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August 15, 2013

SEC Revises Annual Financial Reporting Requirements for Broker-Dealers and Imposes New Report Filing Requirements

[27460]

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TO: SECURITIES OPERATIONS ADVISORY GROUP RE: SEC REVISES ANNUAL FINANCIAL REPORTING REQUIREMENTS FOR BROKER-DEALERS AND IMPOSES NEW REPORT FILING REQUIREMENTS

The SEC has announced the adoption of significant revisions to Rule 17a-5 under the Securities Exchange Act of 1934, which governs broker-dealers' quarterly and annual reports, including their financial reports. These revisions will impact all federally-registered broker-dealers, including mutual fund underwriters, and will require the filing of additional reports. [\[1\]](#) According to the Commission, these revisions are intended, among other things, to "increase the focus of independent public accountants on the custody practices of broker-dealers and to help identify broker-dealers that have weak controls for safeguarding investor assets." [\[2\]](#)

Generally speaking, the amendments impose more rigorous requirements on the annual financial statements submitted by broker-dealers and require broker-dealers to file two new reports with the Commission and the registrant's designated examining authority (DEA). These two new reports are: (1) an "Exemption Report," which requires a broker-dealer that relies on the exemption is Rule 15c3-3(k)(1) under the Exchange Act ("the (k)(1)exemption") to affirm its reliance on the (k)(1) exemption; and (2) "Form Custody," which is a standardized form the broker-dealer must complete regarding its custody arrangements. [\[3\]](#) The revisions to Rule 17a-5 and these two new reports are described below.

I. Revisions to the Financial Reporting Requirements in Rule 17a-5

The annual financial reporting requirements imposed on all federally-registered broker-dealers by Exchange Act Rule 17a-5 have been revised, in part, to require the filing of a

report prepared by a PCAOB-registered independent public accountant covering the financial report and the Exemption Report (which is discussed below under II.)

With respect to the contents of the financial reports required by Rule 17a-5(d)(2), the revised rule continues to require that broker-dealers prepare and file an annual audited report containing specified information in a format consistent with Form X-17A-5 Part II or IIa, as applicable, including a statement of financial condition, an income statement, a statement of cash flows, a statement of changes in owners' equity, and a statement of changes in liabilities subordinated to claims of general creditors. The revised rule also continues to require the annual audited report contain supporting schedules and a reconciliation between the net capital and reserve computations in the audited report and those in the most recent Form X-17A-5 Part II or IIa, if there were material differences between the annual audited report and the Form. The provisions of subsections (d)(2)-(4) of the current rule have been combined in subsection (d)(2) of the new rule without substantive modification to these provisions. The title of (d)(2) has been revised to "Financial report" to distinguish its requirements from the provisions in the rule relating to the new Exemption Report and compliance report. New to the rule are requirements that the broker-dealer also file (1) an Exemption Report (or compliance report as applicable) that along with the financial statements, has been reviewed by an independent public accountant subject to the standards of the PCAOB; and (2) a new form, "Form Custody." The rule's provisions relating to independent public accountants' responsibilities are discussed under II.A., below.

With the exception of the Form Custody, these annual reports must be filed at the SEC's regional office for the region in which the broker-dealer has its principal place of business, the SEC's Washington, D.C. office, and the principal office of the broker-dealer's DEA. [\[4\]](#) Copies must also be filed with FINRA, unless FINRA, by rule, waives this requirement. Form Custody is to be filed with the broker-dealer's DEA.

II. The New Exemption Report Requirement

As discussed above, the revised rule requires every broker-dealer relying on the (k)(1) exemption to file an "Exemption Report." According to the Release, "if the broker-dealer claimed an exemption from Rule 15c3-3 in its [FOCUS Reports] throughout the fiscal year, it must file the Exemption Report even if it had exceptions to the exemption provisions." [\[5\]](#) The report must be executed by the person who makes the oath or affirmation under Rule 17a-5(e)(2).

