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

26 August 2011

**Re: Proposed Rule on Broker-Dealer Reports (File No. S7-23-11)**

Dear Ms. Murphy:

Ernst & Young LLP is pleased to comment on the Securities and Exchange Commission's (SEC or Commission) proposed amendments to the broker-dealer financial reporting rule under the Securities Exchange Act of 1934 (the Proposed Rule) and related commentary (the Proposing Release).

We generally support the Proposed Rule and believe it is a necessary step in updating broker-dealer financial reporting.[1] We also believe the Proposed Rule would provide the clarity necessary for the Public Company Accounting Oversight Board (PCAOB) to develop and adopt appropriate auditing and reporting standards for auditors of registered broker-dealers as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

With regard to the Proposed Rule:

- We recommend the Commission publish additional guidance to further define instances of material non-compliance, given the heightened reporting and notification requirements for material non-compliance matters contemplated in the Proposed Rule.
- We recommend that the proposed assertion in the Compliance Report relating to the effectiveness of internal control over compliance with the Financial Responsibility Rules pertain to an assessment as of a point in time, the broker-dealer's fiscal year-end, rather than the entire fiscal year. A point-in-time assessment would be consistent with the requirement for issuers subject to internal control reporting under Section 404 of the Sarbanes-Oxley Act of 2002 (SOX 404), and consistent with the point-in-time requirement for the report on internal control currently required by SEC Rule 17a-5. We would, however, support allowing broker-dealers that also are subject to the Investment Adviser (IA) Custody rule to elect to the make the proposed assertion pertain to the entire fiscal year to satisfy their reporting requirements under the IA Custody Rule.
- We do not support the notification requirements outlined in the Proposed Rule. We believe the notification requirements that currently exist in Rule 17a-5 are sufficient to address the Commission's objectives.

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[1] 17 CFR 240.17a-5

- We do not support the performance of a review engagement, as contemplated by the PCAOB's interim attestation standards, of a broker-dealer's assertion that it is exempt from Rule 15c3-3. Instead, we support requiring the performance of an agreed-upon procedures engagement, with suitable procedures developed for such an engagement, or an examination engagement, with suitable criteria developed for such an examination. We further recommend aligning the effective dates of the Proposed Rule and the proposed PCAOB standards for attestation engagements related to broker and dealer compliance or exemption reports required by the SEC.

- We recommend eliminating the proposed transition period and deferring the effective date to fiscal years ending on or after 15 December 2012 to give both broker-dealers and their auditors the time to adequately address final rules.

- We do not support the "clean up" amendment in the Proposed Rule that would expand the ability of the Securities Investor Protection Corporation (SIPC) to bring lawsuits against the independent auditors of broker-dealers.

- We also believe clarifying certain other aspects of the Proposed Rule, as outlined below, would facilitate more consistent application and compliance by both broker-dealers and auditors.

We have organized our detailed comments consistent with the structure of the Proposing Release.

## I Annual reporting amendments

### 1. *Clarification of the definition of material non-compliance*

The Proposed Rule defines an instance of material non-compliance as a "failure by the broker-dealer to comply with any of the requirements of the Financial Responsibility Rules in all material respects."[2] The Financial Responsibility Rules are identified in the Proposed Rule as (1) Rule 15c3-1, (2) Rule 15c3-3, (3) Rule 17a-13 and (4) the Account Statement Rule.

The Proposing Release notes that the consideration of whether an instance of non-compliance is material should include "all relevant factors including but not limited to (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] We believe the Proposed Rule does not provide sufficient implementation guidance to assist broker-dealers and auditors in assessing the factors relevant to determining whether an instance of non-compliance for each of the identified Financial Responsibility Rules is material. Without additional implementation guidance, we believe it likely that broker-dealers and auditors will frequently disagree about whether instances of non-compliance are material, which we do not believe furthers the objectives of the Proposed Rule.

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[2] See proposed paragraph (d)(3)(ii) of Proposed Rule 17a-5.

[3] See Proposing Release, Section II.B.1.

