

March 2014

## **Broker-Dealer Updates, SEC/PCAOB Changes and Implications**

In the wake of a very active year for the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) in terms of regulation affecting brokers and dealers, it is imperative now more than ever that we work together to stay in front of the new reporting, audit, notification, and other requirements that brokerage firms and Brown Smith Wallace are subject to. As a result, we have prepared this document to facilitate discussion pursuant to some of the more pertinent changes and to hopefully answer some of the questions that you might have as we look at 2014 and beyond.

### **SEC Amendments**

- ***Rule 17a-5, Reports to Be Made by Certain Brokers and Dealers***
- ***Financial Responsibility Rules for Broker-Dealers (Net Capital, Customer Protection, Books and Records, and Notification)***

The following represent significant changes resulting from amended SEC Rule 17a-5 and corresponding effective dates for implementation:

- Paragraph (f)(2) of Rule 17a-5 requires that a broker-dealer file a statement with the SEC and its designated examining authority (DEA) called "Notice pursuant to Rule 17a-5(f)(2)" designating an independent public accountant responsible for performing the annual audit of the broker-dealer. If the engagement letter is not of a continuing nature, the broker-dealer will be required to file this statement each successive year. Amendments to 17a-5(f)(2) require each clearing broker-dealer to include representations allowing SEC and DEA examination staff access to review independent public accountant audit

documentation associated with its annual audit reports and to allow the accountant to discuss findings relative to the audit reports.

- December 31, 2013
  - Pursuant to amendments to paragraph (a) of Rule 17a-5, Form Custody is to be filed by the broker-dealer quarterly with its DEA within 17 business days after the end of each calendar quarter.
  - Pursuant to amendments to paragraph (d)(6) of Rule 17a-5, broker-dealer annual reports must be filed with the Securities Investor Protection Corporation (SIPC).
- Fiscal Years Ending on or After June 1, 2014
  - Application of PCAOB Audit Standards (vs. US Generally Accepted Auditing Standards) – Before the SEC amendments to Rule 17a-5, audits of brokers and dealers were required to be performed under generally accepted auditing standards (GAAS) established by the American Institute of Certified Public Accountants (AICPA). Audits performed pursuant to the PCAOB standards will require more time and resources from both the client and the audit firm. Some of the more pertinent issues are highlighted below in the section titled *Public Company Accounting Oversight Board (PCAOB) and What to Expect*.
  - *Compliance Report* (Carrying/Clearing broker-dealers) – To be filed by broker-

dealers that did not claim an exemption from Exchange Act Rule 15c3-3 and must contain statements regarding the broker-dealer's compliance with Exchange Act Rules 15c3-1 and 15c3-3, including internal control over compliance. The Compliance Report must also contain descriptions of each material weakness in the broker-dealer's internal control over compliance and any instances of non-compliance with the aforementioned rules. The Compliance Report is to be prepared in accordance with PCAOB Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*.

- *Exemption Report* (Non-carrying broker-dealers) – To be filed by broker-dealers that did claim exemption from rule 15c3-3 and must contain statements regarding the broker-dealer's claimed exemptions from Rule 15c3-3. The Exemption Report is to be prepared in accordance with PCAOB Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*. Consistent with a "review", procedures will consist primarily of inquiry and analytics and will require auditors to obtain moderate assurance.

### **Public Company Accounting Oversight Board (PCAOB) and What to Expect**

Audits performed under PCAOB standards (as opposed to GAAS) will be noticeably different for each and every broker-dealer across the country. Some of the changes that will be required under the new structure, and as a component of PCAOB and SEC regulation, are as follows (*note that this list is not all inclusive but rather is intended to provide some clarity in comparing the two standards*):

- **Audit Documentation Standards** – PCAOB rules related to audit documentation and

retention are defined in PCAOB AS 3, *Audit Documentation*, and are effectively an expansion of the GAAS rules but are significantly more stringent. The PCAOB has expanded guidance and has added additional consideration to areas including risk assessment, sampling, dual purpose testing, supervisory functions, and workpaper review and approval.

- **PCAOB Broker-Dealer Audit and Attest Standards** – As a function of its oversight pertaining to audit engagements of brokers and dealers, the PCAOB approved certain audit and attest standards required to be adhered to for engagements of this nature:
  - PCAOB Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers* – Referenced above under Compliance Report.
  - PCAOB Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers* – Referenced above under Exemption Report.
  - PCAOB Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements* – To better align its standards for performing auditing procedures and reporting on supplemental information with the SEC's requirements pursuant to amended Rule 17a-5, the PCAOB implemented AS No. 17 to establish the auditor's responsibilities when performing audit procedures and reporting on supplemental information that accompanies the audited financial statements of broker-dealers (and other entities such as employee benefit plans that must file with the SEC audited financial statements and schedules).

- **Engagement Quality Review (EQR)** – PCAOB rules as defined in PCAOB AS No. 7, *Engagement Quality Review*, require a second audit partner, also known as a “concurring partner”, familiar with audits of broker-dealers, to provide concurring approval prior to the issuance of the audit. The EQR is to be documented in a sufficient manner to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer. A function of the EQR procedures includes assessment of the engagement team, and thus the firm’s, independence.

It should be noted that the rules, as currently drafted, do not require audit firm partner rotation for “non-issuer” broker-dealers.

- **Access to Audit Documentation** – Broker-dealer audit engagements will have an additional layer of regulation as the PCAOB will periodically examine public accounting firms and will review corresponding selected audit engagements, with a frequency minimum of once every three years, or more based on the size of the firm. The PCAOB will have the ability to review the auditor’s workpapers and, if necessary, refer matters to the SEC and DEA, along with the relevant state board of accountancy. It should be noted that the PCAOB has the authority to issue disciplinary action against the audit firm as deemed appropriate.

### **PCAOB Interim Inspection Program and Findings**

In 2011, the PCAOB’s interim inspection program for auditors of brokers and dealers registered with the SEC commenced. Pursuant to the interim inspections performed, there have been two inspection progress reports published by the PCAOB with a third and final inspection progress report expected to be published in the summer of

2014. The following represents a brief summary of these inspection progress reports:

#### **First Progress Report Released August 20, 2012**

The first report presented observations from inspections of portions of 23 audits at ten firms conducted as part of the interim inspection program. The inspections staff identified deficiencies in all of the audits inspected.

#### **Second Progress Report Released August 19, 2013**

The second report presented observations from inspections of portions of 60 audits conducted by 43 firms. The inspections staff identified deficiencies in 57 of the 60 audits selected for inspection. Deficiencies were identified across the spectrum of brokers and dealers selected, regardless of their characteristics.

A third and final interim inspection report is scheduled to be released in the summer of 2014. This final report holds significant importance as the PCAOB has expressed that they will utilize findings to facilitate additional recommendations and final changes to broker-dealer audit standards. As such, it is possible that the standards and rules can change at any given point as they continue to evaluate and form conclusions.

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For more information on these and other broker-dealer developments, and to explore how Brown Smith Wallace can assist you in these areas and with other regulatory matters, please contact Lincoln K. Gray, CPA, at 314.983.1235, lgray@bswllc.com.

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