



Invested in America

By Electronic Mail To: rule-comments@sec.gov

August 25, 2011

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Proposed Amendments to Rule 17a-5 Under the Securities Exchange Act of 1934; Release No. 34-64676, 76 Fed. Reg. 37,572; File No. S7-23-11 (the "Release")

Dear Ms. Murphy:

The Securities Industry and Financial Markets Association ("SIFMA")¹ welcomes this opportunity to comment on the amendments to Rule 17a-5 under the Securities Exchange Act of 1934 (the "Exchange Act") and Form Custody proposed by the Securities and Exchange Commission (the "Commission" or the "SEC") in the Release.

Certain of the amendments proposed by the Release (the "Proposed Amendments") are of particular interest to us, including amendments under which

- a broker-dealer that holds customer funds or securities (a "carrying broker-dealer") would be required to file a new report (the "Compliance Report") that, among other things, describes each identified instance of "material non-compliance" and "material weakness" in internal control over compliance with rules prescribed by designated examining authorities ("DEAs") requiring broker-dealers to send account statements to customers (the "Account Statement Rules") or Rules 15c3-1, 15c3-3 or 17a-13 under the Exchange Act (collectively, including the Account Statement Rules, the "Financial Responsibility Rules");
- a broker-dealer that is not a carrying broker-dealer would be required to file a report asserting its exemption from the requirements of Rule 15c3-3 (the "Exemption Report");
- a broker-dealer's independent public accountant would be required to prepare either a report based on an examination of the Compliance Report (the "Examination Report") or a report based on an examination of the Exemption Report, including discussion as to

¹ SIFMA brings together the shared interests 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.

whether any “material modification” should be made to the Exemption Report, and to notify the Commission within one business day of determining that an instance of “material non-compliance” exists with respect to the Financial Responsibility Rules;

- a clearing broker-dealer would be required to consent to permitting its independent public accountant to make available to Commission and DEA examination staff the audit documentation associated with the broker-dealer’s Annual Report (defined in Part I below), Compliance Report and/or Exemption Report and to discuss findings relating to those reports with Commission and DEA examination staff and
- a broker-dealer would be required to file a new Form Custody designed to elicit information concerning whether the broker-dealer maintains custody of customer and non-customer assets and how such assets are maintained.

We comment below on (1) the definitions of “material non-compliance” and “material weakness” in the Proposed Amendments, (2) the proposed requirement that an auditor disclose any “material modification” that should be made to the Exemption Report, (3) the access to audit documents and auditors granted to the Commission and DEA examination staff under the Proposed Amendments, (4) the proposed Form Custody, (5) certain costs associated with the Proposed Amendments and (6) the effective date of the Proposed Amendments.

I. “Material Non-Compliance” and “Material Weakness”

Rule 17a–5 currently requires broker-dealers to file an annual report that includes financial information² and supporting schedules³ and is audited by an independent public accountant⁴ (the “Annual Report”). An audit must be sufficient to provide reasonable assurance that “material inadequacies” existing as of the date of the examination in the broker or dealer’s accounting system, internal accounting controls, procedures for safeguarding securities and practices and procedures with respect to the following activities would be disclosed: (i) computation of aggregate indebtedness and net capital under Rule 17a–3(a)(11) and the reserve required by Rule 15c3–3(e), (ii) quarterly securities counts required by Rule 17a–13, (iii) compliance with the requirement under Federal Reserve Board Regulation T for prompt payment for securities

² Specifically, the report must contain “a Statement of Financial Condition ..., a Statement of Income, a Statement of Cash Flows, a Statement of Changes in Stockholders’ or Partners’ or Sole Proprietor’s Equity, and Statement of Changes in Liabilities Subordinated to Claims of General Creditors.” If the Statement of Financial Condition is not consolidated, the notes to the Statement must include a summary of financial data, including the assets, liabilities and net worth or stockholders’ equity, for the unconsolidated subsidiaries. Rule 17a–5(d)(2).

³ The supporting schedules must include “a Computation of Net Capital Under Rule 15c3–1, a Computation For Determination of the Reserve Requirements Under Exhibit A of Rule 15c3–3, and Information Relating to the Possession or Control Requirements Under Rule 15c3–3.” Rule 17a–5(d)(3).

⁴ The audit must be conducted by the independent public accountant in accordance with generally accepted auditing standards (“GAAS”) and must include “all procedures necessary under the circumstances to enable the independent public accountant to express an opinion on the statement of financial condition, results of operations, cash flows, and the Computation of Net Capital Under Rule 15c3–1, the Computation for Determination of Reserve Requirements for Brokers or Dealers Under Exhibit A of Rule 15c3–3, and Information Relating to the Possession or Control Requirements Under Rule 15c3–3.” Rule 17a–5(g)(1). The Proposed Amendments would change the audit standards applicable to broker-dealer audits and compliance examinations from GAAS to standards promulgated by the Public Company Accounting Oversight Board (“PCAOB”).

purchased in a cash account and (iv) possession and control of fully paid and excess margin securities as required by Rule 15c3-3.⁵

The concept of a “material inadequacy” is central to these requirements. As the Commission has noted in the Release, the concept of “material inadequacy” is not defined in existing auditing literature.⁶ For purposes of Rule 17a-5, “material inadequacy” is currently defined to include

any condition which has contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to (i) inhibit a broker or dealer from promptly completing securities transactions or promptly discharging his responsibilities to customers, other broker-dealers or creditors; (ii) result in material financial loss; (iii) result in misstatements of the broker’s or dealer’s financial statements; or (iv) result in violations of the Commission’s recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in [the foregoing].⁷

The Commission is proposing to replace the “material inadequacy” standard with two new standards: “material non-compliance” and “material weakness.” The Commission has specifically solicited comments on the clarity and definitions of these terms.⁸

We urge the Commission to adopt a single standard for assessing materiality that (1) broker-dealers and their auditors may employ for purposes of determining both “material non-compliance” and “material weakness,” (2) is consistent with existing standards for assessing materiality already employed by broker-dealers and auditors and (3) looks to a broker-dealer’s good-faith reliance on reasonable controls—as informed over time by the broker-dealer’s interactions with regulators, including informal and formal guidance and examinations—as a benchmark for assessing the materiality of the broker-dealer’s non-compliance or weakness.

