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## Brokers and dealers in securities with conforming changes as of July 1, 2013; Audit and accounting guide

American Institute of Certified Public Accountants (AICPA)

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### Recommended Citation

American Institute of Certified Public Accountants (AICPA), "Brokers and dealers in securities with conforming changes as of July 1, 2013; Audit and accounting guide" (2013). *Industry Guides (AAGs), Risk Alerts, and Checklists*. 1258.

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AUDIT & ACCOUNTING GUIDE

# Brokers and Dealers in Securities

JULY 1, 2013



Brokers and Dealers in Securities

July 1, 2013



## Brokers and Dealers in Securities

ISBN 978-1-93735-289-9



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AUDIT & ACCOUNTING GUIDE

# Brokers and Dealers in Securities

JULY 1, 2013

12847-359

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New York, NY 10036-8775

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1 2 3 4 5 6 7 8 9 0 AAP 1 9 8 7 6 5 4 3

ISBN 978-1-93735-289-9

## Preface

### About AICPA Audit and Accounting Guides

This AICPA Audit and Accounting Guide has been developed by the AICPA Stockbrokerage and Investment Banking Committee to assist management in the preparation of their financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) and to assist practitioners in performing and reporting on their audit engagements.

The Financial Reporting Executive Committee (FinREC) is the designated senior committee of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. Conforming changes made to the financial accounting and reporting guidance contained in this guide are approved by the FinREC chair (or his or her designee). Updates made to the financial accounting and reporting guidance in this guide exceeding that of conforming changes are approved by the affirmative vote of at least two-thirds of the members of FinREC.

This guide does the following:

- Identifies certain requirements set forth in Financial Accounting Standards Board (FASB) *Accounting Standards Codification*<sup>®</sup> (ASC).
- Describes FinREC's understanding of prevalent or sole industry practice concerning certain issues. In addition, this guide may indicate that FinREC expresses a preference for the prevalent or sole industry practice, or it may indicate that FinREC expresses a preference for another practice that is not the prevalent or sole industry practice; alternatively, FinREC may express no view on the matter.
- Identifies certain other, but not necessarily all, industry practices concerning certain accounting issues without expressing FinREC's views on them.
- Provides guidance that has been supported by FinREC on the accounting, reporting, or disclosure treatment of transactions or events that are not set forth in FASB ASC.

Accounting guidance for nongovernmental entities included in an AICPA Audit and Accounting Guide is a source of nonauthoritative accounting guidance. As discussed later in this preface, FASB ASC is the authoritative source of U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the Securities and Exchange Commission (SEC). Accounting guidance for governmental entities included in an AICPA Audit and Accounting Guide is a source of authoritative accounting guidance described in category (b) of the hierarchy of GAAP for state and local governmental entities and has been cleared by the Governmental Accounting Standards Board. AICPA members should be prepared to justify departures from GAAP, as discussed in Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, ET sec. 203 par. .01).

Auditing guidance included in an AICPA Audit and Accounting Guide is recognized as an interpretive publication pursuant to AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Interpretive publications are recommendations on the application of generally accepted auditing standards (GAAS) in specific circumstances, including engagements for entities in specialized industries.

An interpretive publication is issued under the authority of the AICPA Auditing Standards Board (ASB) after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with GAAS. The members of the ASB have found this guide to be consistent with existing GAAS.

Although interpretive publications are not auditing standards, AU-C section 200 requires the auditor to consider applicable interpretive publications in planning and performing the audit because interpretive publications are relevant to the proper application of GAAS in specific circumstances. If the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should document how the requirements of GAAS were complied with in the circumstances addressed by such auditing guidance.

The ASB is the designated senior committee of the AICPA authorized to speak for the AICPA on all matters related to auditing. Conforming changes made to the auditing guidance contained in this guide are approved by the ASB chair (or his or her designee) and the director of the AICPA Audit and Attest Standards staff. Updates made to the auditing guidance in this guide exceeding that of conforming changes are issued after all ASB members have been provided an opportunity to consider and comment on whether the guide is consistent with the Statements on Auditing Standards (SASs).

