

Forum on Auditing Smaller Broker-Dealers

December 2, 2014

Las Vegas, NV

Caveat

One of the benefits of today's session is that you will hear firsthand from one of the PCAOB Board members and numerous PCAOB staff. You should keep in mind, though, that when we share our views they are those of the speaker alone, and do not necessarily reflect the views of the Board, its members or staff.

Welcome

Jay D. Hanson
Board Member, PCAOB

Implementing Rule 17a-5 and the PCAOB Audit and Attestation Standards



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Caveat

The views we express today are our own and do not necessarily reflect the views of the Board, individual Board members, or other members of the Board's staff.

Agenda

- ❑ Coordinating the Audit and Audit Procedures on the Supporting Schedules and the Attestation Engagements
- ❑ Performing Audit Procedures on Supporting Schedules
- ❑ Examination Engagements
- ❑ Review Engagements
- ❑ Other PCAOB Standards and Rules



PCAOB Forum on Auditing Smaller Broker-Dealers

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U.S. Securities and Exchange Commission

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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**
 - **Implementation Observations**

❖ **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 requirement to file a Compliance Report and Exemption Report and the related auditor reports is effective for fiscal years ending on or after June 1, 2014**

Applicability of New PCAOB Standards*

	Broker-Dealer	Related Auditor Requirement
Carrying broker (custody of customer assets)	<u>Financial Report:</u> <ul style="list-style-type: none"> Financial statements Supporting Schedules <u>Compliance Report</u> (new)	Audit Audit procedures: <u>AS 17</u> Examination: <u>AT 1</u>
Non-carrying broker (no custody of customer assets)	<u>Financial Report:</u> <ul style="list-style-type: none"> Financial statements Supporting Schedules <u>Exemption Report</u> (new)	Audit Audit procedures: <u>AS 17</u> Review: <u>AT 2</u>

* Effective for all broker-dealers with fiscal years ending on or after June 1, 2014.



Coordinating the Audit and Audit Procedures on the Supporting Schedules and the Attestation Engagements

Coordinating

PCAOB standards require coordination among the audit, the audit procedures on the supporting schedules, and the examination engagement or review engagement

- Financial statement audit
 - The auditor should take into account evidence obtained from the results of the auditing procedures on the supporting schedules and the examination engagement or review engagement when evaluating the results of the audit and forming an opinion on the financial statements
- Supporting schedules
 - The auditor should take into account relevant evidence from the audit of the financial statements and the examination or review in planning and performing audit procedures related to the supporting schedules and in evaluating the results of the audit procedures to form the opinion on the supporting schedules

Coordinating

PCAOB standards require coordination among the audit, the audit procedures on the supporting schedules, and the examination engagement or review engagement (cont.)

- ❑ Examination or review engagement
 - In planning and performing procedures for, and evaluating the results of the procedures performed in, the examination or review engagement, the auditor should take into account relevant evidence from the audit of the financial statements and the audit procedures performed on the supporting schedules

- ❑ The objectives of the audit and the examination or review are not the same, however, so the auditor must plan and perform the work to meet the objectives of both the audit and the attestation engagement



Supporting Schedules: Auditing Standard No. 17

Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements*

- ❑ Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements*, applies when the auditor of the financial statements is engaged to audit and report on supplemental information that accompanies audited financial statements.
- ❑ Examples of supplemental information include the supporting schedules required by SEC Rule 17a-5 for broker-dealers.

Auditing Standard No. 17, Auditing Supplemental Information Accompanying Audited Financial Statements

- Objective of the auditor
 - To obtain sufficient appropriate audit evidence to express an opinion (reasonable assurance) on whether the SI is fairly stated, in all material respects, in relation to the financial statements as a whole

- Materiality
 - Generally the same materiality considerations as those used in planning and performing the audit of the financial statements

Auditing Standard No. 17, Auditing Supplemental Information Accompanying Audited Financial Statements

- Requires the auditor to perform certain audit procedures to test and evaluate the supplemental information including
 - Obtain an understanding of the methods of preparing the SI, evaluate the appropriateness of those methods, and determine whether those methods have changes from the methods used in the prior period and, if the methods have changed, determine the reasons for and evaluate the appropriateness of such changes
 - Inquire of management about any significant assumptions or interpretations underlying the measurement or presentation of the SI
 - Determine that the SI reconciles to the underlying account and other records or to the financial statements, as applicable

Auditing Standard No. 17, Auditing Supplemental Information Accompanying Audited Financial Statements

- Requires the auditor to perform certain audit procedures to test and evaluate the supplemental information including (cont.)
 - Perform procedures to test the completeness and accuracy of supplemental information to the extent that it was not tested as part of the audit of financial statements
 - Evaluate whether the supplemental information, including its form and content, complies with relevant regulatory requirements or other applicable criteria, if any

Auditing Standard No. 17, Auditing Supplemental Information Accompanying Audited Financial Statements

- Reporting
 - Report is different from report in AU sec. 551
 - Opinion (reasonable assurance)

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)

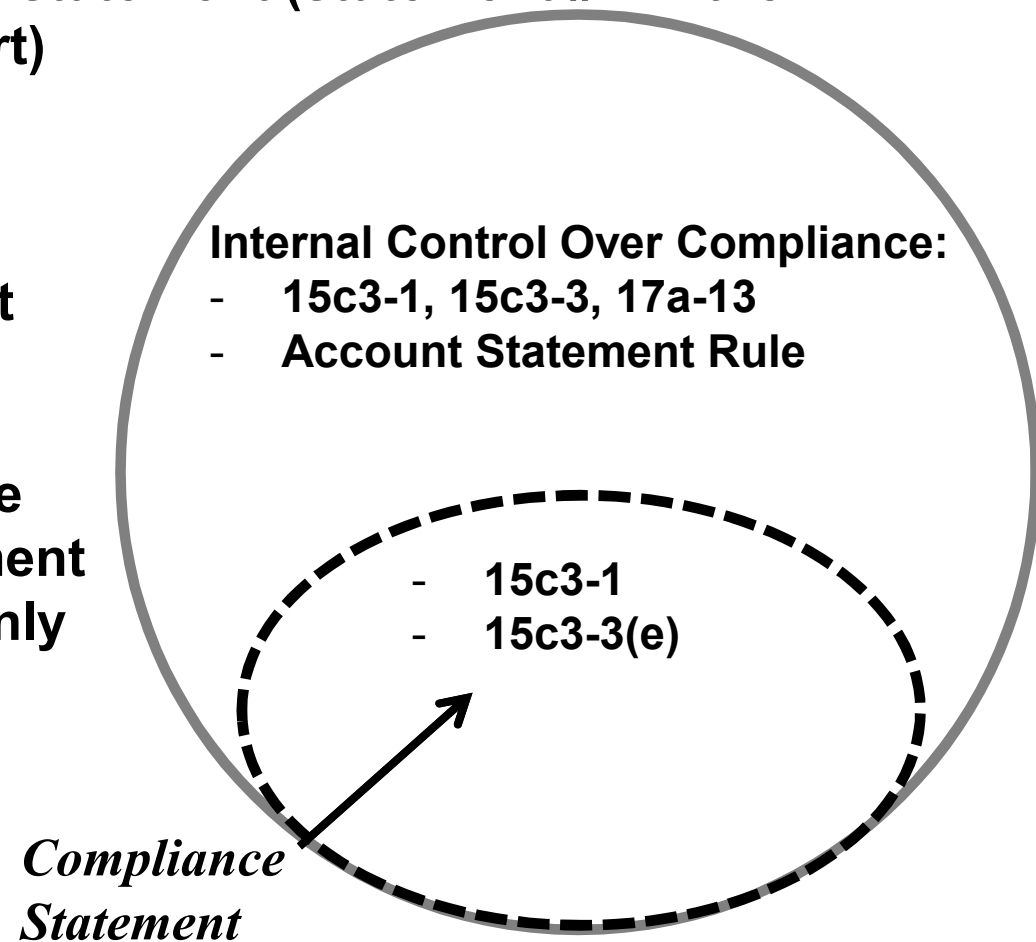
- ❖ **If applicable, a carrying broker-dealer would be required to include:**
 - **A description of each material weakness in Internal Control Over Compliance during the most recent fiscal year**
 - **A description of each instance of non-compliance with Rules 15c3-1 or 15c3-3(e) as of the end of the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



Examination Engagements: Attestation Standard No. 1

Examination Engagement: Attestation Standard No. 1

- The auditor's objective in the examination is to express an opinion regarding whether the assertions made by the broker-dealer in its compliance report are fairly stated, in all material respects.