Accordingly, as elaborated below, we propose that the Commission define (1) “material non-compliance” as a failure by the broker-dealer to comply with any of the requirements of the Financial Responsibility Rules arising from a material weakness and (2) “material weakness” as a material failure of a broker-dealer’s systems, policies or practices regarding the Financial Responsibility Rules involving numerous customers, multiple errors or significant dollar amounts. The chart below compares our proposed definitions of “material non-compliance” and “material weakness” to the Commission’s proposed definitions of those terms.

⁵ Rule 17a-5(g)(1). We note that Rule 17a-5(g)(1)(iii) cites Section 4(c) of Regulation T; however, the operative language in Section 4(c) for purposes of Rule 17a-5(g)(1) has been moved to Section 8 of Regulation T. *See* Complete Revision and Simplification of Regulation T, 48 Fed. Reg. 23,161 (May 24, 1983).

⁶ Release, 76 Fed. Reg. at 37,576-77.

⁷ Rule 17a-5(g)(3).

⁸ We note that the Commission has not proposed any change in the materiality standard applicable when a broker-dealer reconciles “material differences” between its net capital or reserve computations provided in its Annual Report and the corresponding computations provided in its most recently filed Part II or Part IIA of Form X-17A-5. *See* Rule 17a-5(d)(4) and Proposed Rule 17a-5(d)(2)(iii). Such “material differences,” therefore, are not necessarily instances of “material non-compliance” or evidence of “material weakness” under either the Commission’s or our proposed definitions of those terms.

	SEC Proposed Definition	SIFMA Proposed Definition
Material Non-Compliance	A failure by the broker-dealer to comply with any of the requirements of the Financial Responsibility Rules in all material respects.	A failure by the broker-dealer to comply with any of the requirements of the Financial Responsibility Rules arising from a <i>material weakness</i> .
Material Weakness	A deficiency, or a combination of deficiencies, in internal control over compliance with the Financial Responsibility Rules, such that there is a reasonable possibility that material non-compliance with those provisions will not be prevented or detected on a timely basis.	A <i>material weakness</i> is a material failure of a broker-dealer's systems, policies or practices regarding the Financial Responsibility Rules involving numerous customers, multiple errors or significant dollar amounts.

1. Material Non-Compliance

Under the Proposed Amendments, a carrying broker-dealer would be required to describe any instance of “material non-compliance” with the Financial Responsibility Rules in its Compliance Report.⁹ In addition, the broker-dealer’s independent public accountant would be required to report to the Commission any instances of “material non-compliance” it encountered during the course of preparing its Examination Report within one business day of its determination of “material non-compliance.”¹⁰ If either the broker-dealer or the independent public accountant identifies an instance of “material non-compliance” (or a “material weakness,” which will be discussed below), the broker-dealer would be prohibited from relying on the exemption under Rule 17a-5(c)(5) that permits qualifying broker-dealers to publish their audited and unaudited financial statements online in lieu of delivering the statements to customers in paper form.¹¹

The Commission has proposed to define “material non-compliance” as a failure by the broker-dealer to comply with the requirements of the Financial Responsibility Rules “in all material respects.”¹² Although the Release does not define a threshold for materiality, it provides the following non-exclusive factors that should be considered: “(1) The nature of the compliance requirements, which may or may not be quantifiable; (2) the nature and frequency of non-compliance identified; and (3) qualitative considerations.”¹³ The Release also states that the Commission preliminarily believes that certain instances of non-compliance are material per se, including any failure to maintain minimum net capital required by Rule 15c3-1 and any failure to maintain reserves required by Rule 15c3-3.¹⁴

⁹ Proposed Rule 17a-5(d)(3)(i)(C).

¹⁰ Proposed Rule 17a-5(h).

¹¹ Proposed Rule 17a-5(c)(5)(vi). See Part V, *infra*, for a discussion of the costs associated with, and proposed amendments to, this requirement.

¹² Proposed Rule 17a-5(d)(3)(ii).

¹³ Release, 76 Fed. Reg. at 37,577.

¹⁴ *Id.*

As a preliminary matter, we disagree with the Commission’s proposed requirement that independent public accountants report instances of “material non-compliance” to the Commission directly. Independent public accountants currently are required to provide notice of any “material inadequacy” to the broker-dealer who then is obligated to provide notice to the Commission; if the independent public accountant does not receive a copy of the broker-dealer’s notice to the Commission or disagrees with the notice, the independent public accountant is obligated to inform the Commission.¹⁵ We believe the proposed protocol for reviewing instances of “material non-compliance” determined by the independent public accountant unnecessarily precludes the Commission from considering the views of the broker-dealer—the entity best equipped to provide the Commission with relevant information regarding such instances.

We also believe the Commission’s guidance on identifying instances of material non-compliance is unhelpfully open-ended and would introduce unnecessary ambiguity in broker-dealers’ regulatory obligations to report non-compliance and control weaknesses. First, the Commission’s definition of material non-compliance is circular and relies on a standard for materiality that differs from the standard applicable to the Commission’s proposed definition of material weakness. Second, it is not clear how the Commission’s definition of material non-compliance relates to broker-dealers’ existing obligations to self-report violative conduct. Finally, the Commission’s guidance does not preclude the prospect of a broker-dealer engaging in material non-compliance despite its good-faith reliance on reasonable controls.

As noted above, we propose a simple formula for determining material non-compliance under which a broker-dealer would be in material non-compliance if a failure to comply with the Financial Responsibility Rules arises from a material weakness. Unlike the definition of material non-compliance proposed in the Release, our proposed definition of material non-compliance, as discussed at greater length below in the discussion of our proposed definition of material weakness, (1) relies in a straightforward way on the standard a broker-dealer would employ to determine material weaknesses, (2) is based on the standard for self-reporting currently applicable to broker-dealers under FINRA Rule 4530 and (3) effectively creates a safe harbor for broker-dealers that rely on reasonable controls in good faith because our proposed definition of material weakness effectively creates such a safe harbor.

We believe the Commission could provide helpful guidance regarding the definition of material non-compliance by identifying examples of non-compliance it would deem non-material. We provide such examples in [Appendix A](#) and urge the Commission to assess the materiality of the conduct illustrated in these examples in any release adopting the Proposed Amendments.

