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Client Alert

Current Issues Relevant to Our Clients

August 5, 2013

SEC Amends Broker-Dealer Reporting, Audit and Notification Requirements

The Securities and Exchange Commission (the *"SEC"*) recently adopted amendments to the broker-dealer annual reporting, audit and notification requirements of Rule 17a-5 under the Securities Exchange Act of 1934 (the *"Exchange Act"*). The amendments generally require:

- that broker-dealer audits be conducted in accordance with standards of the Public Company Accounting Oversight Board (*"PCAOB"*) under authority granted in the Dodd-Frank Wall Street Reform and Consumer Protection Act;
- a broker-dealer that clears transactions or carries customer accounts to agree to allow the SEC or the broker-dealer's designated examining authority (*"DEA"*) to review the documentation associated with certain reports of the broker-dealer's independent public accountant and to allow the accountant to discuss its findings with regulators in connection with broker-dealer exams; and
- broker-dealers to file a new Form Custody with their DEA that includes information about practices with respect to the custody of securities and funds of customers and non-customers.

A copy of the related SEC release is available here. The amended rules will have various effective dates ranging from 60 days after publication in the Federal Register to June 1, 2014.

Background

The SEC originally proposed the rule amendments in June 2011. The SEC adopted certain portions of the rules as originally proposed and adopted revised versions of the proposed rules in response to certain comments received during the public comment period. This Client Alert summarizes selected portions of the final amended rules.

Amended Broker-Dealer Reporting Requirements

Existing Rule 17a-5 generally requires a broker-dealer to file annually with the SEC certain financial statements and supporting schedules and a report prepared by the broker-dealer's independent public accountant covering the financial statements and supporting schedules. As adopted, the amendments to Rule 17a-5 add the requirement that broker-dealers also file either a compliance report or an exemption report, as applicable, and a report prepared by the broker-dealer's independent public accountant based on an examination of the compliance report or a review of the exemption report. Whether a firm files a compliance report or an exemption report is determined by whether the broker-dealer maintains custody of customer assets. Exchange Act Rule 15c3-3 requires broker-dealers that maintain custody of customer securities (so-called "carrying" broker-dealers) to (i) maintain physical possession or control over such customers' fully-paid and excess margin securities, and (ii) maintain a reserve of cash or qualified securities in certain bank accounts that is at least equal in value to the net cash owed to customers, including cash obtained from the use of customers' securities. Generally, an exemption from Rule 15c3-3 is available if a broker-dealer does not hold customer securities or funds, or, if it does receive customer securities or funds, it promptly delivers the securities or promptly transmits the funds to appropriate persons.

A broker-dealer that did ***not*** claim an exemption from Rule 15c3-3 at any time during the most recent fiscal year or claimed an exemption for only part of the fiscal year must prepare and file the compliance report. Alternatively, a broker-dealer must prepare the exemption report if the firm ***did*** claim an exemption from Rule 15c3-3 throughout the most recent fiscal year. In either case, the broker-dealer must also file reports prepared by a PCOAB-registered independent public accountant covering the financial report and either the compliance report or exemption report, as applicable. The amended rules keep in place the requirement that all annual reports must be filed within 60 calendar days after the fiscal year end. The amended rules are scheduled to become effective on June 1, 2014.

The Compliance Report

The compliance report must contain statements as to whether:

1. The broker-dealer has established and maintained "Internal Control Over Compliance". This means that the firm has reasonable assurance that it will prevent or detect non-compliance with Exchange Act Rules 15c3-1, 15c3-3, and 17a-13, and applicable DEA rules that require broker-dealers to periodically send account statements to customers (collectively, the *"financial responsibility rules"*);

2. The Internal Control Over Compliance of the broker-dealer was effective during the most recent fiscal year;

3. The Internal Control Over Compliance of the broker-dealer was effective as of the end of the most recent fiscal year;

4. The broker-dealer was in compliance with the financial responsibility rules as of the end of the most recent fiscal year; and

5. The information used to assert compliance with the financial responsibility rules was derived from the books and records of the broker-dealer.

If applicable, the compliance report must also contain a description of:

1. Each identified material weakness in the Internal Control Over Compliance during the most recent fiscal year, including those that were identified as of the end of the fiscal year; and

2. Any instance of non-compliance with the financial responsibility rules as of the end of the most recent fiscal year.

For purposes of the rule, "material weakness" means a deficiency, or a combination of deficiencies, in the broker-dealer's Internal Control Over Compliance such that there is a reasonable possibility that non-compliance with the financial responsibility rules will not be prevented or detected on a timely basis.

