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Via E-Mail to CookFC@gao.gov

November 13, 2012

Mr. F. Chase Cook
Senior Analyst, Financial Markets & Community Investment
U.S. Government Accountability Office (GAO)
441 G Street Northwest
Washington, DC 20548

Re: GAO Study of Custody Rule Costs (250684)

Dear Mr. Cook:

The Private Client Legal Committee of the Securities Industry and Financial Markets Association ("SIFMA")[1] is pleased to submit these responses and comments to questions posed by the Government Accountability Office ("GAO") in connection with the GAO's study, pursuant to Section 412 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1577 (July 21, 2012) ("Dodd-Frank"), on the compliance costs that registered investment advisers incur to comply with Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940, as amended (the "Advisers Act") and the costs that some advisers might incur if the surprise-examination exemptions under the Custody Rule were eliminated.

SIFMA has actively participated on Custody Rule issues over the past few years because of the Custody Rule's importance to investor protection. In this area, SIFMA has supported the efforts by the Securities and Exchange Commission (the "SEC") to enhance controls for maintaining custody of client assets and improving oversight of custodial arrangements. In this regard, SIFMA has commented on, and has suggested modifications to, certain amendments to the Custody Rule to balance the costs of such controls with their potential benefits and to align certain provisions of the Custody Rule to provide a cohesive approach

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

to custodial arrangements for advisers that are already regulated as qualified custodians because they are dually-registered as broker-dealers and for advisers that utilize an affiliated qualified custodian to maintain custody of client assets.[2] The member firms of SIFMA consider the protection of their clients' assets a vital responsibility in the conduct their businesses.

SIFMA appreciates the opportunity to comment on the GAO's questions on the costs of complying with the Custody Rule and related investor protection issues. SIFMA is concerned that the application of certain provisions of the Custody Rule, under the amendments finalized on December 30, 2009,[3] imposes significant costs on certain industry participants, particularly dual registrants and advisers that use related qualified custodians to maintain custody of clients' assets, without adding commensurate protections for investors or clients. In this regard, SIFMA proposes that the customer protection and financial responsibility rules under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), including Rule 15c3-1, Rule 15c3-3 and 17a-5 as currently drafted and as modified by the amendments proposed by the SEC,[4] are appropriate for regulating custody of advisers that are dually-registered as broker-dealers, as well as for broker-dealers acting as qualified custodians for their affiliated advisers. SIFMA believes that the rules under the Exchange Act provide the best regime for regulating custodial arrangements of broker-dealers.

Accordingly, SIFMA recommends that the SEC should adopt as part of any changes to Rule 17a-5 under the Exchange Act an express exception for dual registrants from the surprise examination and internal control report requirements under the Custody Rule. SIFMA further recommends that the Custody Rule should also defer to Exchange Act rules for regulating custodial arrangements of advisers that maintain client assets with related broker-dealers acting as qualified custodians and, thus, eliminate duplicative requirements. In addition, SIFMA members have encountered interpretative issues with respect to

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[2] *See* Comment Letter from Mark Shelton, Chair, SIFMA Private Client Legal Committee, SIFMA to Elizabeth M. Murphy, SEC, dated July 28, 2009 regarding Proposed amendments to Rule 206(4)-2, Advisers Act Custody Rule, available at http://www.sifma.org/workarea/downloadasset.aspx?id=436.

[3] Investment Advisers Act Release No. 2968 (December 30, 2009), 75 FR 1456 (January 11, 2010) (the "Finalizing Release"), available at http://www.sec.gov/rules/final/2009/ia-2968fr.pdf.

[4] *See* Securities Exchange Act Release No. 64676 (June 15, 2011) 76 FR 37572 (June 27, 2011) (the "Rule 17a-5 Proposing Release"), available at http://www.gpo.gov/fdsys/pkg/FR-2011-06-27/pdf/2011-15341.pdf.

the definition of "custody" under the Custody Rule. SIFMA suggests modifications to the Custody Rule or related SEC guidance to clarify this provision, which should also help to further balance costs with protections.

I. What investor protection issues are raised when investment advisers have custody of their clients' assets, and how do the SEC's rules serve to protect investors from the misuse of their assets?