- Reasonable assurance
 - A high level of assurance
 - Express an "opinion" on each of the broker-dealer's assertions

Examination Engagement: Attestation Standard No. 1

- Planning the engagement
 - Establishing an overall strategy for the examination and developing a plan which includes, the nature, timing and extent of procedures necessary to obtain reasonable assurance
 - Coordinating with the audit of the financial statements and audit procedures performed on the supporting schedules
 - Performing planning procedures
 - Assessing the risk of fraud, including the risk of misappropriation of customer assets

Examination Engagement: Attestation Standard No. 1

Testing Internal Controls Over Compliance both throughout the year and as of year end

- Obtain an understanding of the broker's or dealer's processes, including relevant controls, regarding compliance with the financial responsibility rules
- ICOC – Internal controls that have the objective of providing the broker or dealer with reasonable assurance that non-compliance with SEC Rules 15c3-1, 15c3-3, 17a-3, or any rule of the DEA of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer, will be prevented or detected on a timely basis

Examination Engagement: Attestation Standard No. 1

Testing Internal Controls Over Compliance both throughout the year and as of year end (cont.)

- Test controls
 - Evidence depends upon the risk associated with the control
 - As the risk associated with the control being tested increases, the persuasiveness of the evidence that the auditor should obtain also increases

Examination Engagement: Attestation Standard No. 1

Testing Internal Controls Over Compliance both throughout the year and as of year end (cont.)

- Design effectiveness
 - Testing design effectiveness includes determining whether the broker's or dealer's controls, if they are operating as prescribed by persons possessing the necessary authority and competence to perform the control effectively, can effectively prevent or detect instances of non-compliance with the financial responsibility rules on a timely basis.

Examination Engagement: Attestation Standard No. 1

Testing Internal Controls Over Compliance both throughout the year and as of year end (cont.)

- Operating effectiveness
 - Obtain evidence throughout the year *and* as of year end
 - Methods of testing include a mix of inquiry, observation, inspection, and reperformance
 - Understanding changes in controls and testing new and superseded controls

Examination Engagement: Attestation Standard No. 1

Testing Internal Controls Over Compliance both throughout the year and as of year end (cont.)

- Evaluate deficiencies in ICOC to determine whether the deficiencies individually or in combination, are Material Weaknesses in ICOC
- The auditor cannot assume that an identified deficiency in ICOC is an isolated occurrence
- The auditor should evaluate the effect of any identified control deficiency on the auditor's assessment of risks associated with the controls and non-compliance
- The auditor should evaluate the effect Material Weaknesses on the audit of the financial statements and audit procedures performed on supplemental information

Examination Engagement: Attestation Standard No. 1

Testing Compliance with SEC Rule 15c3-1 and SEC Rule 15c3-3(e)

- Evaluate whether the amounts in the schedules were determined in accordance with SEC rules
- Test the accuracy and completeness of information in schedules
- Determine whether the broker or dealer maintained the required level of net capital
- Determine whether the broker or dealer maintained a special reserve bank account for the exclusive benefit of customers and deposited funds in at least the required amount in accordance with paragraph (e) of SEC Rule 15c3-3

Examination Engagement: Attestation Standard No. 1

Testing Compliance with SEC Rule 15c3-1 and SEC Rule 15c3-3(e) (cont.)

- Determine whether the information in the schedules was derived from the books and records of the broker or dealer
- Determine whether the broker or deal made the notifications, if any, required by the net capital rule and reserve requirements rule as of the end of the most recent fiscal year
- Plan and perform compliance tests that are responsive to the risks, including fraud risks, associated with non-compliance with 15c3-1 and 15c3-3(e)
- Perform procedures to obtain evidence about the existence of customer funds or securities held for customers

Examination Engagement: Attestation Standard No. 1

Testing Compliance with SEC Rule 15c3-1 and SEC Rule 15c3-3(e) (cont.)

- Evaluate identified instances of non-compliance with the net capital rule and the reserve requirements rule to determine whether any instance of non-compliance existed as of the end of the most recent fiscal year
- The auditor cannot assume that an identified instance of non-compliance is an isolated occurrence
- Instances of non-compliance might indicate the existence of one or more Deficiencies in ICOC
- The auditor should evaluate the effect of any instance of non-compliance on the auditor's assessment of risks associated with the controls and non-compliance

Examination Engagement: Attestation Standard No. 1

Testing Compliance with SEC Rule 15c3-1 and SEC Rule 15c3-3(e) (cont.)

- The auditor should evaluate the effect on the audit of the financial statements and audit procedures performed on supplemental information

Examination Engagement: Attestation Standard No. 1

Testing that the information used to assert compliance was derived from the books and records of the broker-dealer

- Consider work performed on 15c3-1 and 15c3-3 supporting schedules
- Consider compliance work performed
- Evaluate identified instances in which the information used to assert compliance with the 15c3-1 or paragraph (e) of 15c3-3 was not derived from the broker's or dealer's books and records to determine whether material, individually or in combination

Examination Engagement: Attestation Standard No. 1

- Evaluating the results
 - Evaluate all evidence obtained
 - Evaluate whether sufficient appropriate evidence has been obtained to support the conclusions to be presented in the examination report taking into account
 - the risks associated with controls and non-compliance
 - the results of the examination procedures performed
 - The appropriateness (i.e., the relevance and reliability) of the evidence obtained

Examination Engagement: Attestation Standard No. 1

□ Communications

- In an examination engagement, the auditor should communicate:
 - To management; all identified deficiencies in Internal Control Over Compliance
 - To management and the audit committee; instances of identified noncompliance with the financial responsibility rules, identified Material Weaknesses, and identified instances in which information used to determine compliance with the SEC Rule 15c3-1 or paragraph (e) of SEC Rule 15c3-3 was not derived, in all material respects, from the broker's or dealer's books and records

Examination Engagement: Attestation Standard No. 1

- Reporting
 - Reporting on the assertions (not the process)
 - Opine on each assertion
 - Adverse opinion must express an opinion on the subject matter rather than on the assertion.
 - Modified or adverse report
 - Can have clean opinion on one or more of the assertions along with an adverse opinion on one of more of the assertions
 - For example, BD was in compliance as of year end and compliance was determined from the books and records, however, a material weakness exists in internal controls over compliance with the specified financial responsibility rules



Break

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).**



Review Engagements: Attestation Standard No. 2

Review Engagement: Attestation Standard No. 2

- ❑ The auditor's objective is to state a conclusion regarding whether, based upon the results of the review procedures, the auditor is aware of any material modifications that should be made to the broker-dealer's assertions for the assertions to be fairly stated in all material respects.
- ❑ Moderate assurance
 - Obtained by performing with due professional care the inquiries and other procedures required by AT No. 2 in order to reach a conclusion about whether there is a need to modify the broker's or dealer's assertions for the assertions to be fairly stated

Review Engagement: Attestation Standard No. 2

- ❑ Assertions would not be fairly stated, in all material respects when:
 - Assertion that identifies the provisions in paragraph (k) of SEC Rule 15c3-3 under which the broker or dealer claimed an exemption is inaccurate;
 - The broker or dealer asserts that it met the identified exemption provisions in paragraph (k) of SEC Rule 15c3-3 without exception when the auditor is aware of exceptions
 - The broker's or dealer's assertion that identifies and describes each exception during the most recent fiscal year in meeting the identified exemption provisions in paragraph (k) of SEC Rule 15c3-3 is inaccurate or incomplete

Review Engagement: Attestation Standard No. 2

- Planning the review
 - Should be coordinated with the audit of the financial statements and the audit procedures performed on the supporting schedules
 - Includes taking into account the results of the procedures from the audit and the auditing procedures on the supporting schedules
 - Plan and perform the work to meet the objectives of both engagements

Review Engagement: Attestation Standard No. 2

- Nature, timing, and extent of procedures depends on, among other things:
 - History of instances of noncompliance with the exemption provisions
 - Changes in procedures, controls, or the environment in which the controls operate since the prior year
 - The risk of fraud, including the risk of misappropriation of customer assets, relevant to the exemption provisions
 - Evidence about the broker's or dealer's compliance with the exemption provisions or about the effectiveness of controls over compliance with the exemption provisions obtained from the audit of the financial statements and the audit procedures performed on supplemental information

