

## Broker-Dealer Annual Audits and Accounting Standards: SEC and PCAOB Developments

December 21, 2010

As the year closes, there are three recent **broker-dealer financial and operational developments** that we believe merit your attention. First, the Securities and Exchange Commission (SEC) recently issued a letter to the AICPA (American Institute of Certified Public Accountants) concerning **2010 broker-dealer annual audits**. Second, the Public Company Accounting Oversight Board (PCAOB) voted last week to propose new rules that will impose a fee on certain broker-dealers to offset PCAOB examination costs and also announced the adoption of an interim program to inspect public accounting firm audits of broker-dealers.

### SEC Letter to AICPA

In a letter dated November 18, 2010, the SEC's Chief Accountant and the SEC's Director of the Division of Trading and Markets reminded auditors that they must design their audits of broker-dealers in a manner "sufficient to provide reasonable assurance that any material inadequacies existing as of the date of the examination ... would be disclosed." The letter reiterates the importance of the auditors' role in ensuring that broker-dealers comply with the SEC's financial responsibility rules, and portends a year in which external auditors are likely to be even more cautious and rigorous in their broker-dealer exams.

***The letter obligates auditors to review a broker-dealer's practices, procedures and controls to ensure compliance with the securities possession or control requirements and the cash reserve elements of the Customer Protection Rule and tells auditors that their reviews should include those tests that the auditor considers necessary to provide reasonable assurance that any material inadequacies (and significant deficiencies or material weaknesses) existing at the examination would be disclosed.***

A copy of the SEC/AICPA letter can be found [here](#).

### PCAOB Actions

On December 14, 2010, the PCAOB voted at a meeting held in Washington, D.C. to issue two new rule proposals to commence implementation of provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) that expand PCAOB's oversight authority to include audits of brokers and dealers.

### Accounting Support Fee for Brokers and Dealers

The PCAOB issued for public comment a proposed funding rule that would impose a new accounting support fee on certain brokers and dealers. The proposed rule is the result of the Dodd-Frank Act, which, through an amendment to Section 109 of the Sarbanes-Oxley Act of 2002 (SOX), assigned PCAOB the responsibility to oversee audits of brokers and dealers, and instructed the PCAOB to allocate an

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1

accounting support fee equitably among issuers, brokers and dealers. The PCAOB proposes that the accounting support fee be based on quarterly “tentative net capital,” as reported on brokers’ and dealers’ FOCUS reports. For those brokers and dealers with a tentative net capital equal to or less than \$5 million, the PCAOB proposes that this class of brokers and dealers be allocated a share of zero of the accounting support fee. Under this approach, the PCAOB estimates that approximately 640 of 4,600 FINRA brokers and dealers would pay a share of the accounting support fee. The theory behind this allocation between different classes of broker-dealers is that tentative net capital is a proxy for a broker-dealer’s size and complexity, and that audits of more “complex” broker-dealers may require more PCAOB time and resources than audits of other, less complex broker-dealers.

Because a separate accounting support fee is already imposed on issuers, it is possible under the proposed rule for an issuer that has one or more broker-dealer subsidiaries to be allocated a share of the issuer accounting support fee and for each broker-dealer subsidiary to be allocated a share of the broker-dealer accounting support fee. PCAOB states in the proposing release that in this circumstance, the issuer would be responsible for payment of the issuer accounting support fee and each subsidiary would be responsible for payment of its allocated share of the broker-dealer accounting support fee.

The proposed rules would also change the formula for assessing the accounting support fee paid by issuers; among other things, the basis for calculating an issuer’s market capitalization would be revised to include the market capitalization of all classes of the issuer’s voting and non-voting common equity. Among the changes, the PCAOB is proposing to raise the average, monthly market capitalization threshold for investment company issuers and business development companies from \$250 million to \$500 million, thus resulting in an accounting support fee equal to zero.

The PCAOB proposes to begin the allocation and collection of the broker-dealer accounting support fee in 2011. Auditors would be prohibited from signing an audit report or similar notice or report if a broker-dealer was past due in the payment of its accounting support fee.

A link to the PCAOB rulemaking release for allocating the PCAOB’s accounting support fee among issuers, brokers, and dealers can be found [here](#).

### **Interim Inspection Program for Audits of Brokers and Dealers**

Pursuant to its authority under recent amendments to SOX under the Dodd-Frank Act, the PCAOB also issued for public comment a proposed temporary rule that would establish an interim inspection program for audits of SEC registered brokers and dealers. This interim inspection program would be designed to enable the PCAOB to assess the degree of compliance and the “actual practice” of registered public accounting firms in connection with the performance of their audits of brokers and dealers and to inform the PCAOB’s future determinations regarding the elements of a permanent inspection program. The interim inspection program would seek to assess the degree to which auditors are complying with SEC and PCAOB rules and professional auditing standards when they conduct broker-dealer audits. The interim inspection program would also be designed to assess whether a permanent inspection program should differentiate among classes of brokers and dealers (distinguishing, for example, between broker-dealers that receive customer funds and securities and those that do not) as well as whether to exempt any category of public accounting firm from the PCAOB’s inspection program. Ultimately, any temporary rule that PCAOB adopts for the interim program would take effect only if approved by the SEC.

Importantly, the proposing release announces the PCAOB's intent to adopt new professional standards and rules applicable to broker-dealer audits, based at least in part on the PCAOB's experience with the interim inspection program. The release states that the PCAOB is "evaluating whether to issue or amend auditing or attestation standards to provide specific procedures regarding the regulatory reports required under SEC Rule 17a-5, such as, among other things, the reports on internal accounting controls and on the procedures for safeguarding customer securities, and the computation of net capital." The release also states that the PCAOB expects to report conduct that suggests a violation of SEC or other rules by broker-dealers, to the SEC, FINRA or other authorities.

A link to the PCAOB rulemaking release for an interim program of inspection related to audits of brokers and dealers can be found [here](#).

Comments to the PCAOB are due for both rule proposals by no later than February 15, 2011.



*If you have any questions about this Legal Alert or are considering commenting on any of the proposed rules, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*

**Author**

Holly H. Smith

202.383.0245

[holly.smith@sutherland.com](mailto:holly.smith@sutherland.com)

**Related Attorneys**

Stephen E. Roth

202.383.0158

[steve.roth@sutherland.com](mailto:steve.roth@sutherland.com)

Eric A. Arnold

202.383.0741

[eric.arnold@sutherland.com](mailto:eric.arnold@sutherland.com)

Clifford E. Kirsch

212.389.5052

[clifford.kirsch@sutherland.com](mailto:clifford.kirsch@sutherland.com)

Michael B. Koffler

212.389.5014

[michael.koffler@sutherland.com](mailto:michael.koffler@sutherland.com)

Susan S. Krawczyk

202.383.0197

[susan.krawczyk@sutherland.com](mailto:susan.krawczyk@sutherland.com)