

**ASSOCIATION YEAR 2011-2012**

**CHAIR**

Linda J. Rusch  
P.O. Box 3528  
721 North Cincinnati Street  
Spokane, WA 99220

**CHAIR-ELECT**

Martin E. Lybecker  
607 Fourteenth Street NW  
Washington, DC 20005

**VICE CHAIR**

Dixie Johnson  
Suite 800  
1001 Pennsylvania Avenue, NW  
Washington, DC 20004

**SECRETARY**

Paul "Chip" Lazard Lion, III  
755 Page Mill Road  
Palo Alto, CA 94304

**BUDGET OFFICER**

Renie Yoshida Grohl  
8300 Fox Hound Run, NE  
Warren, OH 44484

**CONTENT OFFICER**

Jonathan C. Lipson  
975 Bascom Mall  
Madison, WI 53706

**IMMEDIATE PAST CHAIR**

Lynne B. Barr  
Exchange Place  
53 State Street  
Boston, MA 02109

**SECTION DELEGATES TO**

**THE ABA HOUSE OF DELEGATES**

Lynne B. Barr  
Boston, MA

Mary Beth Clary  
Naples, FL

Maury B. Poscover  
St. Louis, MO

Steven O. Weise  
Los Angeles, CA

**COUNCIL**

Margaret M. Foran  
Newark, NJ

Lawrence A. Hamermesh  
Wilmington, DE

Myles V. Lynk  
Tempe, AZ

Christopher J. Rockers  
Kansas City, MO

Jolene A. Yee  
Modesto, CA

Doneene Keemer Damon  
Wilmington, DE

Jean K. FitzSimon  
Philadelphia, PA

Lawrence A. Goldman  
Newark, NJ

Joel I. Greenberg  
New York, NY

Donald C. Lampe  
Greensboro, NC

Warren E. Agin  
Boston, MA

Patrick T. Clendenen  
Boston, MA

Frances Gauthier  
Geneva, Switzerland

Samantha Horn  
Toronto, ON

Peter J. Walsh, Jr.  
Wilmington, DE

Michael St. Patrick Baxter  
Washington, DC

Carol Hansell  
Toronto, ON

Ben F. Tennille  
Winston Salem, NC

Vicki O. Tucker  
Richmond, VA

James J. Wheaton  
Virginia Beach, VA

**BOARD OF GOVERNORS**

**LIAISON**

Barbara Mendel Mayden  
Nashville, TN

**SECTION DIRECTOR**

Susan Daly Tobias  
Chicago, IL  
(312) 988-6244  
susan.tobias@americanbar.org

321 North Clark Street

Chicago, IL 60654

(312) 988-5588

Fax: (312)988-5578

[www.ababusinesslaw.org](http://www.ababusinesslaw.org)

businesslaw@americanbar.org

September 15, 2011

**BY EMAIL AND U.S. MAIL**

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

**Re: File No. S7-23-11  
Release No. 34-64676  
Proposed Rules for Broker-Dealer Reports**

Ladies and Gentlemen:

This letter is submitted on behalf of the Federal Regulation of Securities Committee (the "Committee") of the Business Law Section (the "Section") of the American Bar Association (the "ABA") in response to the request for comments by the Securities and Exchange Commission (the "Commission") in its June 15, 2011 release referenced above (the "Proposing Release").<sup>1</sup> The comments expressed in this letter represent the views of the Committee only and have not been approved by the ABA's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, this letter does not represent the official position of the Section.

The Proposing Release proposes amendments to existing rules that would apply to the broker-dealer financial reporting rule under the Securities Exchange Act of 1934 (the "Exchange Act") (collectively, the "Proposed Amendments"). The first set of amendments would, among other things, change the existing requirements of Exchange Act Rule 17a-5 to enable the Public Company Accounting Oversight Board (the "PCAOB") to implement oversight of independent public accountants ("IPAs") of broker-dealers as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), and eliminate potentially redundant requirements for certain broker-dealers affiliated with, or dually-registered as, investment advisers. The second set of amendments would require broker-dealers that either clear transactions or carry customer accounts to consent to allowing the Commission and designated examining authorities ("DEAs") to have access to IPAs to discuss their findings with respect to annual audits of the broker-dealers and to review related audit documentation.