Custody of client assets by investment advisers poses potential risks that those advisers might misappropriate assets, although these risks are heightened for advisers that are regulated only by the rules under the Advisers Act. Such risks are minimized for advisers that are subject to additional regulatory rules, such as dual registrants and advisers that maintain client assets with related broker-dealers acting as qualified custodians that are also subject to the rules under the Exchange Act and self-regulating organization ("SRO") rules.

The SEC's most recent amendments to the Custody Rule seek to decrease the risks of misappropriation by investment advisers and increase the chances for earlier detection of fraudulent activity by requiring, with limited exceptions, that client assets be maintained in the custody of a qualified custodian and imposing additional requirements on investment advisers that have broad authority over client assets. Among other requirements, as it currently applies, the Custody Rules requires, unless an exemption is available, an adviser with custody of client cash or securities:

- to undergo an annual surprise examination by an independent public accountant to verify client assets; and
- unless client assets are maintained by an independent custodian (or a related person that is "operationally independent"), to obtain a report on the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board (PCAOB).

These amendments were intended to strengthen protections, decrease the likelihood of customer assets being misappropriated, lost, misused or subject to advisers' financial reverses and increase chances for earlier detection of fraudulent activity.

SIFMA believes that surprise examinations and internal control reports could be useful methods to detect irregularities at certain advisers (*e.g.*, advisers that hold client assets under non-qualified custody situations). However, for advisers that are dually-registered as broker-dealers and advisers that maintain client assets with related broker-dealers acting as qualified custodians, SIFMA believes that the cost of the surprise examinations and internal control reports greatly outweighs any potential benefits to clients, and that these two requirements duplicate existing safeguards afforded to advisory clients of such advisers. In particular and as described in more detail below, firms that are dually-registered as advisers and broker-dealers are regulated as brokers-dealers and qualified custodians under the Exchange Act rules and SRO rules. These rules subject broker-dealers (including advisers that are dually-registered as broker-dealers and serve as qualified custodians) to extensive regulatory oversight, which, among others, impose strict internal control requirements and regulations for how client assets are maintained, such that the risk of misappropriation is already addressed through these existing requirements on qualified custodians.[5] In addition, for advisers that maintain client assets with related broker-dealers acting as qualified custodians, those broker-dealers are subject to the same extensive regulatory oversight, such that requiring both the surprise examination and internal control reports substantively or functionally duplicate measures to protect client assets and detect instances of fraud.

Broker-dealers, including dual registrants and those that act as qualified custodians for their related advisers, are expected to have strong internal controls in place, including measures to guard against misappropriation acts and to aid in early detection of fraudulent activity. For example, such firms are subject to several customer protection and financial responsibility rules under the Exchange Act, that, in the words of a former Chief Counsel to the Division of Investment Management, are "generally far more rigorous than, the Custody Rule."[6] For example, Rule 15c3-3 under the Exchange Act is the principal rule protecting customer funds and securities held by broker-dealers, and Rule 15c3-1 imposes strict minimum financial requirements on broker-dealers to ensure their ability to

[5] *See* Appendix A for a description of numerous regulatory protections that currently apply to broker custodied assets. This list is not intended to be exhaustive, and not all dual registrants are directly subject to all of the regulatory protections in Appendix A, such as firms that clear through another broker-dealer subject to these regulatory protections.

[6] *See* Thomas S. Harman & Lanae Holbrook, *Custody Rules for Investment Advisers*, Investment Lawyer (July 1994).

meet obligations. Rule 17a-5 also requires that the broker-dealer annual audit include a review of the broker-dealer's procedures for safeguarding client and customer securities, which is also the primary purpose of the internal control report. Support for the former Chief Counsel's statement is further provided by the SEC in its Rule 17a-5 Proposing Release. In the Rule 17a-5 Proposing Release, the SEC acknowledged redundancies between the Custody Rule and the rules under the Exchange Act, stating that "[t]he first set of amendments would, among other things…eliminate potentially redundant requirements for certain broker-dealers affiliated with, or dually-registered as, investment advisers."[7] Additional regulatory protections that apply to broker custodied assets, such as assets that are maintained by dual registrants, are described in the attached Appendix A.