2. Material Weakness

Under the Proposed Amendments, a broker-dealer required to complete the Compliance Report would be required to describe each “material weakness in internal control over compliance” with the Financial Responsibility Rules.¹⁶ The Commission proposes to define a “material weakness” as “a deficiency, or a combination of deficiencies, in internal control over compliance” with the Financial Responsibility Rules, such that there is a “reasonable possibility that material non-compliance with [the Financial Responsibility Rules] will not be prevented or detected on a timely basis.”¹⁷ The Proposed Amendments further define a “deficiency in internal control” as occurring “when the design or operation of a control does not allow the broker or dealer, in the normal

¹⁵ Rule 17a-5(h)(2).

¹⁶ Proposed Rule 17a-5(d)(3)(i)(C).

¹⁷ Proposed Rule 17a-5(d)(3)(iii).

course of performing their assigned functions, to prevent or detect non-compliance with [the Financial Responsibility Rules] on a timely basis.”¹⁸ The Release states that an event is “reasonably possible” when the chance of its occurring is “more than remote.”¹⁹ In sum, under the Proposed Amendments, a material weakness is present when there is a more than remote chance that the broker-dealer would not ordinarily detect or prevent an instance of “material non-compliance” in a timely manner.

As a preliminary matter, we seek guidance regarding the assertion in the proposed Compliance Report that a carrying broker-dealer’s internal control over compliance with the Financial Responsibility Rules was effective during the most recent fiscal year such that there were no instances of material weakness.²⁰ In particular, we request confirmation that a carrying broker-dealer could make the assertion above if, during the prior fiscal year, the broker-dealer identified and promptly remediated a control weakness that, if left unremediated, would have constituted a material weakness. We believe the broker-dealer’s prompt remediation precludes any characterization of such a control weakness as a material weakness.

We also believe the Commission’s definition of material weakness, like the Commission’s definition of material non-compliance, introduces unnecessary ambiguity in broker-dealers’ regulatory obligations to report non-compliance and control weaknesses. First, although the Commission’s definition of material weakness references the definition of “material non-compliance,” it also relies on certain undefined qualitative concepts that are not incorporated in the definition of “material non-compliance” (*i.e.*, “remote chance” and “timely basis”) and therefore relies on a standard for materiality that differs from the standard applicable to the Commission’s proposed definition of “material non-compliance.” Second, it is not clear how the Commission’s definition of material weakness relates to broker-dealers’ existing obligations to self-report violative conduct. Finally, the definition does not preclude the prospect of a broker-dealer having a material weakness despite its good-faith reliance on reasonable controls.

As noted above, we propose that the Commission define material weakness as a material failure of a broker-dealer’s systems, policies or practices regarding the Financial Responsibility Rules involving numerous customers, multiple errors or significant dollar amounts. Like the SEC’s proposed definition of material weakness and the current definition of “material inadequacy,” our proposed definition of material weakness focuses on the strength of a broker-dealer’s internal controls. Unlike those definitions, however, our proposed definition of material weakness (1) relies on the same underlying materiality standard applicable to our proposed definition of material non-compliance, (2) is based on the standard for self-reporting currently applicable to broker-dealers under FINRA Rule 4530²¹ and (3) because it is predicated on material failures in control rather than instances of non-compliance, effectively creates a safe harbor for broker-dealers that rely on reasonable controls in good faith.

¹⁸ *Id.*

¹⁹ Release, 76 Fed. Reg. at 37577.

²⁰ Proposed Rule 17a-5(d)(3)(i)(B)(3).

²¹ FINRA Rule 4530 requires a broker-dealer to report to FINRA violations by the broker-dealer or its associated persons of any securities-, insurance-, commodities-, financial- or investment-related laws, rules, regulations or standards of conduct of any U.S. or non-U.S. regulator or self-regulatory organization. FINRA expects a broker-dealer to report violative conduct only if the conduct “has widespread or potential widespread impact to the member, its customers or the markets” or “arises from a material failure of the member’s systems, policies or practices involving numerous customers, multiple errors or significant dollar amounts.” FINRA Rule 4530.01. *See also* FINRA Regulatory Notice 11-06 (Feb. 2011).

Taking the proposed definitions of material non-compliance, material weakness and FINRA Rule 4530 together, a broker-dealer would be obligated to (1) report any material failure of its systems, policies or practices regarding the Financial Responsibility Rules involving numerous customers, multiple errors or significant dollar amounts in its Compliance Report as a material weakness; (2) report any failure to comply with the Financial Responsibility Rules arising from such a material weakness as an instance of material non-compliance in its Compliance Report²² and (3) self-report any such failure to FINRA pursuant to FINRA Rule 4530.²³ While we acknowledge that broker-dealers would need to apply certain qualitative concepts under our proposed definition of material weakness and, therefore, our proposed definition of material non-compliance (*i.e.*, “material failure,” “numerous customers,” “multiple errors” and “significant dollar amounts”), these are concepts that broker-dealers already are required to apply for purposes of complying with FINRA Rule 4530,²⁴ and so unlike the Commission’s proposed definitions of material non-compliance and material weakness, our proposed definitions of those terms do not introduce new ambiguity in broker-dealers’ regulatory obligations to report non-compliance and control weaknesses.

As noted above with respect to material non-compliance, we believe it would be helpful for the Commission to identify examples of non-material weaknesses. We provide such examples in [Appendix A](#) and urge the Commission to assess the materiality of the conduct illustrated in these examples in any release adopting the Proposed Amendments.

3. [Examples](#)

The examples in [Appendix A](#) clarify the definitions of “material non-compliance” and “material weakness.” The Commission has published helpful examples in connection with past rulemakings;²⁵ we believe the publication of examples applying the concepts of “material non-compliance” and “material weakness” as they relate to the Financial Responsibility Rules under the Proposed Amendments similarly would help broker-dealers and auditors apply those terms in practice. We believe the examples in [Appendix A](#) do not reflect instances of “material non-compliance” or “material weaknesses” under either the Commission’s or our proposed definitions of those terms. The examples illustrate instances of non-compliance that are detected and

²² The broker-dealer’s independent public accountant also would be required to report any such instance to the Commission within one business day under the Proposed Amendments. We note that under the current “material inadequacy” standard, instances of non-compliance, even if deemed material, are not necessarily included in Annual Reports or reported by broker-dealers’ independent public accountants to the Commission.

