PCAOB
Public Company Accounting Oversight Board

Forum on Auditing Smaller Broker-Dealers

May 28, 2014

Chicago, IL

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

Jeanette Franzel
Board Member, PCAOB

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

Kevin Stout

Senior Associate Chief Accountant, Office of the Chief Accountant , SEC

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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

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

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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**
- **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 filing of 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)	Financial Report: • Financial statements • Supporting Schedules *Compliance Report (new)*	Audit Audit procedures: ***AS 17*** Examination: ***AT 1***
Non-carrying broker (no custody of customer assets)	Financial Report: • Financial statements • Supporting Schedules *Exemption Report (new)*	Audit Audit procedures: ***AS 17*** Review: ***AT 2***

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

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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)

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 and 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

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**

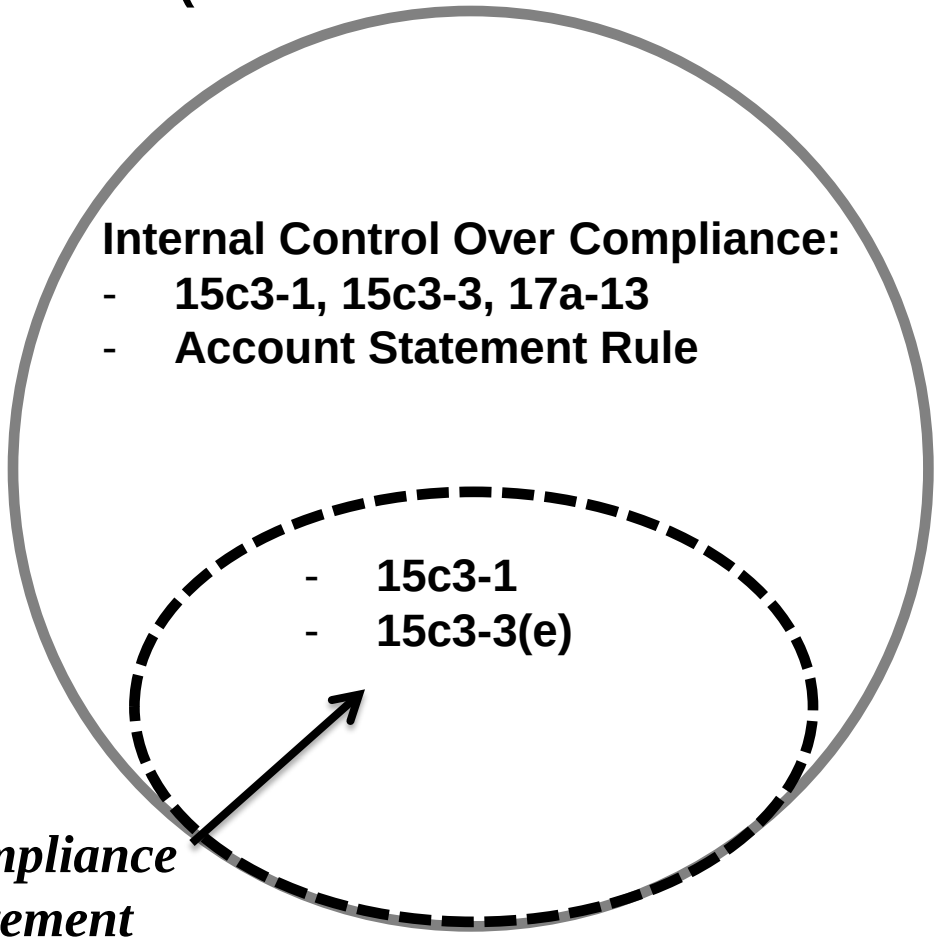
July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)

- **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 assertion for the assertion 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**

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.

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 focus on 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**

Standard-Setting Agenda

Standard-Setting Agenda

- Related party transactions
- Transparency
- Auditor's reporting model

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
- Subscription to PCAOB e-mail updates of web postings: http://pcaobus.org/About/Pages/Subscribe.aspx

Questions?

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

Mary M. Sjoquist, Director,
Office of Outreach and
Small Business Liaison
May 28, 2014
Chicago, IL

PCAOB
Public Company Accounting Oversight Board

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 1 Application for Registration Affecting BD Auditors (cont'd)

- BD auditors are required to report whether individuals in the firm or contractors to the firm are currently subject to:
  - a Board sanction suspending or barring them from being an associated person of the firm
  - a Commission order suspending or denying the privilege of appearing or practicing before the Commission
  - a court-ordered injunction prohibiting appearance or practice before the Commission

Key Changes to Form 1 Application for Registration Affecting BD Auditors (cont'd)

- Listing of filings disclosing issues with brokers or dealers related to any matter of accounting principles or practices, financial statement disclosure, auditing scope or procedure, or compliance with applicable rules of the Commission made by a broker or dealer during the current or preceding calendar year in a filing with the Commission.

Change to Form 1-WD-Request for Leave to Withdraw from Registration

- Form 1-WD is now required to be filed electronically. No hard copy required to be filed as in past.

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 form 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.

Form 4—Succeeding to the Registration Status of a Predecessor Entity

- Form 4
  - Requires a “yes” or “no” answer to “did any firm identified in the transaction underlying the succession issue an audit report with respect to a BD audit client for financial statements with years ending after 12/31/08 while not registered with the Board and which did not thereafter have a registration approved by the Board?”

Office of Outreach Contact Information

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

PCAOB
Public Company Accounting Oversight Board

Questions?

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

PCAOB Forum on Auditing Smaller Broker-Dealers

Chicago, IL May 28, 2014

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

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Amendments to the Financial Responsibility Rules for Broker-Dealers

"Onnig" Amendments

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

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Financial Responsibility Rules Amendments

- **On July 30, 2013 the Commission published a final rulemaking, amending the broker-dealer financial responsibility rules**
  - Financial Responsibility Rules for Broker-Dealers
    - Release 34-70072
- **Designed to address several concerns regarding the financial responsibility requirements for broker-dealers**
- ***These slides, addressing the changes in the "Onnig Amendments", highlight only the changes that could impact non-carrying firms***

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)
  - Issues with respect to expense sharing agreements continue to be significant
    - Lack of demonstrated resources of the parent or other third party
    - Allocation of costs that are not reasonable
      - Insufficient, or excessive, allocations are each problematic; although for different reasons

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…."

