



Regulatory and Auditing Changes That Will Affect  
the Financial Services Industry – A Practical  
Discussion  
SIFMA Regional Conference

# Attendees / Disclaimer

- Any of the following present (just so I know):
  - Regulators (probably yes)
  - Law makers (I don't think so)
  - Representatives from the PCAOB or SEC (YES)
  - Press (I don't think so)
- JTH Disclaimer

# Agenda

- **RULES IMPACTING BROKER-DEALERS**
  - SEC Proposed Rules
  - PCAOB Proposed Rules
- **RULES IMPACTING INVESTMENT ADVISERS**
  - Dodd-Frank
    - General Comments
    - Form PF

# Ka-ching versus Value

- Let's keep track of this throughout the presentation



# SEC Proposed Rules

# SEC Proposed Three Amendments

- 1. PCAOB oversight of auditors of broker-dealers
  - Proposed changes to SEC Rule 17a-5
  - PCAOB oversight
  - Align rules with investment adviser rules
- **2. SEC access to auditors of broker-dealers and underlying audit documentation**
- **3. SEC monitoring of broker-dealer's custody practices (Custody Form)**

# 1. Proposed Changes to SEC Rule 17a-5

- Existing annual reporting requirements
  - Auditor's report on the financial statements
  - Auditor's report on the supplemental schedules
    - Net capital
    - Customer reserve requirements
  - **Material inadequacy letter**
  - SIPC
- Proposed reporting requirements
  - Auditor's report on the financial statements
  - Auditor's report on the supplemental schedules
  - **For carrying firms – compliance report / examination report**
  - **For non-clearing firms – exemption report / review report**
  - SIPC – an agreed-upon procedures report
  - ALL PERFORMED PURSUANT TO PROPOSED AUDITING STANDARDS BY THE PCAOB

# Proposed Changes to SEC Rule 17a-5 Compliance Report

- Includes three specific assertions by management:
  - Whether the firm was in compliance with the Financial Responsibility Rules (FRRs) as of FYE
  - Whether the information used to assert compliance with the FRRs was derived from the firm's books and records
  - Whether internal control over compliance with the FRRs **was effective during the FY** such that there were no instances of material weakness
- No assertion over the effectiveness of internal control over financial reporting (SOX) – **thank GOODNESS?????? Really????? – ie – where does it start?????**



# Double Ka-Ching versus Value

- Come on – the entire year.....



# Proposed Audit Report on Supplemental Information for Broker-Dealers

- Our audit was conducted for the purpose of forming an opinion on the financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the financial statements, but is supplementary information required by Rule 17a-5 under the Securities Exchange Act of 1934. Such information is the responsibility of management **and was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements.** The information contained in the schedules has been subjected to the auditing procedures applied in the audit of the financial statements **and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America.** In our opinion, the information presented in Schedules I, II, III, and IV is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

# CFTC

- So – a key question that must be asked is:
  - “WHERE IS THE CFTC ON THIS MATTER?”
- The PCAOB has no jurisdiction over CFTC registrants
- Interesting dilemma for dual registrants
- But wait – there are other rules impacting FCMs – a chief compliance officer

## 2. SEC Access to Audit Documentation

- **Clearing/carrying broker-dealers consent to permit its auditor to:**
  - **Make available audit documentation**
  - **Discuss findings related to audit reports**
- Used in conjunction with routine SEC examinations
- Limited to broker-dealers that:
  - Clear transactions (proprietary trading)
  - Carry customer accounts
- What they are asking for:
  - List of service providers
  - Due diligence documents, background checks, etc.
  - Business continuity plans
  - Disaster recovery plans
  - SAS70
  - Privacy agreements

# Ka-Ching versus Value

- Auditors would typically charge \$\$ for this
- Value?