Review Engagement: Attestation Standard No. 2

- Performing the review engagement
 - Read documentation regarding the broker's or dealer's identified exceptions and compare it to the information included in the exemption report
 - Other review procedures
 - Reading correspondence with SEC and DEA
 - Reading reports of internal auditors, others who perform an equivalent function and compliance functions that are relevant to compliance
 - Reading regulatory filings that are relevant to compliance with the exemption conditions

Review Engagement: Attestation Standard No. 2

- Performing the review engagement (cont.)
 - Inquiries regarding
 - Compliance with the exemption provisions
 - Regulatory examinations and correspondence
 - Subsequent events
 - Known instances of non-compliance
 - Nature and frequency of customer complaints that are relevant to compliance
 - Controls in place to maintain compliance
 - Nature and frequency of monitoring activities

Review Engagement: Attestation Standard No. 2

- Performing the review engagement (cont.)
 - Examples of audit procedures that may provide evidence for review engagement (will vary based on type of exemption claimed)
 - Testing of transactions related to customer trades
 - Testing of specially designated cash accounts or other audit procedures regarding cash
 - Testing investment inventory or transactions related to the broker-dealer's proprietary trading
 - Audit procedures performed on the clearing agreement, test of commission revenue, or clearing expense

Review Engagement: Attestation Standard No. 2

- Evaluating the results
 - If information comes to the auditor's attention indicating that one or more undisclosed exceptions might exist, other than the exceptions disclosed in the exemption report or if the audit has substantial doubt about one or more of the assertions the auditor should perform additional procedures as necessary to address the matter

Review Engagement: Attestation Standard No. 2

- Evaluating the results (cont.)
 - Evaluate whether information has come to the auditor's attention that causes the auditor to believe that one or more of the assertions are not fairly stated in all material respects.
 - If the assertion is not fairly stated in all material respects:
 - Modify the review report (see reporting)
 - Evaluate the effect of the matter on the audit and the audit procedures on the supporting schedules

Review Engagement: Attestation Standard No. 2

□ Communications

- The auditor should communicate to management and to the audit committee; any exceptions to the exemption provisions identified by the auditor and information that causes the broker's or dealer's assertions about the exemption provisions not to be fairly stated in all material respects

Review Engagement: Attestation Standard No. 2

- Reporting
 - If assertion(s) are not fairly stated, in all material respects, the auditor must modify the report to describe the reasons
 - If one or more exceptions was omitted, the auditor's report should disclose each omitted exception

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**

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

❖ Reporting

- **SEC Form X-17a-5 Part III**
- **Compliance and Exemption Report**
 - **Reports must cover the requirements in Rule 17a-5(d)(3)(i)(A)-(C) for the Compliance Report and Rule 17a-5(d)(4)(i)-(iii) for the Exemption Report**
 - **Same person that signs the oath or affirmation to sign the Compliance or Exemption Report**
 - **No required template**
 - **Material Inadequacy report no longer relevant (replaced by Examination Report or Compliance Report for SEC registered broker-dealers)**



PCAOB Standards and Rules

PCAOB Standards and Rules

- PCAOB auditing and related professional practice standards include:
 - Auditing Standards
 - Attestation Standards
 - Ethics and Independence Standards and Rules
 - Quality Control Standards

- Standards consist of:
 - Standards issued by the Board
 - Standards adopted by the Board on an initial transitional basis as amended by the Board

Auditing Standard No. 3, *Audit Documentation*

- ❑ Auditor must document procedures performed, evidence obtained, and conclusions reached.
- ❑ An experienced auditor must understand the work performed.
 - An *experienced auditor* has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry.

Auditing Standard No. 3, *Audit Documentation*

- Two dates defined in this standard:
 - Report release date
 - The date the auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements.
 - Documentation completion date
 - A date not more than 45 days after the report release date when a complete and final set of audit documentation should be assembled for retention.

Auditing Standard No. 3, *Audit Documentation*

- Engagement completion document (cont.)
 - In the examination or review, significant findings or issues include, when applicable: the assessment of, and the responses to, risks requiring special consideration by the auditor, significant matters involving systems, processes, and controls to ensure the appropriateness of the subject matter and management's related assertions; and the evaluation of identified instances of nonconformity with the evaluation criteria (e.g. errors, instances of non-compliance, or control deficiencies).

Auditing Standard No. 7, *Engagement Quality Review*

- ❑ An engagement quality review and concurring approval of issuance are required for the following engagements conducted pursuant to the standards of the PCAOB:
 - Audit engagements
 - Reviews of interim financial information
 - Attestation engagements performed pursuant to Attestation Standard No. 1 and Attestation Standard No. 2
- ❑ Requires concurring approval of issuance prior to granting permission to the client to use the engagement report.

Risk Assessment Standards Overview

- ❑ Auditing Standard No. 8, *Audit Risk*
- ❑ Auditing Standard No. 9, *Audit Planning*
- ❑ Auditing Standard No. 10, *Supervision of the Audit Engagement*
- ❑ Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*
- ❑ Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*
- ❑ Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*
- ❑ Auditing Standard No. 14, *Evaluating Audit Results*
- ❑ Auditing Standard No. 15, *Audit Evidence*

Risk Assessment Standards Overview

- ❑ Covers the entire audit process from initial planning activities to forming the opinions to be expressed in the auditor's report.
- ❑ Establishes a process for obtaining evidence to support the auditor's risk assessments.
- ❑ The requirements link audit tests to the assessed risks.
- ❑ Integrates fraud considerations into the core audit process.
- ❑ Focuses more audit attention on financial statement disclosures.

Auditing Standard No. 16, *Communications with Audit Committees*

- ❑ AS No. 16 requires communications with the audit committee to be made in a timely manner and prior to the issuance of the audit report.
- ❑ Definition of audit committee:
 - For audits of issuers, AS No. 16 retains the definition of audit committee from the Sarbanes-Oxley Act.
 - A committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to the company, the entire board of directors of the company.
 - For audits of nonissuers, if no audit committee or board of directors (or equivalent body) exists with respect to the company, the person(s) who oversee the accounting and financial reporting processes of the company.

Keeping Current with Standards

- Website: <http://www.pcaobus.org/Standards/index.aspx>
 - PCAOB standards and related rules, including interim standards
 - PCAOB proposed standards
 - Staff questions and answers
 - Staff audit practice alerts
 - Standing Advisory Group
- E-mail: info@pcaobus.org
- Online inquiries: [http://pcaobus.org/About/Pages/ContactUsWebForm.aspx?Contact=Standard-related Inquiries](http://pcaobus.org/About/Pages/ContactUsWebForm.aspx?Contact=Standard-related%20Inquiries)
- Subscription to PCAOB e-mail updates of web postings: <http://pcaobus.org/About/Pages/Subscribe.aspx>



*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 activity in 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

❖ **Office of the Chief Accountant**

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

Questions?



Conforming Amendments to PCAOB Rules and Forms for Broker-Dealer Auditors

Mary M. Sjoquist, Director,
Office of Outreach and
Small Business Liaison
December 2, 2014
Las Vegas, NV

Background on Amendments

- ❑ July 21, 2010, Dodd Frank Wall Street Reform and Consumer Protection Act amended certain provisions of the Sarbanes Oxley Act
- ❑ Primary change was to give PCAOB oversight authority over auditors of SEC-registered brokers and dealers (BDs)
 - Amendments to certain Board rules
 - Amendments to certain Board forms
 - All amendments to forms effective July 1, 2014 except for the Amendments to Form 2 which are effective April 1 2015
 - All Amendments to rules effective June 1, 2014

Changes to Definitions of Audit and Audit Services

- Audit—means an examination of the financial statements, reports, documents, procedures, controls, or notices of any issuer, broker, or dealer by an independent public accounting firm in accordance with the rules of the Board for the purpose of expressing an opinion on the financial statements or providing an audit report.
- Audit Services—with respect to brokers and dealers, the term refers to professional services rendered for the audit of a BD's annual financial statements, supporting schedules, supplemental reports, and for the report on BD's compliance report or exemption report.

