September 2013

Regulatory brief

A publication of PwC's financial services regulatory practice

Broker-dealers: New FOCUS on financial responsibility

Overview

The Securities and Exchange Commission (SEC) adopted two new sets of rules this summer that, taken together, tighten the controls required for broker-dealers holding customer funds and securities. The new rules amend (1) various financial responsibility requirements for broker-dealers (the "financial responsibility requirements") and (2) several reporting and audit rules for broker-dealers and their auditors (the "custody-related requirements"). While most of the amendments impact those broker-dealer firms that carry customer accounts or provide clearing services, all broker-dealers will be required to submit new reports to the SEC.

The SEC's final rules largely implement its proposals from 2007 and 2011, with certain modifications in response to public comments. The SEC approved the amendments to the financial responsibility requirements unanimously, while the amendments to the custody-related requirements generated some disagreement and were approved by a 3-2 vote.

The amendments to the financial responsibility requirements were initially proposed in 2007, before the financial crisis, and are intended to address the SEC's concerns about the safety of customer assets in the event of the failure of a broker-dealer. They amend the customer protection, net capital, books and records, and notification rules (including protections associated with "sweep programs" for customer free credit balances, proprietary accounts of broker-dealers that are held at other broker-dealers, and limitations on banks eligible to hold special reserve accounts). These rules were subject to significant industry and public input (almost 100 comment letters were submitted to the SEC).

The amendments to the custody-related requirements were initially proposed in 2011 following frauds involving broker-dealers, particularly the Bernard Madoff case. They are intended to be the corollary to the SEC's custody-related rules for investment advisers adopted in 2010. Broker-dealers will be required to submit new types of reports to the SEC concerning the custody of customer funds and securities. Clearing and carrying broker-dealers will also be required to permit their independent public accountants to make audit workpapers available to the SEC and their designated examining authority (DEA), and to permit auditors to discuss the audit with examiners.

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The new rules will significantly impact broker-dealers' current compliance with the existing regulatory framework. Taken together, the amended rules will have an impact by:

- Requiring carrying broker-dealers that hold proprietary accounts of other broker-dealers (PAB accounts), to include foreign broker-dealers, put the onus for identification of such accounts on the carrying broker-dealer, and require possession or control of PAB account securities.
- Preventing broker-dealers from holding cash reserve account deposits at affiliated banks and place limits on the cash bank deposits broker-dealers hold at non-affiliated banks.
- Establishing customer disclosure, notice, and consent requirements for cash sweep programs.
- Requiring large broker-dealers to document their market, credit, and liquidity risk management controls.
- Establishing new notification requirements for when a broker-dealer's repurchase and securities lending activities exceed a certain threshold.
- Requiring Public Company Accounting Board (PCAOB) standards for audits of broker-dealers.
- Imposing new annual reporting obligations to file a "compliance report" or an "exemption report" for carrying and non-carrying broker-dealers.
- Replacing the existing Material Inadequacy Letter (MI Letter) with auditor examination or review reports on the newly-mandated broker-dealer statements relating to regulatory compliance or exemption.
- Strengthening SEC and self-regulatory organization (SRO) oversight examinations by requiring a new quarterly report (called "Form Custody") with information about whether and how a broker-dealer maintains custody of customer assets.
- Requiring broker-dealers to consent to allow SEC or SRO examination staff to review auditor work papers upon written request, and to allow auditors to discuss findings with examiners.

The amendments to the financial responsibility requirements become effective October 21, 2013. The new Form Custody filing requirement becomes effective December 31, 2013, with an initial filing date of January 17, 2014. The requirements relating to annual reports become effective for all broker-dealers with fiscal years ending on or after June 1, 2014.

This **Financial Services Regulatory Brief** analyzes the key changes to the financial responsibility and custody-related requirements, and suggests actions that broker-dealers should begin taking.

