

Banking & Securities Spotlight

SEC Issues Final Amendments to Broker-Dealer Reporting Rules

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The Bottom Line

The Form Custody is due quarterly and must be filed simultaneously with the FOCUS Report.

- The SEC issued a [final rule](#)¹ that amends Rule 17a-5² of the Securities Exchange Act of 1934.
- Effective **December 31, 2013 (as applicable)**, broker-dealers:
 - Must file with their designated examining authority (DEA) an unaudited form ("Form Custody") that contains disclosures about their custodial activities. This form is due quarterly and must be filed simultaneously with the FOCUS Report.³
 - Must file an annual audited report with the Securities Investor Protection Corporation (SIPC) for fiscal years ending on or after December 31, 2013.
- Effective **for fiscal years ending on or after June 1, 2014**, broker-dealers:
 - That **did not claim an exemption** from the customer protection rule⁴ throughout the most recent fiscal year must file an annual report that states compliance, and internal control over compliance, with certain SEC FRRs.⁵
 - That **claimed an exemption** from the customer protection rule throughout the most recent fiscal year must file an annual exemption report that states whether the broker-dealer has satisfied the applicable criteria for exemption.
 - Must engage an independent public accountant to perform an audit of their financial reports or compliance or exemption report under PCAOB standards rather than follow the current requirements under generally accepted auditing standards.

¹ SEC Final Rule Release No. 34-70073, *Broker-Dealer Reports*.

² SEC Rule 17a-5, "Reports to Be Made by Certain Brokers and Dealers."

³ Financial and Operational Combined Uniform Single Report.

⁴ SEC Rule 15c3-3, "Customer Protection — Reserves and Custody of Securities."

⁵ Financial responsibility rules.

Beyond the Bottom Line

On July 30, 2013, the SEC issued a final rule amending Exchange Act Rule 17a-5. The amendments were issued in conjunction with the SEC's [final rule](#)⁶ amending the financial responsibility rules for broker-dealers.⁷ This *Banking & Securities Spotlight* provides an overview of amended Rule 17a-5 and highlights the impact of the changes on broker-dealers.

Amendments to Rule 17a-5

Overall, the amendments to Rule 17a-5 reflect the SEC's continued focus on (1) investor protection and (2) audits of broker-dealers' custody activities and related internal controls. They will also give the SEC and the DEA timely and increased insight into broker-dealers' custody practices. The paragraphs below summarize key aspects of the amendments.

Annual Reporting Requirements

As amended, Rule 17a-5 will continue to require broker-dealers to file with the SEC an annual audited report containing financial statements and supplemental schedules;⁸ such report must also be filed with the SIPC for fiscal years ending on or after December 31, 2013. However, the amended rule also requires the audit of the annual report to be performed by a registered independent public accountant in accordance with PCAOB standards for fiscal years ending on or after June 1, 2014.

On October 10, 2013, the PCAOB adopted two [attestation standards](#)⁹ related to examination of broker-dealer compliance and exemption reports. The standards establish requirements that a registered independent public accountant uses to examine a broker-dealer's compliance and exemption reports. In conjunction with the attestation standards, the PCAOB adopted [AS 17](#),¹⁰ which applies when auditors are engaged to report on supplemental information. The standards are not effective until approved by the SEC.

The amended rule also introduces new reporting requirements that differ depending on whether the broker-dealer claims an exemption from the customer protection rule. Broker-dealers that did not claim such exemption throughout the most recent year must file a report that asserts compliance, and effective internal control over compliance, with certain FRRs (i.e., the net capital rule,¹¹ the customer protection rule, and the quarterly securities count rule¹²) and applicable DEA rules related to account statements ("compliance reports"). Broker-dealers that have claimed an exemption from the customer protection rule would be required to file an exemption report asserting that the customer protection rule does not apply to them. The compliance report or exemption report, as applicable, must be filed for fiscal years ending on or after June 1, 2014. These reports replace the previously required supplemental report on internal controls (i.e., the material inadequacy report).

Annual Compliance Report

The amendments to Rule 17a-5 reiterate that broker-dealers holding customer assets must file an annual compliance report, even if their custodial activities are limited.

The compliance report would state whether the broker-dealer "has established and maintained a system of internal control to provide the broker-dealer with reasonable assurance that any instances of [noncompliance with the FRRs] will be prevented

The amendments to Rule 17a-5 reiterate that broker-dealers holding customer assets must file an annual compliance report, even if their custodial activities are limited.

⁶ SEC Final Rule Release No. 34-70072, *Financial Responsibility Rules for Broker-Dealers*.

⁷ See Deloitte's [Issue 5, September 2013](#), *Banking & Securities Spotlight* for additional information about the final rule.

⁸ The amended rule refers to the financial statements and supplemental schedules collectively as a "financial report."

⁹ PCAOB Attestation Standards, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, and *Review Engagements Regarding Exemption Reports of Brokers and Dealers*.

¹⁰ PCAOB Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements*.

¹¹ SEC Rule 15c3-1, "Net Capital Requirements for Brokers or Dealers."