Changes to Definition of Audit Committee

- ❑ Revised to add a definition for audits of non-issuers where there is no audit committee or board of directors (or equivalent body) with respect to the entity.
- ❑ In such cases, “audit committee” means the person(s) who oversee(s) the accounting and financial reporting processes of the entity and audits of the financial statements of the entity.

Ethics and Independence Rules Applicable to Auditors of Brokers and Dealers

- Overall framework (Rule 3520)
- Contingent fees (Rule 3521)
- Tax transactions (Rule 3522)
- Communications with audit committees concerning independence (Rule 3526)
- PCAOB independence rules applicable to auditors of issuers but not to auditors of brokers and dealers (Rules 3523, 3524 and 3525)

Key Changes to Form 1 Application for Registration Affecting BD Auditors

- ❑ Most firms not effected
- ❑ New broker-dealer auditors registering
 - Identifying information on all audit clients for whom and audit report was prepared during the previous and current calendar year: name, address, CRD and CIK numbers, date of report, fees billed for audit services and fees billed for non-audit services
 - For audits expected to be completed during the current calendar year, date and fees are not required
 - For audits for whom the auditor played or expects to play a substantial role: CRD and CIK numbers, name of firm issuing report, date of report, if issued, type of substantial role played

Key Changes to Form 2 Annual Report Affecting BD Auditors

- ❑ Firms are now required to indicate whether they have issued any reports with respect to brokers or dealers during the reporting period.
- ❑ If not, they must indicate if they have played a substantial role in the audit of any such report.
- ❑ For each audit report issued for a broker or dealer, the firm must provide the BD's name, CRD and CIK numbers and dates of reports.
- ❑ Indication of range of number of firm personnel with authority to sign a BD's audit report.
- ❑ If firm signed no audit reports but played a substantial role, the BD's name, CRD and CIK numbers, end dates of the periods covered by the financial statements, and a description of the substantial role played by the firms.

Key Changes to Form 3—Special Report

□ Form 3

- Firm has become aware that in a matter arising out of his or her conduct in the course of providing audit or other accounting service certain firm partners, employees or others have become involved in certain legal proceedings.
- In addition to Board disciplinary sanctions barring or suspending persons from being an associated person of a registered public accounting firm and Commission orders denying the privilege of appearing or practicing before the Commission, a provision requiring court-ordered injunctions prohibiting appearance or practice before the Commission has been added to Items 2.12 and 2.13 of Form 3.

Office of Outreach Contact Information

- ❑ Outreach@PCAOBUS.ORG
- ❑ 202-591-4135

Questions?



Financial and Operational Requirements for Broker-Dealers & Regulatory Issues and Concerns

PCAOB Forum on Auditing Smaller Broker-Dealers
Las Vegas, NV – December 2, 2014

Susan DeMando Scott, Associate Vice President
Risk Oversight and Operational Regulation
Financial Operations Policy Group



Amendments to the Financial Responsibility Rules for Broker-Dealers

Includes Amendments to:

- Net Capital Rule – Rule 15c3-1
- Customer Protection Rule – Rule 15c3-3
- Books and Records Rules – Rules 17a-3 and 17a-4
- Notification Rule – Rule 17a-11

SEC Release Number 34-70072

NOTE: The following slides summarize select changes to the referenced rules.



Amendments to the Net Capital Rule (SEA Rule 15c3-1)

SEC Authority to Restrict Withdrawals of Capital

■ Rule Text

“The Commission may by order restrict, for a period of up to twenty business days, any withdrawal by the broker or dealer of equity capital or unsecured loan or advance to a stockholder, partner, sole proprietor, member, employee or affiliate under such terms and conditions as the Commission deems necessary or appropriate in the public interest or consistent with the protection of investors if the Commission, based on the information available, concludes that such withdrawal, advance or loan may be detrimental to the financial integrity of the broker or dealer, or may unduly jeopardize the broker or dealer’s ability to repay its customer claims or other liabilities which may cause a significant impact on the markets or expose the customers or creditors of the broker or dealer to loss without taking into account the application of the Securities Investor Protection Act of 1970.”

- SEA Rule 15c3-1(e)(3)(i)
- Rule Change Effective October 21, 2013

■ FINRA Commentary

- Amended rule is more restrictive.
- Previously, the Commission’s authority did not extend to *any* withdrawal, but rather only those that “When aggregated with all other withdrawals, advances, or loans on a net basis during a 30 calendar day period exceeds 30 percent of the broker or dealer’s excess net capital...”

Amendments to the Net Capital Rule (SEA Rule 15c3-1) *Broker-Dealer Insolvency*

■ Rule Text

“For the purposes of this section, a broker or dealer is insolvent if the broker or dealer:

(i) Is the subject of any bankruptcy, equity receivership proceeding or any other proceeding to reorganize, conserve, or liquidate such broker or dealer or its property or is applying for the appointment or election of a receiver, trustee, or liquidator or similar official for such broker or dealer of its property;

(ii) Has made a general assignment for the benefit of creditors;

(iii) Is insolvent within the meaning of section 101 of title 11 of the United States Code, or is unable to meet its obligations as they mature, and has made an admission to such effect in writing or in any court or before any agency of the United States or any State; or

(iv) *Is unable to make such computations as may be necessary to establish compliance with this section or with § 240.15c3-3.*” (emphasis added)

- SEA Rule 15c3-1(c)(16)

- Rule Change Effective October 21, 2013

■ Select Language from the Adopting Release

- “By making solvency a requirement of Rule 15c3-1, this amendment will require an insolvent broker-dealer to cease conducting a securities business pursuant to section 15(c)(3) of the Exchange Act, which generally prohibits a broker-dealer from effecting any transaction in, or inducing or attempting to induce the purchase or sale of, any security in contravention of the Commission’s financial responsibility rules (which include Rule 15c3-1).”

■ FINRA Commentary

- Paragraph (iv) clearly emphasizes the importance of the Net Capital, Customer Protection and Books and Records rules.

Amendments to the Net Capital Rule (SEA Rule 15c3-1)

Requirement to Subtract from Net Worth Certain Non-Permanent Capital Contributions

■ Rule Text

In calculating net capital, deduct from net worth

“... any contribution of capital to the broker or dealer: (1) Under an agreement that provides the investor with the option to withdraw the capital; or (2) That is intended to be withdrawn within a period of one year of contribution. Any withdrawal of capital made within one year of its contribution is deemed to have been intended to be withdrawn within a period of one year, unless the withdrawal has been approved in writing by the Examining Authority for the broker or dealer.”

- SEA Rule 15c3-1(c)(2)(i)(G)
- Rule Change Effective October 21, 2013

■ FINRA Commentary

- FINRA Rule 4110(c)(1) states: “No equity capital of a member may be withdrawn for a period of one year from the date such equity capital is contributed, unless otherwise permitted by FINRA in writing....”

Summary of Amendments to the Net Capital Rule (SEA Rule 15c3-1) ***Requirement to Deduct from Net Worth Liabilities or Expense Assumed by Third Parties***

■ Rule Text

In calculating net capital, deduct from net worth

“... any liability or expense relating to the business of the broker or dealer for which a third party has assumed the responsibility, unless the broker or dealer can demonstrate that the third party has adequate resources independent of the broker or dealer to pay the liability or expense.”

- SEA Rule 15c3-1(c)(2)(i)(F)
- Rule Change Effective October 21, 2013

■ FINRA Commentary

- Largely codifies July 11, 2003 SEC Letter to NYSE and NASD (Notice to Members 03-63)

Amendments to the Financial Responsibility Rules for Broker-Dealers. *Dates and Links*

- **Proposed: March 9, 2007 (Release No. 34-55431)**
 - <http://www.sec.gov/rules/proposed/2007/34-55431.pdf>
 - Comment Period Extended: May 12, 2007 (Release No. 34-55777)
 - Comment Period Reopened: May 3, 2012 (Release No. 34-66910)

- **Adopted: July 30, 2013 (Release No. 34-70072)**
 - <http://www.sec.gov/rules/final/2013/34-70072.pdf>
 - Effective Date: October 21, 2013

- **Effective Dates Extended for Certain Amendments: October 17, 2013 (Release No. 34-70701)**
 - <http://www.sec.gov/rules/exorders/2013/34-70701.pdf>
 - Relief Extends Effective Date to March 3, 2014 for Following Amendments:
 - Rule 15c3-3, except paragraph (j)(1)
 - Rule 15c3-3a
 - Rule 17a-3
 - Rule 17a-4
 - Paragraph (c)(2)(iv)(E)(2) of Rule 15c3-1

The Paragraph (k) Exemptions of SEA Rule 15c3-3



Understanding the Exemptions to the Customer Protection Rule

SEA Rule 15c3-3 contains three exemptions under paragraph (k).

