LLP

cc:

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

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