In addition, broker-dealers routinely employ internal controls reasonably designed to prevent misappropriation of customer assets, whether by their own employees or by third parties. Indeed, SRO rules require that broker-dealers establish and maintain appropriate procedures for supervision and control with respect to disbursement of customer assets from firm accounts.[8] In particular, NASD Rule 3010 generally requires member firms to establish a supervisory system, adopt written supervisory policies and procedures, adopt measures to enforce such supervisory policies and procedures, conduct annual internal inspections and prepare annual written inspection reports. Further, NASD Rule 3012 requires firms to designate one or more principals to examine and test the effectiveness of the compliance supervisory system annually and report the results to senior management in connection with a certification to be made by the firm's CEO pursuant to FINRA Rule 3130. Policies and procedures that require such examinations include those designed to review and monitor the following activities directly dealing with custody controls: (i) all transmittals of funds or securities from customer accounts to third party accounts and to locations other than the customer's primary residence and (ii) customer changes of addresses and validation of such address changes. Such policies and procedures must also include a means or method of customer confirmation, notification or follow-up that can be documented. Additionally, Rule 17a-3(a)(17)(i)(B)(2) under the Exchange Act requires broker-dealers to confirm customer requests for a change

[7] Rule 17a-5 Proposing Release at 37572.

[8] *See* FINRA Rule 3130, NASD Rule 3010, NASD Rule 3012, NYSE Rule 342(a) and (b) and NYSE 342.23.

of address by notice to the customer at the customer's old address within 30 days of receiving a notice of the requested change.

The application of earlier versions of the Custody Rule to dual registrants further supports that the surprise examination requirement provides minimal, if any, additional protections to clients of such dual registrants. In particular, when the SEC adopted the Custody Rule in 1962 to protect clients from the insolvency of an adviser and the misappropriation of client assets held by an adviser, advisers that were dually-registered as broker-dealers were exempt from the rule.[9] The SEC viewed the Custody Rule necessary, in part, because the Advisers Act does not require advisers to adhere to any specified standards of financial responsibility, and implicit in the exemption for dual registrants was the recognition that such advisers were already subject to regulatory oversight of their custodial arrangements.

It is notable that amendments to the Custody Rule finalized in 2003 (the "2003 Amendments") – intended to improve protections for advisory clients by, for example, requiring the use of qualified custodians, and removing so-called "unnecessary regulatory requirements," such as providing for certain exemptions, to balance protection of client assets with costs – eliminated the exemption from the Custody Rule for dual registrants. However, despite the elimination of the exemption, the 2003 Amendments provided for exemptions from the annual surprise examination requirement for advisers that maintained their client assets with qualified custodians and had a reasonable belief that the qualified custodians send account statements directly to their clients at least quarterly.[10] In practice, it was not until the recent 2009 amendments to the Custody Rule that left dual registrants and most advisers that maintain client assets with related qualified custodians unable to qualify for an exemption from the surprise examination requirements. SIFMA believes that this is an unintended consequence for advisers that are dually-registered as broker-dealers and advisers that maintain client assets with related broker-dealers acting as qualified custodians given the historical purpose and application of the Custody Rule since such firms were

[9] *See* Investment Advisers Act Release No. 2876 (May 20, 2009) (the "Proposing Release"), http://www.sec.gov/rules/proposed/2009/ia-2876.pdf.

[10] The SEC noted in the Proposing Release that, in promulgating the 2003 Amendments, it believed that the "direct delivery of account statements by qualified custodians would provide clients with confidence that any erroneous or unauthorized transactions would be reflected and, as a result, would be sufficient to deter registered advisers from fraudulent activities." Proposing Release, Section II.A.1.

already regulated, and continue to be regulated, with respect to their custodial arrangements pursuant to the financial responsibility and customer responsibility rules under the Exchange Act and other SRO rules, which provide for robust safeguarding measures and internal controls to protect client assets, deter misappropriation and increase the likelihood for early detection of misappropriation.