<sup>1</sup> 76 Fed. Reg. 33420 (June 8, 2011).

The third set of amendments would, in the view of the Commission, enhance the ability of the Commission and examiners of a DEA to oversee broker-dealers' custody practices by requiring broker-dealers to file a new Form Custody.

#### I. CLARIFICATION OF THE TERM "MATERIAL NON-COMPLIANCE"

Proposed paragraph (d)(3)(ii) of Rule 17a-5 defines the term material non-compliance to be "...a failure by the broker or dealer to comply with the requirements of §§ 240.15c3-1, 240.15c3-3, and 240.17a-13 or the Account Statement Rule in all material respects." The release further states that "[W]hen determining whether an instance of non-compliance is material, the Commission preliminarily believes that the broker-dealer should consider 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."

IPAs prepare and apply presumptive materiality thresholds when auditing broker-dealers. However, it is not clear to us how those thresholds would be applied for purposes of reviewing Rules 15c3-1 and 15c3-3. Moreover, the Release does not provide any guidance about what would constitute material non-compliance in the context of box counts under Rule 17a-13 and account statements under FINRA or other applicable self-regulatory organizations, and those are not areas in which IPAs have established standards for evaluating materiality. We believe that further clarification of the term "material non-compliance" would be helpful to both broker-dealers in filing their Compliance Report as well as their IPAs when evaluating the assertions made in that report. In particular, specific guidance and examples regarding non-quantifiable and qualitative concerns that could be considered to be included within the definition of material non-compliance would be beneficial.

#### II. NOTICE OF MATERIAL NON-COMPLIANCE

Proposed paragraph (h) of Rule 17a-5 would require that "[U]pon 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..." Presently, if the IPA determines that a material inadequacy exists, current paragraph (h)(2) provides that:

"...the independent public accountant shall call it to the attention of the chief financial officer of the broker or dealer, who shall have a responsibility to inform the Commission and the designated examining authority by telegraphic or facsimile notice within 24 hours thereafter as set forth in §240.17a-11 (e) and (g). The broker or dealer shall also furnish the accountant with a copy of said notice to the Commission by telegram or facsimile within said 24 hour period. If the accountant fails to receive such notice from the broker or dealer within said 24 hour period, or if the accountant disagrees with the statements contained in the notice of the broker or dealer, the accountant shall have a responsibility to inform the Commission and the designated examining

authority by report of material inadequacy within 24 hours thereafter as set forth in §240.17a-11(g). Such report from the accountant shall, if the broker or dealer failed to file a notice, describe any material inadequacies found to exist. If the broker or dealer filed a notice, the accountant shall file a report detailing the aspects, if any, of the broker's or dealer's notice with which the accountant does not agree.”

We believe that the current process for providing notice of material inadequacies has worked well and we do not see a compelling reason for it to be changed. The proposal also creates inconsistencies in the compliance notification scheme for broker-dealers. Generally, the proposal would make inconsistent when compliance deficiencies are reported, by whom and to whom they are reported and whether the reporting is treated as confidential or not.

Rule 17a-11 includes a list of specific compliance infractions that must be self-reported by the broker-dealer within 24 hours. The list includes a decrease in net capital below the so-called early warning level but does not include violations of Rule 17a-13, the Account Statement Rules and the possession or control requirements of Rule 15c3-3. Rule 15c3-3(i) requires the broker-dealer to make notice within 24 hours when it is under deposited in its Rule 15c3-3 Reserve Account. With respect to those instances of material non-compliance with the financial responsibility rules that are not covered by Rule 17a-11 or Rule 15c3-3, the broker-dealer would report them in its annual Compliance Report, which may be filed months after the infraction occurred and would be treated as confidential by the Commission if the broker-dealer followed the process outlined in Rule 17a-5(e)(3). The proposed rule is unclear as to whether the IPA would be required to file a paragraph (h) notice for those instances of material non-compliance that the broker-dealer self-reported in its compliance report. In either case, it does not make sense to give the IPA 24 hours to report something that the broker-dealer could wait until the end of the year to report had it discovered itself earlier in the year.