Background

The SEC's financial responsibility requirements for broker-dealers under the Securities Exchange Act of 1934 (Exchange Act) are intended to safeguard customer cash and securities in the event of a broker-dealer's insolvency. These rules include:

- *Customer Protection Rule (Rule 15c3-3)* – Requires broker-dealers to safeguard and segregate customer assets by obtaining physical possession or control of its customers' fully-paid and excess margin securities, and maintaining (in a reserve bank account for the benefit of customers) at least the difference between customer credit amounts (e.g., cash in securities accounts) and customer debit amounts (e.g., margin loans).
- *Net Capital Rule (Rule 15c3-1)* – Requires broker-dealers to maintain a minimum amount of liquid net assets, and to hold more than a dollar of highly liquid assets for each dollar of liabilities.
- *Books and Records Rules (Rules 17a-3 and 17a-4)* – Require broker-dealers to make and maintain certain business records to assist the firm in accounting for its activities, and assist securities regulators in compliance examinations.
- *Notification Rule (Rule 17a-11)* – Requires broker-dealers to give notice to the SEC and other regulators when certain events occur, such as the firm's net capital falling below its required minimum.

The SEC's custody-related requirements are designed to protect and account for broker-dealers' customer assets, subjecting such broker-dealers to reporting requirements including:

- *Annual Report Rules (Exchange Act Sections 17(a) and (e) and Rule 17a-5)* – Require broker-dealers to file with the SEC and relevant SRO annual reports containing audited financial statements and supporting schedules that must be audited by a PCAOB-registered independent accountant. Supporting schedules include computations of net capital, computations of customer reserve requirements or statement of exemption from such requirements, and information concerning possession and control of customer securities.
- *Quarterly Security Count Rule (Rule 17a-13)* – Requires broker-dealers on a quarterly basis to count, examine, and verify the securities it physically holds (or otherwise controls) and compare those results against their records. If there are unresolved differences, a broker-dealer must take capital charges and record the differences in its records.
- *Account Statement Rules (SRO rules)* – Require member broker-dealers to send, at least quarterly, an account statement to each customer reflecting that customer's securities positions, cash balances, and account activity during the period.

Amendments to the financial responsibility requirements

Customer Protection Rule

The SEC's amendments implement several important changes to the Customer Protection Rule.

Proprietary accounts of broker-dealers. The amendments expand the definition of PAB account to include foreign broker-dealers and foreign banks acting as broker-dealers. The new rules also require carrying broker-dealers that hold customer securities and funds to maintain a new segregated reserve account for PAB account holders.

This resolves a disparity between the definition of "customer" in the Customer Protection Rule, which did not include PAB account holders, and the definition of "customer" under the Securities Investor Protection Act (SIPA), which includes PAB account holders. The SEC's concern was that if a carrying broker-dealer were liquidated, the claims of SIPA customers – including PAB account holders – would exceed available customer assets since the carrying broker-dealer was not required to comply with the possession and control and customer reserve account provisions of the Customer Protection Rule.

As adopted, the rules require carrying broker-dealers to: (i) perform a separate reserve calculation for PAB accounts; (ii) maintain a separate reserve account for PAB account holders; and (iii) obtain physical possession or control of non-margin securities held for PAB accounts, unless the PAB account holder objects following written notice that the broker-dealer intends to use those securities in the ordinary course.

In response to public comments concerning item iii, above, the final rule requires written notice to the PAB account holder to use non-margin securities, instead of written permission. The SEC acknowledged that written notice sufficiently increases protections for PAB account holders without unduly interfering with existing custodial relationships between broker-dealers.

Additionally, carrying broker-dealers may exclude from the PAB account reserve computation proprietary accounts that subordinate their claims to the claims of creditors of the broker-dealer.

Broker-dealers will need to change processes or systems to provide notification to account holders, to monitor objections, and to track possession or control of PAB account holder securities.

Banks holding customer reserve accounts. The new rule places two main limitations on the banks that broker-dealers may use to hold their customer reserve accounts. First, the rule now prevents broker-dealers from holding customer cash deposits at affiliated banks. The SEC noted that a broker-dealer may lack impartiality in evaluating an affiliate bank's soundness, and its customers could be at risk if parent bank holding company were to become insolvent.

Second, the rule limits customer cash deposits held at non-affiliated banks to no more than 15% of the bank's equity capital, as reported by the bank in its most recent call report. In response to public comments, the SEC increased the bank equity capital threshold from 10% to 15% and eliminated an alternative test that would have limited the amount of cash deposits to 50% of the broker-dealer's excess net capital.