We have included the following questions to help highlight the areas in which significant differences in interpretation are likely without additional implementation guidance:

- Would a different materiality assessment be made with regard to each of the Financial Responsibility Rules, given that the first two are more quantifiable than the second two?
- For Rules 15c3-1 and 15c3-3, would an error that was quantitatively significant in the calculation of net capital or the customer reserve formula but which did not result in a failure to maintain either the minimum amount of net capital or the adequate amount of segregated cash or qualified securities constitute an instance of material non-compliance?
- What level of consideration should be given to qualitative factors in evaluating an instance of material non-compliance with Rule 17a-13 and the Account Statement Rule? For example, would the determination of whether the failure to send a single customer statement is a material non-compliance event be based on the total population of customer statements required to be sent (one of five versus one of five thousand)? Furthermore, if one or more customer statements contained errors or omissions of certain required information, would such errors or omissions be evaluated as instances of material non-compliance based on the materiality of such items to the individual customer statement or to the dollar value of all customer statements?
- How specifically should an error or misstatement discovered during the audit of a broker-dealer's financial statements be evaluated in assessing whether an instance of material non-compliance has occurred?

We believe that having clear and defined standards to identify instances of material non-compliance is important, given the notification requirements in the Proposed Rule. In particular, we believe that including examples of instances of material non-compliance with respect to each of the Financial Responsibility Rules would be informative.

2. *Compliance Report requirements*

The Proposed Rule would require carrying broker-dealers to file a new report asserting compliance with the Financial Responsibility Rules and related internal control and an examination report from their independent public accountants that addresses the assertions in the compliance report.

- One of the three assertions to be made by the broker-dealer is "whether the information used to assert compliance with the Financial Responsibility Rules was derived from the books and records of the broker-dealer."[4] While the Financial Responsibility Rules are defined, the term "books and records" is not defined and should be clarified. For example, is this meant to refer to the SEC Rule 17a-3 - Records to be Made by Certain Exchange Members?

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[4] See proposed paragraph (d)(3)(i)(B)(2) of Rule 17a-5.

- Another of the three assertions to be made by the broker-dealer is "whether the broker-dealer was in compliance in all material respects with the Financial Responsibility Rules as of its fiscal year-end."[5] We note that broker-dealers may need to interpret certain requirements of the Financial Responsibility Rules when such rules do not specifically address an aspect of their operations. In other cases, the broker-dealer may be relying on informal interpretations obtained through dialogue with the SEC and (or) its designated examining authority (DEA) in its application of the Financial Responsibility Rules. To better support the assertions made in these circumstances, we recommend that the Commission require broker-dealers to formally document such interpretations and obtain evidence of agreements reached with the SEC and (or) their DEA when they have relied on interpretations not specifically referenced in the Financial Responsibility Rules.

- The Proposed Rule indicates that a "broker-dealer could not assert compliance with the Financial Responsibility Rules, as of its most recent fiscal year-end, if it identifies one or more instances of material non-compliance."[6] We recommend clarifying whether a broker-dealer with an instance of material non-compliance during the year that is remediated by year-end would be required to identify the instance of material non-compliance in its Compliance Report.

  Similarly, the Proposed Rule notes 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."[7] The requirement for management to assert in the Compliance Report to the effectiveness of internal control over compliance with the Financial Responsibility Rules for a period covering the entire fiscal year is a different standard than for issuers subject to internal control reporting under SOX 404, which is a point-in-time assessment. We understand that the proposed assessment period is consistent with requirements in the IA Custody Rule and therefore would allow a dually registered broker-dealer to use the Examination Report to satisfy its reporting requirements under the IA Custody Rule. For carrying broker-dealers that are not subject to the IA Custody Rule, we do not believe that the incremental benefit of having the proposed assertion pertain to the entire fiscal year rather than the year-end assessment date justifies the costs. As an alternative, we support allowing broker-dealers that also are subject to the IA Custody rule to elect to the make the proposed assertion pertain to the entire fiscal year to satisfy their reporting requirements under the IA Custody Rule.

3. *Notification requirements*

   The Proposed Rule would require that the "independent public accountant notify the Commission within one business day if the accountant determines that an instance of material non-compliance exists with respect to any of the Financial Responsibility Rules."[8] We are concerned about the practicality of this proposal and whether it could be effectively

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[5] See proposed paragraph (d)(3)(i)(B)(1) of Rule 17a-5.

[6] See proposed paragraph (d)(3)(ii) of Rule 17a-5.

[7] See proposed paragraph (d)(3)(iii) of Rule 17a-5.