The proposal also creates inconsistencies with respect to where and by whom infractions get reported. Rule 17a-11 notices go to the principal office of the Commission in Washington, D.C., the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the designated examining authority of which such broker or dealer is a member, and the Commodity Futures Trading Commission if the broker or dealer is registered as a futures commission merchant. Proposed paragraph (h) would require the proposed notice of material non-compliance to be filed by the IPA with the Director of the Office of Compliance Inspections and Examinations and the principal office of the designated examining authority for the broker or dealer. It is also likely in many instances, that a determination of an instance of material non-compliance will trigger notification requirements on the broker-dealer under Rule 17a-11 for the same activity. Having separate notifications filed by the broker-dealer and the IPA to different regulatory officials covering the same compliance infraction creates the potential for confusion. The broker-dealer, not the IPA, is primarily responsible for compliance with Rule 17a-5 and the financial responsibility rules. It would be better to continue with the existing practice of allowing the broker-dealer to comply with all of the notification requirements related to its compliance issues, in a single notice transmitted to the same regulatory officials. Another alternative would be to require that the broker-dealer send copy of any notification of material

non-compliance or material weakness to the regulators with a copy to the auditor within 24 hours after the client determines that there is a material non-compliance or material weakness or is so notified by the auditors. The auditor would be required to file a notice of material non-compliance or material weakness only if the client has not done so as required.

The proposed rule also creates inconsistency in the confidential treatment of the reporting scheme. While paragraph (e)(3) sets forth a process that the broker-dealer can follow to provide confidential treatment for its compliance report (and instances of material non-compliance identified in that report), notices filed by the IPA under proposed paragraph (h) would be publicly available under paragraph (c)(2)(iv). We believe that the Commission should revise proposed paragraph (e)(3) to indicate that notices of material non-compliance will also be treated as confidential. The financial responsibility rules are enormously technical in application and compliance with them can frequently fall on a subtle misinterpretation of them. In most cases, those misinterpretations can be and are remedied soon after the issue is pointed out to the brokerage firm by a regulatory examiner or its IPA. Making the notices public would expose securities firms to the risk that they would be misinterpreted by the media or others. Given the one day time proposed under paragraph (h), the public reaction may be quicker than the response by regulators, who are in a much better position to evaluate the circumstances, gather additional facts and make judgments regarding the firm.

### III. RETROACTIVITY

The proposed rules seem to apply retroactively to the beginning of year 2011 since they are proposed to be effective with respect to fiscal years ending after December 15, 2011. Although the Release mentions that for the first fiscal year the assertions will be at the year end in connection with certain of the reports, how the rules apply retroactively and how they will be transitioned is not clear or specific from the Release. We suggest that the Commission consider postponing the assertion requirement until the Rule has been in effect for a full year.

### IV. THE ECONOMIC ANALYSIS OF THE PROPOSAL DOES NOT ACCOUNT FOR ALL RELEVANT ASSOCIATED COSTS

The Commission estimates the cumulative annual cost to the industry of the Proposed Amendments to be approximately \$130 million (“Cost Estimate”).<sup>2</sup> We believe the auditing costs associated with the Compliance Examinations and Reports are underestimated given the Proposing Release contemplates a move from GAAS to PCAOB standards. As discussed below, this transition may require substantial revisions to IPA audit programs, including implementation of new auditing techniques and processes and the associated training programs. We note that the proposed PCAOB standards were not released until after the publication of the Proposing Release<sup>3</sup> and, as a result, the Commission may not have had a sufficient basis to conclude that

---

<sup>2</sup> This includes estimates of annual industry costs of \$45,750,000 for the Compliance Examination and Report, \$14,256,000 for the Exemption Examination and Report, \$660,000 in fees related to Commission and designated examining authority access to independent public accountants and \$69,179,760 for efforts related to Form Custody.

<sup>3</sup> PCAOB Release No. 2011-004 (July 12, 2011).

the “costs associated with the Compliance Examination would be incremental to the current annual audit costs. . . [and] independent public accountants would be able to build upon existing work to satisfy the new requirements.”<sup>4</sup> The Cost Estimate also does not address the costs to deliver the broker-dealer’s audited or unaudited financial statements (“Financial Statements”) to its customers should the broker-dealer or its IPA identify an instance material non-compliance or a material weakness.

