



**Subject: BROKER-DEALER INDUSTRY ALERT –  
Exemption Criteria and PCAOB AS No. 18**

**Date: July 2015**

In the wake of amended SEC Rule 17a-5, brokers and dealers continue to sort through and evaluate the impact to their annual reporting, audit and notification requirements. This includes ongoing preparation to meet external audit requirements now performed by external auditors under PCAOB standards (as opposed to previously required GAAS standards). As such, firms need to continually evaluate changes to their business model and the practices and policies put into place to respond to the various requirements.

As noted by the regulators, a couple of key areas, expanded on below, warrant special attention.

#### **Exemption Provisions and Criteria**

For a broker or dealer claiming exemption from SEC Rule 15c3-3 (generally, a “non-carrying broker or dealer”), amended SEC Rule 17a-5 requires filing of an exemption report containing the following statements (“assertions”):

- A statement that identifies the provisions in paragraph (k) of SEC Rule 15c3-3 under which the broker or dealer claimed an exemption from SEC Rule 15c3-3;
- A statement that the broker or dealer (1) met the identified exemption provisions throughout the most recent fiscal year without exception, or (2) met the identified exemption provisions throughout the most recent fiscal year except as described in the exemption report; and
- If applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified exemption provisions (an “exception”) and that briefly describes the nature of each exception and the approximate date(s) on which the exceptions existed.

As it pertains to the above, non-carrying brokers and dealers should be advised that the SEC expects that they generally track exceptions as part of monitoring compliance with the exemption provisions in paragraph (k) of SEC Rule 15c3-3. As an additional note, exceptions will often be identified through *routine monitoring of compliance processes* as part of the execution of internal controls, internal or external audits, or regulatory examinations. Further, adherence to the exemption provisions in paragraph (k) of SEC Rule 15c3-3 generally is a focus of the SEC examiners when they conduct financial responsibility examinations of this class of firm. Firms claiming exemption should evaluate their policies and corresponding controls, *including documentation supporting these policies and controls*, to ensure compliance with the exemption provisions and criteria and to support the assertions represented within the exemption report, which is required to be provided to the external auditors.



### **PCAOB Auditing Standard No. 18: Related Parties**

**Effective Date** – Fiscal years beginning on/after December 31, 2014 (including reviews of interim financial information within this timeframe)

The PCAOB has issued Auditing Standard No. 18: *Related Parties*, which is effective for audits of broker-dealers in conjunction with the above referenced effective date. The PCAOB has represented that AS No. 18 is intended to “...strengthen auditor performance requirements in three critical areas that historically have represented increased risks of material misstatement in company financial statements.” These areas are comprised of: 1) related party transactions; 2) significant transactions that are outside the normal course of business for the company or that might be unusual due to their timing, size, or nature (“significant unusual transactions”); and 3) a company’s financial relationships and transactions with its executive officers.

- ***Relationships and Transactions with Related Parties*** – *The standard is designed to strengthen auditor performance requirements by setting forth specific procedures for the auditor’s evaluation of a company’s identification of, authorization/approval of, accounting for, and disclosure of relationships and transactions between the company and its related parties.*
- ***Significant Unusual Transactions*** – *Significant unusual transactions can create complex accounting and financial statement disclosure issues that could pose increased risks of material misstatement and have been used to engage in fraudulent financial reporting. The standard is designed to improve the auditor’s identification and evaluation of a company’s significant unusual transactions and, in particular, to enhance the auditor’s understanding of the business purpose (or lack thereof) of such transactions.*
- ***Financial Relationships and Transactions with Executive Officers*** – *A company’s executive officers are in a unique position to influence a company’s accounting and disclosures based on compensatory incentives and pressures. The standard provides that auditors obtain an understanding of the company’s financial relationships and transactions with its executive officers.*

In addition to the aforementioned, AS No. 18 also imposes new requirements relating to the auditor’s communications with the company’s audit committee (or equivalent). One such communication requirement provides that the auditor include evaluation of the company’s identification of, accounting for, and disclosure of its relationships with related parties which would be included within the AS No. 16, *Communications with Audit Committees* letter.

Given the enhanced requirements, all entities subject to PCAOB audit standards (i.e., all broker-dealer engagements), are encouraged to familiarize themselves with AS No. 18 and the corresponding requirements and amendments to existing standards. Companies will be responsible for ensuring that the appropriate policies, procedures and controls are in place to ensure compliance.

Refer to PCAOB Release No. 2014-002 for complete information related to PCAOB AS No. 18: *Related Parties*.

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