39 Broadway, Suite 3300, New York, New York 10006-3019

Via email: rule-comments@sec.gov

August 26, 2011

RE: Amendments to Rule 17a-5 (broker-dealer financial reporting rule) under the Securities Exchange Act of 1934 (the "Exchange Act"); File Number S7-23-11

Integrated Management Solutions USA LLC ("IMS") is pleased to comment on the SEC's proposed amendments to Rule 17a-5 (broker-dealer financial reporting rule) and custody rules (collectively, the "Proposed Amendments") under the Securities Exchange Act of 1934 (the "Exchange Act").[1] By way of background, IMS is one of the largest providers of financial accounting and compliance consulting services to the securities industry, providing such services to about 100 FINRA members, as well as to many investment advisers.[2] We believe this perspective enables us to assess the impact of the Proposed Amendments on FINRA member firms and investment advisers from both a regulatory and business perspective.

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[1] Securities and Exchange Commission, Release No, 34-64676; File No. S7-23-11 (the "Release").

[2] The statements in this comment letter incorporate the views of IMS, and not of our clients. In fact, if the Commission were to accept our recommendations, even in part, IMS's revenues from report preparation might significantly decrease since we currently prepare many of the reports the Commission and the self-regulatory organizations ("SROs") require (and propose to require) annually. Nonetheless, we have a professional obligation to evaluate this proposal objectively and assess honestly its business and regulatory costs to our clients as well as to the brokerage industry as a whole. Despite the potential decrease in IMS's report preparation revenues, we believe that our clients will use our competencies to perform other services.

The Proposed Amendments

The SEC has proposed three categories of amendments relating to broker-dealer reports. The first set of amendments affects the requirement that broker-dealers file annual financial reports with the Commission that must be audited by an independent accountant (collectively, the "Annual Reporting Amendments"). The second set of amendments would require broker-dealers that either clear transactions or carry customer accounts to "consent to access" by the Commission and designated examining authorities ("DEAs") to such firms' independent public accountants. The purpose of such purported consent is to allow the regulators to discuss with a firm's auditors the findings of their annual audits of such broker-dealers and review related audit documentation (collectively, the "Access to Audit Documentation Amendments"). The third set of amendments would require broker-dealers with custody over customers' securities and/or funds to file a new Form Custody quarterly (collectively, the "Form Custody Amendments").

What's Wrong with the Proposed Amendments

We regard the Proposed Amendments to be a knee-jerk reaction to the Dodd-Frank Wall Street Reform and Consumer Protection Act and to the Madoff debacle, a cataclysmic happening which is unlikely to recur. Instead of the over-reaction exhibited in the Proposed Amendments, we believe that not enough attention has been paid to some of the real problems in the reporting scheme, including the fact that much of it creates a tremendous burden for the 90% of FINRA's membership that is small firms whose financial statements are not necessarily relevant anyway. We further believe that the Commission would have proposed a much better version of Rule 17a-5 had it first reviewed a wonderful report that has been in its files since 2005 and adopted some of that report's recommendations.

That report, filed at www.sec.gov/rules/other/265-23/gvniesar091205.pdf, is an excellent treatise prepared by a task force of the American Bar Association Section of Business Law (the "ABA Task Force") regarding the impact of several Commission rules on private placement broker-dealers specifically. Among its recommendations was a plea for eliminating annual audit reports for many broker-dealers. Apparently, the Commission has not yet given the ABA Task Force recommendations the attention they deserve and instead has thrust upon us the Proposed Amendments.

Regrettably, our review indicates that the Proposed Amendments are based on faulty premises, and place unnecessary regulatory burdens and costs on the industry, in general, and smaller firms, in particular. The Proposed Amendments are without a corresponding supervisory or market benefit, do not enhance investor protection, and do not result in better management and internal controls for broker-dealers. They increase costs without mitigating risks. Worse, they ignore the fundamental business and regulatory realities affecting the broker-dealer industry. Although broker-dealers compete against each other for ever-shrinking commission income, they also compete against investment advisers who are not burdened by the same regulatory requirements, including, without limitation, the ones set forth in the Proposed Amendments.[3]

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[3] In January, 2011, the Staff of the SEC released the Study on Investment Advisers and Broker-Dealers, as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, discussing the possible regulatory convergence of broker-dealers and investment advisers. The Study described these two financial sectors as follows:

Current State of the Investment Adviser and Broker-Dealer Industries

Investment Advisers: Over 11,000 investment advisers are registered with the Commission. As of September 30, 2010, Commission-registered advisers managed more than $38 trillion for more than 14 million clients. In addition, there are more than 275,000 state-registered investment adviser representatives and more than 15,000 state-registered investment advisers. Approximately 5% of Commission-registered investment advisers are also registered as broker-dealers, and 22% have a related person that is a broker-dealer. Additionally, approximately 88% of investment adviser representatives are also registered representatives of broker-dealers. A majority of Commission-registered investment advisers reported that over half of their assets under management related to the

The Commission has proposed purported solutions for non-existent problems. Although we suspect that the Proposed Amendments were designed with the Madoff debacle in mind, these proposals will neither generate useful information nor, more importantly, increase either the effectiveness or efficiency of the national exam program. For example, only a very small number of brokers will have anything of substance to report to a regulator in the proposed Compliance Report, but the majority would have to bear the burden of the proposed Exemption Report. The travesty is that regardless of what is contained in either report, each would have to be independently verified by an independent accountant. Perhaps good for the accounting industry, but needlessly expensive and burdensome for most broker-dealers.[4]

Another devastating effect of the Proposed Amendments results from Commission and Public Company Accounting Oversight Board ("PCAOB") rules regarding accountant independence that will deprive the financial services sector of much needed business advice that those accountants could render. While PCAOB-approved, independent accountants are busily

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accounts of individual clients. Most investment advisers charge their clients fees based on the percentage of assets under management, while others may charge hourly or fixed rates.

Broker-Dealers: The Commission and FINRA oversee approximately 5,100 broker-dealers. As of the end of 2009, FINRA-registered broker-dealers held over 109 million retail and institutional accounts. Approximately 18% of FINRA-registered broker-dealers also are registered as investment advisers with the Commission or a state. Most broker-dealers receive transaction-based compensation.

[4] We note that the only comparable reporting requirement affecting investment advisers is for those few investment advisers that maintain custody of customer funds and/or securities; this applies to a minority of investment advisers, not the entire industry. The new Form Custody for broker-dealers with custody over customer assets is the only one of the Proposed Amendments that equalizes the treatment between these two financial industry sectors. However, such equality is expensive. Although we agree, in concept, that Form Custody is appropriate for custodial broker-dealers, the Commission has proposed that Form Custody be filed on a quarterly basis. The Commission has estimated that requirement would result in 20,228 annual responses, with a total annual hour burden of 242,736 hours. Thus, the Commission anticipates that the annual Form Custody cost to the industry will be a staggering $69,179,760. Release, ftns. 215-217 and accompanying text. That number is surreal and such costs would likely indirectly be passed on to customers. We hope that the cost-benefit analysis articulated by the Commission in the Release is reasonably accurate. We are aware that a recent appellate court decision held, in the proxy rules context, that the Commission had failed adequately to consider the rule's effect upon efficiency, competition, and capital formation. <u>Business Roundtable and Chamber of Commerce of the United States of America v. Securities and Exchange Commission</u> (D.C. Cir. July 22, 2011).

signing off on all these audits and new reports, they become disqualified from providing business advice to the clients whose business they understand at a granular level. A true waste!

If nothing else, the Proposed Amendments are premature. What is needed is a serious evaluation of the broker-dealer and investment adviser industries from regulatory, financial and business perspectives. If these two sectors will converge, as suggested in the Study identified in footnote 2, above, then the Proposed Amendments become largely meaningless other than for entities with custody over customer assets. If it is thereafter determined that the reports mandated by the Proposed Amendments continue to be of value to the Commission they should instead be targeted at the small minority of firms that will act as the equivalent of carrying and/or clearing brokers.

