



## MEMORANDUM

**TO:** File No. S7-23-11

**FROM:** Rose Russo Wells  
Division of Trading and Markets

**DATE:** October 5, 2011

**SUBJECT:** Meeting with Securities Industry and Financial Markets Association

On October 5, 2011 Commission staff had a meeting with representatives from the Securities Industry and Financial Markets Association ("SIFMA") to discuss the proposed amendments to the broker-dealer financial reporting rule (Release No. 34-64676).

Commission representatives included John Ramsay, Mike Macchiaroli, Randall Roy, Mark Attar, Rose Wells, and Cecil Mak.

SIFMA representatives included Robert Martini, David Aman, Mark Holloway, Claudia Toni-Smith, Kyle Brandon, Jeremy Simon, Mary Kay Scucci, Krista Ryan, and Bill Tirrell.



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## SEC'S PROPOSAL TO AMEND SEC RULE 17a-5

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OCTOBER 5, 2011

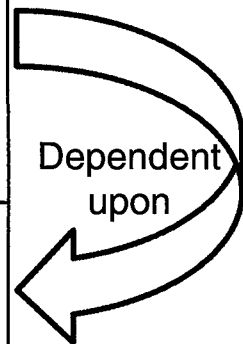
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# Material Non-Compliance and Material Weakness

	SEC Proposed Definition
Material Non-Compliance	A failure by the broker-dealer to comply with any of the requirements of the Financial Responsibility Rules in all material respects.
Material Weakness	A deficiency, or a combination of deficiencies, in internal control over compliance with the Financial Responsibility Rules, such that there is a reasonable possibility that material non-compliance with those provisions will not be prevented or detected on a timely basis.

Independent from

SIFMA Proposed Definition
A failure by the broker-dealer to comply with any of the requirements of the Financial Responsibility Rules arising from a <i>material weakness</i> .
A <i>material weakness</i> is a material failure of a broker-dealer's systems, policies or practices regarding the Financial Responsibility Rules involving numerous customers, multiple errors or significant dollar amounts.



# Example A

A broker-dealer that erroneously books a large inter-affiliate transfer in reverse (e.g., makes a payment from the broker-dealer to an affiliate, rather than the reverse) but promptly detects and reverses the transfer is not in material non-compliance with the Financial Responsibility Rules and has not displayed a material weakness in internal control over compliance, even if the transfer resulted in the broker-dealer being briefly under its minimum net capital level.

Large multi-entity financial institutions make many inter-affiliate transfers of funds and securities on a daily basis to meet regulatory and contractual requirements. Many of these transfers require human intervention and are therefore subject to error. Typically, standard daily reconciliation and verification procedures uncover errors early in the next business day.

Scenario A: Broker-Dealer A had a large receivable from an affiliate. Instead of making a transfer from the affiliate to Broker-Dealer A, however, the firm inadvertently transferred funds from Broker-Dealer A to the affiliate. As affiliate obligations are subject to a one hundred percent capital charge, the inadvertent transfer resulted in a dollar-for-dollar reduction in Broker-Dealer A's net capital such that Broker-Dealer A's net capital fell below the required level. Early the next morning, Broker-Dealer A's systems and controls revealed that an error had been made, and so Broker-Dealer A reversed the transfer made to its affiliate and made the initially contemplated transfer from the affiliate to Broker-Dealer A.

## Example A

Notwithstanding the Commission's preliminary view that any failure to maintain minimum net capital constitutes material non-compliance, we believe the violation of Rule 15c3-1 in Scenario A should not be considered material. Rather, it was an isolated instance of human error that, while potentially large in amount, was promptly discovered and corrected. Its qualitative nature as an inadvertent booking error renders it immaterial. Under our proposed definition, no instance of material non-compliance occurred because the error did not arise from a material weakness (under either proposed definition) in Broker-Dealer A's control systems; although the erroneous transfer was initially processed, Broker-Dealer A's controls functioned properly by promptly detecting and correcting the error.

We note that, in Scenario A, if the erroneous transfer caused a reduction in net capital that triggered an early warning notification requirement under Rule 15c3-1 but did not result in net capital falling below the required level, we believe that the reduction in net capital would not be an instance of "non-compliance" (if Broker-Dealer A gives any required warnings) because the reduction in net capital would not result in a breach of Broker-Dealer A's obligations under Rule 15c3-1.

## Example B

Controls for complying with the net capital rule that do not monitor the classification of accounts with balances below a reasonable threshold do not reflect a material weakness and will not cause the broker-dealer to be in material non-compliance, even if they sometimes result in calculations of net capital that are not precisely correct.

In the preparation of computations under Rule 15c3-3, broker-dealers typically rely on dollar-value minimums when analyzing account balances, in recognition of constraints on both time and resources. Scrutiny by an examiner might reveal that an account with a small balance is a suspense account and, therefore, subject to a different classification within such regulatory computations.

Scenario B: One of Broker-Dealer B's accounts showed an asset consisting of an amount due to it. The total amount of the account was relatively small. The asset was included in Broker-Dealer B's net capital computation for a period of time. Broker-Dealer B later discovered that the account should have been classified as a suspense account and that the value of the asset, therefore, should not have been included in its net capital. The overall effect on net capital was immaterial, and due to the small size of the account, Broker-Dealer B failed to recognize the misclassification for an extended period of time. Had the value of the account been significant, Broker-Dealer B's systems and controls most likely would have triggered a review of the account's classification, and the misclassification most likely would have been corrected in a reasonably short time.

## Example B

This scenario is not an instance of material non-compliance. Broker-Dealer B's actual net capital never dropped below its required net capital or any warning level, and therefore Broker-Dealer B was in compliance with Rule 15c3-1 notwithstanding the misclassified account. Nor is Scenario B an example of a material weakness. Under the Commission's definition, a material weakness is the existence of a deficiency in internal controls over compliance with the Financial Responsibility Rules such that there is a reasonable possibility that material non-compliance with those rules would not be prevented or timely detected. Under our proposed definition, a material weakness is a material failure of a broker-dealer's systems, policies or practices regarding the Financial Responsibility Rules involving numerous customers, multiple errors or significant dollar amounts. Broker-Dealer B had systems and controls that would have detected any misclassification of an account that was large enough to have resulted in material non-compliance or a material failure in the broker-dealer's systems, policies or practices, and so this scenario does not reflect a material weakness under the Commission's or our proposed definition.

## Example C

A broker-dealer that does not have in its possession or control all customer fully paid or excess margin securities (i.e., has a “seg deficit”) is not in material non-compliance with Rule 15c3–3 so long as the broker-dealer takes the steps required by Rule 15c3–3(d) (and interpretations thereof) to obtain possession or control of the relevant securities within applicable time limits set out in Rule 15c3–3(d) (and interpretations thereof).

On the basis of ongoing reviews of their operations and the requirements of Rule 15c3–3, broker-dealers develop procedures for obtaining possession or control of customer fully paid and excess margin securities. The level of seg deficits and the broker-dealer’s procedures for resolving them on a timely basis are generally the subject of review in the course of periodic examinations by the broker-dealer’s regulators.

Scenario C: Broker-Dealer C’s possession or control obligation with respect to XYZ shares increased from 5,000 to 6,000 shares because a customer who had borrowed against her XYZ shares repaid the margin loan, converting margin securities into fully-paid securities. At the time of the increase, Broker-Dealer C had physical possession or control of only 5,000 XYZ shares but also had 1,200 XYZ shares loaned out to Broker-Dealer Z. In compliance with Rule 15c3–3(d)(1), Broker-Dealer C issued instructions to Broker-Dealer Z on the business day after the increase for the return of 1,000 of the loaned XYZ shares. When it appeared to Broker-Dealer C that Broker-Dealer Z would not be able to return the XYZ shares within five business days of Broker-Dealer C’s instructions, Broker-Dealer C promptly commenced efforts to buy in 1,000 XYZ shares. Because of the illiquidity of XYZ shares, Broker-Dealer C was unable to obtain physical possession or control of 1,000 XYZ shares until after five business days following its instructions.



## Example C

Although there was a period of time after the five-day period following its instructions during which Broker-Dealer C did not have possession or control of the customer's fully paid securities, this is not an instance of material non-compliance under the Commission's proposed definition of that term because Broker-Dealer C took the prescribed measures to obtain control over the securities and was unable to do so within five days of its instructions for reasons outside its control (i.e., Broker-Dealer's Z's failure to return XYZ securities and the illiquidity of XYZ securities). This is not an instance of material non-compliance under our proposed definition of that term because it did not arise from a material weakness (under either proposed definition) in Broker-Dealer C's control systems. There is no evidence of a material weakness because Broker-Dealer C was aware of the securities required to be in its physical possession or control and followed the required procedures for obtaining possession or control over those securities.

## Example D

A broker-dealer that is immaterially late in making a deposit in its reserve account is not in material non-compliance and does not display a material weakness in internal control over compliance with the Financial Responsibility Rules.

Pursuant to Rule 15c3–3, broker-dealers are required to make deposits no later than 10:00 a.m. on the second business day following the day of computation. Virtually all broker-dealers meet this requirement with great regularity. Nonetheless, on occasion, for practical reasons or as a result of bank errors, deposits are not made or do not post until after 10:00 a.m.

Scenario D: Broker-Dealer D calculated its reserve requirement as of the close of business on Friday (the last business day of the week) and determined that an additional deposit was needed. Pursuant to Rule 15c3–3(e)(3), it was required to make the deposit no later than 10:00 a.m. on the following Tuesday. While Broker-Dealer D took appropriate steps to make the deposit by the specified time, the deposit did not register in its reserve account until shortly after the deadline (e.g., at 10:05 a.m.).

This scenario is not an instance of material non-compliance or evidence of material weakness. Rather, it represents a short-duration error that is not indicative of material concerns regarding the broker-dealer's compliance or the robustness of its internal controls. Considered within the framework of the Commission's goals, this type of infrequent and technical error, which may reflect a bank error, has no material bearing on strengthening the broker-dealer's compliance with the Financial Responsibility Rules or safeguarding investor assets.

## Example E

A temporary decline in a broker-dealer's reserve account resulting from the order in which deposits and withdrawals that are intended to be simultaneous are posted should not cause the broker-dealer to be in material non-compliance or show that the broker-dealer has a material weakness in internal controls.

A broker-dealer is required to satisfy its reserve requirement under Rule 15c3-3 by depositing cash and/or qualified securities in its reserve account. A broker-dealer may withdraw qualified securities from the reserve account without making a new reserve account computation if federal funds or other qualified securities are deposited prior to or at the same time as the withdrawal such that the remaining balance equals or exceeds the reserve requirement.

Scenario E: Broker-Dealer E determined that it wanted to substitute qualified securities for cash deposited in its reserve account. Although the substitution was intended to take the form of a simultaneous deposit and withdrawal, the withdrawal of cash posted to the account before the credit of the qualifying securities, causing the balance to drop below the reserve requirement for a temporary period.

Scenario E is not an instance of material non-compliance or evidence of material weakness for the reasons discussed above in Example D.

Similarly, we note that a temporary decline in a broker-dealer's reserve account below the reserve requirement should not be an instance of material non-compliance or evidence of material weakness if the decline resulted from a withdrawal caused by a bank error, clerical error or any factor outside the control of the broker-dealer.

## Example F

A broker-dealer that complies with the Financial Responsibility Rules under its reasonable good faith interpretation of those rules and applicable accounting principles is not in material non-compliance and has not displayed a material weakness, even if it later adopts a different interpretation under which, based on restated past calculations in light of the new interpretation, it would have had a net capital or reserve deposit deficiency (a “hindsight deficiency”).

Broker-dealers prepare computations required by Rules 15c3–1 and 15c3–3 on the basis of those rules, applicable accounting standards and interpretations of those rules and standards. Regulators and accounting standard setters have documented many, but not all, such interpretations. In addition, from time to time, they revisit or amend such an interpretation, often prompting broker-dealers to amend computations made prior to the change in interpretation.

Scenario F: Broker-Dealer F calculated its net capital in good faith and based on a reasonable understanding of the Financial Responsibility Rules, accounting standards and interpretations issued in relation thereto. Broker-Dealer F changed its calculation methods based on internal discussion or discussions with its accountants, regulators or peer firms. As a result, Broker-Dealer F recalculated its capital for a period of time in the past and, based on the revised calculation methods, computed a hindsight deficiency in net capital during a past period.

## Example F

There is no material non-compliance with Rule 15c3–1 because Broker-Dealer F complied with the requirements of the rule under a reasonable, good-faith interpretation of the rule. Similarly, there is no material weakness in internal controls because Broker-Dealer F had been properly calculating its net capital under its prior reasonable, good-faith interpretation. The hindsight deficiency resulted from a change in interpretation of the Financial Responsibility Rules. Regarding this scenario as material in any respect would not serve the purposes of strengthening compliance with the Financial Responsibility Rules or safeguarding investor assets because Scenario F is an inevitable consequence of a world in which broker-dealers must interpret the Financial Responsibility Rules in order to apply them. Treating Scenario F as material non-compliance or evidence of material weakness would only encourage broker-dealers to resist evolution in the interpretation of applicable rules and accounting standards.

## Example G

A broker-dealer's application of a mistaken interpretation of generally accepted accounting principles ("GAAP") that does not affect its calculation of net capital under Rule 15c3-1 or its reserve obligations under Rule 15c3-3 does not constitute material non-compliance with the Financial Responsibility Rules or a material weakness in internal controls over compliance with those rules.

Computations required by Rules 15c3-1 and 15c3-3 are based on financial information prepared under GAAP. In some situations, reviews by a broker-dealer or its auditors may reveal the misapplication of GAAP.

Scenario G: Broker-Dealer G applied Accounting Standards Codification ("ASC") Topic 210-20 to net repurchase transactions ("repos") and reverse repurchase transactions ("reverse repos") in the preparation of its U.S. GAAP balance sheet. Based on a misapplication of ASC 210-20, Broker-Dealer G improperly netted certain repos and reverse repos, resulting in an understatement of its balance sheet. The improper netting continued for an extended period of time and was significant enough to require Broker-Dealer G to amend its FOCUS report. However, the misapplication of ASC 210-20 did not affect Broker-Dealer G's net capital calculations or its compliance with the other Financial Responsibility Rules.

## Example G

Scenario G is not an instance of material non-compliance with the net capital rule because Broker-Dealer G's computed net capital was not affected by the deviation from GAAP. Nor is this scenario indicative of material weakness. Under the Commission's proposed definition, a material weakness is the existence of a deficiency in internal controls over compliance with the Financial Responsibility Rules that creates a reasonable possibility that material non-compliance with such rules would not be prevented or timely detected. Because there is no difference in the calculation of net capital if repos and reverse repos are netted or carried gross on the broker-dealer's balance sheet, this misapplication of GAAP could not have resulted in non-compliance with Rule 15c3-1 and therefore could not have reflected a material weakness under the Commission's definition of the term. Under our proposed definition, a material weakness is a material failure of a broker-dealer's systems, policies or practices regarding the Financial Responsibility Rules involving numerous customers, multiple errors or significant dollar amounts. A reasonable, good-faith application of an accounting principle, even if later deemed to be a misapplication, does not reflect a material failure of systems, policies or practices and therefore does not reflect a material weakness under our proposed definition of the term.

# Effective Date of Proposed Amendments

- 1 Under the Proposed Amendments, a carrying broker-dealer would be required to file Compliance Reports on or after December 15, 2011.
  - We propose that the Commission require broker-dealers to file their first Compliance and Exemption Reports no earlier than one quarter after the Commission's adoption of the Proposed Amendments, or a version thereof.
- 2 Under the Proposed Amendments, a carrying broker-dealer with fiscal year ending on or after December 15, 2011, would be required to describe in its Compliance Report each identified instance of material non-compliance or material weakness with respect to the Financial Responsibility Rules.
  - We propose that the Commission require broker-dealers to report identified instances of material non-compliance or material weaknesses over the prior fiscal year in annual reports filed no earlier than five quarters after the Commission's adoption of the Proposed Amendments, or a version thereof.
- 3 The Commission has proposed a transition period from December 15, 2011, to September 15, 2012 during which time a carrying broker-dealer would be required to include in its Compliance Report a point-in-time assertion as to whether its internal control over compliance with the Financial Responsibility Rules was effective rather than an assertion that covered the entire fiscal year.
  - We propose the Commission adopt a transition period, as described in the Release, of no less than five quarters following the Commission's adoption of the Proposed Amendments, or a version thereof.
- 4 The Release does not address the effective date for proposed Form Custody.
  - We believe a reasonable implementation schedule for Form Custody would require a broker-dealer to file its first Form Custody no earlier than three quarters after the effective date of the final rule; any such schedule should be sufficiently flexible to allow broker-dealers to manage the competing regulatory demands to which they imminently will be subject as the result of recent rulemaking efforts by the Commission.