In addition to the current rules, the proposed amendments set forth in the Rule 17a-5 Proposing Release would impose additional requirements on broker-dealers that maintain custody of customer funds to further safeguard such assets. These additional protections would require broker-dealers to comply with the following requirements:

- to file a new Compliance Report asserting, among other items, whether it has a system of internal controls that provide reasonable assurance that any instances of material non-compliance with the net capital rule (Rule 15c3-1), the customer protection rule (Rule 15c3-3), quarterly security counts (Rule 17a-13) and SRO rules concerning delivery of account statements will be prevented or detected on a timely basis and whether its internal control over compliance with these rules was effective during the most recent fiscal year such that there were no instances of material weakness. The firm would need to identify and disclose any instance of material non-compliance or material weakness in its Compliance Report;
- to hire an independent public accountant to (1) examine management assertions in the Compliance Report (Compliance Examination) and (2) complete an Examination Report covering the Compliance Report, addressing assertions by the broker-dealer;
- to consent to permit its independent public accountant to make available to the SEC and DEA Examining Staff the audit documentation associated with its annual audit reports required under Rule 17a-5 and to discuss findings related to the audit reports with SEC and DEA Staff; and
- to submit a new form, Form Custody, to the SEC on a quarterly basis, with their Financial and Operational Combined Uniform Single (FOCUS) reports.

These requirements further support the strong safeguards in place for broker-dealer custodial arrangements under the Exchange Act, but also impose further overlapping requirements on advisers that are dually-registered as broker-dealers and investment advisers and firms that use a related broker-dealer as a qualified custodian.

SIFMA suggests that the additional costs of applying the Custody Rule for dual registrants and advisers that maintain client assets with related broker-dealers acting as qualified custodians are in vast excess to protections the rule is intended to provide because the assets of clients' of such firms are sufficiently protected by other regulatory and control requirements under the Exchange Act and SRO rules, and the Custody Rule duplicates many of these requirements. SIFMA believes that regulations governing the custody and safeguarding of assets that apply to broker-dealers under the Exchange Rule and SRO rules are appropriate in governing custodial arrangements for advisers that are dually-registered as broker-dealers and advisers that maintain client assets with related broker-dealers since they are acting in the capacity of broker-dealers and qualified custodians when they maintain custody of client assets. For this reason, and as discussed below, SIFMA recommends that the Advisers Act rules relating to custody defer to the Exchange Act rules (and SRO rules, where appropriate) for advisers that are dually-registered as broker-dealers and advisers that maintain client assets with affiliated broker-dealers. Accordingly, such deferral should provide such advisers applicable exemptions from the surprise examination and internal control report requirements under the Custody Rule because investor protections and safeguards for client assets are provided under the Exchange Act rules (taking into account the current application of the Exchange Act rules and also the proposed amendments under the Rule 17a-5 Proposing Release) and applicable SRO rules. However, an important safeguard against fraud would still apply for an adviser that uses an affiliate as a qualified custodian if such adviser itself is also deemed to have custody of client assets under the Custody Rule. For such adviser, the necessary protection of the independent accountant's surprise examination would still apply after removing duplicative burdens.

II. What types of key costs do investment advisers with custody of client assets generally incur to comply with SEC's Custody Rules?

There are significant burdens and costs, which have materially exceeded the SEC's estimates, imposed by the surprise examination and internal control report requirements that are not adequately justified given the existing framework of custodial controls of dual registrants and advisers that maintain client assets with related-brokers acting as qualified custodians.

In the Finalizing Release, the SEC estimated that the average annual cost to a firm for a surprise examination would be $125,000 for a large adviser subject to

the surprise examination with respect to 100% of its clients, and $20,000 and $10,000 for a medium sized adviser and small sized adviser, respectively, each subject to the surprise examination with respect to 5% of its clients. The SEC explained that the costs for the internal control reports would vary based on the size and services offered by the qualified custodian but estimated the average cost would be approximately $250,000 per year for each adviser subject to the requirements.

SIFMA members have now gone through several rounds of surprise examinations and internal control reports. SIFMA is in the process of conducting a survey of their member firms of the actual costs of these requirements. Based on the responses from the member firms that have responded thus far, in many cases, the actual costs of the examinations and reports far exceed the SEC's estimates. SIFMA will supplement this response with complied survey data.