<u>The Fallacy of these Proposed Reports</u>

Requiring broker-dealers to prepare and submit reports misses the point. The Proposed Amendments apply across the board to almost all broker-dealers regardless of the nature of their regulator-approved business activities.[5] The vast majority of brokerage firms are neither carrying nor clearing brokers. Many firms only broker securities transactions on an agency basis. Others only engage in private placement transactions or trade for their own proprietary accounts in a manner similar to that of institutional clients. Yet most are subject to the enhanced burdens – and costs – of the new reports the SEC has mandated in the Proposed Amendments. Given the nature of the activities described above, these firms are too small to have much impact on any market for any reason. They do not create systemic risk; nor are most of their customers at risk given that their customers' assets are held by clearing or carrying brokers. In fact, as

[5] We note that the Proposed Amendments continue to exempt many broker-dealers from the requirement to file an audited annual report. <u>See</u>, <u>infra</u>.

noted by the ABA Task Force, the filing of FOCUS Reports and annual audited reports, among others, by such firms "…do little to provide investor protection."[6] Many safeguards are already built into the existing reporting requirements for firms engaged in the more limited forms of securities business that are, nonetheless, required to register with the SEC because they earn transaction-based compensation. A viable alternative approach would be to allow insurance bonds to protect counterparties, such as customers of the smaller broker-dealers. Our intuition tells us that the cost of those bonds would be far less than the cost of annual audits, which the owners of many smaller broker-dealers do not find particularly useful.

The primary targets of the Proposed Amendments are carrying and clearing broker-dealers (many of which overlap) that, if the Proposed Amendments take effect in their current form, will have to submit additional reports to their regulators, each of which, in turn, will have to be audited by independent accountants. The SEC's Release itself demonstrates why its approach is misguided. In the mandatory section of the Release, which purportedly demonstrates the Commission's compliance with the Paperwork Reduction Act (Part VI), the Commission states there were 5,063 broker-dealers registered with the Commission as of year-end 2009. Of those registered broker-dealers, only 305 (approximately 6%) are carrying broker-dealers and only 528 (approximately 10%) are clearing broker-dealers; there is overlap in these two categories. Yet the entire industry is required to shoulder these <u>additional</u> costs, despite the fact that only the reports submitted by carrying and clearing broker-dealers will generate potential market-impact information. The SEC itself estimates an astonishing $45,750,000 annually in additional costs just for the 305 broker-dealers that maintain custody over customer assets.[7] A

[6] ABA Task Force, p. 47 ("Capitalization and Financial Recordkeeping and Reporting Requirements").
[7] Ftn. 202 of the Release sets out the calculation; it amounts to $150,000 annually per broker-dealer. The Commission estimates clearing broker-dealers would incur an additional $660,000 per year in annual costs. Release, ftn. 209 and corresponding text. Other staggering numbers are also stated in the Release, <u>e.g.</u>, the total

lot of paperwork will be generated annually that will provide very little of substance, even from carrying and clearing broker-dealers. Of course, these costs would be passed on to customers. As most of this paperwork, and the related audited reports, will only prove a negative, this is not effective risk management. Nor would these proposed reports have pre-empted the Madoff debacle or any similar disaster such as Gruttadauria[8], where customers were provided with fake confirmations or statements purporting to reflect transactions that occurred or securities held on their behalf by a clearing or carrying broker, but which transactions or securities did not exist in the real world. Where's the logic in that? This is the proverbial tail wagging the dog.

The only FINRA members that rely on the financial standing of non-custodial broker-dealers are the clearing and carrying brokers – and they have deposits and other collateral from the non-custodial firms. Ordinary customers rightfully assume they are protected by the fact that the Commission and SROs routinely make sure that custodial brokers are audited and examined, much as most individuals rely on regulators who examine, at least annually, banks, insurance companies and similar financial intermediaries.

But there is an even more critical fallacy at work here. The financial services industry is not a level playing field. Let's look at the broker-dealer registration process for a moment. A FINRA New Member Application ("NMA"), which takes approximately four to six months to process, specifically asks for information about whether the broker will be a carrying and/or clearing broker-dealer and whether it will have custody of customer funds and/or securities. Most applicants end up not becoming carrying or clearing firms. Up until now, that has provided sufficient regulatory oversight. If a broker-dealer wants to change the scope of its operations so

recordkeeping burden from the Proposed Amendments would be approximately 287,325 hours on an annual basis and 10,214 hours on a one-time basis. Release, ftns. 176 and 177 and corresponding text. Didn't these absurd numbers give anybody pause?

[8] See http://sec.gov/litigation/complaints/complr17369.htm

that it becomes a carrying or clearing firm, it would first have to notify its regulatory coordinator. FINRA would then make the appropriate adjustments to that firm's reporting requirements after it diligently studies the firm's preparedness for such event.