## Recognition

### AICPA Senior Committees

#### Auditing Standards Board

Mike Santay, *ASB Member*

Bruce P. Webb, *Chair*

#### Financial Reporting Executive Committee

Mark Scoles, *FinREC Member*

Richard C. Paul, *Chair*

The AICPA gratefully acknowledges those members of the AICPA Stockbrokerage and Investment Banking Committee (2012–2013) who reviewed or otherwise contributed to the development of this edition of the guide:

Stephen Zammitti, *Chair*

David Bonnar

Christopher Donovan

Michael Fehrman

Craig Goodman

Christopher Johnson

Paul Lameo

Michael McQuade

Paul Nockels

Daniel Palomaki

Mark Ramler

Michael Smith

In addition to the 2012–2013 expert panel members listed, the AICPA gratefully acknowledges those who reviewed and otherwise contributed to the development of this guide: Margaret Dennis, Andrew Labadie, Marshall Levinson, Nicole Luft, Michael Macchiaroli, Kathryn Mahoney, Katherine Mohrhauser, Douglas Van Ness, Stephen Verrone, and Tim Vintzel.

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AICPA Stockbrokerage and Investment Banking Committee Expert Panel

## **Guidance Considered in This Guide**

This edition of the guide has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative guidance since the guide was originally issued, and other revisions as deemed appropriate. Authoritative guidance issued through July 1, 2013, has been considered in the development of this edition of the guide.

Authoritative guidance that is issued and effective for entities with fiscal years ending on or before July 1, 2013, is incorporated directly into the text of this guide. Authoritative guidance issued but not yet effective for fiscal years ending on or July 1, 2013, is being presented as a guidance update. A guidance update is a shaded area that contains information on the guidance issued but not yet effective and a reference to appendix A, “Guidance Updates,” where appropriate. The distinct presentation of this content is intended to aid the reader in differentiating content that may not be effective for the reader’s purposes.

This includes relevant guidance issued up to and including the following:

- FASB Accounting Standards Update (ASU) No. 2013-08, *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements*
- SAS No. 127, *Omnibus Statement on Auditing Standards—2013* (AICPA, *Professional Standards*)
- Statement of Position 13-1, *Attest Engagements on Greenhouse Gas Emissions Information* (AICPA, *Technical Practice Aids*, AUD sec. 14,460)
- Statement on Standards for Attestation Engagements (SSAE) No. 17, *Reporting on Compiled Prospective Financial Statements When the Practitioner’s Independence Is Impaired* (AICPA, *Professional Standards*, AT sec. 301 par. .23)
- Interpretation No. 1, “Reporting Under Section 112 of the Federal Deposit Insurance Corporation Improvement Act,” of AT section 501, *An Examination of an Entity’s Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*, AT sec. 9501 par. .01–.07)

- Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 16, *Communications with Audit Committees* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards)

Users of this guide should consider guidance issued subsequent to those listed previously to determine their effect on entities covered by this guide. In determining the applicability of recently issued guidance, its effective date should also be considered.

The changes made to this edition of the guide are identified in the schedule of changes in appendix P, “Schedule of Changes Made to the Text From the Previous Edition.” The changes do not include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

## FASB ASC Pending Content

### Presentation of Pending Content in FASB ASC

Amendments to FASB ASC (issued in the form of ASUs) are initially incorporated into FASB ASC in “pending content” boxes below the paragraphs being amended with links to the transition information. The pending content boxes are meant to provide users with information about how the guidance in a paragraph will change as a result of the new guidance.

Pending content applies to different entities at different times due to varying fiscal year-ends, and because certain guidance may be effective on different dates for public and nonpublic entities. As such, FASB maintains amended guidance in pending content boxes within FASB ASC until the “roll-off” date. Generally, the roll-off date is six months following the latest fiscal year end for which the original guidance being amended could still be applied.