The Exemption Report must cover the most recent fiscal year and contain the following statements, made to the "best knowledge and belief" of the broker-dealer:

1. A statement that identifies the provisions in the (k)(1) exemption the broker-dealer relies on;
2. A statement that the broker-dealer met the (k)(1) exemption through the most recent fiscal year without exception or that it met the exemption except as described in the Exemption Report; and
3. If applicable, a statement that identifies each exception identified in (2) and that briefly describes the nature of each exception and the approximate date(s) on which the exception existed.

These assertions are intended to provide the Commission and the broker-dealer's DEA with more information than currently is reported in the FOCUS report – i.e., information as to

whether the broker-dealer is meeting the (k)(1) exemption and not simply relying on it. This information is also intended to assist independent public accountants charged with reviewing the broker-dealer's activities and reports.

The Release notes that adherence to the exemptive provisions of the (k)(1) exemption "generally is a focus of Commission examiners when they conduct financial responsibility examinations of this class of firm." [6] Also, the 2011 AICPA Broker-Dealer Audit Guide provides that, in auditing the financial statements of a broker-dealer relying on the (k)(1) exemption, "the auditor should determine whether and to what extent the broker-dealer complied with the specific exemption during the audit period as well as the quality of the broker-dealer's controls and procedures to ensure ongoing compliance." [7]

A. Engagement of the Accountant

As mentioned above, the revised rule requires a broker-dealer to engage an independent public accountant to prepare reports based on an examination of the broker-dealer's financial report and the statements made in the broker-dealer's Exemption Report. Such examinations and reviews must be made in accordance with the standards of the PCAOB. [8] Pursuant to Rule 17a-5(g), the independent public accountant engaged by the broker-dealer to review the financial report and the Exemption Report must, as part of the engagement, undertake to prepare two reports in accordance with the standards of the PCAOB – one based on an examination of the broker-dealer's financial report and one based on a review of the statements made in the Exemption Report. [9]

According to the Release, the PCAOB's proposed standards with respect to the review of the Exemption Report by the independent public accountant will address the following nine topics:

- The objective of the review;
- The relationship between the review engagement and the audit of the financial report;
- The review procedures;
- Evaluating the results of the examination procedures;
- Obtaining a representation letter;
- Communication requirements;
- Reporting on the review engagement;
- The review report date; and
- Review report modifications.

In response to commenters' requests and the fact that the PCAOB's standards regarding broker-dealer audits could not be finalized until the SEC adopted amendments to Rule 17a-5, the SEC has delayed the compliance date for these requirements until June 1, 2014. In particular, a broker-dealer must file reports of its independent public accountant that covers the Exemption Reports for fiscal years ending on or after June 1, 2014. [As noted above, the effective date for the remainder of the rule, including the financial audit requirements, is December 31, 2013.] In the interim, broker-dealers must continue to file material inadequacy reports in accordance with the provisions of Rule 17a-5 as they existed before the current amendments.

Consistent with the current rule, in the event the independent public accountant determines any material weakness exists or that the broker-dealer is not in compliance with SEC Rules 15c3-1, 15c3-3, or 17a-13 [10] under the Exchange Act, or any rule of the DEA requiring account statement to be sent to a customer of the broker-dealer, the accountant must immediately notify the chief financial officer of the broker-dealer of the nature of the

material weakness or non-compliance. While the revised rule incorporates the existing notification process, Subsection (h) has been added to the rule to “emphasize the importance of broker-dealers providing notification to the Commission and other securities regulators of non-compliance with Rule 15c3-1 as required by Rule 17a-11 [11] and non-compliance with [Rule 15c3-3(e) and (i).” [12] A copy of any notice provided to the Commission must also be provided to the accountant within one business day [13] and, if it is not, the accountant must notify the Commission.

B. Confidentiality of the Annual Report

Under revised Rule 17a-5(e)(3), broker-dealers can continue to request confidential treatment of a portion of their annual reports. In particular, if the broker-dealer’s Statement of Financial Condition is bound separately from the balance of the annual reports required by paragraph (d) of the new rule, and each page of the balance of the annual report is stamped “confidential,” then the balance of the annual reports will be deemed confidential to the extent permitted by law. In other words, “if the compliance reports and exemption reports and the related reports of the independent public accountant are submitted in accordance with the procedures specified in paragraph (e)(3) of Rule 17a-5, these reports will be deemed confidential to the extent permitted by law.” [14] Notwithstanding their confidential treatment, the confidential portions of the reports may be accessed for official use by any official or employee of the U.S., a national securities exchange, a registered national securities association of which the broker-dealer is a member, the PCAOB, and other person authorized by the Commission as being in the public interest.