Moreover, as part of the NMA, a broker-dealer has to satisfy FINRA that it has enough net capital to operate. The minimum net capital levels applicable to the vast majority of broker-dealers protect hardly anyone, in particular, a firm's customers. That's because the capital that protects customers or other counterparties is contained within the capitalization of the carrying or clearing firms, not within the typical broker-dealer whose functions are non-custodial.

In contrast, approval of an investment adviser by the Commission takes no more than 45 days; normally, it's less. Comparable periods generally apply in the various states. Investment advisers manage billions in assets and none has a net capital requirement unless they have custody of customer assets. Although investment advisers are subject to periodic audits from the states where they have customers and/or the Commission, they do not have to file the monthly FOCUS Reports required of most broker-dealers. Moreover, unless a particular investment adviser has custody of customer assets, those audits are few and far between. Many states do not even have an audit requirement for investment advisers that don't have custody. Does the public suffer from this looser regulatory scheme?

<u>What the Commission Failed to Fix in Proposed Rule 17a-5</u>

Purportedly, the Commission reviewed all of Rule 17a-5 to prepare the Release. Obsolete provisions in the Rule were deleted. Yet the Commission ignored several provisions in Rule 17a-5 where a simple fix would benefit all, at no cost, and bring the Rule in line with modern business practices.

A. The Majority of Broker-Dealers Should be Exempt from the Proposed Amendments

Protection of the marketplace will not result from making all broker-dealers file reports for activities carried out only by a small minority of broker-dealers. Regulate only those whose business activities carry sufficient risk to warrant such additional regulation and the concomitant costs. For example, Rule 17a-5(d)(1)(iii) currently provides the following exemption from filing annual audited financial statements:

> A broker or dealer which is a member of a national securities exchange and 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, shall not be required to file a report under this paragraph.

Using data available on the Commission's own website, we at IMS surveyed all of the broker-dealers whose headquarters are in Chicago, the home of the Chicago Board Options Exchange ("CBOE"), and discovered that approximately 30% of them do not currently file audited annual reports with the Commission. Presumably, that is so because many of the Chicago broker-dealers are floor members of the CBOE and qualify for the exemption quoted above.

This exemptive provision has applied for many years with no problems. Many more broker-dealers should be similarly exempted if they are non-custodial, e.g., proprietary traders; providers of execution platforms that execute transactions automatically; introducing firms; etc. Required annual audit reports do not help the majority of these firms or the general public.

B. Modernize Mandatory Attestations

Instead of requiring costly reports that will fix nothing, the Commission should take this opportunity to conform its rules to generally accepted business laws. Rule 17a-5(e) has resulted in numerous rejections by FINRA of annual audited financial statements submitted on behalf of limited liability companies ("LLCs") and similar entities, together with an attestation executed by a member's chief financial officer, because FINRA examiners insist on reading that subsection literally or are interpreting the rule to cover LLCs as if they were partnerships. Currently, Rule 17a-5(e) (quoted below) does not specifically cover LLCs (a most common form of business organization) and its reference to partnerships assumes that a general partner is a natural person.[9]

> e. The [annual audited] financial statements filed pursuant to paragraph (d) of this section shall be prepared and filed in accordance with the following requirements:
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> * * * * *
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> 2. Attached to the report shall be an oath or affirmation that, to the best knowledge and belief of the person making such oath or affirmation,
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> i. the financial statements and schedules are true and correct and
>
> ii. neither the broker or dealer, nor any partner, officer, or director, as the case may be has any proprietary interest in any account classified solely as that of a customer. The oath or affirmation shall 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 shall be made by the proprietor; if a partnership, by a general partner; or if a corporation, by a duly authorized officer.**
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> (SEC Rule 17a-5(e) (emphasis added)).

Ironically, the CFTC has updated its regulations and gotten it almost right. CFTC Regulation 1.10, a regulation that, for the most part, is somewhat similar to Rule 17a-5, states:

> 4. Attached to [the report] must be an oath or affirmation that to the best knowledge and belief of the individual making such oath or affirmation the information contained * * * is true and correct. The individual making such oath or affirmation must be:
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> i. If the registrant or applicant is a sole proprietorship, the proprietor; if a partnership, any general partner; if a corporation, the chief executive officer or chief financial

[9] Currently, many partnerships have a corporate or LLC general partner to limit the unlimited liability that a natural person would have as a general partner.