[8] See proposed paragraph (h) of Rule 17a-5.

implemented. While we support the Commission's objective of having timely information to react to instances of non-compliance, we believe that the current reporting framework already provides for timely reporting. Rule 17a-5 requires that the auditor notify the broker-dealer's chief financial officer (CFO) of the existence of a material inadequacy.[9] The CFO is then obligated to notify both the Commission and its DEA within 24 hours.[10] If the broker-dealer fails to make such notification or the independent public accountant disagrees with the broker-dealer's statements in the notification, the independent public accountant would then have the responsibility to notify the SEC and the DEA within 24 hours.

We acknowledge the proposed change would align the notifications with the Custody Rule, but do not believe such alignment is necessary, given the other auditing and reporting responsibilities already in place or proposed.

We believe that the current notification framework meets the Commission's overall objectives and should be modified solely to incorporate instances of material non-compliance under the Financial Responsibility Rules.

4. *Exemption Report*

The Proposed Rule would require broker-dealers that do not hold customer funds or securities to file a new report asserting their exemption from the requirements of Rule 15c3-3 accompanied by a review report from their independent public accountants based on management's assertion regarding exemption from Rule 15c3-3.

We note that the Proposed Rule does not specify whether the assertion regarding exemption from the requirements of Rule 15c3-3 is as of the broker-dealer's fiscal year-end or for the entire fiscal year. We request clarification as to the time period for the assertion, and we believe a point-in-time assertion would be sufficient.

Moreover, we do not support the performance of a review engagement of a broker-dealer's assertion that it is exempt from the requirements of Rule 15c3-3 and do not believe that a review engagement should be employed in these circumstances. Specifically, we do not believe that inquiry and observation, the standard procedures performed in a review engagement, would provide sufficient evidence regarding a broker-dealer's assertion that it is exempt from the requirements of Rule 15c3-3. In making this recommendation, we note that the PCAOB's interim attestation standards (AT section 601, *Compliance Attestation*) states that an auditor should not accept an engagement to perform a "review" level of service related to an entity's compliance with specified requirements, or an assertion thereon. As an alternative, we would support the performance of an agreed-upon procedures engagement (addressing the results of procedures specified by the SEC) related to a broker-dealer's exemption from the requirements of Rule 15c3-3. We would also support requiring the performance of an examination engagement, as contemplated by existing attestation standards, relating to such an assertion, if suitable criteria were developed for such an examination.

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[9] Rule 17a-5(h)(2)

[10] Rule 17a-11(e) and (g)

5. *Effect of change from GAAS to PCAOB standards*

   As noted in the Proposing Release, PCAOB auditing standards differ from the existing US Generally Accepted Auditing Standards (GAAS). The Proposing Release cites two specific PCAOB standards that are currently not required for broker-dealer audits performed under GAAS: PCAOB Auditing Standard 3 (audit documentation requirements) and PCAOB Auditing Standard 7 (engagement quality review). However, audit firms will need to review and evaluate the full body of PCAOB auditing standards (excluding those specifically required for integrated audits) to identify and evaluate all relevant changes to their audit methodologies for broker-dealers.

   The proposed effective date for the related PCAOB proposals for the auditor's examination report on compliance and other required reports applicable to brokers and dealers is for fiscal years ending on or after 15 September 2012, the proposed end of the transition period for SEC Proposed Rule 17a-5. If SEC Proposed Rule 17a-5 is effective 15 December 2011, these new PCAOB standards will not yet be effective and may create confusion as to what guidance auditors should use during this interim period. We recommend aligning the effective dates of these requirements so that SEC Proposed Rule 17a-5 and the proposed PCAOB standards are effective at the same time.

   It also may be important to consider the effect of the proposed changes to the PCAOB's other rule related to the interim inspection program for broker-dealer audits. If the proposed effective dates are adopted, the PCAOB could be inspecting broker-dealer audits currently performed under US GAAS, broker-dealer audits performed under current PCAOB standards (excluding the proposed standards referred to above) and broker-dealer audits performed under revised PCAOB standards (following the adoption of the proposed standards).

6. *Transition timelines and effective date for adoption*

   The proposed effective date for SEC Proposed Rule 17a-5 is for annual reports filed with the SEC for fiscal years ending on or after 15 December 2011. The SEC also intends to implement a transition period for carrying broker-dealers subject to the Compliance Report requirement with fiscal years ending on or after 15 December 2011 but before 15 September 2012.