## 3. Form Custody

- Designed to elicit information concerning whether a broker-dealer:
  - Maintains custody of customer and non-customer assets
  - And, if so, how such assets are maintained
- **Filed quarterly with the FOCUS report**
- No additional audit effort required – THANK GOODNESS

# Form Custody – Ka-ching versus Value

- No ka-ching for external costs
- Internal costs up – systems, controls, procedures, monitoring
- Value - ??????



# PCAOB Rules



# PCAOB Rules

- There are four recent rules issued by the PCAOB, one is final, the other three are proposed.
- Bottom line, these rules now place auditors of broker-dealers subject to review and inspection by the PCAOB – to date, auditors have been subject to very little or no oversight by the SEC
- They also have changed the auditing standards from GAAS to standards of the PCAOB
- The accounting profession and broker-dealers are not sure what to expect when these investigations begin and rules kick in

# PCAOB Inspection Program

- The SEC has recently approved this rule
- There are two principal stated purposes for the rule
  - One, it will allow the PCAOB to assess auditor's compliance with laws, rules, and professional standards in performing audits of broker-dealers
  - Two, it will allow the PCAOB to determine significant elements of a long-term inspection program, so that they can
    - Differentiate between types of broker-dealers – eg decision to only focus on clearing broker-dealers
    - Possibly exempt certain categories of audit firms
    - And determine inspection frequency
- These inspections have begun

# Ka-ching versus Value

- Although not a direct cost by client – if the costs of the audit firm goes up ..... the cost of the audit goes up
- Value - ?????? Difficult to estimate
- Does anybody have **\$274** they can lend me?
- Capital calculations - documentation

# PCAOB Proposed Rules

- Standards for Attestation Engagements (Related to Compliance and Exemption Reports)
  - Align the PCAOB's attestation standards to the proposed SEC auditor's responsibilities re SEC Rule 17a-5
    - General standards (proficiency, independence, etc.)
    - Consideration of materiality
    - Definition of risks of "material non-compliance", including the risk of fraud
    - Requires testing of controls over compliance
    - Reporting
  - **Requires an "engagement quality review" and concurring approval of issuance on all broker-dealers**

# Engagement Quality Reviews and Concurring Reviews

- Concurring Review
- Engagement Quality Review
- **Personal comment – we would typically have a concurring review of a clearing broker-dealer, but**
- **NOT on an introducing broker-dealer – and our comment letter to the PCAOB states that**
- **Typically, we would not have an engagement quality review performed on broker-dealer clients**

# Testing Controls Over Compliance

- **MUST** tests controls – for the auditor to determine that the BD maintains effective internal controls over compliance with each FRR
- **MUST** obtain evidence that the controls over compliance are DESIGNED effectively and OPERATED **effectively during the entire fiscal year**
- **MUST** perform procedures – “compliance tests”
  - Inquiry
  - Observation of operations
  - Inspection of documentation
  - Walkthroughs
  - Re-performance of the control

# Ka-ching versus Value

- **This is a significant change from past practices – where testing compliance with FRRs was primarily a substantive test – really an extension of the audit procedures conducted in the audit of the financial statements**
- **AND for the entire year?**

# Reporting

- Proposed report language is in the rule
- A couple interesting considerations:
  - Work was performed in accordance with the standards of the PCAOB
  - **Requires a manual signature of the auditor**
  - Requires manual filings as the SEC does not have any electronic capabilities



# Tax Returns

- Proposed that auditors would be prohibited from providing any tax service to any person who performs a “financial reporting oversight role” at an audit client
- It would make the auditor appear not independent ?????? Really ??????