> officer; and, if a limited liability company or a limited liability partnership, the chief executive officer, the chief financial officer, the manager, the managing member, or those members vested with the management authority for the limited liability company or a limited liability partnership; * * *
>
> (CFTC Regulation 1.10(d)(4)).

Oaths, etc. should be made by the person responsible for the books and records or reports of the broker or dealer. NASD Rule 1022(b), for example, clearly states that the person rendering final approval of a report filed with securities industry regulatory bodies must be a duly registered Financial and Operations Principal of the firm who is its chief financial officer. Limited liability company statutes were first introduced in 1977. This form of business entity is now accepted nationwide. It's time for the Commission to get onboard. *Tempus Fugit.*

C. The Timing Requirements Conflict with those of CFTC

The reports required under the Proposed Amendments "…shall be filed not more than sixty (60) days after the date of the financial statements." See, proposed Rule 17a-5(d)(5). Yet CFTC Regulation 1.10 mandates filing

> … no later than **90 days** after the close of the * * * fiscal year; Provided, however that a registrant which is **registered with the Securities and Exchange Commission** as a securities broker or dealer must file this report **not later than the time permitted for filing an annual audit report under §240.17a-5(d)(5) of this title**.
>
> (CFTC Regulation 1.10(b)(1)(ii) and (2)(ii)(A) (emphasis added)).

We think that, once again, the CFTC got it right. December 31st is the preponderant audit date for most broker-dealers, especially LLCs and partnerships. Assuming that the Commission continues to insist that non-custodial firms are subject to an annual audit, it should recognize that there are not enough qualified audit personnel to perform audits for the December 31st deadline with the same vigor as there would be if the filing period were moved to 90 days instead of 60. Let's face it, the results of an audit are old news anyway. Another 30 days shouldn't matter much to any potential reader of the financial statements.

D. Designation of Accountants

Requiring a firm to designate its accountant 30 calendar days after effective registration with an SRO is fine (Rule 17a-5(f)(2)). In our experience, however, certain SRO offices have demanded earlier accountant designations by proposed new members. We believe that the Commission is correct on this point. The SROs should apply Rule 17a-5(f)(2) uniformly, as written, and not require an earlier compliance date.

E. Electronic Filing of Reports

Broker-dealers should have the option to file reports required under the Proposed Amendments electronically, perhaps as PDFs. We note that they are available on the Commission's website in that format anyway. Wouldn't it be nice to eliminate the wasteful exercise of scanning the paper filings?[10]

* * * * *

The current audit and reporting requirements have not failed the general public or the marketplace. What did fail was the regulatory process, and the audit of at least one broker-dealer was not performed in accordance with existing regulations. Presumably, in that particular case, Madoff, the Proposed Amendments would not have made any difference in the quality of the reporting or in the annual audited report itself since it was deliberately fraudulent and deceitful. There is little business or regulatory justification for imposing these additional reporting

[10] In this regard we note that President Obama has issued presidential proclamations regarding eliminating waste. The benefit for broker-dealers is that they will be able to organize their documents easily, will be able to overstamp confidential documents so that they are not misfiled, and will gain extra time to file their reports since the reports would be received as soon as they are transmitted. A win-win for all concerned.

requirements and onerous costs of the Proposed Amendments on non-custodial broker-dealers, which constitute the majority of the industry.

Thank you for the opportunity to comment on this matter. Should you have any further questions, feel free to call Howard Spindel at 212-897-1688 or Cassondra Joseph at 212-897-1687, or by e-mail at **hspindel@intman.com** or **cjoseph@intman.com,** respectively.

Very truly yours,

Howard Spindel
Senior Managing Director

Cassondra E. Joseph
Managing Director

cc: Hon. Mary L. Schapiro
Hon. Luis A. Aguilar
Hon. Troy Paredes
Hon. Elisse B. Walter
Mr. Robert W. Cook
Mr. Michael A. Macchiaroli
Mr. Thomas K. McGowan
Mr. Randall W. Roy
Mr. Mark M. Attar
Mr. John F. Offenbacher