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August 25, 2011

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

***Re: Broker-Dealer Reports (Release No. 34-64676, File No. S7-23-11, June 15, 2011)***

Dear Ms. Murphy:

Deloitte & Touche LLP ("D&T") appreciates the opportunity to respond to the request for comments from the Securities and Exchange Commission (the "SEC" or the "Commission") on its Release No. 34-64676, *Broker-Dealer Reports* (the "Proposed Rule").[1] We believe it is important for the Commission to clarify certain areas of the Proposed Rule. Consequently, our comments and observations address the following principal areas:

I. Effective Date and Transition Period

II. Proposed Annual Reporting Amendments

III. Proposed Access to Audit Documentation Amendments

IV. Requirement to File Annual Reports with SIPC

V. Interaction with Other Regulatory Rules

## I. Effective Date and Transition Period

The Proposed Rule would be effective for annual reports filed with the Commission for fiscal years ending on or after December 15, 2011. Because of the significance of the changes to the reporting requirements for broker-dealers and the changes in the applicable professional standards, in particular the requirement that audits be conducted pursuant to Public Company Auditor Oversight Board ("PCAOB") standards, we recommend that the Proposed Rule not take effect until the related proposed PCAOB attestation and auditing standards become effective (which is no earlier than September 15, 2012). This will allow both broker-dealers and their independent public accountants ("accountants") to adequately prepare for the initial implementation of the final rule. We believe the following potential issues would be created if the proposed effective date is included in the final rule:

[1] S*ee* 76 Fed. Reg. 37,572 (June 27, 2011).

- The Proposed Rule would become effective prior to the proposed PCAOB attestation and auditing standards for broker-dealers, which were issued for public comment on July 12, 2011.[2] The PCAOB's proposed standards would be effective for fiscal years ending on or after September 15, 2012. Given the difference in effective dates, accountants performing audit and attestation engagements for broker-dealers would be required to change from GAAS[3] to current PCAOB standards in the first year (at least until the PCAOB proposed standards take effect) and then would be required to implement changes to follow the proposed PCAOB standards beginning in the second year. We believe that the implementation of these changes using the effective date in the Proposed Rule would result in an undue burden on both accountants and broker-dealers.

- We believe the short time period from the Commission's adoption of the Proposed Rule to the proposed effective date[4] is insufficient for broker-dealers to fully assess and implement any changes to their existing policies and procedures that are needed to comply with the final rule.

  Similarly, we believe accountants will need additional time to evaluate the various impacts of having to perform their attest procedures in accordance with PCAOB standards. For example, the initial planning and interim procedures for many December 31, 2011 year-end audit engagements likely will have been completed before the final rule is adopted, and if the proposed effective date remains the same, accountants could have to reassess and likely re-perform procedures or perform incremental procedures once the change from GAAS to PCAOB auditing standards occurs.

- The fiscal 2011 internal control report attestation engagements for certain broker-dealers subject to Rule 206(4)-2 of the Investment Advisers Act of 1940 (the "IA Custody Rule") already have begun. As a result, these broker-dealers would not get the benefit of using the Compliance Report (as described below) in lieu of the internal control report required by the IA Custody Rule and, thus, would face increased costs.

- If the final rule is adopted as proposed there are situations where a broker-dealer could have multiple attestation engagements performed this year covering the custody function, creating duplications and inefficiencies. Such engagements include an internal control report and surprise examination under the IA Custody Rule, a Compliance Report under the Proposed Rule and an attestation of compliance with Commodity Futures Trading Commission Rule 1.16 *("*CFTC Rule 1.16").

- Under the proposed transition, broker-dealers with year-ends from September 30, 2012 to November 30, 2012 would have to assert to the effectiveness of controls over the compliance with the Financial

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2 These include: *Examination Engagements Regarding Compliance Reports of Brokers and Dealers, Review Engagements Regarding Exemption Reports of Brokers and Dealers*, and *Auditing Supplemental Information Accompanying Audited Financial Statements.*

3 Generally Accepted Auditing Standards ("GAAS") as promulgated by the American Institute of Certified Public Accountants (the "AICPA").

