

PUBLICATION

SEC Proposes Additional Compliance Requirements for Broker-Dealers

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The Securities and Exchange Commission (SEC) recently proposed to enhance the financial reporting and oversight rules related to broker-dealers. The proposed amendments would strengthen audit requirements and give regulators access to auditors and audit working papers, particularly for broker-dealers that either clear transactions or carry customer accounts. The changes are part of the SEC's response to recent securities frauds such as the Madoff Ponzi scheme and are intended to restore faith in investment advisers who maintain custody of their customers' securities and cash. The amended rules would complement the interim program the Public Company Accounting Oversight Board (PCAOB) recently implemented to inspect auditors of broker-dealers.

Audit Requirements

On June 15, 2011, the SEC issued proposed amendments to Rule 17a-5 under the Securities Exchange Act of 1934, which governs the financial reporting of broker-dealers. Currently, broker-dealers must file an annual report with the SEC and the Financial Industry Regulatory Authority (FINRA) that contains audited financial statements. Under the proposal, broker-dealers that maintain custody of customer cash and securities would be required to undergo an annual examination by a registered public accounting firm in regard to the broker-dealers' compliance, and internal control over compliance, with existing Exchange Act rules related to the custody of customer assets. The independent public accountant would also be required to notify the SEC of any material non-compliance discovered during the audit.

Under the amended rule, a broker-dealer that does not maintain custody of customer securities and cash would be required to undergo a review by an independent public accountant of its assertion that it is not subject to segregation requirements.

Oversight of Broker-Dealer Custody Practices

Currently, broker-dealers are subject to routine inspections and examinations by SEC and FINRA staff. The proposed amendment would require a broker-dealer that clears transactions or carries customer accounts to permit its independent public accountant to make available to examiners the audit documentation associated with its annual audit reports and discuss its findings with the examiners.

The amendment also requires broker-dealers to file a report with the SEC and FINRA that contains information about whether, and if so, how, it maintains custody of customer securities and cash. The proposed new form would be filed on a quarterly basis along with the broker-dealer's FOCUS Report (Financial and Operational Combined Uniform Single Report).

The SEC will accept comments on the proposed amendments for 60 days after publication in the *Federal Register*.

Broker-dealers should review the policies and controls they have in place to ensure compliance with rules related to the protection of customer assets. Additionally, broker-dealers, especially those that maintain custody of customer cash and securities, should begin coordinating with their auditors to prepare for the

potential for heightened examination if these rules are adopted as proposed. Finally, broker-dealers should expect audit costs to increase along with the increased scrutiny if these rules are adopted as proposed.

If you have questions about the proposed amendments, please contact your Baker Donelson attorney or a member of our Broker-Dealer/Registered Investment Adviser Industry Service Team.