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

Fidelity Bond Deductibles

- **Rule Text**

  In calculating net capital, deduct from net worth

  "… the amount specified by the rule of the Examining Authority for the broker or dealer with respect to a requirement to maintain fidelity bond coverage."

  - SEA Rule 15c3-1(c)(2)(xiv)

  - Rule Change Effective October 21, 2013

- **FINRA Commentary**

  - A broker-dealer may not take a charge to net worth in computing net capital in lieu of obtaining a fidelity bond.

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."

- SEA Rule 15c3-1(c)(16)
- Rule Change Effective October 21, 2013

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)

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 Customer Protection Rule (SEA Rule 15c3-3)

Proprietary Accounts of Broker-Dealers (PAB) – fka PAIB

- **FINRA Commentary**
  - Partial codification and expansion of existing staff position in November 3, 1998 SEC Letter to NYSE and NASD (Notice to Members 98-99)
  - Requires carrying broker-dealers to maintain a segregated reserve account for account holders that are broker-dealers. Previously, optional.
    - As such, a letter from the carrying broker-dealer is no longer necessary for the account holder/broker-dealer to treat such assets as allowable for net capital purposes.
  - SEA Rule 15c3-3(a)(16) defines a PAB Account as "…a proprietary securities account of a broker or dealer…." Such accounts are carried by one firm on behalf of another.
  - SEA Rule 15c3-3(b)(5) requires the carrying firm to "…obtain and thereafter maintain the physical possession or control of securities carried for a PAB account, unless the broker or dealer has provided written notice to the account holder that the securities may be used in the ordinary course of its securities business, and has provided an opportunity for the account holder to object."
    - Whether the PAB Account owner has objected or not, the securities are allowable assets of the PAB Account owner for net capital purposes.

Amendments to the Books and Records Rules (SEA Rules 17a-3 and 17a-4)

Risk Management Controls

- **Rule Text**

  "… every broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934, as amended, shall make and keep current the following books and records relating to its business:…

  A record documenting the credit, market, and liquidity risk management controls established and maintained by the broker or dealer to assist it in analyzing and managing the risks associated with its business activities, Provided, that the records required by this paragraph (a)(23) need only be made if the broker or dealer has more than:… (ii) $20,000,000 in capital, which includes debt subordinated in accordance with § 240.15c3-1d."

  - SEA Rule 17a-3(a)(23)
  - Rule Change Effective March 3, 2014

  Such record must be maintained "…until three years after the termination of the use of the risk management controls documented therein."

  - SEA Rule 17a-4(e)(9)
  - Rule Change Effective March 3, 2014

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

Amendments to the Broker-Dealer Reports Rules

Includes Amendments to:
- Broker-Dealer Reports Rule – Rule 17a-5
- Notification Rule – Rule 17a-11
- Includes the adoption of Form Custody

SEC Release Number 34-70073

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Broker-Dealer Reports Rule (SEA Rule 17a-5)

- **The recent amendments to SEA Rule 17a-5 include:**
  - Provision for Access to Independent Public Accountant and Audit Documentation
    - Requires a carrying or clearing broker-dealer to represent in its *"Statement regarding independent public accountant under SEA Rule 17a-5(f)(2)"* notice that, if requested in writing for purposes of the examination of the broker-dealer, the broker-dealer agrees to:
      - Allow Commission and DEA representatives to review the audit documentation associated with its annual audit reports.
      - Allow its independent public accountant to discuss its findings with such representatives.
  - Form Custody
    - Requires all broker-dealers to file a new form, titled *Form Custody*, with their quarterly FOCUS Reports, commencing with the December 31, 2013 filing.
    - Designed to elicit information concerning whether, and if so how, a broker-dealer maintains custody of customer, and non-customer, assets.

Broker-Dealer Reports Rule (Rule 17a-5)

- **The recent amendments to Rule 17a-5 also include:**
  - Requirement to File Reports
    - Requires non-carrying firms to prepare and file with the Commission annual reports consisting of a financial report and an Exemption Report that are prepared by the broker-dealer
    - The "annual audit" prepared by the broker-dealer's independent public accountant must contain an examination of the broker-dealer's financial report and a review of the broker-dealer's Exemption Report

  Note: Carrying Firms must prepare a Compliance Report which must be examined by the firm's independent public accountant.

Dates and Links

- **Proposed: June 15, 2011 (Release No. 34-64676)**
  - https://www.sec.gov/rules/proposed/2011/34-64676.pdf
- **Adopted: July 30, 2013 (Release No. 34-70073)**
  - https://www.sec.gov/rules/final/2013/34-70073.pdf
- **Effective Date: October 21, 2013**
  - Rule 17a-5(e)(5)
- **Effective Date: December 31, 2013**
  - Rule 17a-5(a)
  - Rule 17a-5(d)(6)
- **Effective Date: June 1, 2014**
  - Rest of the requirements

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

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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 are effective July 7, 2014. 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)

- **Current Rule - Haircuts:**
  - Commercial Paper – SEA Rule 15c3-1(c)(2)(vi)(E)
    - Ratings: In one of the 3 highest categories by at least two NRSROs
    - 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)
    - Ratings: In one of the 4 highest categories by at least two NRSROs
    - Haircut: 2% to 9% based on maturity
  - Preferred Stock - SEA Rule 15c3-1(c)(2)(vi)(H)
    - Ratings: In one of the 4 highest categories by at least two NRSROs
    - Haircut: 10%

Deletion of NRSRO References

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

- **Amended Rule - Haircuts:**
  - Broker-Dealer can continue to avail itself of the lower haircuts noted on the previous slide if the broker-dealer can establish that the securities involve a *minimal amount of credit risk* (emphasis added).
    - Note: 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.**
- **Firms may still rely on the SEC's various no-action letters with respect to these securities.**

The Exemption Report

Financial Industry Regulatory Authority

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."

Understanding the Exemptions to the Customer Protection Rule – SEA Rule 15c3-3 (k)(1)

In summary, requirements for firms that claim a (k)(1) exemption:

(1) The firm's transactions as broker (agent) are limited to:

- (a) the sale and redemption of redeemable securities of registered investment companies or of interests or participations in an insurance company separate account, whether or not registered as an investment company;
- (b) the solicitation of share accounts for savings and loan associations insured by an instrumentality of the United States; and
- (c) the sale of securities for the account of a customer to obtain funds for immediate reinvestment in redeemable securities of registered investment companies.