4 While we cannot predict the date upon which the Commission would adopt a final rule, if it is adopted with the proposed effective date, the period between adoption and effectiveness would certainly be less than four months as measured from the date comments are due (August 26, 2011).

Responsibility Rules ("FRR")[5] from the beginning of their fiscal year. Thus, if the Proposed Rule becomes effective October 1, 2011 or later, these broker-dealers would potentially have to first apply the requirements of the Proposed Rule after their fiscal year already will have started.

## II. Proposed Annual Reporting Amendments

Under the Proposed Rule, a carrying broker-dealer would be required to file a new report in which the broker-dealer would make certain assertions about compliance with specified rules and related internal controls (the "Compliance Report"). In connection with the Compliance Report, a carrying broker-dealer also would be required to file a report from its accountant resulting from the accountant's examination of the assertions made by the broker-dealer in the Compliance Report (the "Examination Report").

A broker-dealer that does not hold customer funds or securities would be required to file an "Exemption Report" – in lieu of a Compliance Report – asserting the basis for its exemption from Rule 15c3-3, *Customer Protection – Reserves and Custody of Securities* ("Rule 15c3-3"). The broker-dealer would also be required to file a report from its accountant arising from the accountant's review of the broker-dealer's assertion that it was exempt from Rule 15c3-3.[6]

As we discuss below, we believe that certain of these proposed annual reporting amendments merit further clarification or modification.

### *a. Objective and Scope of Internal Control over Compliance with the Financial Responsibility Rules*

We encourage the Commission to provide additional guidance about the control objectives that should be met to achieve effective internal control over compliance with the FRR. We note that the Commission provided similar guidance related to the IA Custody Rule.[7]

A broker-dealer's evaluation and assessment of its internal control over compliance with the FRR is a separate activity from the accountant's examination and therefore does not need to be conducted in the same manner. However, we note that because the accountant is examining management's assertion about the broker-dealer's compliance with the FRR, the two activities intersect in key ways. Therefore, the accountant in performing the examination engagement will likely seek to use the work performed and the documentation generated by the broker-dealer in conducting its assessment. As a result, the manner in which the broker-dealer conducts its assessment, the competence and objectivity of those responsible for the internal control over compliance with the FRR to support the broker-dealer's assessment, and the documentation available to support that assessment, all will impact the potential efficiency of the accountant's Compliance Examination. Given that broker-dealers have

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5 The Proposed Rule defines the FRR, collectively, as Rule 15c3–1, Rule 15c3–3, Rule 17a–13, and the Account Statement Rule. *See* 76 Fed. Reg. at 37,576.

6 *See* Proposed Rule 17a-5(d)(4), 76 Fed. Reg. at 37,604.

7 *See* Commission Guidance Regarding Independent Public Accountant Engagements, Investment Advisers Act Release No. 2969, 75 Fed. Reg. 1,492 (Jan. 11, 2010).

not previously been subject to the proposed requirements, both broker-dealers and their accountants would benefit from additional guidance regarding the scope and level of required documentation by the broker-dealer that is contemplated.

*b. Interaction of the Proposed Rule with the Financial Statement Audit*

The Proposed Rule clearly indicates that the Compliance and Examination Reports do not extend to Internal Control over Financial Reporting ("ICFR").[8] Thus, broker-dealers are not required to assert to the effectiveness of their ICFR and accountants are not required to opine on the effectiveness of ICFR. We note, however, that there may be certain ICFR controls that could overlap with controls over compliance with the FRR. As noted in II a. above, we believe it would be helpful for the Commission to provide further guidance on the control objectives related to compliance with the FRR. In addition to the question of how the control objectives for ICFR relate to control objectives for compliance with the FRR, it is unclear how a control deficiency – including a material weakness – identified in the financial statement audit should be evaluated in relation to the effectiveness of internal control over compliance with the FRR. As a result, any overlap in control objectives could cause confusion to broker-dealers and accountants (particularly in light of the statement in the release that the Commission does not desire to have broker-dealers' ICFR separately tested). Accordingly, we encourage the Commission to clarify the interaction of the Proposed Rule with the financial statement audit.