²³ Under FINRA Rule 4530, broker-dealers also are required to self-report instances of non-compliance that have “widespread or potential widespread impact to the member, its customers or the markets.” A self-reporting obligation also may be triggered by non-compliance outside the context of the Financial Responsibility Rules. We believe the existence of a broader reporting obligation to FINRA than to the Commission is consistent with FINRA’s role as a self-regulatory organization, and often DEA, in regular contact with its membership.

²⁴ A broker-dealer’s application of these concepts, therefore, is informed on an ongoing basis by interactions with FINRA staff, including through informal and formal guidance and examinations. Assessments of materiality under the Commission’s proposed definitions of material non-compliance and material weakness, on the other hand, would not benefit in this way from broker-dealers’ ongoing interactions with FINRA staff.

²⁵ For example, in the release adopting Regulation ATS, the Commission provided examples of trading systems, some of which would fall within the scope of the definition of “exchange” as elaborated upon in Rule 3b-16 under the Exchange Act and some of which would fall outside the scope of that definition. SEC Exchange Act Release No. 40760 (Dec. 8, 1998).

corrected because of reasonable controls (Example A), miscalculations involving de minimis amounts that occur despite reasonable controls (Example B), instances of non-compliance that occur despite reasonable controls (Examples C-E) and miscalculations or instances of non-compliance that result from the adoption of one reasonable, good-faith interpretation of the Financial Responsibility Rules or accounting principles in place of another such interpretation (Examples F-G).

II. “Material Modifications” of Exemption Reports

The Proposed Amendments require a broker-dealer that claims an exemption from Rule 15c3-3 to file an Exemption Report in which the broker-dealer asserts that it is exempt because it meets one or more of the conditions set forth in paragraph (k) of the rule with respect to all of its business activities. The broker-dealer also would be required to engage an independent public accountant to prepare a report based on a review of the Exemption Report in which the accountant would disclose any “material modifications” that should be made to the broker-dealer’s assertion in the Exemption Report. The Release states that “an example of a discovery that would necessitate a material modification would be a discovery that the broker-dealer failed to promptly forward any customer securities it received.”²⁶

We request the Commission to provide additional guidance regarding the basis for “material modifications.” In particular, we note that broker-dealers operating under paragraph (k) may occasionally find themselves in possession of customer assets on an overnight basis as the result of procedural errors in the receipt and transmission of customer assets to custodians. Consistent with Example D in Appendix A, we do not believe that such errors, which may include, *e.g.*, bank errors, clerical errors or any factor outside the control of the broker-dealer, should warrant the “material modification” of a broker-dealer’s Exemption Report.

III. Access to Audit Documents and Auditors

The Proposed Amendments would permit the Commission and a clearing broker-dealer’s DEA to discuss an audit of the broker-dealer with the broker-dealer’s independent public accountants and to review documentation associated with the independent public accountant’s review of the broker-dealer’s Compliance Report or Exemption Report. As discussed below, we are concerned about (1) the risk of compromising the confidentiality of the information provided by an auditor to the Commission or a DEA, including the confidentiality of customers’ personal information, and (2) the potential effect such contact with auditors and access to audit documentation may have on broker-dealers’ relationships with their auditors.

In light of the potential sensitivity of the information provided by an auditor to the Commission or a DEA, a balance must be struck between transparency and appropriately tailored access. Proposed Rule 17a-5(f)(2) does not address the confidentiality of audit documentation obtained from a broker-dealer’s auditor. In order to minimize the risks associated with disclosing confidential business information, we believe the Proposed Amendments should limit the authorization provided to Commission and DEA staff strictly to the inspection of audit documentation maintained by the accountant in the offices of the accountant. In addition, although we believe that the Annual Report and any audit documentation obtained under proposed Rule 17a-5(f)(2) should qualify for the exemptions under the Freedom of Information Act (“FOIA”) provided under 5 U.S.C. §§ 552(b)(4) (exempting matters that are “trade secrets and commercial or financial information obtained from a person and privileged or confidential”) and/or (b)(8) (exempting matters “contained in or related to examination, operating, or condition

²⁶ Release, 76 Fed. Reg. at 37,580.

reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions”), we urge the Commission to clarify explicitly in proposed Rule 17a–5 that Annual Reports and audit documentation obtained under proposed Rule 17a–5(f)(2) are non-public and exempt from FOIA.²⁷ The inclusion of such language in proposed Rule 17a–5 would further the Commission’s purposes in the Proposed Amendments by encouraging complete disclosures in the Annual Report by broker-dealers and extensive examinations by their auditors.

Broker-dealers often provide their auditors with information that the auditors later conclude fall outside the scope of their audits.²⁸ In order to maintain open and candid relationships between broker-dealers and their auditors, we urge the Commission to (1) require Commission and DEA staff to provide a broker-dealer with a stated purpose for speaking to the broker-dealer’s auditor or for reviewing audit documentation, (2) establish a process by which broker-dealers may object to overly broad or unduly burdensome requests, (3) limit the time and cost expended by broker-dealers in responding to requests, (4) permit a broker-dealer to be present during any conversation between Commission or DEA staff and the broker-dealer’s auditor and (5) prohibit Commission and DEA staff from using any information learned from the broker-dealer’s auditor or audit documentation for any purpose other than determining the scope and focus of a pending examination of the broker-dealer, consistent with the Commission’s stated intent in the Release.²⁹

IV. Form Custody

We request that the Commission clarify certain instructions regarding the proposed Form Custody. Specifically, we would like the Commission to clarify the following points:

- A. Are locations that a broker-dealer uses “to hold securities that it carries” for purposes of Item 3.C (1) the locations where the broker-dealer maintains possession and control of customer fully paid or excess margin securities (*i.e.*, “good control locations”), (2) all locations where the broker-dealer holds customer securities (including locations, such as accounts pledged to secure bank loans, where customer margin securities are held that are not good control locations) or (3) all locations where the broker-dealer holds proprietary or customer securities?³⁰ We believe that summing customer long positions (within each of the specified categories) is a straightforward approach to providing the Commission and other regulators with an assessment of the broker-dealer’s custody activities.
- B. What is the distinction in the instructions for Item 3.C between “locations where the broker-dealer holds securities directly in the name of the broker-dealer” and locations where “the broker-dealer holds securities only through an intermediary”? All of the

²⁷ Acknowledging the sensitivity of firms’ financial information, both the current and proposed versions of Rule 17a–5(e)(3) permit the submitting broker-dealer to designate the Annual Report (with the exception of the Statement of Financial Condition) as confidential.