To comply with these amendments, carrying broker-dealers may have to transfer customer cash deposits from affiliated banks and spread their cash deposits among more non-affiliated banks. Additionally, broker-dealers that wish to hold a reserve account at a US branch of a foreign bank should apply to the SEC for exemptive relief because call reports generally are insufficient to substantiate equity capital under the rule.

This requirement will impact broker-dealers affiliated with banks who maintain a reserve account at the affiliated bank. Further, broker-dealers that had reserve accounts at foreign banks need to consider whether to move those funds or seek exemptive relief.

Sweep accounts. The amendments also establish specific conditions that broker-dealers must meet in order to "sweep" or transfer a customer's free credit balance to a money market fund or interest-bearing bank account. Free credit balance refers to cash funds held in a brokerage account that are payable to the customer on demand.

To cover sweep programs not involving money market funds or bank deposits, the new rule clarifies that a broker-dealer may transfer free credit balances only on a specific order, authorization, or draft from the customer and under customer-specified terms and conditions.

For sweep programs involving money market funds and bank deposits, the final rules permit a broker-dealer to transfer free credit balances if four conditions are met:

- The customer affirmatively consented to the arrangement. This condition only applies to new accounts opened on or after the effective date of the rule.

- The broker-dealer provides the customer with disclosures and notices of SRO requirements about the sweep program.
- The broker-dealer provides notice in quarterly account statements that swept funds can be liquidated on the customer's order and returned to the account or remitted to the customer.
- The broker-dealer provides the customer with at least 30 days of notice, and with options prior to changing the terms of the sweep program or changing the money market or bank deposit products used in the sweep program.

Net Capital Rule

The amendments to the Net Capital Rule set forth several changes that are largely of a technical nature, but will nonetheless require operational and compliance adjustments.

Liabilities or expenses assumed by third parties. The amended rule formalizes the requirement for a broker-dealer, when calculating net capital, to include any liabilities that are assumed by a third party (usually a parent or affiliate under an expense-sharing agreement) if the broker-dealer cannot demonstrate that the third party has the resources – independent of the broker-dealer's income and assets – to pay the liabilities.

Treatment of temporary capital contributions. The amendments formalize the requirement for a broker-dealer to treat as a liability any capital that is contributed under an agreement giving the investor the option to withdraw it. The rule also applies to contributions otherwise intended to be withdrawn within a year. The intent to withdraw capital within one year of its contribution is inferred for net capital purposes unless the broker-dealer receives permission for the withdrawal in writing from its DEA.

Deductions of excess fidelity bond deductibles. Under SRO rules, many broker-dealers must comply with mandatory fidelity bonding requirement that indemnify against loss of property because of fraud, theft or other acts. SRO rules generally permit broker-dealers to keep a deductible up to a certain amount, but to take capital charges against net worth for excess deductible amounts. This is to incentivize firms to keep low enough deductibles to promote customer protection.

The new amendments align the Net Capital Rule with SRO rules by requiring broker-dealers to subtract excess fidelity bond deductibles from net capital calculations.

Broker-dealer solvency requirement. The final amendments also require a broker-dealer to cease conducting a securities business if certain insolvency events occur. Insolvency events include, among other things, voluntary and involuntary bankruptcy or similar proceedings, the appointment of a trustee or receiver, a general assignment by the firm for the benefit of its creditors, an admission of insolvency, or the inability to make computations necessary to comply with the financial responsibility rules.

The companion amendment to Rule 17a-11 requires insolvent broker-dealers to provide notice to the appropriate regulatory authorities.

Books and Records Rules

Amendments to the Books and Records Rules require large broker-dealers to document their market, credit, and liquidity risk management controls. This documentation applies only to larger broker-dealers with more than $1 million of credit items under the customer reserve formula or $20 million in capital. The amendments also require broker-dealers to retain these risk management records for three years after ceasing to use them.

While large broker-dealers already document such controls, their documentation may not be specific to the procedures at the broker-dealer level. It will be important to ensure that such documentation is consistent with actual practice at the broker-dealer and updated on an ongoing basis. Examiners are likely to undertake such inquiries during exams, and will compare current and past risk management controls.