NOTE: The broker-dealer may also engage in limited proprietary trading as noted in the rule.

(2) The firm must promptly transmit all funds and deliver all securities received in connection with its activities, and the firm may not otherwise hold funds or securities for, or owe money or securities to, customers.

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

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

(1) The firm, which is an introducing broker or dealer, must:

- (a) clear all transactions with and for customers on a fully disclosed basis with a clearing broker or dealer, and
- (b) promptly transmit all customer funds and securities to the clearing broker or dealer which carries all of the accounts of such customers.

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).

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

Re: The Exemption Report…

"There may be circumstances in which a broker-dealer has not held customer securities or funds during the fiscal year, but does not fit into one of the exemptive provisions… these broker-dealers should file an exemption report and related accountant's report."

See *Federal Register* 78 FR 51910 dated 2013-08-21 re: Broker-Dealer Reports or SEC Final Rule Release 34-70073, Footnote 74

FINRA Commentary:

The above language is in recognition of the fact that some business models, as noted below, do not align with the language in one of the exemptions in the Customer Protection Rule.

- BD's which have a business model that does not align with language in any of the exemptions:
  - Mergers & Acquisition Firms. Firm should not have any "customers".
  - Firms that engage in only proprietary trading. Firm should not have any "customers".
  - Firms that sell unregistered securities. The firm has customers, but usually does not have an agreement with a clearing and carrying firm.

The above firms tend to claim the (k)(2)(i) exemption.

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? Are there any net capital or books and records implications as a result of the referenced practices?**
  - Scenario A
    - A broker-dealer's registered representatives (RRs) frequently meet with clients in their homes. The clients give checks to the RRs, who give the checks to their branch office manager for processing. The manager sends the checks – by noon of the next business day – to the broker-dealer's main office. Staff at the main office log the receipt of the check and then forward the check, by noon of the following business day, to the clearing firm.
  - Scenario B
    - 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 C
    - 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 Nature and Scope of FINRA's Financial Surveillance, and Risk-Based Examinations, Programs

Financial Industry Regulatory Authority

FINRA's Financial Surveillance Program

- **Includes the routine review of a firm's financial and operational reports:**
  - FOCUS Report
  - Schedule I
  - Form Custody
  - Annual Audit
- **Reviews are largely determined by the creation of certain "exceptions".**
- **Select manual reviews are also conducted.**

FINRA's Risk-Based Examination Program

- **Risk-Based means that the scope, content, frequency and nature of a firm's examination will depend on the characteristics of the firm.**
- **Characteristics include, but are not limited to, firm size, business lines, and nature of operations.**
- **All firms are on a 1, 2, 3 or 4 year examination cycle.**
- **Certain events, for example customer complaints, regulatory tips, can accelerate the start date of an examination, or cause a special examination (e.g., Special FinOp Examination).**

Update from FINRA

- 2014 Financial and Operational (FinOp) Examination Priorities
- 2013 FinOp Examination Findings
- FinOp Regulatory Issues and Concerns

FINRA®

Financial Industry Regulatory Authority

2014 FINRA Examination Priorities

Select Financial and Operational Priorities

Accuracy of Firm's Financial Statements and Net Capital

Overarching Principles:

- BD must be in a position to prepare financial statements throughout the year
- Such statements must be accurate and in accordance with U.S. GAAP
  - Broker-dealers must prepare their books on an accrual basis
    - Firms must refrain from making accruals only at quarter or year end
  - Broker-dealers must refrain from netting transactions unless there is authoritative accounting guidance which permits such netting
- A broker-dealer's net capital computation must be accurate
  - Firms must understand the self-operative nature of the rule
  - Be familiar with rule language and related interpretations that may be applicable in light of the firm's business model

NOTE: FINRA also stressed the requirement that all broker-dealer auditors be independent.

2014 FINRA Examination Priorities

Select Financial and Operational Priorities

Accuracy of Firm's Financial Statements and Net Capital

Rule language and Interpretations that Impact the Net Capital Computation

- 2014 examinations will focus on the following areas:
  - Application of Open Contractual Commitment Charge
  - Haircuts, and if applicable, Undue Concentration
    - On a related note, the securities must be properly valued
  - Non-Allowable Asset Treatment in the case of blockage

2013 FinOp Examination Findings

- **Failure to apply the proper minimum dollar net capital requirement**
- **Failure to properly value assets**
- **Improper application of an Expense Sharing Agreement (ESA)**
  - Allocation of expenses not based on a reasonable allocation
  - Broker-dealer records a capital contribution to eliminate a payable to the parent.
    - No evidence that the parent has actually paid the expense
- **Improper exclusion of items from Aggregate Indebtedness liability**
- **Improper add-back of certain liabilities to net worth in calculating net capital**
  - Add-back not supported by rule language or interpretations

FinOp Regulatory Issues and Concerns

Possible Undeclared Withdrawal of Capital

- **Capital withdrawn from a broker-dealer without recording it as a distribution**
- **Such withdrawals are often facilitated by:**
  - A management services agreement (MSA)
  - A distribution of assets at other than fair value
  - Receivables that are never/infrequently re-paid

FinOp Regulatory Issues and Concerns

Possible Undeclared Withdrawal of Capital (continued)

- **An MSA describes services whereby a party (usually the B/D's parent or affiliate) performs administrative or management services for the B/D.**
  - 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.
  - In an MSA, we look for the following:
    - The parent or affiliate has the capacity to offer the service.
    - The broker-dealer needs the service to support its operations.
    - There is evidence that the services were actually performed.
    - The costs of the services are reasonable. What would a broker-dealer pay an independent 3rd party?