# Timing

- ??????
- SEC wants this effective for FY 2012
- PCAOB hinting it might be 2013



# What Can You Do To Prepare for These Proposed Rules

- Assess the adequacy and completeness of your internal control structure, including documentation
- Involve internal audit to test compliance



# Ka-Ching versus Value

- **Be prepared to open your wallets:**
  - **COSTS – estimated by the SEC to be:**
    - \$150,000 for a clearing broker-dealer, and
    - \$3,000 for an introducing firm
  - **I am not sure that I agree with those amounts, would you believe that the PCAOB estimated the additional costs of implementing Sarbanes-Oxley was @ \$96,000.**
  - **The real kick in the pants – you have earned the right to pay for the privilege to pay the PCAOB a fee for the PCAOB to monitor your auditor**
  - **And here's a kick to the chins too – auditors are required to make sure that broker-dealers pay the assessment**



Dodd-Frank

Rules Impacting Investment Advisers



Assurance ■ Tax ■ Consulting

---

# Dodd-Frank – General Comments

And this is all that is proposed so far.....



# Dodd-Frank – General Comments

- Overall, two primary purposes:
  - Detect Fraud
  - Identify systemic risks to protect the US economy

# Form PF

- The Dodd-Frank Act established the Financial Stability Oversight Council (FSOC) for the purpose of monitoring risks to the stability of the U.S. financial system
- “The primary purpose is to provide information that will assist the FSOC in determining how systemic risk should be assessed and monitoring potential systemic risk in the financial system.”
- Created Form PF - information reported would remain confidential



# Form PF – Private Fund Advisers

- SEC and CFTC jointly adopted rule
- SEC rule –
  - Registered investment advisers (RIAs) that:
    - Advise one or more private funds
    - Greater than \$150 million in AUM attributable to private funds
- CFTC rule requires commodity pool operators and commodity trading advisors to file, but only if they are also an RIA
- Proposed compliance dates:
  - Greater than \$5 billion – June 15, 2012
  - Less than \$5 billion – December 15, 2012

# Form PF – Large Advisers

- Liquidity and money market advisers:
  - \$1 billion
  - 15 days after each quarter starting Dec 2012
- Hedge fund advisers:
  - \$1.5 billion
  - 60 days after each quarter starting Dec 2012
- Private equity advisers:
  - \$2.0 billion
  - 120 days after each fiscal year starting Dec 2012

# Large Private Fund Advisers – Private Equity Funds

- Private equity fund advisers would provide information on each of its private equity funds:
  - Name
  - Borrowings
  - Guarantees to portfolio companies
  - Whether the fund invests in financial institutions
  - Investments
    - By industry
    - Geography
  - Leverage of the portfolio companies in which the fund invests
    - Amount and maturity dates
    - Name of lender

# Dodd-Frank – General Comments

- Comments from the 2011 Hedge Fund Association's Risk and Regulation Symposium:
  - It will not be effective in preventing another financial crisis
  - “The SEC is doing its job, but fund managers will find another way; they're smart people”
  - “Fund managers are players, and steps ahead of the game....I don't think the SEC can pass enough laws to regulate the market”
- **Does everybody really think this will stop fraud or protect the economy?**
- **Should I use MF Global to make my point?**

# THE REACTION?



*"These new regulations will fundamentally change the way we get around them."*

# Questions?

For more information please contact:

John Hague

✉ [john.hague@mcgladrey.com](mailto:john.hague@mcgladrey.com)

☎ 312.634.3345

[www.mcgladrey.com](http://www.mcgladrey.com)

# Experience the power of being understood<sup>sm</sup>

## About McGladrey

McGladrey LLP is the fifth largest U.S. provider of assurance, tax and consulting services with 7,000 professionals and associates in nearly 90 offices.

McGladrey LLP is a member of RSM International (“RSMI”). RSM International is the sixth largest network of independent accounting, tax and consulting firms worldwide, with 714 offices in 83 countries, and more than 32,000 people. The member firms of RSMI collaborate to provide services to global clients, but are separate and distinct legal entities which cannot obligate each other. Each member firm is responsible only for its own acts and omissions, and not those of any other party.

We provide assurance, tax and consulting services through our practice areas:

- [Assurance](#)
- [Tax](#)
- [Consulting](#)
- [Wealth Management](#)
- [Retirement Plan](#)
- [Investment Banking](#)
- [International Business](#)

Follow us on:

