



# *PCAOB Forum on Auditing Smaller Broker-Dealers*

---

***Kevin M. Stout***

***Senior Associate Chief Accountant***

***Office of the Chief Accountant***

***U.S. Securities and Exchange Commission***

***May 28, 2014***



# *Disclaimer*

---

***The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or the other members of the staff of the Commission.***

# *Agenda*

---

## ❖ **Broker-Dealer Rulemaking**

- **July 30, 2013 Amendments to the SEC's Broker-Dealer Financial Responsibility Rules (Release No. 34-70072)**
- **Broker-Dealer Annual Reporting Requirements Prior to July 30, 2013 Amendments to Exchange Act Rule 17a-5**
- **July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)**
  - **Compliance Report (and related Examination)**
  - **Exemption Report (and related Review)**
  - **Other Requirements**
  - **Frequently Asked Questions**

## ❖ **Applicability of Auditor Independence Rules to Broker-Dealer Audits**



---

# *Broker-Dealer Rulemaking*

# *July 30, 2013 Amendments to the SEC's Broker-Dealer Financial Responsibility Rules*

---

- ❖ **Amendments made to:**
  - **Net Capital Rule (15c3-1)**
  - **Customer Protection Rule (15c3-3)**
  - **Books and Records Rules (17a-3 and 17a-4)**
  - **Notification Rule (17a-11)**
- ❖ **The amendments to the broker-dealer financial responsibility rules are designed to better protect a broker-dealer's customers and enhance the SEC's ability to monitor and prevent unsound practices.**
- ❖ **Amendments were effective October 21, 2013 (for certain amendments extension granted until March 3, 2014 – Release No. 34-70701)**

# *Broker Dealer Annual Reporting Requirements Prior to July 30, 2013 Amendments to Rule 17a-5*

---

- ❖ **Generally broker-dealers must file an annual report with the SEC and the broker-dealer's designated examining authority pursuant to Rule 17a-5**
  - **Annual report must contain audited financial statements and certain supporting schedules and supplemental reports, as applicable**
  - **The audit must be conducted in accordance with GAAS (i.e., not PCAOB standards)**
- ❖ **Report on Internal controls**
  - **Study of practices and procedures followed, including consideration of control activities for safeguarding securities (if applicable)**

# *July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)*

---

- ❖ In addition to existing requirements to file audited financial statements and certain supporting schedules (“Financial Report”), the amended Rule 17a-5 also requires the following new reports:
  - **Carrying** broker-dealer (as defined in SEC Release No. 34-70073) that has custody of customer assets to file a new Compliance Report, that will be examined by its independent public accountant
  - **Non-carrying** broker-dealer (as defined in SEC Release No. 34-70073) that does not have custody of customer assets to file a new Exemption Report, that will be reviewed by its independent public accountant

# *July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)*

---

- ❖ **Audits of the Financial Report, the examination of the Compliance Report and the review of the Exemption Report are to be conducted in accordance with PCAOB standards, instead of GAAS**
  - **The PCAOB has developed new attestation standards (AT Nos. 1 & 2) specifically tailored to the examination of the Compliance Report and the review of the Exemption Report, as well as a new auditing standard (AS No. 17) for supplemental information accompanying the financial statements**
  
- ❖ **Effective date:**
  - **The filing of Compliance Report and Exemption Report and the related auditor reports is effective for fiscal years ending on or after June 1, 2014**

# *July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)*

---

- ❖ **Compliance Report to include statements as to whether:**
  - **The broker-dealer has established and maintained Internal Control over Compliance;**
  - **Internal Control over Compliance was effective during the most recent fiscal year;**
  - **Internal Control over Compliance was effective as of the end of the most recent fiscal year;**
  - **The broker-dealer was in compliance with Rule 15c3-1 and Rule 15c3-3(e) as of its fiscal year-end;**
  - **The information used to state whether it was in compliance was derived from the books and records of the broker-dealer.**

# *July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)*

---

- ❖ **If applicable, a carrying broker-dealer would be required to include:**
  - **A description of each material weakness in Internal Control Over Compliance during the most recent fiscal year**
  - **A description of each instance of non-compliance with Rules 15c3-1 or 15c3-3(e) as of the end of the most recent fiscal year**

# *July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)*

---

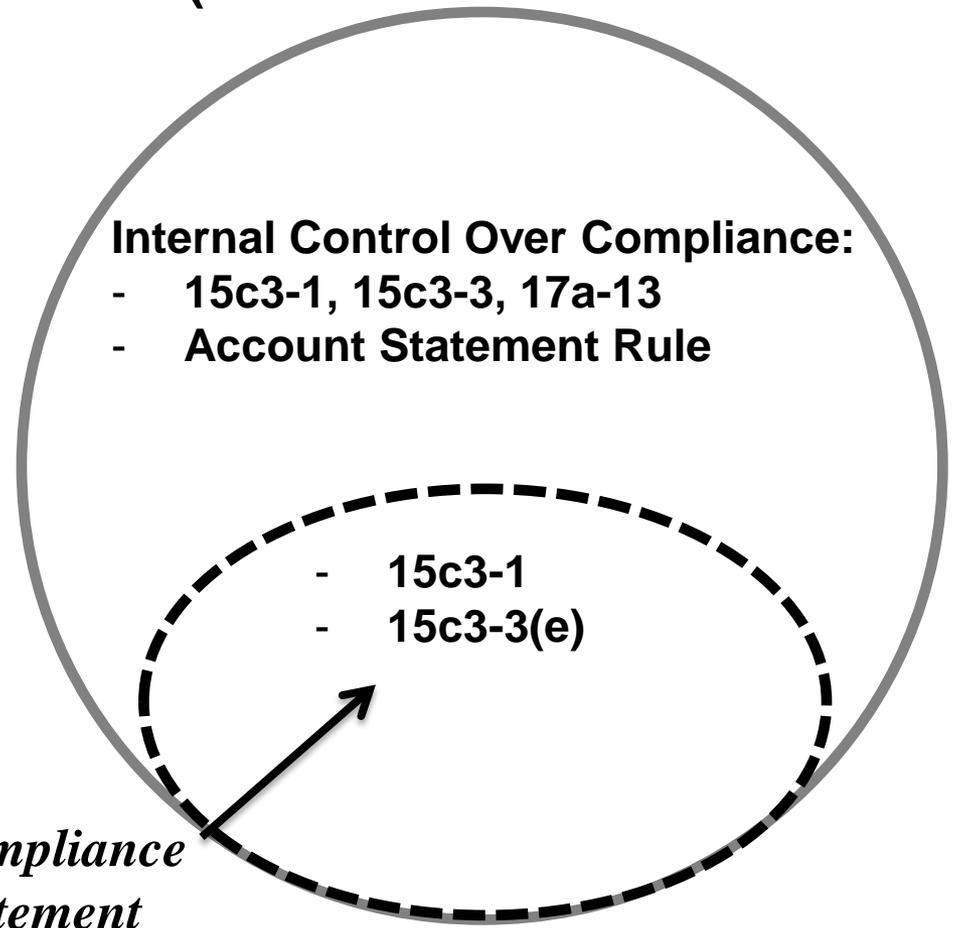
- ❖ **Internal Control Over Compliance (“ICOC”)**
  - **Internal controls that have the objective of providing the broker or dealer with reasonable assurance that non-compliance with Rules 15c3-1, 15c3-3, 17a-13, or any rule of the designated examining authority (“DEA”) of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer (an “Account Statement Rule”) will be prevented or detected on a timely basis**

# *July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)*

---

❖ The rules covered by ICOC are broader than those covered by the compliance statement (statement #4 in the Compliance Report)

❖ Additionally, the statements in the Compliance Report on ICOC cover the entire year and year end, where the compliance statement is as of year end only



# *July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)*

---

- ❖ **ICOC is intended to focus on a broker-dealer's oversight of custody arrangements and protection of customer assets.**
  - **ICOC differs from Internal Control over Financial Reporting ("ICFR"), which focuses on the reliability of financial reporting and the preparation of financial statements.**
  - **The recently amended rule does not require that the effectiveness of ICFR be included as one of the statements made by the broker-dealer in the compliance report, or opined on by the auditor**