The Exemption Report

The exemption report must contain the following statements made to the best knowledge and belief of the broker-dealer:

1. A statement that identifies the specific provisions of Rule 15c3-3 under which the broker-dealer claimed an exemption from Rule 15c3-3;

2. A statement that the broker-dealer met the identified exemption provisions of Rule 15c3-3 throughout the most recent fiscal year without exception, or that it met the identified exemption provisions of Rule 15c3-3 throughout the most recent fiscal year except as described in the exemption report; and

3. If applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified exemption provision of Rule 15c3-3 and that briefly describes the nature of each exception and the approximate date(s) on which the exception existed.

Filing the Reports

Under existing Rule 17a-5, annual reports must be filed at the regional office of the SEC for the region in which the broker-dealer has its principal place of business, the SEC's principal office in Washington, DC, and the principal office of the DEA of the broker-dealer. In addition, copies are required to be provided to all self-regulatory organizations (*"SROs"*) of which the broker-dealer is a member. The amended Rule 17a-5 changes these requirements in two ways. First, an SRO that is not a broker-dealer's DEA can by rule waive the requirement that broker-dealers file annual reports with it. Second, a broker-dealer must also file their annual reports with the Securities Investor Protection Corporation (*"SIPC"*).

Coordination with Investment Advisers Act Rule 206(4)-2

Rule 206(4)-2 under the Investment Advisers Act of 1940 generally provides that when an investment adviser maintains client funds and securities as qualified custodian, the adviser must annually obtain a written internal control report prepared by a PCAOB-registered independent public accountant. Under amended Rule 17a-5, an independent public accountant's report based on an examination of the compliance report will satisfy the internal control report requirement under Rule 206(4)-2. However, those broker-dealers who are also registered as investment advisers that are required to file the exemption report under amended Rule 17a-5 must still comply with the internal control report requirement in Rule 206(4)-2.

Access to Accountant and Audit Documentation

Amended Rule 17a-5 requires that a clearing broker-dealer's notice designating its independent public accountant include, among other things, representations that:

1. The broker-dealer agrees to allow representatives of the SEC or the broker-dealer's DEA, if requested for purposes of an examination of the broker-dealer, to review the documentation

associated with the reports of its independent public accountant prepared pursuant to paragraph (g) of Rule 17a-5; and

2. The broker-dealer agrees to permit its independent public accountant to discuss with representatives of the SEC and the broker-dealer's DEA, if requested for the purposes of an examination of the broker-dealer, the findings associated with the reports of the accountant prepared pursuant to paragraph (g) of Rule 17a-5.

If a broker-dealer does not clear transactions, amended Rule 17a-5 would not require the broker-dealer to provide such representations in the notice.

Form Custody

Existing Rule 17a-5 requires broker-dealers to file periodic FOCUS Reports with the SEC and the broker-dealer's DEA. Amended Rule 17a-5 adds the requirement that broker-dealers file new Form Custody with its DEA at the same time it files its FOCUS Report. The DEA is then required to transmit the information obtained from Form Custody and FOCUS Report to the SEC. Form Custody generally consists of the following nine items regarding the broker-dealer's custodial activities:

1. Whether the broker-dealer introduced customer accounts to another broker-dealer on a fully disclosed basis, and, if so, to identify each broker-dealer to which customer accounts are introduced on a fully disclosed basis;

2. Whether the broker-dealer introduced customer accounts to another broker-dealer on an omnibus basis, and, if so, to identify each broker-dealer to which customer accounts are introduced on an omnibus basis;

3. Whether the broker-dealer carried securities accounts for customers and for persons that are not customers, and identify the types of locations where it held securities and the frequency with which it performed reconciliations between the information on its stock record and information on the records of those locations;

4. Whether the broker-dealer has acted as a carrying broker-dealer for other broker-dealers;

5. Whether the broker-dealer, or a vendor on behalf of the broker-dealer, sends transaction confirmations to customers and other accountholders;

6. Whether the broker-dealer sends account statements directly to customers and other accountholders;

7. Whether the broker-dealer provided customers and other accountholders with electronic access to information about the securities and cash positions in their accounts;

8. Whether and how the broker-dealer operated as an investment adviser; and

9. Whether the broker-dealer was an affiliate of an investment adviser, and, if so, whether it has custody of the client assets of the adviser and the approximate U.S. dollar market value of any such assets.

The rules relating to filing Form Custody are scheduled to become effective December 31, 2013.

For More Information

For more information on any topic discussed in this client alert, please contact an attorney in our Investment Management Group or visit us online at Chapman.com.