Notification Rule

The amendments to the Notification Rule will establish new requirements for when a broker-dealer's securities lending and repurchase activities exceed a threshold of 2,500% of tentative net capital. The amendment is intended to alert regulators to a sudden increase in a broker-dealer's stock loan and repurchase positions – indications that the firm may be assuming excessive risk.

In lieu of this notification requirement, the final rule provides that a broker-dealer may report its stock loan and repurchase activity to its DEA monthly, in a form acceptable to its DEA.

Amendments to the custody-related requirements

Annual Report Rules

The Annual Report Rules currently require broker-dealers to file an annual report with the SEC and its DEA that contains financial statements audited by an independent public accountant registered with the PCAOB. For clarity, the new rule refers to this (now) legacy annual report as a "financial report." The substantive requirements for these annual broker-dealer financial reports remain unchanged.

The SEC amended the Annual Report Rules to require that broker-dealers also file certain new annual reports intended to improve custody safeguards and strengthen audit requirements. The SEC's intention is to help focus broker-dealers and their independent auditors on custody practices, and to identify those firms with weak controls for protecting customer assets.

All broker-dealers generally must file either a Compliance Report or an Exemption Report depending on whether they claim exemption from the Customer Protection Rule. Firms must also file a related report from its independent public accountant, as discussed below. The new accountant report replaces the material inadequacy report required previously.

Compliance Report. A broker-dealer that does not claim exemption from the Customer Protection Rule must file a Compliance Report with the SEC to verify that it is adhering to net capital requirements, protecting customer assets, and periodically sending account statements to customers.

The broker-dealer must also state whether it has maintained internal controls to prevent or detect non-compliance with the financial responsibility requirements. If applicable, the Compliance Report must describe each identified material weakness[1] in those internal controls and any instance of non-compliance with the financial responsibility requirements during the most recent fiscal year. In response to public comments, the final rule more narrowly focuses on the core obligations of the financial responsibility requirements.

In addition, the broker-dealer also must engage a PCAOB-registered independent public accountant to prepare a report based on an examination of certain statements in the broker-dealer's Compliance Report.

[1] A "material weakness" is generally defined as a deficiency or combination of deficiencies in the broker-dealer's internal controls that precludes the firm's management or employees from preventing or detecting non-compliance with the financial responsibility rules in the normal course.

This examination is intended to focus on the statements made by the broker-dealer around compliance with, and internal controls over, the financial responsibility requirements (it does not cover the effectiveness of the firm's internal controls over financial reporting).

Broker-dealers should consider creating a process to identify the relevant controls, and to monitor the operating effectiveness of those controls in order to meet the requirements of the Compliance Report.

Exemption Report. A broker-dealer that claims exemption from the Customer Protection Rule must file an Exemption Report with the SEC citing its exemption from requirements applicable to carrying broker-dealers. In response to public comments, the final rule clarifies how firms should treat certain exceptions that may otherwise prevent them from claiming exemption from status as a carrying broker-dealer.

The broker-dealer also must engage a PCAOB-registered independent public accountant to prepare a report based on a review of certain statements in the broker-dealer's Exemption Report.

Broker-dealers should consider creating a process to identify the exceptions and a process for reporting exceptions in their annual report as required by the rule.

Timing for filing. Under the final rule, broker-dealers must annually file their (i) financial reports, (ii) either a Compliance Report or Exemption Report, and (iii) reports prepared by an independent public accountant relating to the above reports, within 60 calendar days after the firm's fiscal year end.

Filing of annual reports with SIPC. Broker-dealers that are members of the Securities Investor Protection Corporation (SIPC) must file the above-mentioned annual reports with SIPC. This is intended to enable SIPC to better monitor industry trends and enhance its knowledge of particular firms.

Auditing and Attestation Standards

Under the adopted rule, the independent public accountant's examination or review of the new Compliance and Exemption Reports, as well as the audit of the financial reports, must be conducted in accordance with PCAOB standards, rather than AICPA Generally Accepted Auditing Standards (GAAS).