FinOp Regulatory Issues and Concerns

Possible Undeclared Withdrawal of Capital (continued)

- **Evidenced by:**
  - Increase in MSA agreements that appear to have no economic substance
  - Decline in notifications to report Withdrawals of Equity Capital
  - Decline in amount of total withdrawals reported as Withdrawals of Equity Capital on FOCUS Reports
  - Questionable profit margins

FinOp Regulatory Issues and Concerns

Possible Undeclared Withdrawal of Capital (continued)

- **Distribution of assets at other than fair value**
- **Such withdrawals are often facilitated by the "transfer/assignment" of an asset to the parent.**
- **Example:**
  - Firm acquires securities as compensation
  - Securities do not have a ready market
  - Broker-dealer either values the securities at zero, or a low value that can't be supported
  - Securities are then transferred or assigned to the parent at such value

NOTE: Other issues arise when the firm transfers/assigns the securities to their registered representatives

FinOp Regulatory Issues and Concerns

Possible Undeclared Withdrawal of Capital (continued)

- **Receivables that are never/infrequently re-paid**
  - Pattern suggests no/limited intent to re-pay
  - Funds advanced may have been put to other uses, making re-payment less likely, at least in the foreseeable future

Understanding the Net Capital Computation – Attendee Participation

- **What is the correct minimum dollar net capital requirement imposed on a broker-dealer (BD) who engages in each of the following activities, and why? Are there any other net capital implications?**
  - Scenario A
    - A broker-dealer engages in the buying and selling of corporate debt. On a trade date basis, the firm never has inventory (long or short) at the end of the day. The firm's business practice is such that it only buys (or sells) from Broker-Dealer "A" when it has corresponding orders from Broker-Dealer "B".
  - Scenario B
    - Transactions that result from a error in a customer trade, are transferred to the broker-dealer's error account. Securities in the error account are sold by the broker-dealer based on its judgment as to when it can obtain the best overall price for the shares, thus limiting the firm's loss.
  - Scenario C
    - A broker-dealer is a minority-owned firm. It is an underwriter (per the Prospectus) of certain bonds. The lead underwriter has provided the BD with a written Securities Purchase Agreement stating that it will assume the risk of any unsold allotment that would otherwise be purchased by the minority-owned firm.

Understanding the Net Capital Computation – Attendee Participation

- **What is the impact to the broker-dealer's financial statements with respect to each of the following? What are the net capital implications, if any, in each scenario?**
  - Scenario A
    - A broker-dealer has signed a settlement agreement with a customer, for $500,000, for which it is jointly and severally liable with its parent. The payment is due, in full, in 90 days. The broker-dealer has $500,000 worth of insurance, with a $50,000 deductible. Based upon the broker-dealer's review of the insurance policy, the loss should be covered by the insurance company. Further, the parent has provided a written representation to the broker-dealer that if some/all the funds used to pay the settlement come from the broker-dealer, that the parent will reimburse the broker-dealer that amount.
  - Scenario B
    - A broker-dealer has been in business for five years. During its first four years of operations, it was not involved in any disputes of any kind. In 2013, the broker-dealer was named as a respondent in three arbitration claims (filed in January, April, and May of 2013), and a defendant in two lawsuits (filed in August and December 2013). With respect to the broker-dealer's fiscal year end of December 31, 2013, answer the questions above.

Computation of Aggregate Indebtedness

As contained in a FOCUS Report

COMPUTATION OF AGGREGATE INDEBTEDNESS

16. Total A.I. liabilities from Statement of Financial Condition				$	3790
17. Add:					
A. Drafts for immediate credit	34	$	3800		
B. Market value of securities borrowed for which no equivilent 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 lne 10)				%	3850
21. Percentage of aggregate indebtedness to net capital *after* anticipated capital withdrawals (line 19 ÷ by line 10 less Item 4880 page 25)				%	3853

PCAOB Attestation Standard No. 2

Review Engagements Regarding Exemption Reports of Brokers and Dealers

FINRA Disclaimer:

- **FINRA can't provide guidance on how to test for a broker-dealer's compliance with the exemptive provisions of SEA Rule 15c3-3.**
- **FINRA can, however, share observations that may assist the auditor in carrying out its responsibilities.**

Review Engagements Regarding Exemption Reports Attestation Standard 2 – Review Procedures*

The nature, timing and extent of the necessary inquiries and other review procedures depend on certain risk factors.

(1) The broker-dealers history of instances of non-compliance with the exemption provisions.

FINRA Comments:

- A firm's prior procedures (pre-2013/2014) may not have been designed in a way to permit a firm to effectively identify all exceptions.
- Lack of findings in this area as a result of a FINRA examination do not necessarily mean that the firm has previously operated in a manner consistent with the claimed exemption.
  - Examination Frequency
  - Examination Scope
  - Review Periods/Sample Sizes
  - Examination Location
  - Other Factors

* Page A2 – 5.

Review Engagements Regarding Exemption Reports Attestation Standard 2 – Review Procedures*

The nature, timing and extent of the necessary inquiries and other review procedures depend on certain risk factors.

(2) Changes since prior year in the broker-dealers procedures, controls, or the environment in which the controls operate.

FINRA Comments:

- It is important to understand a firm's operations, and to determine if any changes were made since the prior year.
- It is also important to understand the following:
  - Which offices are branch offices. Which offices are Offices of Supervisory Jurisdiction (OSJs).
  - Does the broker-dealer have any locations which are utilized solely for customer service and/or back office type functions (i.e., a non-branch location).
    - Does the broker-dealer receive and process customer funds or securities at that location?
- FINRA requires that firms have procedures in place for the supervision of activities that occur at all of its locations.
  - Information about a firm's branch offices/OSJs will be on its Form BD.

* Page A2 – 5.

Review Engagements Regarding Exemption Reports Attestation Standard 2 – Review Procedures*

The nature, timing and extent of the necessary inquiries and other review procedures depend on certain risk factors.

(2) Changes since prior year in the broker-dealers procedures, controls, or the environment in which the controls operate.

FINRA Comments:

- It is important to understand a firm's operations, and to determine if any changes were made since the prior year.
  - Such changes may not necessarily result in compliance with the claimed exemption.
  - Procedures and practice are often inconsistent.
    - What happens when a firm does not comply with its procedures.
- Some other factors that may impact the environment
  - Costs/cost-cutting
  - Change in management/management philosophy
  - Overall compliance environment
  - Expansion of broker-dealer operations (personnel and/or geographic changes)

* Page A2 – 5.

Review Engagements Regarding Exemption Reports Attestation Standard 2 – Review Procedures*

The nature, timing and extent of the necessary inquiries and other review procedures depend on certain risk factors.

(3) Changes in the broker-dealers operations that are relevant to compliance with the exemption provisions.