   As the comment period for SEC Proposed Rule 17a-5 ends 26 August 2011, there is very little time for broker-dealers to prepare for the new SEC reporting requirements and for independent auditors to comply with the new PCAOB standards. There are a number of other clarifying points enumerated above that need to be addressed in order for both broker-dealers and their auditors to effectively comply with the new requirements. Therefore, we recommend eliminating any transition period for carrying broker-dealers and deferring the effective date of the Proposed Rule to fiscal years ending on or after 15 December 2012. We believe this will give broker-dealers and their auditors the time required to effectively address the final rules.

7. *Interaction with Commodity Futures Trading Commission (CFTC) Regulation 1.16*

Independent auditors of certain broker-dealers that are either dually or solely registered as futures commission merchants (FCMs) with the CFTC are required to file a report under CFTC Regulation 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 dually registered as FCMs and with the SEC would be required to provide both the existing report required by CFTC Regulation 1.16 and either the Compliance or Exemption Report required by the Proposed Rule.

We recommend that the SEC work with the CFTC to include the requirements of Regulation 1.16 in the Proposed Rule to avoid the potential confusion and cost of having dual reporting frameworks.

## II Access to audit documentation amendments and Form Custody amendments

1. *Access to audit documentation*

The Proposed Rule would require "each clearing broker-dealer to consent to permitting its independent auditors to make available to Commission and DEA examination staff the audit documentation associated with its annual reports required under Rule 17a-5 and to discuss findings relating to the audit reports with Commission and DEA examination staff."[11]

We recommend that the Commission clarify the process to request audit documentation and which audit documents could be requested. For example, would requests cover audit documentation related only to the current year?

The Commission indicates in the Proposing Release that such requests would be made exclusively in connection with a regulatory examination of the clearing broker-dealer and not to examine independent auditors, which is a task performed by the PCAOB. We think this point should be made clear in the rule text itself. Thus, Rule 17a-5(f)(2)(ii)(F) should include a phrase such as, "such review being made solely for the purpose of conducting an examination of the clearing broker-dealer," and Rule 17a-5(f)(2)(ii)(G) should say "such discussion taking place solely for the purpose of conducting an examination of the clearing broker-dealer."

2. *Transition timelines and effective date for adoption*

We recommend clarifying the proposed effective date for Form Custody and Access to Audit Documentation amendments. The Proposed Rule is very specific about the effective dates for the annual reporting requirements, but it is less definitive about the effective dates for the Form Custody and Access to Audit Documentation amendments.

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[11] See proposed paragraph (f)(2)(ii)(F) and (G) of Rule 17a-5.

## III Additional amendments to Rule 17a-5

We are concerned with one of the "clean up" amendments discussed in Section V of the Proposing Release.

This amendment would require that broker-dealers file copies of their annual reports with SIPC. The stated reason for the change is that, under existing case law in New York, SIPC cannot successfully bring lawsuits against independent accounting firms because SIPC "was not a recipient of the annual audit filing and could not have relied on it."

This is not merely a "clean up" amendment to the broker-dealer rules. Establishing a new SEC regulatory requirement in order to expand accountant liability in private litigation is unprecedented to our knowledge and should be the subject of careful consideration and discussion and should not be included in a lengthy rulemaking release dealing with other topics. This is a matter that Congress might more appropriately consider; yet, in the Dodd-Frank Act, there is never any mention of a need to expand the already considerable liability imposed on the accounting profession. The proposal is particularly misplaced because the SIPC's ability to sue the accounting profession and others for money damages in such circumstances has been a source of extensive judicial analysis, including two cases in which the United States Supreme Court has rejected SIPC's efforts to assert such claims.[12] Accordingly, we urge the Commission to table this proposal.

## Conclusion

In summary, we generally support the objectives of the Proposed Rule and believe the proposed amendments to SEC Rule 17a-5 are a necessary step in updating the existing requirements. We encourage the Commission to clarify the elements of the Proposed Rule discussed above to facilitate consistent application and compliance. We also encourage the Commission to delay the effective date of the Proposed Rule to coincide with the effective dates for the PCAOB standards for auditors to perform the required Compliance Examination Report or Exemption Review Report and to report on supplementary information.

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We would be pleased to discuss our comments with the Commission or its staff at your convenience.

Very truly yours,

Ernst & Young LLP

[12] See Holmes v. SIPC, 503 U.S. 258 (1992); Touche Ross & Co. v. Redington, 442 U.S. 560 (1979).