The SEC states that this change is consistent with the explicit authority granted to the PCAOB by the Dodd-Frank Act to establish auditing and attestation standards for broker-dealer audits. According to the SEC, the change from GAAS to PCAOB standards will also facilitate the SEC's regulatory authority because it has direct oversight over PCAOB and has the ability to approve or disapprove the PCAOB's rules and standards.

As noted at the SEC's open meeting, the PCAOB is in the process of finalizing its standards for broker-dealer audits and its inspection program. Meeting PCAOB standards will require care by broker-dealer auditors and the PCAOB's expectations may affect the documentation required from the firm by its auditors.

Relation of custody-related requirements to audits of investment advisers

In 2010, the SEC adopted Rule 206(4)-2 under the Investment Advisers Act of 1940 (Advisers Act), indicating what an investment adviser or its affiliate must do if it is a qualified custodian of its client funds and securities. In those situations, the adviser must obtain annually (or receive from its related person as defined by Rule 206(4)(2)) a written internal control report prepared by an accountant registered with, and subject to regular inspection by, the PCAOB. This report must be supported by the accountant's examination of the qualified custodian's custody controls.

The new amendments eliminate redundancies for broker-dealers that also must comply with the Advisers Act custody rule. For these firms, the SEC has determined that the independent public accountant's report based on an examination of the Compliance Report will satisfy the internal control report requirement under Rule 206(4)-2. In this way, the rule better aligns the custody controls that relate to both broker-dealers and investment advisers.

Notification requirements

The amendments require that if the independent public accountant, in the course of preparing its reports, determines that the broker-dealer is not in compliance with any of the financial responsibility requirements, the accountant must immediately notify the firm's CFO. Upon receiving such notice, the broker-dealer must provide notice to the SEC and its DEA if required to do so under the Notification Rule.

In response to comments, the SEC declined to require the accountant to notify the SEC and DEA directly because the primary obligation to notify regulators should remain with the broker-dealer.

Access to audit documentation

The amendments require broker-dealers, regardless of whether they have custody of customer assets, to agree to allow SEC and DEA staff to review the audit documentation associated with reports of their independent public accountants, if requested in writing for purposes of a regulatory examination. Broker-dealers must also allow their accountants to discuss their findings with SEC and DEA examiners.

Broker-dealers should expect that SEC and SRO examiners will inquire about controls and custody practices during examinations, and may ask to speak with auditors to understand the nature of the audit steps they performed. This practice has become more common in recent years, as examiners are seeking to leverage from the work performed during the audit, and seeking to gain confidence that customer assets are appropriately protected.

This aspect of the amended rule drew dissent from two commissioners, who cited their concern that the final rule does not explicitly limit the scope of examiners' requests for audit documentation and the uses to which the SEC could put any information it receives from an auditor. They expressed concern that important discussions between a broker-dealer and its auditor could be chilled, and that auditors could be deprived of potentially important information regarding the broker-dealers they audit.

Form Custody

Under the new amendments, broker-dealers are required to file a new quarterly report called Form Custody that contains information about whether and how it maintains custody of its customers' securities and cash.

Broker-dealers must file Form Custody with their DEA at the same time they file periodic FOCUS reports – within 17 days business days after the end of each quarter or fiscal year end. The initial filing deadline is January 17, 2014.

Broker-dealers must report the following information on Form Custody:

- Accounts introduced on a fully disclosed basis.
- Accounts introduced on an omnibus basis.
- How a carrying broker-dealer held cash and securities.

- Whether the broker-dealer carried transactions for other broker-dealers.
- Whether the broker-dealer sends trade confirmations to accountholders.
- Whether the broker-dealer sends account statements directly to accountholders.
- Whether the broker-dealer provides accountholders electronic access to account information.
- Whether the broker-dealer is registered as an investment adviser with the SEC or states, including the number of clients and custody information.
- Whether the broker-dealer is an affiliate of an investment adviser, including whether it has custody of the adviser's client assets.

These reports will be used by the SEC and SRO staff to establish a "custody profile" for the broker-dealer that examiners can use to identify firms for examination and as a starting point to focus their custody examinations. Likely, the SEC staff will weight each factor in determining the relative risks related to custody.

Additional information

For additional information about PwC's Financial Services Regulatory Practice and how we can help you, please contact:

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