FINRA Comments:

- It is important to inquire about changes in the firm's operations in the prior year as certain changes may impact which exemption(s) the firm elects, or the firm may have become subject to the Customer Protection Rule.
- NASD Rule 1017 requires that firms to file an application with FINRA (for approval) if the firm undergoes a material change in business operations as defined in NASD Rule 1011(k). Specifically, such changes include, but are not limited to:

  (1) removing or modifying a membership agreement restriction;

  (2) market making, underwriting, or acting as a dealer for the first time; and

  (3) adding business activities that require a higher minimum net capital under SEC Rule 15c3-1.

* Page A2 – 5.

Review Engagements Regarding Exemption Reports Attestation Standard 2 – Review Procedures*

The nature, timing and extent of the necessary inquiries and other review procedures depend on certain risk factors.

(4) Competence of firm personnel responsible for processing the receipt and forwarding of customer funds and securities to the appropriate party, or persons who supervise such personnel. Changes to personnel during the period of review.

FINRA Comments:

- Skill set likely to be minimal.
- Safeguards/supervision is paramount.
- Hiring procedures/back-ground checks.

* Page A2 – 5.

Review Engagements Regarding Exemption Reports Attestation Standard 2 – Review Procedures*

The nature, timing and extent of the necessary inquiries and other review procedures depend on certain risk factors.

(5) The risk of fraud, including the risk of misappropriation of customer assets, relevant to the exemption provisions.

FINRA Comments:

- Risk of fraud may be greater if:
  - Broker-dealer receives checks in its own name as opposed to the name of the ultimate intended recipient, e.g., clearing firm, mutual fund company.
  - BD receives securities
    - Stock Power may be largely blank
- Broker-dealer has inadequate supervisory procedures with respect to:
  - Changes in Customer Address
  - Examinations of Branches or OSJs
- Certain Short-term Risk Factors

* Page A2 – 5.

Review Engagements Regarding Exemption Reports Attestation Standard 2 – Review Procedures*

The nature, timing and extent of the necessary inquiries and other review procedures depend on certain risk factors.

(6) Potential non-compliance associated with related parties, including related parties that are investment advisors or entities with which the broker-dealer has a custodial or clearing relationship.

FINRA Comments:

Broker-dealer claiming an exemption from the Customer Protection Rule should not:

- permit a related party (or any other person/entity for that matter) to maintain custody of the assets of its customers UNLESS such entity is permitted to do so under U.S. law and is subject to supervision accordingly.
  - OK: An affiliated clearing and carrying firm registered with the SEC at which the customer maintains an account introduced on a fully-disclosed (by the introducing firm) basis.
  - OK: An affiliated mutual fund company which maintains an account in the customer's name.
- hold customer assets in its name ANYWHERE as a nominee.
- permit a related party (or any other person/entity) to process the handling of customer funds or securities to the ultimate intended recipient.
  - This function should be conducted in-house by associated persons of the broker-dealer, and supervised by associated persons of the broker-dealer.

* Page A2 – 5.

Review Engagements Regarding Exemption Reports Attestation Standard 2 – Review Procedures*

The nature, timing and extent of the necessary inquiries and other review procedures depend on certain risk factors.

(7) The degree to which the broker-dealer's processes that relate to the exemption provisions are performed, monitored, or controlled in a centralized or decentralized environment.

FINRA Comments:

The following is not prohibited:

- Registered Representatives receiving checks while in the field.

NOTE: RR's that work from home, in a non-branch location, should not be seeing customers at that location and therefore should not be receiving checks at those locations.

* Page A2 – 6

Review Engagements Regarding Exemption Reports Attestation Standard 2 – Review Procedures*

Evidence about the broker-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.

FINRA Comments:

Review of the broker-dealer's cash accounts may be informative, if:

- This firm used its operating accounts to deposit customer checks or issue redemptions. NOTE: Operating Accounts should not be used in this manner by any broker-dealer claiming an exemption.
- Payments to "customers" may suggest the broker-dealer settled with a customer, or paid an arbitration award. If the customer's complaint dealt with missing funds or securities, the review would be informative.

* Page A2 – 6

SEA Rule 15c2-4 - Transmission or Maintenance of Payments Received in Connection with Underwritings

For firms that sell unregistered securities that do not have a clearing firm, or where the clearing firm is not willing to settle these transactions, compliance with SEA Rule 15c2-4 may be required.

SEA Rule 15c2-4: It shall constitute a "fraudulent, deceptive, or manipulative act or practice"… for any BD… participating in any distribution of securities, other than a firm-commitment underwriting, to accept any part of the sale price of any security being distributed unless:

(1) The money or other consideration received is promptly transmitted to the persons entitled thereto (NOTE: if payment is to the BD, it is subject to a $250,000 net capital requirement, even if the money is then promptly forwarded to the issuer); or
(2) If the distribution is being made on any … basis which contemplates that payment is not to be made to the person on whose behalf the distribution is being made until some further event or contingency occurs,

(a) the money or other consideration received is promptly deposited in a separate bank account, as agent or trustee for the persons who have the beneficial interests therein, until the appropriate event or contingency has occurred, and then the funds are promptly transmitted or returned to the persons entitled thereto (NOTE: Only permitted of firms that have $250,000 in net capital and which are permitted to operate in this manner.), or

(b) all such funds are promptly transmitted to a *bank* which has agreed in writing to hold all such funds in escrow for the persons who have the beneficial interests therein and to transmit or return such funds directly to the persons entitled thereto when the appropriate event or contingency has occurred.

Questions?

PCAOB
Public Company Accounting Oversight Board

Lunch

(75 minutes)

PCAOB
Public Company Accounting Oversight Board

Division of Enforcement and Investigations:
An Overview

John Abell

Associate Director

Division of Enforcement and Investigations

Disclaimer

The views expressed are the views of the speaker and do not necessarily reflect the views of the Board, individual Board members, or other members of the Board's staff.

