October 29, 2013

Preventing Another Madoff: SEC Adopts New Custody Rules for Broker-Dealers

On July 30, the Securities and Exchange Commission (SEC) announced new investor protection rules requiring broker-dealers that have custody of customer securities and funds to file an annual report attesting to their compliance with the broker-dealer financial responsibility rules, as well as a quarterly report (Form Custody) discussing their custody practices. Firms that do not have custody are required to file an exemption report as well as the new Form Custody. In a public statement praising the new rules, SEC Commissioner Luis A. Aguilar stated, "These amendments, in conjunction with the 2009 rules regarding the custody practices of investment advisers, are designed to create a framework to ensure that investor assets are safely held. This framework is critical to cultivating early detection and to preventing the type of fraud Madoff perpetuated."

The new rules will increase the reporting requirements of broker-dealers and provide an enhanced role for independent public accountants, who must review the new filings and prepare reports stating the accountant's opinion with respect to certain statements.

Annual Compliance Report

Each broker-dealer that has custody of customer assets must file a "compliance report" with the SEC verifying that the firm is adhering to the broker-dealer "financial responsibility rules," which require a broker-dealer to maintain a certain level of net capital, protect customer assets it holds and periodically send account statements to customers. [1] The report must certify that the broker-dealer has effective internal controls to ensure compliance with the financial responsibility rules. According to Commissioner Aguilar, the compliance report "will enhance early detection of misappropriated or lost assets, and identify weaknesses in a broker-dealer's internal controls that could jeopardize the safety of customer assets." Specifically, the compliance report must contain statements as to whether:

- the broker-dealer has established and maintained internal controls over compliance;
- the broker-dealer's internal controls over compliance were effective both during and as of the end of the most recent fiscal year;
- the broker-dealer was in compliance with the Net Capital Rules (Rule 15c3-1) and the customer reserve requirements of the Customer Protection Rule (Rule 15c3-3(e)) as of the end of the most recent fiscal year; and
- the information the broker-dealer used to state whether it was in compliance with the Net Capital Rules and the customer reserve requirements of the Customer Protection Rule was derived from the books and records of the broker-dealer.

If applicable, the compliance report must contain a description of:

- each identified material weakness in the broker-dealer's internal controls over compliance during the most recent fiscal year, including those that were identified as of the end of the fiscal year; and

- any instance of non-compliance with net capital and customer reserve requirements as of the end of the most recent fiscal year.

If there are one or more material weaknesses in its internal controls over compliance, a broker-dealer is not permitted to conclude that its internal controls over compliance were effective. The compliance report must be filed 60 calendar days after the fiscal year-end.

The Dodd-Frank Act vested the Public Company Accounting Oversight Board (PCAOB) with new oversight authority over the audits of SEC-registered broker-dealers. Financial statements of broker-dealers filed with the SEC for fiscal years ending after December 31, 2008, must be certified by a PCAOB-registered public accounting firm.

With the new rules, the broker-dealer is required to engage its PCAOB-registered independent public accountant to examine certain statements in the compliance report, perform its own independent evaluation of the related internal controls and prepare a report based on the results of this examination. This examination, and audits of broker-dealers, must be conducted in accordance with the standards of the PCAOB, consistent with the explicit authority granted to the PCAOB by the Dodd-Frank Act to establish (subject to SEC approval) auditing and attestation standards with respect to broker-dealer audits. Prior to the rule amendments, audits of broker-dealer reports were required to be made in accordance with generally accepted auditing standards (GAAS), which are established by the Auditing Standards Board of Certified Public Accountants. The amendments to Exchange Act Rule 17a-5 adopted by the SEC require that audits and attestations of broker-dealer reports filed under Rule 17a-5 be made in accordance with the standards of the PCAOB. This change is intended to facilitate the SEC's regulatory oversight authority because the SEC has direct oversight authority over the PCAOB, including the ability to approve or disapprove the PCAOB's rules or standards. The PCAOB standards will become applicable to audits and attestations of financial statements for fiscal years ending on or after June 1, 2014.

Notification of Noncompliance or Material Weakness

The broker-dealer's independent public accountant is required to immediately notify the broker-dealer if the accountant determines that the broker-dealer is not in compliance with the financial responsibility rules or that any material weakness exists in the broker-dealer's internal control over compliance. In certain circumstances, the broker-dealer may be required to file a notification with the SEC and the broker-dealer's designated examining authority (DEA).

Annual Exemption Report

A broker-dealer that does not have custody of customer assets must file an "exemption report" with the SEC citing its exemption from the Customer Protection Rule. For example, a broker-dealer is exempt from the Customer Protection Rule if it carries no margin accounts, promptly transmits (i.e., by noon of the business day following receipt) all customer funds and securities received and does not otherwise hold or owe money or securities to customers, and effectuates financial transactions with customers through one or more bank accounts designated as a special account for the exclusive benefit of customers. *See* Rule 15c3-3, paragraph (k)(2)(i). The exemption report must contain the following statements, made to the best knowledge and belief of the broker-dealer:

- The basis under which the broker-dealer claimed an exemption from the Customer Protection Rule.
- A statement that the broker-dealer qualified for the claimed exemption from the Customer Protection Rule throughout the most recent fiscal year, either without exception or with exceptions.
- If applicable, a statement identifying each instance during the most recent fiscal year in which the broker-dealer failed to comply with each exemption, and the nature and approximate dates of the incident.

The exemption report is designed to provide the SEC with more information than currently is reported by noncarrying broker-

dealers, and according to the Adopting Release, "requiring that the exemption report be filed with the Commission should increase broker-dealers' focus on the statement being made, facilitating consistent compliance with the exemption provisions in Rule 15c3-3, and therefore, providing better protection of customer assets."

A noncarrying broker-dealer must engage a PCAOB-registered independent public accountant to prepare a report based on the exemption report, but the accountant's role is limited to reviewing the statements in the exemption report.

SEC Access to Accountant and Audit Documentation

The new rules require broker-dealers that clear transactions or carry customer accounts to permit the SEC or their DEA to review the annual audit work papers of the firm's independent public accountant, either upon written request or in the context of a regulatory examination. The broker-dealer is also required to permit the SEC or DEA examiners to discuss the findings relating to the accountant's report with the accountant.

Form Custody

The new rules require each broker-dealer to file a new quarterly report (Form Custody) consisting of nine items, with subparts, which elicits information about the broker-dealer's practices with respect to the custody of securities and funds of customers and noncustomers. The Form Custody must be filed within 17 business days after the end of each calendar quarter.[2]

Timetable for Compliance

Broker-dealers must file the Form Custody by the end of this year, and the compliance report/exemption report starting June 1, 2014.

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[1] These "financial responsibility rules" for broker-dealers consist of the following: Exchange Act Rule 15c3-1 (the Net Capital Rule) (prescribing net capital requirements for broker-dealers); Exchange Act Rule 15c3-3 (the Customer Protection Rule) (prescribing requirements regarding the holding of customer securities and funds by broker-dealers); Exchange Act Rule 17a-13 (Quarterly Securities Count Rule) (requiring broker-dealers to perform quarterly securities counts); and the rules of the self-regulatory organizations requiring broker-dealers to periodically send account statements to customers. The SEC has issued new rules strengthening the financial responsibility rules. See Financial Responsibility Rules for Broker-Dealers, SEC Release No. 34-70072 (July 30, 2013).

[2] If a broker-dealer has selected a fiscal year-end date that is not the end of a calendar year, the broker-dealer must also file the Form Custody within 17 business days after the end of the broker-dealer's fiscal year.