²⁸ We note in this regard that several states have enacted statutory privileges that protect accountant-client communications.

²⁹ Release, 76 Fed. Reg. at 37,583 (“[T]he Commission preliminarily intends that any such requests would be made exclusively in connection with conducting a regulatory examination of the clearing broker-dealer.”).

³⁰ We note that Item 3.C refers to “securities [the broker-dealer] carries” while Item 3.D refers to “securities [the broker-dealer] carries for the accounts of customers.”

locations listed in Item 3.C, with the exception of the vault, are intermediaries through which the broker-dealer can hold securities.

- C. Are broker-dealers expected to populate the chart provided in Item 3.D with (1) checkmarks, thereby indicating the appropriate range of approximate market value for each type of security, or (2) more precise estimates of market value? If the latter, what level of precision (*e.g.*, two significant figures) is required? Finally, we request clarification of the meaning of the phrase “securities carried by the broker-dealer” for purposes of Item 3.D. Does the phrase refer to all long positions in customer accounts or only to customer securities the broker-dealer has in its possession or control?
- D. Do alternative investments, mutual funds and exchange traded funds fall within the scope of “Other” securities for purposes of Items 3.D and 3.E?
- E. With respect to Item 5.A, should a broker-dealer indicate that it sends trade confirmations directly to customers (by checking “yes”) where it employs a vendor to do so?
- F. Should a broker-dealer that sends account statements to the beneficial owner of an account and duplicate account statements to persons other than the beneficial owner of the account mark “yes” for Item 6.C?
- G. How should broker-dealers account on Form Custody for securities that are not priced in their systems at the time that the Form Custody is prepared for submission?
- H. Should broker-dealers reflect their holdings in precious metals on behalf of customers on Form Custody?
- I. Should broker-dealers reflect securities pledged to them in connection with transactions regulated by the U.S. Commodity Futures Trading Commission on Form Custody?

V. Costs Associated with Proposed Amendments

We have a number of concerns regarding the costs associated with the Proposed Amendments.

First, the Release does not address the additional costs broker-dealers would incur in preparing Compliance Reports.

Second, under the Proposed Amendments, an instance of material non-compliance or a material weakness with respect to the Financial Responsibility Rules—rather than a notice of material inadequacy under current Rule 17a-5—during the prior year precludes a broker-dealer from making its audited and unaudited financial statements available on its website in lieu of sending these statements to customers in paper form.³¹ The Release does not address the additional costs potentially associated with this requirement in light of the proposed substitution of the material non-compliance and material weakness standards for the existing material inadequacy standard. Given the costs associated with this requirement as it currently exists and as proposed—as well as the general absence of a logical connection between the existence of an instance of material non-

³¹ Release, 76 Fed. Reg. at 37,577.

compliance or material weakness with respect to the Financial Responsibility Rules and the provision of audited and unaudited financial statements in paper form to customers—we propose this requirement be eliminated. Alternatively, we propose replacing this requirement with one under which, if a broker-dealer or its independent public accountant identifies an instance of material non-compliance or material weakness, the broker-dealer would be required to include notice of the instance of material non-compliance or material weakness on its customer account statements for a year following the identification of the instance of material non-compliance or material weakness.

Third, the Release does not address the additional costs independent public accountants and, indirectly, their broker-dealer clients would incur as a result of the proposed requirement that audits be conducted according to PCAOB standards rather than GAAS.

Finally, the Release does not address the costs associated with the development and implementation of controls to comply with proposed amendments to the Financial Responsibility Rules.³² The development and implementation of controls to comply with new requirements under the Financial Responsibility Rules increases the risk that an instance of material non-compliance or material weakness will occur during initial implementation periods and thereby trigger reporting or other obligations under the Proposed Amendments.

VI. Effective Date of Proposed Amendments

We also have a number of concerns regarding the effective dates of the Proposed Amendments.

First, under the Proposed Amendments, a carrying broker-dealer would be required to file Compliance Reports on or after December 15, 2011. Each Compliance Report must include a statement as to whether the broker-dealer has established and maintained a system of internal control to provide it with reasonable assurance that any instances of material non-compliance with the Financial Responsibility Rules will be prevented or detected on a timely basis.³³ While the proposed effective date of December 15, 2011, for making such a statement would be reasonable if the Commission adopted the Proposed Amendments, or a version thereof, in September 2011, it is not clear whether the Commission will be able to act on the Proposed Amendments that quickly. Accordingly, in order to afford carrying broker-dealers sufficient time to implement internal controls that are aimed at identifying, reporting and remediating instances of material non-compliance and material weaknesses in a manner that is responsive to the Commission's amendments and related guidance—including the development, testing and implementation of systems, training and updates to compliance, trading and sales desk and supervisory policies and procedures—we propose that the Commission require broker-dealers to file their first Compliance and Exemption Reports no earlier than one quarter after the Commission's adoption of the Proposed Amendments, or a version thereof.

Second, under the Proposed Amendments, a carrying broker-dealer with fiscal year ending on or after December 15, 2011, would be required to describe in its Compliance Report each identified instance of material non-compliance or material weakness with respect to the Financial

³² See, e.g., SEC Exchange Act Release No. 64969 (Jul. 26, 2011) (requesting comment on proposed FINRA Rule 2231, under which, among other things, members would be required to deliver customer account statements monthly rather than quarterly); and SEC Exchange Act Release No. 64352 (Apr. 27, 2011) (proposing, among other things, to remove references to credit ratings in Rules 15c3-1 and 15c3-3).

³³ Proposed Rule 17a-5(d)(3)(i)(A). This proposed provision would need to be revised if the Commission adopted our proposed definition of material weakness.