# *July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)*

---

## ❖ **Material Weakness**

- **A deficiency, or a combination of deficiencies, in Internal Control Over Compliance such that there is a reasonable possibility that non-compliance with Rule 15c3-1 or Rule 15c3-3(e) will not be prevented or detected on a timely basis or that non-compliance to a material extent with Rule 15c3-3, except for paragraph (e), Rule 17a-13, or any Account Statement Rule will not be prevented or detected on a timely basis**

- ❖ **Term “material inadequacy” no longer appears in Rule 17a-5**

# *July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)*

---

- ❖ **Carrying broker-dealer is not permitted to conclude that its ICOC was effective**
  - **During the fiscal year if there were one or more material weaknesses in ICOC during the fiscal year**
  - **As of the end of the fiscal year if there were one or more material weaknesses in ICOC as of the end the fiscal year**
- ❖ **Carrying broker-dealer required to engage an independent public accountant to:**
  - **Prepare a report based on an examination of certain of the broker-dealer's statements contained in the Compliance Report**

# *July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)*

---

- ❖ **Non-carrying broker-dealer required to state the following in its Exemption Report:**
  - **The provisions in Rule 15c3-3(k) under which the broker-dealer claimed an exemption from Rule 15c3-3**
  - **Either:**
    - **The broker-dealer met the identified exemption provisions in Rule 15c3-3(k) throughout the most recent fiscal year without exception, or**
    - **The broker-dealer met the identified exemption provisions except as described in the Exemption Report**
  - **If applicable, an identification of each exception, a description of the nature of each exception, and the approximate date(s) on which the exception existed**

# *July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)*

---

- ❖ **Non-carrying broker-dealer required to engage an independent public accountant to:**
  - **Prepare a report based on a review of the broker-dealer's statements contained in the Exemption Report**
- ❖ **Note that a broker-dealer must file an Exemption Report if it claimed that it was exempt from Rule 15c3-3 throughout the most recent fiscal year, even in situations in which the broker-dealer had exceptions to meeting the exemption provisions in 15c3-3(k).**

# *July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)*

---

## ❖ **Notification requirements**

- **An auditor must immediately notify the CFO of the broker-dealer if**
  - **the auditor determines, in the course of preparing its reports, that the broker-dealer was not in compliance with Rule 15c3-1, 15c3-3, 17a-13 or its DEA's Account Statement Rule, or**
  - **In the performance of an examination of the Compliance Report, the accountant determines that any material weakness existed in the broker-dealer's ICOC**

# *July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)*

---

## ❖ **Notification requirements (cont'd)**

- **The broker-dealer must file a notification with the Commission, its DEA and the Commodity Futures Trading Commission (“CFTC”) (if the broker-dealer is registered as a futures commission merchant) if the auditor’s notice relates to an instance of non-compliance that would trigger notification, and provide a copy of the notification to the auditor**
- **If the auditor does not receive a copy of the notification within 1 business day, or if the auditor does not agree with the statements in the notification, the auditor must notify the SEC and DEA within one business day**
- **Amendments to the notification requirements are effective for fiscal years ending on or after June 1, 2014**

# *July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)*

---

## ❖ **Form Custody**

- **New form to be filed by all broker-dealers quarterly**
- **Filed with DEA concurrent with FOCUS Reports**
- **Comprised of 9 items designed to elicit information about a broker-dealer's custodial activities**
- **New Form Custody requirement effective on December 31, 2013**

# *July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)*

---

## ❖ **Access to audit documentation**

- **Clearing and Carrying broker-dealers to consent to permitting their independent public accountants to:**
  - **Make available to the Commission and DEA examiners the audit documentation associated with its annual reports required under Rule 17a-5**
  - **Discuss findings relating to the audit reports with the Commission and DEA examiners**
- **Consent required to be included in the independent public accountant designation letter that all broker-dealers are required to file with the Commission and their DEA**