Division of Enforcement and Investigations Overview

- Staff consists of approximately 30 attorneys, 20 accountants, and 10 support staff, based in DC and NY offices
- Enforcement's role:
  - Identify appropriate matters for investigation
  - Conduct investigations and make recommendations to the Board
  - Litigate disciplinary proceedings before Board's Hearing Officer and, on appeal, to the Board

Enforcement's Jurisdiction

- Registered Public Accounting Firms
  - Audits of "Issuers" (*i.e.*, public companies) and Broker/Dealers
- "Associated Persons"

Investigative Authority

- The PCAOB may investigate possible violations by registered public accounting firms or their associated persons of:
  - Any relevant provision of the Sarbanes-Oxley Act
  - The rules of the Board
  - The provisions of the securities laws relating to the preparation and issuance of audit reports
  - Professional standards

Sources of Investigations

- Other PCAOB divisions and offices
  - Division of Registration and Inspections
  - Office of Research and Analysis
- Enforcement public source analysis
  - Issuer disclosures of restatements and auditor changes
  - Media reports, blogs, and analyst reports
  - Tips
- Referrals from other regulators, *e.g.*, SEC and FINRA

Common Types of Investigations

- Violations of professional standards
  - Significant and/or numerous departures from professional standards: *e.g.*, failure to obtain sufficient audit evidence, exercise due care and professional skepticism (ignored red flags)
  - Failure of firm quality control procedure to operate effectively
- Independence violations
- Failure to cooperate with an inspection or investigation

Investigations Process Overview

- The Act requires confidentiality of investigative information
- Most matters start as informal inquiries—reliance on voluntary productions based on Division requests
- If matter warrants significant use of resources, or parties are not complying with requests, Staff requests an Order of Formal Investigation from the Board
  - "Accounting Board Demands" compel firms/associated persons to
    - Produce documents
    - Testify
    - Provide other information
  - Refusal to comply may amount to sanctionable non-cooperation
- DEI frequently coordinates its investigations with the enforcement efforts of other regulators, such as the SEC

Investigations Process Overview

- If evidence of serious violations exists
  - Staff communicates to the firm or associated persons and gives them an opportunity to respond to staff's position in writing
  - Staff reviews the responses and determines whether to recommend charges against firm(s) and/or associated person(s), or closure of the formal investigation
  - Staff communicates recommendations to the Board

Investigations Process Overview

- Enforcement recommendations to the Board for disciplinary proceedings
  - Enforcement submits a memorandum to the Board outlining facts and law and parties to be charged with violations
    - If Board approves litigated proceeding, order is nonpublic
  - If parties wish to settle, the recommendation will include whether acceptance of the settlement is recommended by the Division
    - If Board approves settlement, order becomes public

Disciplinary Proceedings and Hearings

- Hearings (trials) are conducted by the Board Hearing Officer to determine whether firms or associated persons committed violations and should be disciplined
- Hearings are nonpublic, as required by Act
- Initial decision by Board's Hearing Officer
- Any sanctions imposed can be appealed to the Board, then to the SEC, and then to the United States Circuit Court

Sanctions

- In a disciplinary proceeding, the Board may
  - Impose a censure
  - Suspend or permanently bar an individual from association with a registered public accounting firm
  - Temporarily or permanently revoke a firm's registration
  - Temporarily or permanently limit the activities, functions, or operations of a firm or person
  - Impose a civil money penalty
  - Appoint an independent monitor
  - Require additional professional education or training, and/or impose any other sanction allowed by the Board rules

Effect of Suspension or Bar

- A person suspended or barred from associating with a registered public accounting firm by the Board is prohibited from associating with a registered public accounting firm
- Dodd-Frank also makes it unlawful for the person to associate with any issuer, broker, or dealer in an accountancy or a financial management capacity

Settled and Adjudicated Disciplinary Proceedings

- To date the Board has settled or completed adjudication on 75 disciplinary orders
- These orders have resulted in the following sanctions:
  - Bars (Firms and auditors)
  - Suspensions
  - Censures
  - Civil money penalties
  - Undertakings / Independent monitors

Recent Settled Disciplinary Proceedings

- Patrick Rodgers, CPA, PA and Patrick E. Rodgers, CPA
- Labrozzi & Co., P.A., and Douglas A. Labrozzi, CPA
- Harris F. Rattray CPA, PL and Harris F. Rattray, CPA
- Hood & Associates CPAs, P.C. and Rick C. Freeman, CPA
- Acquavella, Chiarelli, Shuster, Berkower & Co., LLP
- Deloitte & Touche LLP
- Nathan M. Suddeth, CPA
- Lake & Associates, CPA's LLC and Jay Charles Lake, CPA
- Gruber & Co., LLC, and E. Randall Gruber, CPA
- Rehan Saeed, CPA
- Michael F. Cronin, CPA and Michael F. Cronin, CPA

**In all of the settled disciplinary proceedings, the firms and the associated persons neither admitted nor denied the Board's findings, except as to the Board's jurisdiction over them and the subject matter of the proceedings.*

Recent Settled Disciplinary Proceedings

Harris F. Rattray CPA, PL (November 21, 2013)

- Mr. Rattray's conduct involves four audit clients, in two cases for multiple years.
- Mr. Rattray and his firm were charged with fraud for falsely stating that audits of three issuers had been conducted in accordance with PCAOB standards.
- At the time Mr. Rattray began auditing US issuer clients he had no experience auditing under PCAOB Standards nor familiarity with U.S. GAAP.
- He also failed to plan and perform sufficient audit work in critical areas of the audits.
- Violated 10A(a) of the Exchange Act by failing to design procedures around possible illegal acts with a direct and material effect on the financial statements.
- The Board permanently revoked firm's registration; permanently barred Mr. Rattray.

Recent Settled Disciplinary Proceedings

Hood & Associates CPAs, P.C. (November 21, 2013)

- Rick Freeman was the sole audit partner at Hood & Associates CPAs.
- Matter involves the audits of three issuers over multiple years.
- Mr. Freeman violated Section 10A(j) of the Exchange Act related to independence because on two clients he served as engagement partner for more than 5 years.
- Mr. Freeman and the firm falsely stated that audits of three issuers had been conducted in accordance with PCAOB standards thereby violating Rule 10b-5.
- There were multiple audit failures including failure to properly perform fraud procedures, to properly select samples for testing, to gather sufficient audit evidence and to have an EQR performed on the audits as required by AS No. 7.
- Mr. Freeman caused the firm to violate the quality control standards.
- The Board revoked firm's registration with a right to reapply after three years and imposed a $10,000 penalty; permanently barred individual.