Further, the survey respondents that are dually-registered or maintain client assets with related broker-dealers acting as qualified custodians have to date reported that the surprise examinations have not led to any identification of client assets being misappropriated. This makes sense given the other requirements and controls by broker-dealers that deter misappropriation or misuse of client assets.

SIFMA suggests that the Custody Rule be revised to exempt advisers that are dually-registered as broker-dealers and advisers that maintain client assets with affiliated broker-dealers, and instead defer to the rules under the Exchange Act for regulating custodial arrangements of such advisers. In the alternative, dual registrants and advisers that maintain client assets with affiliated broker-dealers (and do not otherwise have custody of client assets) should be excluded from the surprise examination requirements and the internal control report requirements should be modified to ensure consistency between the Custody Rule and the rules under the Exchange Act for such firms to balance costs with utility and eliminate duplicative requirements. In particular, the Rule 17a-5 broker-dealer annual audit and other compliance reports, combined with the internal control reports (modified to be consistent with reports required under the Exchange Act rules), would provide sufficient protection to clients.

The SEC indicated similar suggestions in the Rule 17a-5 Proposing Release, which provides that "the Commission preliminarily believes that broker-dealers that also are registered as investment advisers and hold advisory client funds or

securities, or that hold funds or securities for related investment advisers, would be able to use the Examination Report described [in the release] to satisfy the internal control report requirements under both Rule 17a–5, as it is proposed to be amended, and the…Custody Rule."[11] SIFMA commends the SEC's efforts to develop consistent standards to the internal control report required by the Custody Rule and the Examination Report required under the proposed Rule 17a-5 amendments, and further believes that the Exchange Act rules, as opposed to the Custody Rule, are appropriate for regulating all custodial arrangements of advisers that are dually-registered as broker-dealers when they are acting in the capacity of qualified custodians in maintaining client assets, as well as advisers that maintain client assets with their affiliated broker-dealer also acting in the capacity of a qualified custodian.

SIFMA notes that the GAO asked about additional costs that would be incurred by operationally independent custodians if they were not exempt from the surprise examination requirement. If this exemption were revoked, advisers and their operationally independent qualified custodians would incur significant additional costs and burdens, such as those discussed above. For this reason, SIFMA does not recommend the revocation of this exemption. Instead, SIFMA recommends that the Custody Rule provide for deferral to the Exchange Act rules for advisers that are dually-registered as broker-dealers and advisers that maintain client assets with related broker-dealers, accordingly, for the elimination of the surprise examination and internal control report requirements for such firms because their custodial arrangements are already regulated by the stringent rules under the Exchange Act rules and other SRO rules, which largely duplicate the Custody Rule requirement, provide strong and adequate protections for client assets and also serve as deterrents from potential misuse of client assets.

In, addition, SIFMA recommends that the SEC reconsider its definition of operational independence in the context of the Custody Rule so that its conditions are stated with greater clarity so as to not disqualify affiliated qualified custodians that effectively function as separate and independent business units. In the experience of SIFMA members, very few firms have concluded they can satisfy the Custody Rule's conditions for operational independence from a practical standpoint even where their investment advisers and affiliated qualified custodians (including broker-dealers subject to Exchange Act and SRO rules

[11] Rule 17a-5 Proposing Release at 37574.

governing custody) in fact operate as separate business units and they have controls in place to safeguard customer assets.

III. What concerns do you have about the Custody Rule and what significant challenges may advisers and other persons face in applying the rule?

The definition of "custody" under the Custody Rule is inconsistent with prior guidance from the SEC and existing financial regulatory requirements and should be modified to address these issues.