Responsibility Rules.³⁴ Though the Proposed Amendments are not clear, this requirement presumably would apply to all instances of material non-compliance and all material weaknesses over the prior fiscal year. Thus, a broker-dealer with fiscal year ending December 31, 2011, would be required to describe each instance of material non-compliance or material weakness with respect to the Financial Responsibility Rules that occurred between January 1, 2011, and December 31, 2011. Assuming the Commission adopts the Proposed Amendments, or a version thereof, in September 2011, carrying broker-dealers with fiscal year ending December 31 would be required to apply the Commission's standards regarding material non-compliance and material weakness retroactively to conduct that occurred since January 1, 2011, at least nine months earlier. We believe a requirement that broker-dealers investigate and report prior instances of material non-compliance or material weaknesses that were not characterized as such at the time they occurred would be unduly burdensome given the logistical challenges broker-dealers simultaneously would need to overcome to implement forward looking controls aimed at identifying, reporting and remediating future instances of material non-compliance and material weaknesses. Accordingly, we propose that the Commission require broker-dealers to report identified instances of material non-compliance or material weaknesses over the prior fiscal year in annual reports filed no earlier than five quarters after the Commission's adoption of the Proposed Amendments, or a version thereof.

Third, the Commission has proposed a transition period from December 15, 2011, to September 15, 2012 during which time a carrying broker-dealer would be required to include in its Compliance Report a point-in-time assertion as to whether its internal control over compliance with the Financial Responsibility Rules was effective rather than an assertion that covered the entire fiscal year.³⁵ Thus, a carrying broker-dealer with fiscal year ending September 30 would be required to file a Compliance Report on September 30, 2012, that asserts whether its internal control over compliance with the Financial Responsibility Rules were effective from October 1, 2011, to September 30, 2012. Assuming the Commission adopts the Proposed Amendments, or a version thereof, in September 2011, carrying broker-dealers with fiscal year ending September 30 would have no more than four weeks (likely much less) to implement an internal control over compliance with the Financial Responsibility Rules that reflected the Commission's amendments and related guidance. We believe the Commission should afford broker-dealers sufficient time to implement controls aimed at identifying, reporting and remediating instances of material non-compliance and material weaknesses, as noted above, before holding broker-dealers accountable for those controls. Accordingly, we propose the Commission adopt a transition period, as described in the Release, of no less than five quarters following the Commission's adoption of the Proposed Amendments, or a version thereof.

Finally, the Release does not address the effective date for proposed Form Custody. The Commission believes that information a broker-dealer currently maintains for purposes of completing FOCUS reports could be used to complete Form Custody.³⁶ Even if broker-dealers were able to use information they maintain for purposes of FOCUS reporting, the development, testing and implementation of systems, training and updates to compliance, accounting and supervisory policies and procedures needed to produce complete, accurate and timely Form Custody reporting will nonetheless require significant time and coordination within each broker-dealer. Broker-dealers cannot begin to undertake such efforts in earnest until final rules are promulgated that specify both the precise information to be provided on Form Custody and the

³⁴ Proposed Rule 17a-5(d)(3)(i)(C).

³⁵ Release, 76 Fed. Reg. at 37,581. The assertion as to whether a broker-dealer's internal control was effective would be required under Proposed Rule 17a-5(d)(3)(i)(B)(3).

³⁶ Release, 76 Fed. Reg. at 37,597.

format for presenting that information. We believe a reasonable implementation schedule for Form Custody would require a broker-dealer to file its first Form Custody no earlier than three quarters after the effective date of the final rule; any such schedule should be sufficiently flexible to allow broker-dealers to manage the competing regulatory demands to which they imminently will be subject as the result of recent rulemaking efforts by the Commission.³⁷

* * *

We thank the Commission for the opportunity to comment in advance of its rulemaking in this area. Should you have any questions regarding our comments, please do not hesitate to contact the undersigned at (202) 962-7400 or via e-mail at kbentsen@sifma.org or David Aman of Cleary Gottlieb Steen & Hamilton LLP at 212-225-2262 or via e-mail at daman@cgsh.com.

Sincerely,



Kenneth E. Bentsen, Jr.
Executive Vice President, Public Policy and Advocacy

cc: Mary L. Schapiro, Chairman
Luis A. Aguilar, Commissioner
Troy A. Paredes, Commissioner
Elisse B. Walter, Commissioner

Robert Cook, Director, Division of Trading and Markets
Michael A. Macchiaroli, Associate Director, Division of Trading and Markets

³⁷ Under such rulemakings, *e.g.*, broker-dealers with market access must implement appropriate risk management controls and supervisory procedures under recently adopted Rule 15c3-5 under the Exchange Act by November 30, 2011, broker-dealers must maintain records related to, report and monitor large trader activity under recently adopted Rule 13h-1 under the Exchange Act by April 30, 2012, and broker-dealers will be required to implement any final rule adopted by the Commission removing references to credit ratings under the Exchange Act, including references in the Financial Responsibility Rules. SEC Exchange Act Release No. 64748 (June 27, 2011); SEC Exchange Act Release No. 64976 (July 27, 2011); SEC Exchange Act Release No. 64352 (Apr. 27, 2011).

Appendix A

A. A broker-dealer that erroneously books a large inter-affiliate transfer in reverse (*e.g.*, makes a payment from the broker-dealer to an affiliate, rather than the reverse) but promptly detects and reverses the transfer is not in material non-compliance with the Financial Responsibility Rules and has not displayed a material weakness in internal control over compliance, even if the transfer resulted in the broker-dealer being briefly under its minimum net capital level.

Large multi-entity financial institutions make many inter-affiliate transfers of funds and securities on a daily basis to meet regulatory and contractual requirements. Many of these transfers require human intervention and are therefore subject to error. Typically, standard daily reconciliation and verification procedures uncover errors early in the next business day.

Scenario A: Broker-Dealer A had a large receivable from an affiliate. Instead of making a transfer from the affiliate to Broker-Dealer A, however, the firm inadvertently transferred funds from Broker-Dealer A to the affiliate. As affiliate obligations are subject to a one hundred percent capital charge, the inadvertent transfer resulted in a dollar-for-dollar reduction in Broker-Dealer A's net capital such that Broker-Dealer A's net capital fell below the required level. Early the next morning, Broker-Dealer A's systems and controls revealed that an error had been made, and so Broker-Dealer A reversed the transfer made to its affiliate and made the initially contemplated transfer from the affiliate to Broker-Dealer A.