The Commission also should consider the cost of the recent proposal by the Financial Industry Regulatory Authority (“FINRA”) to require its member firms to move from quarterly customer account statements to monthly account statements (“Monthly Statement Proposal”)<sup>5</sup> given the Proposal will incorporate FINRA’s Account Statement Rules. Three broker-dealers have estimated that the Monthly Statement Proposal as initially proposed could cost between \$1.5 million and \$18 million each<sup>6</sup> which suggests an industry-wide cost far in excess of the \$130 million that the Commission has estimated as the total cost of this Proposal.

V. THE COMMISSION SHOULD EXAMINE WHETHER BETTER, MORE INNOVATIVE AND LESS BURDENSOME TOOLS EXIST FOR ACHIEVING THE STATED REGULATORY GOALS

The additional costs set forth above could be substantial and should not be overlooked given the Commission’s statutory obligation to assess the economic consequences of the Proposed Amendments upon efficiency, competition and capital formation.<sup>7</sup> The Commission should look for avenues to reduce the overall impact on broker-dealers where possible. President Obama’s recent series of executive orders (“the Orders”)<sup>8</sup> requesting that independent regulatory agencies consider various goals when reviewing their regulations, including “identify[ing] and us[ing] the best, most innovative, and least burdensome tools for achieving regulatory ends” are particularly relevant.<sup>9</sup>

By way of example, the Commission should permit broker-dealers to deliver Financial Statements to their customers through the posting of the Financial Statement to an Internet website, regardless of whether the broker-dealer or its IPA has identified an instance of non-

---

<sup>4</sup> 76 Fed. Reg. at 37,599.

<sup>5</sup> See Proposed FINRA Rule 2231 as reflected in Exch. Act Rel. No. 34-59921 (May 14, 2009), 74 Fed. Reg. 23912 (May 21, 2009) and subsequent Notice of Filing of Amendment No. 1 and Proposed Rule Change To Adopt FINRA Rule 2231 (Customer Account Statements) in the Consolidated FINRA Rulebook, Exch. Act Rel. No. 34-64969 (July 26, 2011), 76 Fed. Reg. 46,340 (August 2, 2011).

<sup>6</sup> *Id.* at 46,342

<sup>7</sup> Sections 3(f) and 23(a)(2) of the Exchange Act. See also *Business Roundtable v. SEC*, (D.C. Cir. July 22, 2011), *American Equity Investment Life Insurance Company v. SEC*, 613 F.3d 166 (D.C. Cir. 2010), and *Chamber of Commerce v. SEC*, 412 F.3d 133, 143 (D.C. Cir. 2005).

<sup>8</sup> See Executive Order 13563, Improving Regulation and Regulatory Review, 76 Fed. Reg. 3821 (Jan. 21, 2011) (“Order 13563”) and Executive Order 13579, Regulation and Independent Regulatory Agencies, 76 Fed. Reg. 41,587 (July 14, 2011) (“Order 13579”).

<sup>9</sup> Order 13565 at 3821.

compliance or a material weakness. There is precedent in other contexts for allowing broker-dealers to inform customers of the availability of regulatory documents through written disclosure directing the customer to a specific Internet site or a toll-free number through which the information can be obtained free of charge. In the proxy voting context, the “Notice and Access” model of Rule 14a-16 of the Exchange Act permits the delivery of a notice to shareholders of the availability of proxy materials through a dedicated Internet website in lieu of delivery of a full set of proxy materials provided paper or e-mail copies of the proxy materials are made available upon shareholder request at no charge and such requests are responded to within three business days.

The Orders also highlight that “[s]ome sectors and industries face a significant number of regulatory requirements, some of which may be redundant, inconsistent or overlapping. Greater coordination across agencies could reduce these requirements, thus reducing costs and simplifying and harmonizing rules.”<sup>10</sup> To this end, the Commission in concert with FINRA should reconsider whether it is necessary for broker-dealers to mail monthly (rather than quarterly) account statements to customers where the customer has continuous access to account information via online account access or a toll free telephone number and the broker-dealer undergoes an annual audit conducted by an IPA which is designed to identify instances of material non-compliance and material weaknesses.

## VI. EXTEND COMMENT PERIOD

A. Common Period Extension. For all of the reasons set forth above and those set forth below, we strongly suggest that the comment date for the proposed rules be extended until after adopted, including adoption of relevant FINRA rules or PCAOB rules for broker-dealer audits.