Overarching principle of the exemptions:

Exemptions are available when a firm “promptly transmits” all customer funds and securities to the appropriate party.

(k)(1) - firms that claim this exemption are primarily firms whose business is limited to mutual funds and variable annuities

(k)(2)(ii) - firms that introduce customer accounts on a fully disclosed basis to a clearing and carrying firm which is a FINRA member

And then there is (k)(2)(i)...

Understanding the Exemptions to the Customer Protection Rule – SEA Rule 15c3-3 (k)(2)(i)

In summary, requirements for firms that claim a (k)(2)(i) exemption:

(1) The firm:

- (a) must promptly transmit all customer funds and deliver all securities received in connection with its activities as a broker or dealer, and
- (b) Effectuate all financial transactions between the broker or dealer and its customers through one or more bank accounts, each to be designated as “Special Account for the Exclusive Benefit of Customers of (name of the broker or dealer)”. (Note: A “Special Account” needs to be established properly, which means the broker-dealer’s agreement with the bank must contain the no-lien language as described in SEA Rule 15c3-3(f)).

Note: (1)(a) and (b) describe a BD that clears customer transactions on a RVP/DVP basis.

(2) The firm:

- (a) may not carry margin accounts, nor
- (b) otherwise hold funds or securities for customers, nor
- (c) owe money or securities to customers.

FINRA Commentary

- (2)(a)-(c) effectively precludes the firm from carrying customer securities accounts.
- Per the language of (k)(2)(i), this exemption may only be claimed by firms that operate as required by (1)(a) and (b) and which also comply with the prohibitions in (2)(a)-(c).

Requirements for all Broker-Dealers Claiming an Exemption from the Customer Protection Rule

- (1) Firms must maintain blotters (per SEA Rule 17a-3(a)(1)) to evidence prompt transmission
 - (a) Blotters may be in “log” or “unit” form
 - (b) Blotters must accurately reflect information with respect to receipt and forwarding
- (2) Firms should have a supervisory system in place that makes sense given:
 - a) The firm’s operations, and
 - b) The firm’s potential risk exposure.

Understanding the Exemptions to the Customer Protection Rule (SEA Rule 15c3-3) – Attendee Participation

■ With respect to the following scenarios, did the broker-dealer comply with the claimed (k)(2)(ii) exemption?

- Scenario A

- A broker-dealer has only three associated persons, who are also RRs. They are frequently out of the office meeting with prospective clients. To ensure that customer checks do not remain unprocessed while the associated persons/RRs are in the field, the firm permits an affiliated company to receive the checks from the broker-dealer's customers at the affiliate's main office. The checks are made payable to the broker-dealer's clearing firm. The affiliate promptly forwards the checks, by noon of the next business day, to the clearing firm. The affiliate prepares a checks received and forwarded blotter to document its actions with respect to the customers' checks and provides a copy of the blotter to the broker-dealer.

- Scenario B

- In addition to the (k)(2)(ii) exemption, an introducing broker-dealer also claims the (k)(2)(i) exemption. The firm receives checks from customers made payable to itself. The firm has opened a (k)(2)(i) account (which has the required "no-lien" language) and deposits the checks into that account. On settlement date, the firm wires funds to the clearing firm for all trades scheduled to settle that day.

The Exemption Report

The Exemption Report – SEA Rule 17a-5(d)(4)

“The Exemption Report must contain the following statements made to the best knowledge and belief of the broker-dealer:

- (i) A statement that identifies the provisions in §240.15c3-3(k) under which the broker or dealer claimed an exemption from §240.15c3-3;
- (ii) A statement that the broker-dealer met the identified exemption provisions in §240.15c3-3(k) throughout the most recent fiscal year without exception or that it met the identified exemption provisions in §240.15c3-3(k) throughout the most recent fiscal year except as described under paragraph (d)(4)(iii) of this section; and
- (iii) If applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified provisions in §240.15c3-3(k) and that briefly describes the nature of each exception and the appropriate date(s) on which the exception existed.”

The Exemption Report – SEA Rule 17a-5(d)(4)

FINRA Observations of the Exemption Reports

From just over 200 FINRA members (5% of our membership) that had a fiscal year ending in June or July 2014, a sample of 20 of those audits, selected at random reflect the following:

- All firms claimed “compliance” “without exception”.
- All but one firm identified the exemption upon which it is relying.
- Only 20% of the Exemption Reports contained the “best knowledge and belief” language.
- One firm stated that it also complied with its own procedures with respect to its claimed exemption.
- One firm stated that no regulatory agency took issue with how the firm complied with its claimed exemption during the applicable audit period, or after the close of its FYE up to the date of the filing of the report.

Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934

Includes Amendments to:

- Net Capital Rule – Rule 15c3-1
- Customer Protection Rule – Rule 15c3-3
- Books and Records Rule – Rule 17a-4
- Confirmation of Transactions - Rule 10b-10

SEC Release Number 34-71174



Deletion of NRSRO (nationally recognized statistical rating organizations) References
Summary of Changes from the Perspective of the Net Capital Rule

- **On January 8, 2014, the Commission published a final rulemaking, amending certain SEA Rules, as noted.**
 - Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934
 - Release 34-71194, 79 FR 1521
- **Amendments in response to Section 939A of the Dodd-Frank Act.**
- **Amendments applicable to broker-dealers that maintain positions in commercial paper, nonconvertible debt, or preferred stock.**
- **Changes the manner in which firms determine the haircuts on positions in each of the above referenced securities.**
- **Effective Date July 7, 2014**

Deletion of NRSRO References

Summary of Changes from the Perspective of the Net Capital Rule (continued)

■ **Haircuts:**

- Commercial Paper – SEA Rule 15c3-1(c)(2)(vi)(E)
 - Haircut: 0% to ½ of 1%, if securities have less than one year to maturity
For longer maturities: as stated in Rule, 1 ½% to 6%
- Nonconvertible Debt - SEA Rule 15c3-1(c)(2)(vi)(F)
 - Haircut: 2% to 9% based on maturity
- Preferred Stock - SEA Rule 15c3-1(c)(2)(vi)(H)
 - Haircut: 10%

■ **Prior to July 7, 2014, a firm could apply the above haircuts if the securities were rated as follows:**

- For Commercial Paper, if the securities were rated in one of the 3 highest categories by at least two NRSROs.
- For Nonconvertible Debt and Preferred Stock, if the securities were rated in one of the 4 highest categories by at least two NRSROs

■ **Effective July 7, 2014, a firm may apply the above haircuts if the securities:**

- have a ready market AND a minimal amount of credit risk

Deletion of NRSRO References

Summary of Changes from the Perspective of the Net Capital Rule (continued)

■ **Amended Rule - Haircuts:**

- No other changes to the referenced paragraphs were made.
 - For example, nonconvertible securities still may not be traded flat or in default as to principal or interest to be haircut under SEA Rule 15c3-1(c)(2)(vi)(F)
- Otherwise, haircut is 15% if the securities have a ready market.
- If no ready market, the position is treated as a non-allowable asset.

■ **The Release references several factors that may be considered by a broker-dealer to establish that the securities involve a minimal amount of credit risk.**

■ **The factors discussed in the release were not intended to be exhaustive.**

Financial and Operational (FinOp) Regulatory Issues/Concerns.



Inaccurate Financial Statements. Inaccurate Net Capital Computations.

- Inaccurate Financial Statements
 - Broker-Dealers must prepare their books on an accrual basis
 - Broker-Dealers must report revenue when earned
 - Broker-Dealers must refrain from making accruals only at quarter or year end
 - Assets must be properly valued
- Inaccurate Net Capital Computations
 - Computations must include the accurate minimum dollar net capital requirement
 - Assets are only allowable under certain conditions
 - Securities subject to blockage charges are non-allowable
 - Broker-Dealers fail to calculate/properly calculate open contractual commitment charges, haircuts and undue concentration

Interpretations of Financial and Operation Rules

<http://www.finra.org/Industry/Regulation/Guidance/FOR/>

Inaccurate Computation of Aggregate Indebtedness

- Inaccurate Computation of Aggregate Indebtedness

Liability for Law Suit Damages, Penalties, etc.

