

Client Alert

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SEC to Broker-Dealers: More Oversight, Fewer Madoffs?

By Daniel Nathan and Adam Fleisher

The Securities and Exchange Commission (SEC) published a [Final Rule](#) last week amending certain annual reporting, audit, and notification requirements for broker-dealers in the broker-dealer reporting rule (Rule 17a-5) and the broker-dealer notification rule (Rule 17a-11). These amendments were enacted using the additional authority provided to the Public Company Accounting Oversight Board (PCAOB) by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The PCAOB is empowered to establish standards with regard to audits of broker-dealer reports filed with the SEC, and, thus, the PCAOB is in a position to exercise its standard-setting authority over audits of broker-dealers registered with the SEC. The primary impetus for the amendments apparently was the series of high-profile cases involving fraudulent conduct by investment advisers and broker-dealers, such as the Bernie Madoff and Stanford International Bank scandals. This action also follows findings by the PCAOB last summer of consistent problems with the work done by auditors of broker-dealers.

The Final Rule will increase the reporting requirements of broker-dealers, and expose them—and their auditing firms—to greater scrutiny. Broker-dealers (BDs) must file annual reports with the SEC that consist of a financial report along with either (1) a compliance report, or (2) an exemption report. In addition, all BDs must file reports prepared by independent public accountants that cover the internally-prepared reports. Such accountants must be registered with the PCAOB and the review must be consistent with PCAOB standards (as opposed to generally accepted auditing standards (GAAS)).

In addition, the Final Rule requires accountants to immediately notify the BDs of any noncompliance issues that arise during the course of preparing the accountants' reports. If an accountant finds any material weakness in the BD's internal compliance controls, the accountant must notify the BD, and the BD may in turn have to file notice with the SEC and the BD's designated examining authority (DEA).

The other significant component of the Final Rule is the requirement that a BD that clears transactions or carries customer accounts must allow the SEC or DEA examiners to review the background materials supporting the reports as provided by the BD's independent public accountant. The BD must permit the accountant to discuss findings related to its reports with examiners when requested in connection with a regulatory examination of the BD. Finally, the Rule's amendments also include new form filing requirements and new technical amendments.

More detail on the Final Rule is provided below.

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REQUIREMENT TO FILE REPORTS; NATURE OF COMPLIANCE REPORT AND EXEMPTION REPORT

- Under amended Paragraph (d)(1) of Rule 17a-5, all BDs must generally prepare and file a financial report and either a compliance report or an exemption report.
- BDs also must have a PCAOB-registered independent public accountant create a report covering the BD's financial report and the compliance report or exemption report, as applicable, and then file that report.
- Under amended Paragraph (d)(3), a BD's compliance report must contain statements regarding whether the following have occurred:
 - The BD has established and maintained Internal Control Over Compliance, i.e., internal controls that are intended to provide the BD with reasonable assurance that non-compliance with the financial responsibility rules will be prevented or timely detected;
 - The Internal Control Over Compliance was effective during the most recent fiscal year and as of the end of the most recent fiscal year;
 - The BD was in compliance with the net capital requirements of Rule 15c3-1 and the customer protection requirements of Paragraph (e) of Rule 15c3-3 as of the end of the most recent fiscal year; and
 - The information the BD used to state its compliance with the net capital and customer reserve requirements was in fact pulled from the BD's books and records.
- In addition, if applicable, the compliance report must contain a description of:
 - Each identified material weakness in the Internal Control Over Compliance during the most recent fiscal year, including those identified before year-end; and
 - Any instance of non-compliance with the minimum net capital requirements or customer reserve requirements as of the end of the most recent fiscal year.
- The Final Rule also includes extensive details regarding the conditions for a BD to conclude that its Internal Control Over Compliance was effective.
- Finally, under Paragraph (d)(4) of Rule 17a-5, exemption reports must contain the following statements made to the best knowledge and belief of a BD:
 - a statement that identifies the basis for the BD's claimed exemption from the minimum net capital requirements;
 - a statement that the BD met exemption provisions specified by rules regarding those minimum requirements, or that it met the exemptions except as indicated in the exemption report; and
 - if applicable, a statement that identifies each exception during the most recent fiscal year to meeting the minimum net capital requirements that briefly describes the nature of each exception and when the exception existed.

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INDEPENDENT PUBLIC ACCOUNTANT REQUIREMENTS

- The Final Rule changes the standards for accounting reports auditing BDs' reports. Instead of GAAS, accountants now must prepare a report based on an examination of a BD's financial report in accordance with the standards of the PCAOB.
- With regard to audit documents, under revised Paragraph (f)(2)(ii)(F) of Rule 17a-5, examiners from the SEC and/or a BD's DEA may ask to review audit documentation in connection with a BD examination.
 - The amended Final Rule makes clear that a regulator must make any request to a BD's independent public accountant to discuss audit findings or for access to audit documentation in writing.

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