III. New “Form Custody” Filing Requirement

A. Overview; Purpose of the Form

As part of its rulemaking, the Commission has also adopted “Form Custody,” which is designed to elicit information about a broker-dealer’s custodial activities. [15] Form Custody must be filed with the registrant’s DEA by all broker-dealers along with the FOCUS report. [16] To address instances in which certain items on the Form do not apply to certain types of broker-dealers, the instructions to the Form clarify that such items do not need to be answered by the broker-dealer. [17] The Commission’s Release clarifies that a broker-dealer completing Form Custody is not required to engage an independent public accountant to review the Form. [18]

According to the Commission, all broker-dealers must file this form because the “Commission is concerned about circumstances where broker-dealers falsely represent to regulators and others that they do not handle funds or securities or issue trade confirmations or account statements.” [19] Form Custody is intended to both “assist Commission and DEA examiners in identifying potential misrepresentations relating to a broker-dealer’s custody of assets . . . [and enable] examiners . . . to better understand a broker-dealer’s custody profile and identify custody-related violations and misconduct.” [20]

B. Form Custody Contents

Form Custody is comprised of the following nine items:

Item 1 – Accounts Introduced on a Fully-Disclosed Basis: Those registrants that introduce customer accounts to another broker-dealer must disclose the identity of each broker-dealer to which the customer accounts are introduced on a fully-disclosed basis.

Item 2 – Accounts Introduced on an Omnibus Basis: If a broker-dealer introduces customer accounts to another broker-dealer on an omnibus basis, it must disclose the broker-dealers to which such accounts are introduced.

Item 3 – Carrying Broker-Dealers: This item consists of five subparts designed to elicit information about those broker dealers that carry customer accounts and hold customer funds and securities. As noted above, registrants that do not carry customer accounts do not need to answer these questions.

Item 4 – Carrying for Other Broker-Dealers: Those broker-dealers that carry accounts for other broker-dealers must disclose such activity pursuant to Item 4, including the number of broker-dealers it has such an arrangement with, the identity of such firms, and whether the arrangement is on a fully-disclosed or omnibus basis. The broker-dealer must also disclose whether any of the broker-dealers it has an arrangement with are affiliates.

Item 5 – Trade Confirmations: This item requires the broker-dealer to disclose whether it sends (or employs a vendor to send) transaction confirmations to customers and other accountholders. According to the Release, this information will enable examiners to confirm with the third-party receiving the confirmation that the broker-dealer is, in fact, sending such confirmations. [\[21\]](#)

Item 6 – Account Statements: Item 6 requires broker-dealers to disclose whether they send account statements to customers and other accountholders.

Item 7 – Electronic Access to Account Information: This item on Form Custody requires broker-dealers to indicate whether they provide accountholders electronic access to information about the securities and cash positions in their accounts. This information is intended to inform the Commission regarding “how readily customers can access and review account information.” [\[22\]](#)

Item 8 – Broker-Dealers Registered as Investment Advisers: This item requires a broker-dealer to disclose whether it is registered with the SEC or one or more states as an investment adviser. If so, it must provide the Commission detailed information concerning its advisory clients including information about: its custody arrangements, its authority over its customers’ advisory accounts, and the account statements provided to advisory clients.

Item 9 – Broker-Dealers Affiliated with Investment Advisers: This item requires a broker-dealer to disclose information regarding its affiliation with any state or federally-registered investment adviser. If there is an affiliation, the broker-dealer must disclose information regarding its custody arrangements with the affiliate.