Where long term liabilities, such as damages in a lawsuit, penalties, etc., are payable in installments or a lump sum over a long term, the full amount of the liability must be recorded and included in Aggregate Indebtedness.

In the event the liability is recorded on the books of account at present value under GAAP, *the full amount of the liability (not the present value amount) must be included in Aggregate Indebtedness.* (Emphasis added.)

- SEA Rule 15c3-1(c)(1)/12

Court Judgment Rendered against a Broker-Dealer

A court judgment adverse to a broker-dealer is, at a minimum, a contingent liability of the firm and *included in the calculation of aggregate indebtedness unless an opinion of counsel indicates otherwise.* If the broker-dealer has exhausted its remedies, the liability must be booked. Each situation must be analyzed on the particular facts present in the matter. (Emphasis added.)

- SEA Rule 15c3-1(c)(1)/16

Interpretations of Financial and Operation Rules:

<http://www.finra.org/Industry/Regulation/Guidance/FOR/>

Inaccurate Computation of Aggregate Indebtedness. *Continued.*

- Inaccurate Computation of Aggregate Indebtedness

Fines and Other Monetary Penalties Assessed by a Governmental Agency or Self-Regulatory Organization

A fine, an order to pay restitution or similar penalty imposed by a governmental agency or self-regulatory organization (“fine”), at a minimum, *shall be treated as a contingent liability of the broker-dealer and included in the computation of aggregate indebtedness at the time such fine is imposed.* (Emphasis Added.)

In addition, under Generally Accepted Accounting Principles (GAAP), broker-dealers have an ongoing obligation to assess the specific facts applicable to each pending or decided matter that may result or has resulted in the imposition of a fine and to make a determination as to whether an actual liability must be recorded in the financial statements.

In any event, once all available appeals or other remedies have been exhausted, the broker-dealer must record the full amount of the fine as a liability in its financial statements.

- SEA Rule 15c3-1(c)(1)/26

Interpretations of Financial and Operation Rules:

<http://www.finra.org/Industry/Regulation/Guidance/FOR/>

Computation of Aggregate Indebtedness.

COMPUTATION OF AGGREGATE INDEBTEDNESS

16. Total A.I. liabilities from Statement of Financial Condition	\$		3790
17. Add:			
A. Drafts for immediate credit	\$	3800	
B. Market value of securities borrowed for which no equivalent value is paid or credited	\$	3810	
C. Other unrecorded amounts (List)	\$	3820	3830
18. Deduct: Adjustment based on deposits in Special Reserve Bank Accounts (15c3-1(c)(1)(vii))	\$		3838
19. Total aggregate indebtedness	\$		3840
20. Percentage of aggregate indebtedness to net capital (line 19 ÷ by line 10)	%		3850
21. Percentage of aggregate indebtedness to net capital <i>after</i> anticipated capital withdrawals (line 19 ÷ by line 10 less Item 4880 page 25)	%		3853

Related Party Transactions

Related Party Transactions raise regulatory concerns on several levels.

Expense Sharing Agreements

Allocation of costs are frequently not done on a reasonable basis.

Securities Transactions with Affiliates

Transfer or sale of assets at other than fair value.

Assignment of Revenue to Affiliates

May violate Federal Securities Laws.

Financial Transactions with Affiliates

Loans/advances that are never re-paid may be used to disguise capital withdrawals.

Management Services Agreements

May be used to disguise capital withdrawals.

Related Party Transactions Management Services Agreements

An MSA describes services whereby a party (usually the broker-dealer's parent or affiliate) performs administrative or management services for the broker-dealer.

For this purpose, we will distinguish an MSA from an ESA. In an MSA, the parent or affiliate is providing the services. In an ESA, there is a contract with a 3rd party that provides a good or service.

Considerations:

- Does the parent or affiliate have the capacity to offer the service?
- Does the broker-dealer need the service to support its operations?
- Is there evidence that the services were actually performed?
- Was the cost for the services reasonable?

Questions?

Lunch

(75 minutes)

Inspections: Observations and Case Studies

Bob Maday and Kate Ostasiewski
Division of Registration and Inspections

December 2, 2014
Las Vegas, NV

Agenda

- ❑ Summary of Interim Inspection Program
- ❑ Inspections Observations
- ❑ Case Studies
 - ❑ Case Study 1
 - ❑ Case Study 2
 - ❑ Case Study 3
- ❑ Questions

Interim Inspection Program – Objective

- ❑ Assess compliance with applicable Board and Commission rules and professional standards
- ❑ Help inform the Board's eventual determinations about the scope and elements of a permanent inspection program
- ❑ Assist in the development of the approach to inspections under a permanent inspection program

Interim Inspection Process

- ❑ Communication and scheduling
- ❑ Inspection of audit work
- ❑ Information gathering
- ❑ Communication of findings/observations

Interim Inspection Process (continued)

- ❑ Firm response to findings and responsibilities
- ❑ Reporting
- ❑ Communication with the SEC and other regulators
- ❑ Enforcement

Interim Inspection Program - Disclaimer

The information presented in the following slides is not necessarily indicative of the population of firms or of audits of brokers and dealers because the selection of firms and of audits of brokers and dealers for inspection is not necessarily representative of these populations.

Interim Inspection Program - Reporting

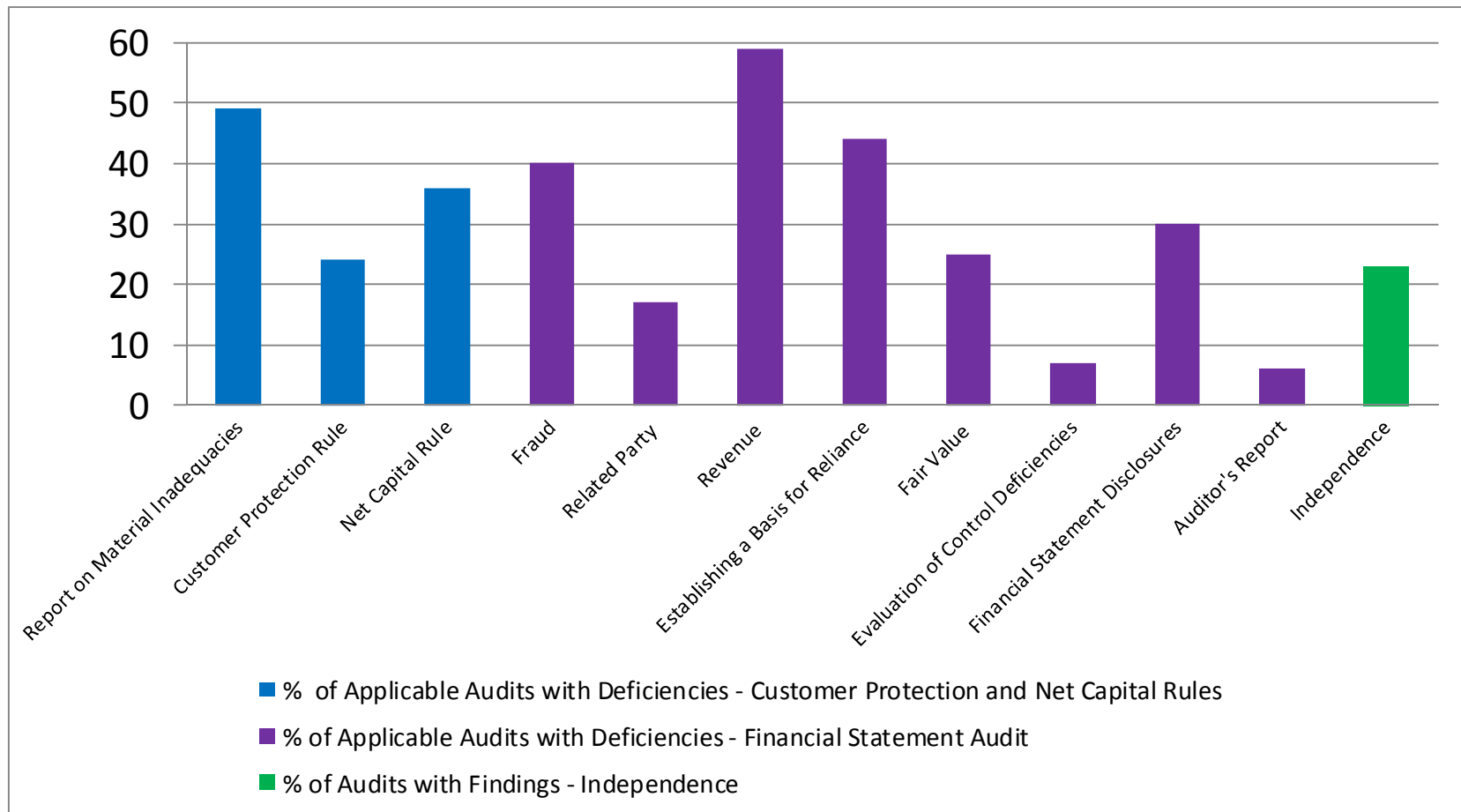
- ❑ Inspections - First Progress Report
 - ❑ Inspected 10 Firms and portions of 23 audits