Recent Settled Disciplinary Proceedings

Acquavella, Chiarelli, Shuster, Berkower & Co., LLP (November 21, 2013)

- Violations relate to the firm and partner David Svoboda.
- Matter involves audit failures in audits of two issuers based in PRC and one based in Hong Kong.
- Mr. Svoboda did not speak or read Chinese and relied on lower level personnel, including those from the Chinese firms, to identify audit issues and analyze audit evidence.
- To make matters worse, Mr. Svoboda reviewed hardly any of their audit work.
- Mr. Svoboda also violated the SEC's independence rules related to prohibited services by preparing financial statements for two clients that he then audited.
- The Board revoked firm's registration with a right to reapply after two years and imposed a $10,000 penalty; barred individual with a right to petition the Board to terminate the bar after three years.

Recent Settled Disciplinary Proceedings

Nathan M. Suddeth, CPA (Sept. 10, 2013)

- Former Partner in Charge of Deloitte's audit practice in the firm's Pittsburgh office.
- Failed to cooperate in Board inspection and violated audit documentation standards by improperly backdating work papers for an audit selected for inspection.
- Among other things, Suddeth added backdated documents on the morning the Board inspection began.
- Deloitte voluntarily reported to PCAOB and removed Suddeth from role as Partner in Charge and from direct audit responsibilities.
- Suddeth was censured and barred with the right to file a petition for Board consent to associate after two years.

Recent Settled Disciplinary Proceedings

Lake & Associates, CPA's LLC and Jay Charles Lake, CPA (Aug. 13, 2013)

- Audit failures in audits of four issuers (three China-based).
- Mr. Lake failed to adequately plan the audit or conduct the most basic substantive audit procedures of confirming accounts receivable or observing inventory.
- Lake also failed to reconcile and properly test accounting records that showed material differences with the general ledger and suggested accounts receivable and revenue were materially overstated.
- He failed to put quality control policies and procedures in place to provide reasonable assurance that audits were performed in compliance with applicable standards including PCAOB Standards.
- Firm received censure and revocation of registration, with right to reapply for registration after three years.
- Mr. Lake received censure and bar from association, with right to file petition for Board consent to associate after three years.

Recent Adjudicated Disciplinary Proceedings

S.W. Hatfield, CPA and Scott W. Hatfield, CPA (July 3, 2013)

- First Commission ruling in PCAOB audit case.
- Upholds permanent bar and revocation.
- Whether financial statements were materially misleading or investors misled not the issue.
- Whether companies lied or withheld documents not the issue
- Issue is whether auditor acted "diligently and with a reasonable degree of competence."
- Auditor deferred to untested management reps and relied on experience with other companies without adequate audit evidence, despite red flags.
- Matter was non-public for over four years.

Extraordinary Cooperation

- April 2013: Board's first formal statement on the benefits of extraordinary cooperation in enforcement matters.
- Extraordinary cooperation is voluntary and timely action beyond compliance with legal or regulatory obligations.
- Includes self-reporting violations before the conduct comes to the attention of the Board or another regulator, taking remedial or corrective action to reduce the risk of similar violations recurring, and providing substantial assistance in the PCAOB's investigative processes.
- May result in reduced charges or sanctions.

Whistleblower Protection and Auditors

- Section 806 of the Sarbanes-Oxley Act entitles employees of public companies to protection from retaliation for whistleblowing on their employer.

- In March 2014 the United States Supreme Court held in *Lawson v. FMR LLC* that the whistleblower protections in Section 806 of the Act apply to independent contractors and subcontractors of public companies (such as consultants and auditors).

- These protections under Section 806 attach even when the whistleblower does not alert law enforcement authorities, but instead provides information to his or her supervisor.

PCAOB Center for Enforcement Tips, Complaints and Other Information

Website:	http://pcaobus.org/Enforcement/Tips
Letter:	PCAOB Tip Center
	1666 K Street, NW
	Washington, DC 20006
FAX:	202-862-0757
Telephone:	800-741-3158

Questions?

PCAOB
Public Company Accounting Oversight Board

Inspections: Observations and Case Studies

Bob Maday and Kate Ostasiewski
Division of Registration and Inspections

May 28, 2014
Chicago, IL

Agenda

- Summary of Interim Inspection Program
- Inspections Observations
- Case Studies
  - Case Study 1
  - Case Study 2
- Closing Remarks

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, including
  - Whether and how to differentiate among classes of brokers and dealers
  - Whether to exempt any category of registered public accounting firms
  - Establishment of minimum inspection frequency schedules

Interim Inspection Process

- Communication and scheduling with the registered public accounting firm
- Inspection of audit work
- Information gathering (occurs throughout inspection process)
- Communication of findings/observations
- Firm response to findings and responsibilities
- Reporting

PCAOB
Public Company Accounting Oversight Board

Interim Inspection Program - Status

- 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 during 2013
  - Inspected 60 firms and portions of 90 audits

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Inspections: Observations

Overview of the Second Annual Progress Report

- Issued on August 19, 2013
  - Part I – Inspections of Registered Public Accounting Firms
  - Part II – Determining the Scope and Elements of a Permanent Inspection Program
  - Part III – Recent Developments and Next Steps of the Interim Inspection Program