IV. Miscellaneous Amendments

Other amendments to Rule 17a-5 include the following:

A. Revisions to Paragraph (f)(2), Statement Regarding Independent Public Accountant – Paragraph (f)(2) requires registrants to file notices with the Commission and the DEA regarding the registrant’s independent public accountant. The notices currently on file with the Commission (which were required under the previous version of this rule) do not contain all of the representations required by the revised rule. Accordingly, all registrants will be required to file a new statement under Paragraph (f)(2). If the engagement covered by the new statement is of a continuing nature, no subsequent filing would be required

unless and until the registrant changes its independent public accountant or amends its engagement. [23]

Access to Accountant and Audit Documentation – Paragraph (f)(2) now requires a broker-dealer to include a representation in its statement regarding its independent public accountant that the broker-dealer agrees to allow Commission and DEA examination staff to review the audit documentation associated with its annual audit reports and to allow its independent public accountant to discuss findings relating to such reports with the SEC and DEA examination staffs if requested for the purpose of an examination of the registrant. Importantly, the requirement to include this representation is limited to those broker-dealers that clear transactions or carry customer accounts. According to the Commission's Release, clearing broker-dealers "generally have more complex business operations than non-carrying firms . . . [t]hus access to accountants and audit documentation was considered of substantially greater value when preparing for regulatory examinations of these types of broker-dealers, as compared to firms with more limited business models." [24] [Emphasis added.]

C. Coordination with Rule 206(4)-2 under the Investment Advisers Act – Rule 206(4)-2 governs the custody arrangements of investment advisers that maintain custody of clients' funds or securities. [25] It permits registered broker-dealers to act as a qualified custodian for an investment adviser so long as the broker-dealer provides the adviser a written internal control report prepared by an independent public accountant registered with and subject to regular inspections by the PCAOB. To coordinate the reports required by revised Rule 17a-5 with those that advisers must obtain from a broker-dealer custodian under Rule 206(4)-2, the Release notes that the reports required by Rule 17a-5 are intended to satisfy the written internal control report requirement of Rule 206(4)-2 for those carrying broker-dealers that are either dually registered as an investment adviser or that maintain assets of an affiliated investment adviser.

D. Technical Amendments – The revisions include various technical, non substantive amendments to Rule 17a-5. These include, among others, deleting references to Y2K from the rule; revising all references in the rule to the registrant's accountant to "independent public accountant"; replacing the term "balance sheet" with "Statement of Financial Condition"; and replacing "date selected for the annual audit of financial statements" with "end of the fiscal year of the broker or dealer," though both phrases have the same meaning.

V. Effective Date

The Commission has established December 31, 2013 as the effective dates for the requirement to file Form Custody. Accordingly, broker-dealers must begin filing Form Custody with their DEAs 17 business days after the calendar quarter or fiscal year, as applicable, ended December 31, 2013. With respect to the remainder of the rules' requirements, the Commission is delaying the effective date for the requirements relating to broker-dealer annual reports to June 1, 2014 in order to provide broker-dealers, independent public accountants, and DEAs time to prepare for the changes resulting from the new requirements. According to the Release, "Given the complexity and practical difficulty of having certain provisions become effective before others, the amendments to Rule 17a-5 and the amendments to Rule 17a-11 will become effective on June 1, 2014, regardless of whether they relate to the annual report requirements, except that there will be different effective dates for the amendments to paragraph (a) of Rule 17a-5 (which

includes the filing requirement for Form Custody) . . .” [26]

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endnotes

[1] See Broker-Dealer Reports, SEC Release No. 34-70073 (July 30, 2013) (the “Release”), which is available on the SEC’s website at: <https://www.sec.gov/rules/final/2013/34-70073.pdf>. The Release is 316 pages. The revised rule text begins on p. 283.

[2] Release at p. 21.

[3] Broker-dealers that cannot rely on the exemption in Rule 15c3-3(k)(1) are instead required to file a new “Compliance Report,” which appears to be far more detailed. This memo focuses on the requirements of the Exemption Report since mutual fund underwriters generally rely on the (k)(1) exemption.

[4] See Rule 17A-5(d)(6). Members of SIPC must also file a copy of the annual report with SIPC. This filing is intend both to assist SPIC in monitoring the financial strength of broker-dealers that are members of SIPC and to better enable it to “overcome a legal hurdle to pursuing claims against a broker-dealer’s accountant where the accountant’s failure to adhere to professional standards in auditing a broker-dealer caused a loss to the SIPC fund.” Release at p. 54.