In addition to the potential overlap in controls, we note that many aspects of the FRR are derived, at least in part, from the basic financial statements. For example, it is unclear what the implications would be to compliance with the FRR in a situation in which a broker-dealer applies the correct "haircut" percentage required by Rule 15c3-1, *Net Capital Requirements for Brokers or Dealers* ("Rule 15c3-1"), to a security whose value is incorrectly stated in the broker-dealer's balance sheet. In such a situation, the Proposed Rule does not indicate whether the control over compliance with Rule 15c3-1 could still be considered effective, notwithstanding the error in the broker-dealer's balance sheet. Accordingly, we believe the final rule should clarify how the accountant would evaluate errors and control deficiencies identified in the financial statement audit in relation to the evaluation of compliance with the FRR and internal control over compliance with the FRR.

Further, the second assertion in the Compliance Report requires the broker-dealer to affirm that the information used to assert compliance with the FRR was derived from the books and records of the broker-dealer. We believe the Commission should clarify the meaning of the phrase "derived from the books and records of the broker-dealer." Specifically, it is unclear if the Commission intends this phrase to mean the records maintained by the broker-dealer under Rule 17a-3, *Records to be Made by Certain Exchange Members, Brokers and Dealers* ("Rule 17a-3"). We encourage the Commission to include a cross-reference to these specific rules to clarify that this is the intended meaning.

*c. Definition of the Term "Material Non-Compliance"*

The Proposed Rule defines "material non-compliance" as a failure by the broker-dealer to comply with the FRR in all material respects. The Proposed Rule also provides some examples of "material non-compliance," specifically with respect to Rule 15c3-1 and Rule 15c3-3.[9]

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[8] *See* 76 Fed. Reg. at 37,578.

[9] *See* 76 Fed. Reg. at 37,577.

Although the Proposed Rule contains two examples of what is meant by "material non-compliance," we urge the Commission to include additional examples in the final rule. In particular, we believe it would be helpful for both accountants and broker-dealers if the Commission provides specific examples of deficiencies that would constitute instances of material non-compliance within the context of each of the FRR, not just Rule 15c3-1 and Rule 15c3-3.

We believe that additional guidance specifying the nature of quantitative and qualitative factors to consider when evaluating the materiality of instances of non-compliance also would be beneficial to both accountants and broker-dealers. For example, in the case where a broker-dealer fails to provide account statements to certain clients during a particular period, the Commission should address whether materiality depends on quantitative factors such as the number of statements not provided relative to the total number of statements required to be provided or the dollar value of accounts for which statements were not provided relative to the total value of all accounts. If the Commission believes that an assessment of such quantitative factors alone would be insufficient, we would urge the Commission to provide examples of qualitative factors that could be considered to evaluate materiality.

Another concern is whether an error in the calculation of net capital or reserve requirement that does not result in a deficiency in the required level of net capital or reserve would be viewed as an instance of material non-compliance. For example, it is unclear how the following would be evaluated:

- An error occurred that resulted in net capital being overstated; notwithstanding the error, the required minimum net capital under Rule 15c3-1 was maintained; or
- An error occurred that increased the deposit requirement but did not result in a broker-dealer failing to meet its actual minimum deposit requirement under Rule 15c3-3.

Further clarification would be beneficial in assessing whether materiality for these types of errors should be considered in the context of the financial statements or in the context of the FRR.

*d. Notification of Material Non-Compliance*

The Proposed Rule requires that the accountant notify the Commission within one business day if the accountant determines during the course of the Compliance Examination that an instance of "material non-compliance" exists with respect to any of the FRR.[10]

We believe that the Commission should be notified of an instance of material non-compliance in a timely manner, whether the matter was found by the broker-dealer or by the accountant. Further, we believe that the current reporting process for notification under Rule 17a-5(h)(2) and Rule 17a-11(e) satisfies this objective.[11] We are concerned, however, that the Proposed Rule could undermine the effectiveness of this notification process, in

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10 *See* Proposed Rule 17a-5(h), 76 Fed. Reg. at 37,606.

11 Under these rules, a broker-dealer currently is required to furnish the accountant with a copy of its notification to its applicable regulators within 24 hours of identification of a material inadequacy. If the accountant fails to receive such notice within 24 hours or if the accountant disagrees with the content of the notice, the accountant must notify the Commission and other applicable examining authorities within 24 hours thereafter.

part because the Proposed Rule also includes a conforming change to Rule 17a-11(e) that removes any reference to Rule 17a-5.[12] We would urge the Commission to retain the current reporting process and clarify that the broker-dealer is principally responsible for the timely notification of any instance of material non-compliance found by the broker-dealer.

Further, we believe the Proposed Rule also creates inconsistency in the confidential treatment of the reporting scheme. Although proposed 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 independent accountant under proposed paragraph (h) would be publicly available under proposed 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. Because the FRR are highly technical in application, success or failure to comply with them frequently results from an interpretation (or a misinterpretation) of a subtlety or nuance with the FRR. In many cases, non-compliance caused by misinterpretations can be and often are remedied soon after a broker-dealer discovers the issue. We believe that making the notices public would expose broker-dealers to the risk that they would be misinterpreted by the public.

The broker-dealer, not the accountant, is primarily responsible for compliance with Rule 17a-5 and the FRR, and we therefore believe that it would be most appropriate to continue with the existing practice of requiring the broker-dealer to comply with all of the notification requirements related to its material non-compliance. We thus believe that the current requirement for the broker-dealer to notify the Commission should continue without modification. In addition, such notices should remain confidential.

*e. Scope of and Period Covered By Compliance Examination*

The Proposed Rule would require the Compliance Examination to address the effectiveness of internal control over compliance with the FRR for the entire fiscal year. This is in marked contrast to the opinion an accountant provides on an issuer's ICFR under PCAOB Auditing Standard No. 5 ("PCAOB AS 5"), which is as of a fixed point in time (i.e., the end of the issuer's fiscal year). Under the Proposed Rule, a broker-dealer that identifies a material weakness, whether or not it was remediated, at any point during the fiscal year would not be able to assert that its internal control over compliance with the FRR was effective for that period. By contrast, an issuer that identifies and remediates one or more material weaknesses during the course of a fiscal year would still be able to conclude that its ICFR was effective at the reporting date if no other material weaknesses were identified as of that date.

We are concerned that the requirement for the Compliance Examination to address the entire fiscal year may be onerous and overly punitive – especially in circumstances in which (1) a material weakness is identified early in the fiscal year and was remediated soon thereafter or (2) the magnitude of the deficiency decreased due to changes in materiality or other factors. We are also concerned that the proposed amendments could result in unnecessary confusion for broker-dealers and their customers and significant additional costs relative to the approach that is currently followed under PCAOB AS 5.

Accordingly, we recommend that the Commission modify the final rule, consistent with PCAOB AS 5, so that the evaluation of effectiveness of internal control over compliance with the FRR is as of the end of the broker-dealer's fiscal year and, therefore, would provide broker-dealers the opportunity to remediate material

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[12] *See* Proposed Rule 17a-11(e), 76 Fed. Reg. at 37,607.

weaknesses and allow accountants to consider remediation of a material weakness in determining the effectiveness of internal control over compliance with the FRR as of the end of the fiscal year.

*f. Period Covered By Exemption Report*

The Proposed Rule would (1) require a broker-dealer claiming an exemption from Rule 15c3–3 to make an assertion that it is exempt from the provisions of Rule 15c3-3 because it meets conditions set forth in paragraph (k) of Rule 15c3-3, and (2) require the accountant to prepare a report based on a review of this assertion. However, the Proposed Rule is silent on whether the broker-dealer's assertion and the accountant's review are required for a period of time or as of a certain date. We believe that the assertion and review should be as of the broker-dealer's fiscal year end and, accordingly, urge the Commission to clarify this in the final rule.

## III. Proposed Access to Audit Documentation Amendments

The Proposed Rule would require, in the annual statement that each clearing broker-dealer files with the Commission, that the broker-dealer designate its accountant and represent that examination staff from the Commission and the broker-dealer's designated examination authority (the "staff") will be permitted to (1) review the audit documentation associated with the accountant's annual audit reports required under Rule 17a–5 and (2) discuss the findings relating to the audit reports with the accountant.[13] The Proposed Rule also indicates that the Commission intends that requests for access to audit documentation be made exclusively in connection with conducting regulatory examinations of clearing broker-dealers.[14]

If the final rule adopts the proposed language regarding requests for access to audit documentation and for discussions with the accountant (collectively, "access"), we believe the Commission should clarify the process by which the staff would seek access in order to facilitate efficient coordination of this procedure. In particular, we suggest that the staff should first provide notification to the broker-dealer, in writing, that the staff plans to request such access. The staff should then make a written request to the accountant. We also believe it would be helpful if certain information about the access sought, such as the objective, scope, and periods requested, be included in the requests for access. In addition, we believe that the audit documentation that is accessed should only relate to engagements that have been completed and for which the audit documentation has been assembled for retention.

We believe the final rule also should clarify that documents to which the staff would have access, including any information derived from such documents or from discussions with the accountants, (1) will be subject to confidential treatment, (2) will be protected from requests made under the Freedom of Information Act, and (3) will be used only for purposes of the examination for which access is provided.

## IV. Requirement to File Annual Reports with SIPC

The Commission proposes to amend paragraph (d)(6) of Rule 17a–5 to require broker-dealers to file copies of their annual reports, including the accountant's report, with the Securities Investor Protection Corporation ("SIPC"). The proposal expressly notes that providing annual reports to SIPC is intended to facilitate

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13 *See* Proposed Rule 17a-5(f)(2)(ii)(F) and (G), 76 Fed. Reg. at 37,605 – 6.

14 76 Fed. Reg. at 37,583.

SIPC's efforts in bringing claims against accountants that had audited the annual reports of failed broker-dealers that are in liquidation.

We question the propriety of the Commission's stated purpose for implementing the proposed requirement. The provision of annual reports to SIPC does not appear to be essential to any regulatory function of SIPC; indeed, the Proposed Rule would not require that SIPC do anything with the reports. Instead, in proposing this particular amendment, the Commission admits that its purpose is to somehow facilitate suits brought by SIPC, a private entity, against other private entities. That is not a proper purpose for a government regulation.

In addition, the scope of SIPC's authority to pursue claims against third parties, including accountants, has been the subject of significant judicial scrutiny. The Supreme Court has expressly limited SIPC's authority to bring such claims under the Securities Investor Protection Act ("SIPA") and certain securities laws.[15] We are concerned that the proposed change is improperly designed to expand the circumstances in which accountants may be sued, notwithstanding the important and complex legal and policy considerations affecting SIPC's ability to pursue such claims. We urge the Commission to refrain from including this requirement in its final rule.

Moreover, we note that the proposal does not address the potential costs and benefits of requiring broker-dealers to provide copies of their annual reports to SIPC. Proper analysis of costs would include the incremental potential for litigation that the proposal is designed to foster. Given that the Commission is required under Section 3(f) of the Exchange Act to consider whether a proposed rule will promote efficiency, competition and capital formation, we urge the Commission to refrain from imposing this requirement until the appropriate analysis is conducted.[16]

## V. Interaction with Other Regulatory Rules

The Proposed Rule will impact a number of other regulations, including CFTC regulations and requirements under the Investment Advisers Act of 1940. Accordingly, the Commission should consider the relationship between the Proposed Rule and these other rules, and should revise the final rule as appropriate in light of these relationships.

### *a. IA Custody Rule*

In the Proposed Rule the Commission states that one of the objectives of the annual reporting amendments is to "eliminate potentially redundant requirements for certain broker-dealers affiliated with, or dually registered as, investment advisers."[17] We support the Commission's objective of reducing unnecessary duplication in a broker-dealer's compliance with both Rule 17a-5 and the IA Custody Rule when complying with

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15 *See Holmes v. SIPC*, 503 U.S. 258 (1992) (holding that SIPA does not give SIPC the right to sue third-parties for monetary damages resulting from matters arising in the liquidation proceedings of broker-dealers); *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979).

16 We note that the D.C. Circuit recently invalidated an SEC rule on these grounds. *See Bus. Roundtable v. S.E.C.*, No. 10-1305, 2011 WL 2936808, at *8 (D.C. Cir. Jul. 22, 2011).