# *July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)*

---

- ❖ **Securities Investor Protection Corporation (SIPC) Reporting**
  - **Broker-Dealer that is a SIPC member must file the annual report with SIPC. Requirement is effective for fiscal years ending on or after December 31, 2013**
  - **The independent public accountant report on applying agreed-upon procedures will continue to be conducted in accordance with AICPA attestation standards**
  - **Broker-Dealer required to file the SIPC supplemental report with SIPC until the earlier of the Commission approving a rule adopted by SIPC or two years**

# *July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)*

---

- ❖ **Interaction with the Investment Advisers Custody Rule 206(4)-2:**
  - **Broker-dealers that must also comply with the Investment Adviser Custody Rule are required to obtain annually an auditor's written internal control report**
  - **The Commission has determined that the independent public accountant's report based on an examination of the Compliance Report will satisfy this requirement**

# *July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)*

---

- ❖ **Division of Trading and Markets issued Frequently Asked Questions (FAQs) on April 4, 2014 that address amendments to Rule 17a-5 and reporting requirements in Form Custody:**
  - **FAQ No. 1 – Transitional guidance on reporting requirement for statements in the Compliance and Exemption Reports that refer to the “most recent fiscal year”**
  - **FAQ No. 2 – Period covered by the Compliance Report and the accountant’s examination report to satisfy the requirements for the internal control report under the Custody Rule**
  - **FAQ No. 3 - Applicability of the Compliance Report and the accountant’s examination report to other requirements in the Investment Adviser Custody Rule**

# *July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)*

---

- ❖ **April 4, 2014 FAQs (cont'd) :**
  - **FAQ No. 4 – Reporting requirements for statement regarding independent public accountant**
  - **FAQ No. 5 – Proprietary Accounts of Broker-Dealers (PAB) reserve computation and the supporting schedules accompanying the financial statements**
  - **FAQ No. 6 – Types of broker-dealers that can file an exemption report if not claiming exemption from Rule 15c3-3**
  - **FAQ No. 7 – No. 16 – Various reporting matters related to Form Custody**

---

*Applicability of Auditor  
Independence Rules to Broker-  
Dealer Audits*

# *Applicability of Auditor Independence Rules to Broker-Dealer Audits*

---

- ❖ **Auditors of both issuer and non-issuer broker-dealers are required to be qualified and independent in accordance with the Commission's auditor independence requirements in Rule 2-01 of Regulation S-X, *Qualifications of Accountants***
  - **No currently proposed changes to current requirements**
- ❖ **Division of Enforcement focus on this area**
  - **September 19, 2013 speech by Andrew Ceresney, Co-Director of the Division of Enforcement**

# *Applicability of Auditor Independence Rules to Broker-Dealer Audits*

---

- ❖ **Examples of applicable independence requirements:**
  - **Non-Audit Services – An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides, among others, the following non-audit services to an audit client:**
    - **Bookkeeping or other services related to the accounting records or financial statements of the audit client**
    - **Financial information systems design and implementation**
    - **Management Functions or Human Resources**
  - **Other Financial Interests in Audit Client – Broker-dealer accounts. Refer to Rule 2-01(c)(1)(ii)(C)**

# *Applicability of Auditor Independence Rules to Broker-Dealer Audits*

---

- ❖ **Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence**
  - **Auditors should not provide typing and word processing services nor financial statement templates that are not publicly available to broker-dealer audit clients**
  - **Auditors of non-issuer brokers-dealers are not subject to SEC rules related to:**
    - **Partner rotation requirements**
    - **Certain partner compensation arrangements**
    - **Audit committee administration requirements**
    - **“Cooling off” period requirements**

# *Contact Information*

---

## ❖ **Division of Trading and Markets**

- <http://www.sec.gov/divisions/marketreg/mrcontact.htm>
- Phone: (202) 551-5777
- E-mail : [tradingandmarkets@sec.gov](mailto:tradingandmarkets@sec.gov)

## ❖ **Office of the Chief Accountant**

- **Professional Practice Group (including Independence )**
- **Accounting**
- Phone: (202) 551-5300
- E-mail : [OCA@sec.gov](mailto:OCA@sec.gov)

---

*Questions?*