Notwithstanding the Commission's preliminary view that any failure to maintain minimum net capital constitutes material non-compliance, we believe the violation of Rule 15c3-1 in Scenario A should not be considered material. Rather, it was an isolated instance of human error that, while potentially large in amount, was promptly discovered and corrected. Its qualitative nature as an inadvertent booking error renders it immaterial. Under our proposed definition, no instance of material non-compliance occurred because the error did not arise from a material weakness (under either proposed definition) in Broker-Dealer A's control systems; although the erroneous transfer was initially processed, Broker-Dealer A's controls functioned properly by promptly detecting and correcting the error.

We note that, in Scenario A, if the erroneous transfer caused a reduction in net capital that triggered an early warning notification requirement under Rule 15c3-1 but did not result in net capital falling below the required level, we believe that the reduction in net capital would not be an instance of "non-compliance" (if Broker-Dealer A gives any required warnings) because the reduction in net capital would not result in a breach of Broker-Dealer A's obligations under Rule 15c3-1.

B. Controls for complying with the net capital rule that do not monitor the classification of accounts with balances below a reasonable threshold do not reflect a material weakness and will not cause the broker-dealer to be in material non-compliance, even if they sometimes result in calculations of net capital that are not precisely correct.

In the preparation of computations under Rule 15c3-3, broker-dealers typically rely on dollar-value minimums when analyzing account balances, in recognition of constraints on both time and resources. Scrutiny by an examiner might reveal that an account with a small balance is a suspense account and, therefore, subject to a different classification within such regulatory computations.

Scenario B: One of Broker-Dealer B's accounts showed an asset consisting of an amount due to it. The total amount of the account was relatively small. The asset was included in

Broker-Dealer B's net capital computation for a period of time. Broker-Dealer B later discovered that the account should have been classified as a suspense account and that the value of the asset, therefore, should not have been included in its net capital. The overall effect on net capital was immaterial, and due to the small size of the account, Broker-Dealer B failed to recognize the misclassification for an extended period of time. Had the value of the account been significant, Broker-Dealer B's systems and controls most likely would have triggered a review of the account's classification, and the misclassification most likely would have been corrected in a reasonably short time.

This scenario is not an instance of material non-compliance. Broker-Dealer B's actual net capital never dropped below its required net capital or any warning level, and therefore Broker-Dealer B was in compliance with Rule 15c3-1 notwithstanding the misclassified account. Nor is Scenario B an example of a material weakness. Under the Commission's definition, a material weakness is the existence of a deficiency in internal controls over compliance with the Financial Responsibility Rules such that there is a reasonable possibility that material non-compliance with those rules would not be prevented or timely detected. Under our proposed definition, a material weakness is a material failure of a broker-dealer's systems, policies or practices regarding the Financial Responsibility Rules involving numerous customers, multiple errors or significant dollar amounts. Broker-Dealer B had systems and controls that would have detected any misclassification of an account that was large enough to have resulted in material non-compliance or a material failure in the broker-dealer's systems, policies or practices, and so this scenario does not reflect a material weakness under the Commission's or our proposed definition.

C. A broker-dealer that does not have in its possession or control all customer fully paid or excess margin securities (*i.e.*, has a "seg deficit") is not in material non-compliance with Rule 15c3-3 so long as the broker-dealer takes the steps required by Rule 15c3-3(d) (and interpretations thereof) to obtain possession or control of the relevant securities within applicable time limits set out in Rule 15c3-3(d) (and interpretations thereof).

On the basis of ongoing reviews of their operations and the requirements of Rule 15c3-3, broker-dealers develop procedures for obtaining possession or control of customer fully paid and excess margin securities. The level of seg deficits and the broker-dealer's procedures for resolving them on a timely basis are generally the subject of review in the course of periodic examinations by the broker-dealer's regulators.

Scenario C: Broker-Dealer C's possession or control obligation with respect to XYZ shares increased from 5,000 to 6,000 shares because a customer who had borrowed against her XYZ shares repaid the margin loan, converting margin securities into fully-paid securities. At the time of the increase, Broker-Dealer C had physical possession or control of only 5,000 XYZ shares but also had 1,200 XYZ shares loaned out to Broker-Dealer Z. In compliance with Rule 15c3-3(d)(1), Broker-Dealer C issued instructions to Broker-Dealer Z on the business day after the increase for the return of 1,000 of the loaned XYZ shares. When it appeared to Broker-Dealer C that Broker-Dealer Z would not be able to return the XYZ shares within five business days of Broker-Dealer C's instructions, Broker-Dealer C promptly commenced efforts to buy in 1,000 XYZ shares. Because of the illiquidity of XYZ shares, Broker-Dealer C was unable to obtain physical possession or control of 1,000 XYZ shares until after five business days following its instructions.

Although there was a period of time after the five-day period following its instructions during which Broker-Dealer C did not have possession or control of the customer's fully paid securities, this is not an instance of material non-compliance under the Commission's proposed definition of

that term because Broker-Dealer C took the prescribed measures to obtain control over the securities and was unable to do so within five days of its instructions for reasons outside its control (*i.e.*, Broker-Dealer's Z's failure to return XYZ securities and the illiquidity of XYZ securities). This is not an instance of material non-compliance under our proposed definition of that term because it did not arise from a material weakness (under either proposed definition) in Broker-Dealer C's control systems. There is no evidence of a material weakness because Broker-Dealer C was aware of the securities required to be in its physical possession or control and followed the required procedures for obtaining possession or control over those securities.

D. A broker-dealer that is immaterially late in making a deposit in its reserve account is not in material non-compliance and does not display a material weakness in internal control over compliance with the Financial Responsibility Rules.

Pursuant to Rule 15c3-3, broker-dealers are required to make deposits no later than 10:00 a.m. on the second business day following the day of computation. Virtually all broker-dealers meet this requirement with great regularity. Nonetheless, on occasion, for practical reasons or as a result of bank errors, deposits are not made or do not post until after 10:00 a.m.