1. Broker-Dealer Assurance Procedures. Broker-dealers will need a significant amount of time to develop and implement Sarbanes-Oxley-type procedures, policies and to train personnel with respect to the assurances (“Assurances”) that are to be provided in connection with the Compliance Report and the Exemption Report (“Reports”). For medium and large firms, whoever signs the Reports will need Assurances from subordinates that the Report is accurate with respect to their respective areas of responsibility.

2. Guidance as to What IPAs Must “Address” in the Examination Report. The Release states that broker-dealers will be required to file a report from the broker-dealer’s IPA (the Examination Report) that “addresses” the Assurances in the Compliance Report or the Exemption Report, as the case may be. The Release and proposed rules should provide more guidance with respect to what an IPA firm’s review of the “assurances” of a broker-dealer Compliance Report or Exemption Report is to “address.” Nowhere in the Release or in the proposed rules is there guidance as to what “addresses” means or entails. Presumably, the Commission will rely on the Public

---

<sup>10</sup> *Id.* at 3822.

Company Accounting Oversight Board (PCAOB) rules, which have been recently proposed regarding standards for IPA audits of broker-dealer financial statements and supplemental information (“PCAOB Rules”) and review standards for Examination Reports addressing Compliance Reports and Exemption Reports.<sup>11</sup> The PCAOB Rules have a 60-day comment period ending on August 15, 2011. The proposed PCAOB rules have a proposed finalization date of September 12, 2011 with an unknown SEC approval date. We suggest that the proposed amendments with respect to the IPAs’ obligations with respect to the Examination Report should be deferred until the PCAOB rules are finalized. Since the Release does not discuss the impact of the PCAOB proposed rules in the Release, there is no meaningful way that comments may be made at this time with respect to that part of the Release until after the PCAOB rules are final.

3. Administrative Procedures Act.<sup>12</sup> Under the Administrative Procedures Act, the Commission must give the public the opportunity to comment on proposals except in certain emergency situations. However because, as explained above, it is impossible to comment at this time with respect to certain points of the proposed rules because the PCAOB audit and review standards are not finalized, we suggest that the effective date of the rules proposed in the Release should be deferred until after a public comment period of at least 60 days after (1) the PCAOB Rules are finalized and/or (2) the Commission amends its proposal to include specifics as to what “address” means, and what type of review is required by IPAs. Consequently, we recommend that the Commission defer the relevant parts of the proposed amendments until a reasonable time after the PCAOB Rules have been adopted by PCAOB and approved by the Commission, or clarification for public comments the current proposals.

B. Revision of the Broker-Dealer Audit Guide. The proposed rules will require a significant revision of the Guide to Broker-Dealer Audits published by the American Institute of Certified Public Accountants (AICPA). It is estimated this will require at least six months. The proposed rules should not be effective unless the audit guide for broker-dealers is revised and updated.

\*\*\*\*\*

---

<sup>11</sup> PCAOB Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards; PCAOB Release No. 2011-004, PCAOB Rulemaking Docket Matter No. 035; PCAOB Proposed Auditing Standard Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB’s Standards. PCAOB Release No. 2011-005, July 12, 2011.

<sup>12</sup> 5 U.S.C. §553(C).

Once again, the Committee appreciates the opportunity to submit these comments and we respectfully request that the Commission consider our recommendations. We have endeavored to discuss the Commission's proposals in the level of detail they deserve, while also devoting attention to the many other ongoing legislative and regulatory initiatives affecting broker-dealer financial reports. Members of the Committee are available to meet and discuss these matters with the Commission and its Staff and to respond to any questions.

Very truly yours,

/s/ Jeffrey W. Rubin

Jeffrey W. Rubin

Chair, Federal Regulation of Securities Committee

Drafting Committee:

Paul B. Uhlenhop, Chair of the Drafting Committee

W. Hardy Callcott

Matthew Comstock

Peter W. LaVigne

Pamela Lewis Marlborough

cc: Honorable Mary L. Schapiro, Chairman  
Honorable Luis A. Aguilar, Commissioner  
Honorable Troy A. Paredes, Commissioner  
Honorable Elisse B. Walter, Commissioner  
Robert W. Cook, Director, Division of Trading and Markets