¹² SEC Rule 17a-13, "Quarterly Security Counts to Be Made by Certain Exchange Members, Brokers, and Dealers."

or detected on a timely basis.” The report should also describe any instances of noncompliance with the net capital rule and the customer reserve requirement in the customer protection rule as well as any instances of material weakness.¹³ It must state that:

- (1) the broker-dealer has established and maintained Internal Control Over Compliance (which . . . is a defined term in the final rule¹⁴);
- (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 Rule 15c3-1 and paragraph (e) of Rule 15c3-3 as of the end of the most recent fiscal year; and
- (5) the information the broker-dealer used to state whether it was in compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3 was derived from the books and records of the broker-dealer. [Emphasis added]

The compliance report would also include, if applicable, a description of the following:

- (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 Rule 15c3-1 or paragraph (e) of Rule 15c3-3 as of the end of the most recent fiscal year.

A broker-dealer cannot assert compliance with FRRs if one or more instances of noncompliance have been identified. Also, the broker-dealer will not be able to assert that its internal control over compliance with FRRs during the fiscal year was effective if one or more material weaknesses related to internal control over compliance were identified.

Broker-dealers that are subject to the internal control reporting requirement of Rule 206(4)-2¹⁵ of the Investment Advisers Act of 1940 will be able to meet such requirement by filing the compliance report under amended Rule 17a-5.

For fiscal years ending on or after June 1, 2014, the amended rule also requires broker-dealers that file a compliance report to engage a registered independent public accountant to (1) perform an examination of the broker-dealer’s compliance report and (2) issue an examination report based thereon in accordance with PCAOB attestation standards. The registered independent public accountant’s report will pertain solely to certain statements made by the broker-dealer and not to the broker-dealer’s process in arriving at those assertions. Further, the registered independent public accountant is not required to opine on the effectiveness of the broker-dealer’s internal control over financial reporting.

Annual Exemption Report

A broker-dealer that has claimed an exemption from the customer protection rule throughout the most recent fiscal year must include with its annual filing an exemption report that states whether the broker-dealer complied with the rule’s exemption provisions.

A broker-dealer cannot assert compliance with FRRs if one or more instances of noncompliance have been identified.

¹³ Amended Rule 17a-5 defines material weakness as “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 Rule 15c3-1 or paragraph (e) of Rule 15c3-3 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” (footnotes omitted).

¹⁴ Amended Rule 17a-5(d)(3)(ii) defines internal control over compliance as “internal controls that have the objective of providing the broker-dealer with reasonable assurance that non-compliance with the financial responsibility rules will be prevented or detected on a timely basis.”

¹⁵ SEC Rule 206(4)-2, “Custody of Funds or Securities of Clients by Investment Advisers.”

Broker-dealers that are dually registered as futures commission merchants should also monitor the rulemaking of the CFTC.

Specifically, the exemption report must contain the following:

- (1) a statement that identifies the provisions in paragraph (k) of Rule 15c3-3 under which the broker-dealer claimed an exemption from Rule 15c3-3;
- (2) a statement the broker-dealer met [the exemption] throughout the most recent fiscal year without exception or that it met [the exemption] 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 exemption] and that briefly describes the nature of each exception and the approximate date(s) on which the exception existed.

For fiscal years ending on or after June 1, 2014, amended Rule 17a-5 requires broker-dealers that file an exemption report to engage a registered independent public accountant to (1) perform a review of the assertions in the exemption report and (2) issue a review report based thereon in accordance with PCAOB attestation standards. As in a compliance report examination, a registered independent public accountant that reviews an exemption report need not opine on the effectiveness of the broker-dealer's internal control over financial reporting.

Form Custody

For calendar quarters or fiscal years ending December 31, 2013, broker-dealers are also required to file quarterly a new form — Form Custody — that contains information about the broker-dealer's custodial activities and makes it easier for examiners to identify risks and possible violations of laws and regulations regarding the broker-dealer's custody of assets.

A broker-dealer must file a Form Custody with its DEA at the same time it files its periodic FOCUS Report under Rule 17a-5(a). The form must be filed within 17 **business days** after the end of each calendar quarter. A broker-dealer whose fiscal-year-end date is not the end of a calendar year must file the Form Custody with its DEA within 17 **business days** after the end of the broker-dealer's fiscal year. The SEC intends for all broker-dealers to file a Form Custody without exception. There is no requirement to audit or review the Form Custody.

Access to Audit Documentation

Under amended Rule 17a-5, a broker-dealer that clears transactions or carries customer accounts (i.e., a clearing broker-dealer) must allow its DEA and the SEC to discuss annual audit findings with the broker-dealer's registered independent public accountant and to review related audit documentation.

Requests to the broker-dealer's registered independent public accountant to access audit documentation or discuss audit findings would be made in writing.

Next Steps

Broker-dealers can begin to ensure their compliance with amended Rule 17a-5 by:

- Considering whether their current infrastructure is equipped to handle any additional data requirements as a result of the Form Custody or whether system enhancements will be necessary.
- Reviewing their current processes and controls to ensure that these are adequate to support their statements in the compliance report.
- Having a process in place that will enable them to identify and report all exceptions throughout the most recent fiscal year if they expect to file an exemption report.

Broker-dealers that are dually registered as futures commission merchants should also monitor the rulemaking of the Commodity Futures Trading Commission (CFTC). If the CFTC does not amend its reporting rules to conform to the SEC's new rules, such broker-dealers would potentially be required to comply with the requirements of two reporting frameworks.

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