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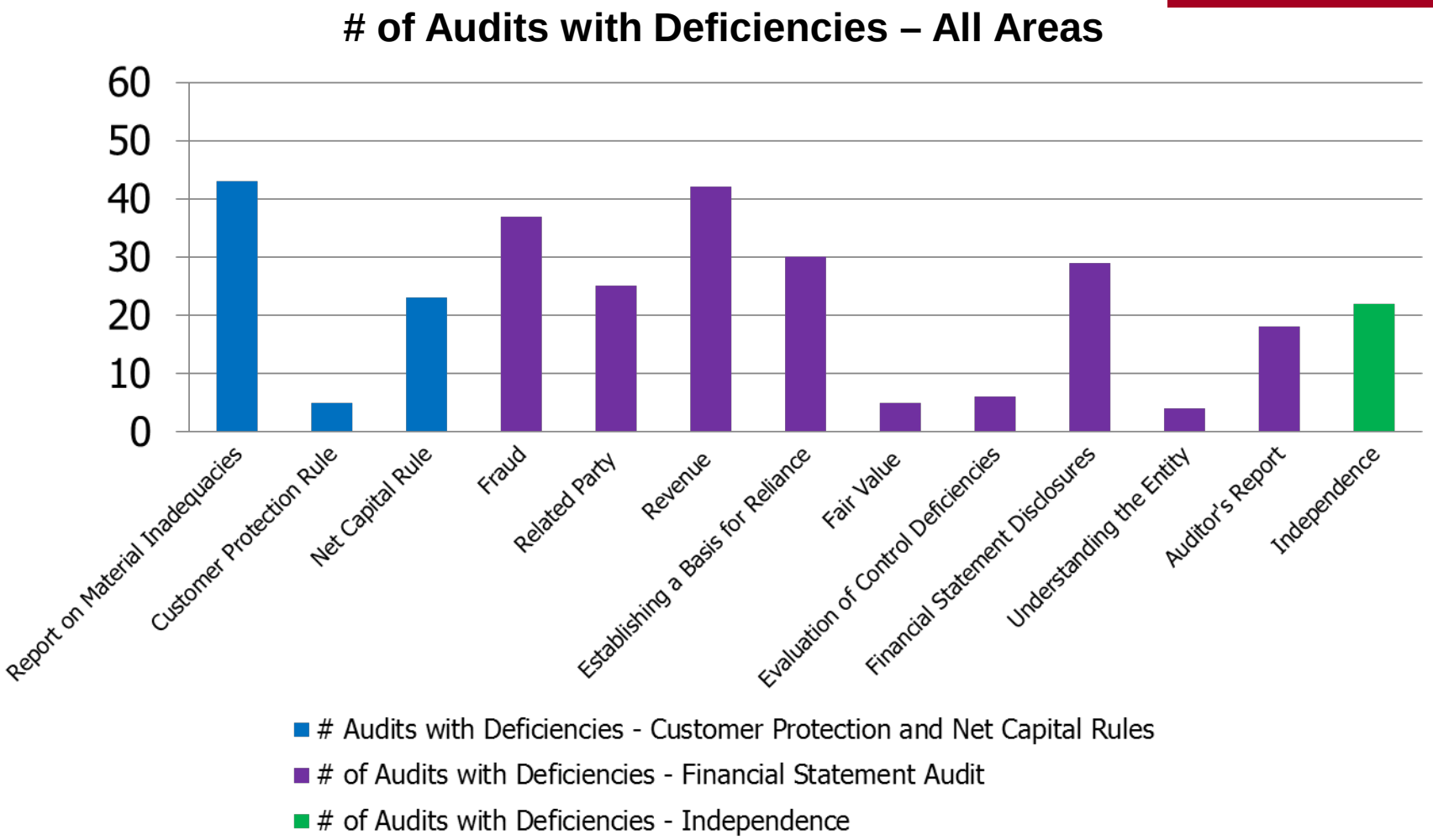
Inspections Observations by Audit Area



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Compliance with Independence Requirements

22 out of 43 Firms failed to satisfy independence requirements (37% of applicable audits):

- Preparing, or assisting in the preparation of financial statements
- Preparation of journal entries

Compliance with Net Capital Requirements

Deficiencies noted related to:

- Minimum net capital requirements
- Allowable assets
- Haircuts

Compliance with Customer Protection Rule

Deficiencies noted related to:

- Customer credits or debits
- Special Reserve Bank Account

Consideration of Material Misstatement Due to Fraud

Deficiencies noted related to:

- Audit response to identified fraud risk
- Presumption that revenue recognition is a fraud risk
- Journal entry testing

Related Party Transactions

Deficiencies noted related to:

- No procedures performed
- Existence and identification of related parties and related party transactions
- Examining identified related party transactions

Revenue Recognition

Deficiencies noted related to:

- Extent of testing
- Substantive analytical procedures
- Other procedures to test revenue recognition

Establishing a Basis for Reliance on Records and Reports

Deficiencies noted related to:

- Completeness and accuracy of records and reports from service organizations
- Completeness and accuracy of records and reports produced by brokers and dealers

Evaluation of Internal Control Deficiencies

Deficiencies noted related to:

- Assessment of the severity of a control deficiency
- Evaluation of errors performed as part of substantive testing

Financial Statement Disclosures

Deficiencies noted related to:

- Omitted disclosures
- Inaccurate or incomplete disclosures
- Fair value disclosures

Observations from 2013 Inspections

- No observations for the selected portions of some audits
- Many observations are similar to those noted in first two progress reports
- Independence findings

2014 Inspections

- 60 firms and portions of 100 audits
- Continued coverage of cross-sections of firms and brokers and dealers
- Reassessed the initial plan
- Do not intend to issue firm-specific reports

Summary

- Interim inspection program continues through 2014
- Third Progress Report to be issued in August 2014
- Transition to PCAOB Standards effective for audits with fiscal years ending on or after June 1, 2014
- Determination of the scope and elements of a permanent inspection program under consideration
- Rule proposal for a permanent inspection program

Next Steps for Firms that Audit Brokers and Dealers

- Review and enhance as necessary:
  - Arrangements with brokers and dealers and quality control procedures to help ensure that SEC independence rules are not violated
  - Guidance and training to determine whether topics observed as audit deficiencies are given appropriate attention
  - Policies for supervision and review to help ensure partners and supervisory personnel place appropriate attention to these areas
- Effectively transition to PCAOB Standards and amended Rule 17a-5 requirements

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Case Study 1

Case Study 1: Instructions

- Read case background and scenario provided
  - 5 minutes
- Answer questions and discuss in table groups
  - 10 minutes
- Debrief
  - 15 minutes

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Case Study 1: Debrief

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Break

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Case Study 2

Case Study 2: Instructions

- Read case background and scenario provided
  - 5 minutes
- Answer questions and discuss in table groups
  - 10 minutes
- Debrief
  - 15 minutes

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Case Study 2: Debrief

Closing Remarks

- Case Studies are composites of observations from inspections
- Audits of brokers and dealers with fiscal year ends on or after June 1, 2014:
  - Performed in accordance with PCAOB standards
  - New PCAOB standards:
    - AS 17
    - AT 1 and AT 2
- Next steps

Questions?

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PCAOB/SEC/FINRA Panel

Moderator: Jeanette Franzel

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Closing Remarks

Jeanette Franzel
May 28, 2014
Chicago, IL