Scenario D: Broker-Dealer D calculated its reserve requirement as of the close of business on Friday (the last business day of the week) and determined that an additional deposit was needed. Pursuant to Rule 15c3-3(e)(3), it was required to make the deposit no later than 10:00 a.m. on the following Tuesday. While Broker-Dealer D took appropriate steps to make the deposit by the specified time, the deposit did not register in its reserve account until shortly after the deadline (*e.g.*, at 10:05 a.m.).

This scenario is not an instance of material non-compliance or evidence of material weakness. Rather, it represents a short-duration error that is not indicative of material concerns regarding the broker-dealer's compliance or the robustness of its internal controls. Considered within the framework of the Commission's goals, this type of infrequent and technical error, which may reflect a bank error, has no material bearing on strengthening the broker-dealer's compliance with the Financial Responsibility Rules or safeguarding investor assets.

E. A temporary decline in a broker-dealer's reserve account resulting from the order in which deposits and withdrawals that are intended to be simultaneous are posted should not cause the broker-dealer to be in material non-compliance or show that the broker-dealer has a material weakness in internal controls.

A broker-dealer is required to satisfy its reserve requirement under Rule 15c3-3 by depositing cash and/or qualified securities in its reserve account. A broker-dealer may withdraw qualified securities from the reserve account without making a new reserve account computation if federal funds or other qualified securities are deposited prior to or at the same time as the withdrawal such that the remaining balance equals or exceeds the reserve requirement.

Scenario E: Broker-Dealer E determined that it wanted to substitute qualified securities for cash deposited in its reserve account. Although the substitution was intended to take the form of a simultaneous deposit and withdrawal, the withdrawal of cash posted to the account before the credit of the qualifying securities, causing the balance to drop below the reserve requirement for a temporary period.

Scenario E is not an instance of material non-compliance or evidence of material weakness for the reasons discussed above in Example D.

Similarly, we note that a temporary decline in a broker-dealer's reserve account below the reserve requirement should not be an instance of material non-compliance or evidence of material weakness if the decline resulted from a withdrawal caused by a bank error, clerical error or any factor outside the control of the broker-dealer.

F. A broker-dealer that complies with the Financial Responsibility Rules under its reasonable good faith interpretation of those rules and applicable accounting principles is not in material non-compliance and has not displayed a material weakness, even if it later adopts a different interpretation under which, based on restated past calculations in light of the new interpretation, it would have had a net capital or reserve deposit deficiency (a "hindsight deficiency").

Broker-dealers prepare computations required by Rules 15c3-1 and 15c3-3 on the basis of those rules, applicable accounting standards and interpretations of those rules and standards. Regulators and accounting standard setters have documented many, but not all, such interpretations. In addition, from time to time, they revisit or amend such an interpretation, often prompting broker-dealers to amend computations made prior to the change in interpretation.

Scenario F: Broker-Dealer F calculated its net capital in good faith and based on a reasonable understanding of the Financial Responsibility Rules, accounting standards and interpretations issued in relation thereto. Broker-Dealer F changed its calculation methods based on internal discussion or discussions with its accountants, regulators or peer firms. As a result, Broker-Dealer F recalculated its capital for a period of time in the past and, based on the revised calculation methods, computed a hindsight deficiency in net capital during a past period.

There is no material non-compliance with Rule 15c3-1 because Broker-Dealer F complied with the requirements of the rule under a reasonable, good-faith interpretation of the rule. Similarly, there is no material weakness in internal controls because Broker-Dealer F had been properly calculating its net capital under its prior reasonable, good-faith interpretation. The hindsight deficiency resulted from a change in interpretation of the Financial Responsibility Rules. Regarding this scenario as material in any respect would not serve the purposes of strengthening compliance with the Financial Responsibility Rules or safeguarding investor assets because Scenario F is an inevitable consequence of a world in which broker-dealers must interpret the Financial Responsibility Rules in order to apply them. Treating Scenario F as material non-compliance or evidence of material weakness would only encourage broker-dealers to resist evolution in the interpretation of applicable rules and accounting standards.

G. A broker-dealer's application of a mistaken interpretation of generally accepted accounting principles ("GAAP") that does not affect its calculation of net capital under Rule 15c3-1 or its reserve obligations under Rule 15c3-3 does not constitute material non-compliance with the Financial Responsibility Rules or a material weakness in internal controls over compliance with those rules.

Computations required by Rules 15c3-1 and 15c3-3 are based on financial information prepared under GAAP. In some situations, reviews by a broker-dealer or its auditors may reveal the misapplication of GAAP.

Scenario G: Broker-Dealer G applied Accounting Standards Codification ("ASC") Topic 210-20 to net repurchase transactions ("repos") and reverse repurchase transactions ("reverse repos") in the preparation of its U.S. GAAP balance sheet. Based on a misapplication of ASC 210-20, Broker-Dealer G improperly netted certain repos and reverse repos, resulting in an understatement of its balance sheet. The improper netting

continued for an extended period of time and was significant enough to require Broker-Dealer G to amend its FOCUS report. However, the misapplication of ASC 210-20 did not affect Broker-Dealer G's net capital calculations or its compliance with the other Financial Responsibility Rules.

Scenario G is not an instance of material non-compliance with the net capital rule because Broker-Dealer G's computed net capital was not affected by the deviation from GAAP. Nor is this scenario indicative of material weakness. Under the Commission's proposed definition, a material weakness is the existence of a deficiency in internal controls over compliance with the Financial Responsibility Rules that creates a reasonable possibility that material non-compliance with such rules would not be prevented or timely detected. Because there is no difference in the calculation of net capital if repos and reverse repos are netted or carried gross on the broker-dealer's balance sheet, this misapplication of GAAP could not have resulted in non-compliance with Rule 15c3-1 and therefore could not have reflected a material weakness under the Commission's definition of the term. Under our proposed definition, a material weakness is a material failure of a broker-dealer's systems, policies or practices regarding the Financial Responsibility Rules involving numerous customers, multiple errors or significant dollar amounts. A reasonable, good-faith application of an accounting principle, even if later deemed to be a misapplication, does not reflect a material failure of systems, policies or practices and therefore does not reflect a material weakness under our proposed definition of the term.