[5] Release at p. 20. Any exceptions to meeting the provisions of the (k)(1) exemption must be identified in the Exemption Report. Release at fn. 73. Also, “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 file the compliance report.” Release at p. 22. The Release clarifies that the Exemption Report “is not intended to establish a new private cause of action.” Release at p. 23.

[6] Release at p. 46.

[7] Ibid. The Release contains an extensive discussion regarding the independent public accountant’s responsibilities under the revised rule. See Release at pp. 79-97.

[8] The Release notes that, since the Commission proposed its amendments to Rule 17a-5, the PCAOB has taken a number of actions to implement the explicit authority over broker-dealer audits that was provided to it by the Dodd-Frank Act. These actions include establishing requirements for examining broker-dealer compliance reports and reviewing broker-dealer Exemption Reports. Release at pp. 68-69.

[9] Eliminated from the rule is the current requirement in paragraph (j) of the rule that requires the audit to be conducted in accordance with GAAS. According to the Release, “the change from GAAS to PCAOB auditing standards will facilitate the Commission’s regulatory oversight authority because the Commission has direct oversight authority over the PCAOB. Release at pp. 80-81. The Release also notes that, according to an August 2012 report published by the PCAOB, the PCAOB identified deficiencies in all 23 of the audits it reviewed that had been conducted of 23 broker-dealer audits by ten public

accounting firms in accordance with GAAS. “For example, as to all of the 14 audits of broker-dealers that claimed an exemption from Rule 15c3-3, the staff stated that the accountant ‘did not perform sufficient procedures to ascertain that the broker or dealer complied with the conditions of the exemption.’” Release at p. 83.

[10] Rule 17a-13 governs the quarterly securities count required of certain broker-dealers.

[11] Conforming amendments have been made to Rule 17a-11 to accommodate the change in Rule 17a-5(d)(3) from “material weakness” to “material inadequacy.” Release at p. 109.

[12] The Release clarifies that the notification provisions in Rule 17a-5(h) relating to non-compliance with the financial responsibility rules “apply regardless of whether the independent public account is engaged to prepare a report based on examination of a broker-dealer’s compliance report or a review of a broker-dealer’s Exemption Report.” Also, “the notification provisions with respect to an instance of material weakness only apply to broker-dealers that file a compliance report because material weakness is defined for purposes of the compliance report.” Release at p. 107.

[13] The current rule specifies a “24 hour period.” The revision is designed “to account for non-business days during which certain actions may not be feasibly completed.” Release at fn. 431.

[14] Release at pp. 59-60.

[15] Form Custody can be found on pp. 307-316 of the Release.

[16] The DEA, in turn, is required to maintain the information obtained through Form Custody and transmit such information to the SEC when it transmits FOCUS Report data to the Commission. The Form must be filed within seventeen (17) business days after the end of each calendar quarter.

[17] This clarification appears in Paragraph A. under the General Instructions to the Form. According to this instruction, “For example, a broker-dealer that does not hold customer and non-customer funds or securities does not need to answer Items 3.C.-3.E.”

[18] Release at p. 140.

[19] Release at p. 139. The Release notes, however, that if the Commission subsequently determined that it is appropriate to exempt certain types of broker-dealers from this requirement, it could issue a rule, regulation, or order providing for such exemption under Section 36 of the Exchange Act. Ibid.

[20] Ibid. The Instructions add, “For example, “if a broker-dealer represents on Form Custody that it does not issue account statements, but an examiner received an account statement issued by the broker-dealer, the examiner will be able to react more quickly to the misrepresentation.”

[21] Release at p. 161.

[22] Release at p. 164.

[23] Release at p. 118.

[\[24\]](#) Release at p. 128. See Rule 17a-5(f)(2)(G)(iii), which limits the application of this requirement to certain carrying broker-dealers. As discussed in the Release, the provision generated much comment and controversy. Release at pp. 128-134.

[\[25\]](#) Note that custody arrangements of mutual funds are expressly excluded from these requirements because they are governed by other provisions under the federal securities laws.

[\[26\]](#) Release at p. 169.

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