17 76 Fed. Reg. at 37,572.

one rule would meet the objectives of both rules. In addition, we believe there are additional areas of redundancy that could be eliminated, namely:

*i. Annual Surprise Examination of Client Assets*

The IA Custody Rule requires registered investment advisers with "custody" of client assets (which includes broker-dealers affiliated with, or dually registered as, investment advisers) to have an independent accountant conduct an annual surprise examination of those assets to verify client funds and securities. The accountant's procedures for the surprise examination should normally include (on a sample basis per client account): (1) confirmation with both the qualified custodian (as defined in the IA Custody Rule) and clients of the clients' funds and securities and (2) confirmation with clients of contributions and withdrawals. We believe that a carrying broker-dealer subject to this aspect of the IA Custody Rule should be able to use the accountants' Examination Report on the Compliance Report to satisfy the annual surprise examination requirements of the IA Custody Rule. The objectives and the specific operational requirements of Rule 17a-13, *Quarterly Security Counts to be Made by Certain Exchange Members, Brokers and Dealers* and the account statement rules covered by the Examination Report are consistent with the objectives of the IA Custody Rule. In addition, consistent with the objectives of both sets of rules, the Proposed PCAOB standards for Examination Engagements Regarding Compliance Reports of Brokers and Dealers require accountants to obtain evidence of the existence of customer funds or securities held for customers, noting that direct observation (for physical securities) and third-party confirmation are examples of such procedures.

*ii. Review Report on the Exemption Report*

As discussed above, under the proposed annual reporting amendments, a broker-dealer that does not hold customer funds or securities (a "non-carrying broker-dealer") would be required to file an Exemption Report asserting the basis for its exemption from Rule 15c3-3, along with a report from its accountant (a "Review Report") concerning the accuracy of this assertion. As noted in the Proposed Rule, however, a broker dealer that is exempt from Rule 15c3-3 may still be a "qualified custodian" under the IA Custody Rule and hence could be required to engage an accountant to issue a separate internal control report to satisfy the IA Custody Rule.[18] The discrepancy between these requirements arises because each rule views the limited custodian services that a non-carrying broker-dealer may have to perform differently. Broadly, under Rule 15c3-3 a non-carrying broker-dealer must promptly transmit any customer assets it receives in a timely manner; by doing otherwise it would lose its exemption status and be subject to the Compliance Report. Thus, the accountant's Review Report considers customer assets that are processed by an exempt broker-dealer (e.g., an introducing broker that is affiliated with an investment adviser). If customer assets have not been promptly transmitted, the broker-dealer may lose its exemption and would then be subject to the proposed Compliance Report.

We also note that, in proposing the IA Custody Rule, the Commission specified control objectives that should be addressed by the accountant's internal control report required by that rule. We note that most of the control objectives specified in that release are not relevant to the operations of introducing brokers, as a result of the nature of their operations. Accordingly, we believe that a review of the transmittal procedures is a more appropriate check of the broker-dealer's operations and should be recognized by the Investment Adviser regulatory regime promulgated by the Commission.

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18 *See* Proposed Rule fn. 85, 76 Fed. Reg. at 37,580.

*b. Commodity Futures Trading Commission Rule 1.16*

CFTC Rule 1.16 requires an accountant that conducts an audit of a broker dealer that is registered with the CFTC as a Futures Commission Merchant ("FCM") to file a report with the CFTC related to the accountant's study of the broker-dealer's practices and procedures in complying with CFTC Rule 1.16.

In current practice, the accountant issues one report on the study of the FRR and CFTC Rule 1.16. If the Proposed Rule is adopted as currently drafted, accountants for certain broker-dealers would be required to provide two reports, one required by the Proposed Rule and one required by the CFTC rule. Requiring two reports may result in duplication of effort and could lead to increased costs for broker-dealers. Instead, we urge the Commission to work with the CFTC to align the requirements of CFTC Rule 1.16 with the requirements of the Proposed Rule in order to alleviate the burden and cost of duplicative reporting in the case of broker-dealers that are also FCMs.

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We are available to discuss our comments with the Commission and its staff. If you have any questions or would like to discuss these matters further, please do not hesitate to contact Dipti Gulati at (212) 436-5509, Chris Donovan at (212) 436-4478, or Bill Platt at (203) 761-3755. We thank you for your consideration of these matters.

Very truly yours,

Deloitte & Touche LLP

cc: Mary L. Schapiro, Chairman
Luis A. Aguilar, Commissioner
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