The Custody Rule currently defines "custody" to include "[p]ossession of client funds or securities, (but not of checks drawn by clients and made payable to third parties) unless you receive them inadvertently and you return them to the sender promptly but in any case within three business days of receiving them. . . ." This definition appears to overturn a Staff no-action position issued in 2007 that provides better protection for client assets. Specifically, in 2007, the Staff provided no-action assurances to advisers that sought to avoid having custody when they received tax refunds, class action settlement checks, and other client assets from non-clients and forwarded those assets to clients or their custodians. If instead advisers returned those assets to the senders, clients likely would experience delays in receiving their assets, and the risk of loss would increase, as the senders would likely not be fiduciaries to clients and would not have procedures to properly safeguard client assets. In its letter to the Investment Advisers Association, the Staff stated that it would not recommend enforcement action under Rule 206(4)-2 if an adviser "promptly forwards client assets that it inadvertently receives from Third Parties in the situations and under the circumstances described above within five business days of the adviser's receipt of such assets, to its client (or former client) or a qualified custodian."[12] SIFMA submits that client assets will be better protected if advisers who receive client assets from a non-client are permitted to continue to forward them to the client or the client's custodian and not be deemed to have custody in these situations. Accordingly, SIFMA recommends that the SEC confirm that its 2007 position continues to apply.

SIFMA acknowledges the SEC's guidance providing that an adviser would not be deemed to have custody if it has limited authority to withdraw assets to transfer a client's assets between the client's accounts maintained with the same

[12] Publicly available Sept. 20, 2007.

or different qualified custodian, provided that the client has authorized the adviser in writing to make such transfers.[13] In connection with this guidance, SIFMA requests clarification from the SEC that the client's authorization may apply prospectively, and, for example, may take the form of an authorization specific to account transfers or an investment advisory contract.

Notwithstanding our overall support for the Custody Rule, including the stated goals of the most recent amendments, as the rule currently applies, it imposes significant costs and burdens on dually-registered advisers and advisers that maintain client assets with related broker-dealers acting as qualified custodians without additional protections given the application of the rules under the Exchange Act and SRO rules concerning the safeguarding of client assets. SIFMA believes that, with the suggested adjustments, the Custody Rule could be further updated in a way that makes sense given industry practices without compromising investor protections.

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Thank you for giving SIFMA's Private Client Legal Committee the opportunity to comment on the foregoing. If you have any questions regarding this letter, please contact the undersigned at 202.962.7382 (kcarroll@sifma.org).

Sincerely,

Kevin M. Carroll
Managing Director and
Associate General Counsel

[13] Staff Responses to Questions about the Custody Rule, Question II.4, publicly available.

APPENDIX A
Protections for Broker Custodied Assets

Protection	Details
1. *Brokers Must Control Customer Securities They Hold (*Customer Protection–Reserves and Custody of Securities: Exchange Act Rule 15c3-3(b); FINRA Rule 2330; NYSE Rule 402)	▪ Brokers –must promptly obtain and maintain physical control of all customer "fully paid" and "excess margin securities" in a "satisfactory control location" ▪ Satisfactory control locations include securities depositories (such as the Depository Trust Company) and banks. ▪ Brokers must identify and segregate – by customer – both fully paid and excess margin securities. ▪ Determinations are required daily
2. *Brokers Must Reconcile Securities Held Quarterly* (Quarterly Securities Counts: Exchange Act Rule 17a-13)	▪ Brokers must perform a quarterly "box count" of customer securities – that is, physically examine and count all securities and compare the results of the count with the broker's records, to verify there are no discrepancies.
3. *Brokers Must Confirm Customer Change of Address* (Records to be Made: Exchange Act Rule 17a-3(a)(17)(i)(B)(2))	▪ Brokers must confirm customer requests for a change of address by sending notice to the customer at the customer's old address within 30 days of receiving an address change request.
4. *Brokers Must Establish, Test and Verify Supervisory Policies and Procedures, including Dealing with Custody Controls* (Supervision and Supervisory Control System: NASD Rules 3010 and 3012(a)(2)(B); FINRA Rule 3130)	▪ Brokers must establish and adopt written policies and procedures, which, among others, must cover the safeguarding of customer funds and securities, transmittals of funds and validation of changes in customer account information. ▪ Brokers must designate principals to test and verify such supervisory policies and procedures on an annual basis and to create additional or amend procedures in response to such testing. Principals must report results of such testing to senior management. ▪ The CEO must certify annually that the firm has in place processes to establish, maintain, review, test and modify its supervisory policies and procedures.
5. *Brokers Cannot Borrow or Pledge Customer Securities unless the Customer Owes it Money* (Hypothecation: Exchange Act Rules 8c-1 and 15c2-1; NYSE Rule 402))	▪ Brokers may not pledge customer securities in an amount exceeding the customer's indebtedness or commingle the securities with securities of the broker or other customers. ▪ Even where permitted, brokers must notify a customer in writing before pledging customer securities as collateral for repayment of indebtedness. ▪ Brokers also may not borrow customer fully paid securities without a written agreement and providing collateral to the customer.
6. *Brokers Must Set Aside Money Owed to Customers* (Protection of Customer Cash--Special Reserve Bank Accounts: Exchange Act Rule 15c3-3(e); NYSE 402)	▪ Brokers must segregate net amount of monies owed to customers. ▪ Brokers must deposit cash or qualified liquid securities - in accordance with an enumerated reserve formula --in a separate "Special Reserve Bank Account" for the benefit of customers ▪ The account must be free of liens and separate from any other account of the Broker ▪ Determinations and deposit required weekly
7. *Brokers Must Send Customers Quarterly Account Statements Detailing Transactions and Securities Held* (Customer Account Statements: Exchange	▪ Brokers must send customers quarterly account statements ▪ Statements must show amount of money and value of securities held for the customer as of the period end date ▪ Monthly statements required if certain transactions are made in any month (e.g., options, commodities and certain money transfers)