- ❑ Inspections - Second Progress Report
 - ❑ Inspected 43 Firms and portions of 60 audits

- ❑ Inspections – Third Progress Report
 - ❑ Inspected 60 firms and portions of 90 audits

Inspections Observations by Audit Area - 2013

% of Applicable Audits with Observations



Compliance with Independence Requirements

20 out of 60 Firms failed to satisfy independence requirements by:

- ❑ Preparing, or assisting in the preparation of financial statements or supporting schedules
- ❑ Preparation of journal entries or source data underlying the financial statements

Compliance with Independence Requirements - *continued*

- ❑ Auditors of brokers and dealers registered with the SEC are subject to SEC independence requirements in (b) and (c) of Rule 2-01 of Regulation S-X.
- ❑ Effective for fiscal years ending on or after June 1, 2014 certain PCAOB independence rules apply to auditors of broker-dealers

Net Capital Requirements and Customer Protection Rule

Deficiencies noted related to testing compliance with *net capital requirements*:

- ❑ Minimum net capital requirements
- ❑ Allowable assets
- ❑ Haircuts

Deficiencies noted related to testing compliance with the *customer protection rule*:

- ❑ Customer credits or debits
- ❑ Special Reserve Bank Account
- ❑ Possession or control requirements

Net Capital Requirements and Customer Protection Rule - *continued*

Effective for fiscal years ending on or after June 1, 2014:

- ❑ Auditing Standard No.17 – Auditing Supplemental Information Accompanying Audited Financial Statements
- ❑ Attestation Standard No. 1 – Examination Engagements Regarding Compliance Reports of Brokers and Dealers
- ❑ Attestation Standard No. 2 - Review Engagements Regarding Exemption Reports of Brokers and Dealers

Financial Statement Audit

Deficiencies noted related to:

- Revenue
- Fraud
- Related Parties
- Establish a Basis for Reliance
- Evaluation of Internal Control Deficiencies
- Financial Statement Disclosures

Financial Statement Audit – *continued*

Effective for fiscal years ending on or after June 1, 2014

	Audit Procedure	PCAOB Standard(s)
Revenue	<ul style="list-style-type: none"> • <i>Identifying and Assessing Risk</i> • <i>Responding to Risk of Material Misstatement</i> • <i>Substantive Analytical Procedures</i> 	<ul style="list-style-type: none"> • AS 12 • AS 13 • AU 329
Fraud	<ul style="list-style-type: none"> • <i>Identifying and Assessing Risk</i> • <i>Responding to Fraud Risk</i> • <i>Addressing Risk of Management Override</i> 	<ul style="list-style-type: none"> • AS 12 • AS 13 • AU 316
Related Parties	<ul style="list-style-type: none"> • <i>Identifying RP Relationships/Transactions</i> • <i>Evaluating RP Accounting and Disclosure</i> 	<ul style="list-style-type: none"> • AU 334
Basis for Reliance	<ul style="list-style-type: none"> • <i>Evaluating Sufficiency of Audit Evidence</i> • <i>Use of Service Organizations</i> 	<ul style="list-style-type: none"> • AS 15 • AU 324
Evaluation of Deficiencies	<ul style="list-style-type: none"> • <i>Responses to Risk of Material Misstatement</i> • <i>Evaluating Audit Results</i> • <i>Communications about Control Deficiencies</i> 	<ul style="list-style-type: none"> • AS 13 • AS 14 • AU 325
FS Disclosures	<ul style="list-style-type: none"> • <i>Evaluating FS Presentation, Including Disclosures and Communicating Results</i> 	<ul style="list-style-type: none"> • AS 14 • AS 16

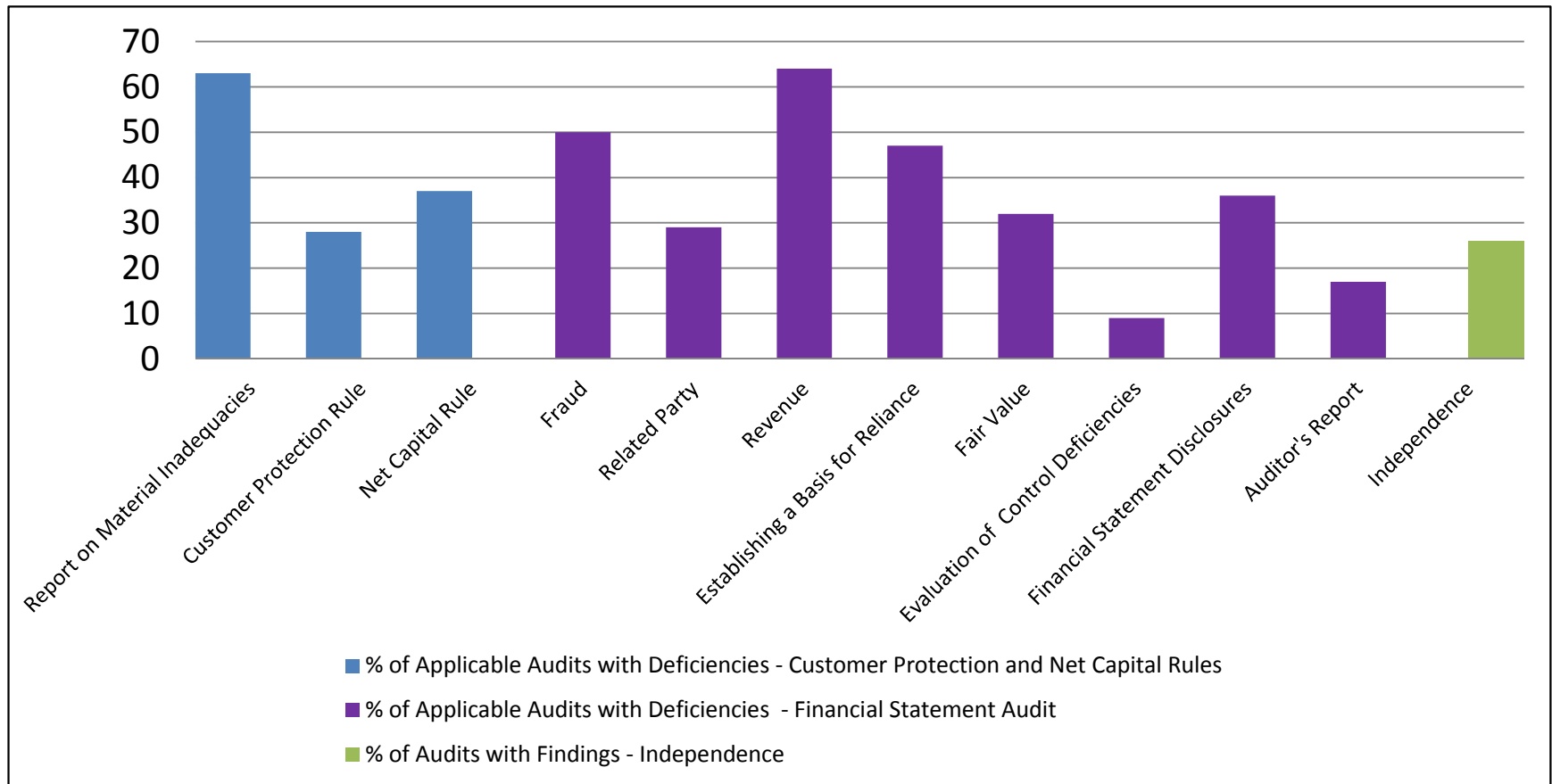
Summary of Inspection Observations

Since Inception of Interim Inspection Program:

- ❑ Audit deficiencies identified in 150 of 173 audits
- ❑ Independence findings identified in 45 of 173 audits
- ❑ Lower percentage of audits inspected with deficiencies when comparing 2013 to inspections through 2012 for each area inspected

Inspections Observations by Audit Area Inception of the Program Through 2013

% of Applicable Audits with Observations



Summary of Inspection Observations (continued)

Observations Stratified by Characteristics:

Firm Characteristics

- Number of broker or dealer audits per firm
- Firms that audited issuers compared to firms that did not

Broker Dealer Characteristics

- Reported Actual Net Capital, Revenue and Assets
- Special Reserve Bank Account

Next Steps for Auditors

- ❑ Re-examine audit approaches
- ❑ Consider whether audit deficiencies and independence findings might be present in audits currently performed and take appropriate action to prevent or correct
- ❑ Take appropriate action when audit deficiencies are discovered after the date of the audit report
- ❑ Consider how to prevent similar or other deficiencies by anticipating and addressing risks that might arise in audits of brokers and or dealers

Next Steps for Auditors (continued)

- ❑ Stress the need to conduct audits with due professional care
- ❑ Review the following with respect to independence:
 - ❑ Agreements for services performed for broker and dealer audit clients
 - ❑ Guidance and training provided to professionals
 - ❑ Quality control procedures
- ❑ Review firm guidance, training and policies around supervision and reviews to ensure areas with reported audit deficiencies are given appropriate attention and focus

Future Inspections

- ❑ 60 firms and portions of 100 audits during 2014
- ❑ Continued coverage of cross-sections of firms and brokers and dealers, will include some firms previously inspected
- ❑ May inspect audits previously inspected
- ❑ During 2015, will inspect audits of brokers and dealers, which are required to be performed in accordance with PCAOB standards

Case Studies

Case Study 1

Case Study 1: Instructions

- ❑ Read case background and scenario provided
 - ❑ 5 minutes

- ❑ Answer questions and discuss in table groups
 - ❑ 5 minutes

- ❑ Debrief
 - ❑ 10 minutes

Case Study 1: Summary

- ❑ Total Trading:
 - ❑ Claimed exemption under (k)(2)(ii)
 - ❑ Reported minimum net capital requirement of \$5,000
 - ❑ Net capital computation included deductions of receivables classified as non-allowable assets and haircuts on proprietary positions
- ❑ Same materiality level used for the financial statements and schedules:
 - ❑ All receivable and proprietary position balances per the trial balance exceeded materiality
- ❑ Procedures planned:
 - ❑ Obtain an understanding of the process followed by Total Trading to prepare the net capital schedule
 - ❑ Obtain an understanding of the Total Trading's business operations
 - ❑ Document considerations related to the minimum net capital required for brokers claiming exemption under (k)(2)(ii)
 - ❑ Test the net capital computation; classification of allowable/non-allowable assets, and haircuts

Case Study 1: Debrief

Case Study 2

Case Study 2: Instructions – Part I

- ❑ Read Part I (case background and scenario provided)
 - ❑ 5 minutes

- ❑ Answer questions 1-3 and discuss in table groups
 - ❑ 5 minutes

- ❑ Debrief
 - ❑ 10 minutes

Case Study 2, Part I: Summary

- ❑ Super Securities:
 - ❑ Agent for customers transacting in equity securities and provides investment banking (“IB”) services
 - ❑ Uses Clean Sweep Clearing (“Clearing”) on fully disclosed basis and records commission revenue based on amounts in Clearing statements
 - ❑ IB revenue includes upfront fee recorded as deferred revenue and success fee recognized when the transaction closes
 - ❑ Commission and IB revenue each individually material
- ❑ Risk Assessment: control risk at maximum, risk of material misstatement at moderate for commission revenue, and fraud risk identified for IB revenue
- ❑ Tests of commission revenue included: 1) obtaining Clearing statements, 2) obtaining SSAE 16 report for Clearing, 3) verifying user entity controls through inquiry, and 4) reviewing trade date/settlement date analysis
- ❑ Tests of IB revenue included: 1) obtaining deal listing and testing for accuracy and completeness, 2) selecting all deals above materiality and a sample below materiality and a) obtaining deal documents and tracing to prospectus, b) recalculating revenue and tracing to terms in deal documents, c) tracing revenue in the GL to closing statements and bank statements, and 3) testing cut-off

Case Study 2: Debrief (Part I)

Case Study 2: Instructions – Part II

- ❑ Read additional facts provided in Part II
 - ❑ 2 minutes

- ❑ Answer questions 4-5 and discuss in table groups
 - ❑ 3 minutes

- ❑ Debrief
 - ❑ 5 minutes

Case Study 2, Part II: Summary

- ❑ Super Securities:
 - ❑ Owned by Sally Kincaid, eight employees, only Walter Smith has accounting duties
 - ❑ QuickBooks application for its general ledger system
 - ❑ Approximately 450 journal entries for the year
 - ❑ Manual journal entries posted daily and monthly
 - ❑ Not all journal entries have a description in the memo field in the general ledger
- ❑ Understanding of the internal control environment:
 - ❑ Segregation of duties identified as difficult to achieve
- ❑ Tests to address the risk of management override:
 - ❑ Inquiry of Walter Smith with respect to adjusting entries
 - ❑ Obtain a copy of general ledger journal entry report (“Report”)
 - ❑ Scan the Report to identify unusual journal entries
- ❑ Audit team concluded:
 - ❑ Nothing significant or unusual identified
 - ❑ No control deficiencies or misstatements

Case Study 2: Debrief (Part II)

Case Study 3

Case Study 3: Instructions – Part I

- ❑ Read Part I (case background and scenario provided)
 - ❑ 5 minutes

- ❑ Answer questions 1-2 and discuss in table groups
 - ❑ 5 minutes

- ❑ Debrief
 - ❑ 5 minutes

Case Study 3, Part I: Summary

- ❑ Buy Securities, Inc.
 - ❑ Wholly owned subsidiary of Capital Conglomerate (the "Parent")
 - ❑ Provides investment advisory ("IA") services to customers; 70% of revenue for the year under audit from Parent, decreased 20% from prior year
 - ❑ Notes to financials include disclosure on revenue and a reimbursement of occupancy expenses to Parent (monthly) under an expense sharing agreement, both amounts are material
- ❑ Planning
 - ❑ Obtained an understanding of internal control environment
 - ❑ Obtained an understanding of revenue and expense cycles
 - ❑ Inquired regarding expense sharing agreement
- ❑ Planned Audit Procedures
 - ❑ Test for undisclosed related parties
 - ❑ Obtain IA agreements with Parent and understand the nature and terms
 - ❑ Trace occupancy expenses from note disclosures to general ledger

Case Study 3: Debrief (Part I)

Case Study 3: Instructions – Part II

- ❑ Read additional facts provided in Part II
 - ❑ 2 minutes

- ❑ Answer questions 3-5 and discuss in table groups
 - ❑ 5 minutes

- ❑ Debrief
 - ❑ 8 minutes

Case Study 3, Part II: Summary

- ❑ IA fee revenue based on assets under management (“AUM”) and rates from advisory agreements
- ❑ Monthly accrual recorded for IA fee revenues earned
- ❑ Accrual adjusted when cash received and adjustment is immaterial
- ❑ Fraud risk identified related to the valuation of IA fee revenue
- ❑ Test IA fee revenue by performing substantive analytical procedures:
 - ❑ Expectation for current-year IA fee revenue to be based on total prior-year IA fee revenue
 - ❑ Compare prior-year amount per general ledger to current-year amount
 - ❑ Investigate differences that exceed 50% of planning materiality by making inquiries of management

Case Study 3: Debrief (Part II)

Questions?





PCAOB/SEC/FINRA Panel

Moderator: Jay Hanson

Closing Remarks

Jay D. Hanson
December 2, 2014
Las Vegas, NV