Act Rule 17a-5; NASD Rule 2340; NYSE Rule 409; CBOE Rule 9.12)	
8. *Brokers Must Send Financial Reports to Customers* (Broker Financial Statements: Exchange Act Rule 17a-5(d)-(e); FINRA 2261; FINRA Rule 4140)	▪ Brokers give customers copies of their financial reports annually. ▪ The report must contain (1) a balance sheet prepared in accordance with GAAP; (2) a statement of the broker's net capital under SEC rules; (3) a statement that an annual audited report is available if the report notes any material inadequacies; and (4) a statement that the Statement of Financial Condition of the most recent annual audit report is available at the broker's principal.
9. *Brokers Must Hire PCAOB Accountants to Conduct Audits and File Financial Statements with the SEC* (Annual Audits by Independent Certified Public Accountants: Exchange Act Rule 17a-5(f))	▪ Brokers must be audited annually by an independent public accountant registered with the PCAOB [*Requirement for PCAOB membership effective 2009*] ▪ Brokers must file audited financial statements with the SEC ▪ Brokers must also file annually a statement indicating an agreement with an independent public accountant to conduct the broker's annual audit during the following calendar year.
10. *Brokers are Required to Supervise their Business and Personnel* ((NASD Rule 3010(c)(2)(A); NYSE Rule 342.26; NYSE Rule 401(b))	▪ Brokers must maintain policies and procedures for safeguarding of customer funds and securities, including appropriate procedures for supervision and control for disbursement of customer assets from customer accounts. ▪ Brokers must inspect office locations on a regular cycle. ▪ Included in inspections is testing and verification of the broker's policies and procedures for safeguarding customer funds and securities.
11. *SIPC Coverage Protects Against Misappropriated or Missing Funds and Securities* (Securities Investor Protection Act of 1970)	▪ Brokers must join SIPC unless their business is limited to (1) selling mutual funds, variable annuities, insurance and government securities or (2) furnishing investment advice to investment companies or insurance companies. ▪ SIPC protects customers of failed brokers. ▪ Customers of a failed broker get back all securities (such as stocks and bonds) registered in their name or are in the process of being transferred to their name. The failed broker's remaining customer assets are then divided on a pro rata basis with funds shared in proportion to the size of claims. If sufficient funds are not available to satisfy customer claims (such as for missing cash or securities), SIPC may advance funds to supplement the distribution to customers, up to a maximum of $500,000 per customer, including a maximum of $250,000 for cash claims.
12. *Brokers are Required to Deliver Trade-by-Trade Confirmations* (Exchange Act Rule 10b-10)	▪ Brokers must deliver a confirmation in writing to the customer at or before the completion of each transaction that contains certain specified information. ▪ The confirmations must detail information pertaining to the trade such as information regarding the quantity, price, time, whether the broker-dealer acted as agent or principal and the amount of remuneration received from the customer in connection with the trade.