### Presentation of FASB ASC Pending Content in AICPA Audit and Accounting Guides

Amended FASB ASC guidance that is included in pending content boxes in FASB ASC on July 1, 2013, is referenced as “Pending Content” in this guide. Readers should be aware that “Pending Content” referenced in this guide will eventually be subjected to FASB’s roll-off process and no longer be labeled as “Pending Content” in FASB ASC (as discussed in the previous paragraph).

## Defining Professional Responsibilities in AICPA Professional Standards

AICPA professional standards applicable to audit engagements use the following two categories of professional requirements, identified by specific terms, to describe the degree of responsibility they impose on auditors:

- *Unconditional requirements.* The auditor must comply with an unconditional requirement in all cases in which such requirement is relevant. GAAS use the word “must” to indicate an unconditional requirement.
- *Presumptively mandatory requirements.* The auditor must comply with a presumptively mandatory requirement in all cases in which such a requirement is relevant except in rare circumstances. GAAS



use the word “should” to indicate a presumptively mandatory requirement.

In rare circumstances, the auditor may judge it necessary to depart from a relevant presumptively mandatory requirement. In such circumstances, the auditor should perform alternative audit procedures to achieve the intent of that requirement. The need for the auditor to depart from a relevant presumptively mandatory requirement is expected to arise only when the requirement is for a specific procedure to be performed, and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the intent of the requirement.

Prior to SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification* (AICPA, *Professional Standards*), the phrase *is required to* or *requires* was used to express an unconditional requirement in GAAS (equivalent to must). With the issuance of SAS No. 122, the phrases *is required to* and *requires* do not convey a requirement or the degree of responsibility it imposes on auditors. Instead, those terms are used to express that a requirement exists. The terms are typically used in the clarified auditing standards to indicate that a requirement exists elsewhere in GAAS.

See the following section for information on defining professional requirements related to auditing standards.

## Applicability of GAAS and PCAOB Standards

Audits of the financial statements of *nonissuer broker-dealers* (those broker-dealers that are not subject to the Sarbanes-Oxley Act of 2002 [SOX], but are subject to the rules of the SEC; generally speaking, this refers to private entities) are conducted in accordance with GAAS,<sup>1</sup> as issued by the ASB, the designated senior committee of the AICPA with the authority to promulgate auditing standards for nonissuers. The ASB develops and issues standards in the form of SASs through a due process that includes deliberation in meetings open to the public, public exposure of proposed SASs, and a formal vote. The SASs and their related interpretations are codified in the AICPA’s *Professional Standards*. Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, ET sec. 202 par. .01), of the AICPA Code of Professional Conduct requires an AICPA member who performs an audit to comply with the standards promulgated by the ASB. Failure to follow GAAS, and any other applicable auditing standards, is a violation of that rule.

Audits of the financial statements of *issuer broker-dealers*, as defined by the SEC (those broker-dealers that are subject to SOX and the rules of the SEC; generally speaking, this refers to public entities), are conducted in accordance with standards established by the PCAOB, a private sector, nonprofit corporation created by SOX to oversee the audits of issuers. The SEC has oversight authority over the PCAOB, including approval of its rules, standards, and budget.

## References to Professional Standards

In citing GAAS and its related interpretations, references use section numbers within the codification of currently effective SASs, not the original statement number, as appropriate. In those sections of the guide that refer to specific

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<sup>1</sup> See the “PCAOB Oversight” section for information related to the Public Company Accounting Oversight Board’s oversight of audits of broker-dealers.

auditing standards of the PCAOB, references are made to the AICPA's *PCAOB Standards and Related Rules* publication.

## AICPA.org Website

The AICPA encourages you to visit its website at [www.aicpa.org](http://www.aicpa.org) and the Financial Reporting Center (FRC) website at [www.aicpa.org/FRC](http://www.aicpa.org/FRC). The FRC supports members in the execution of high-quality financial reporting. Whether you are a financial statement preparer or member in public practice, this center provides exclusive member-only resources for the entire financial reporting process and timely and relevant news, guidance, and examples supporting the financial reporting process, including accounting; preparing financial statements; and performing compilation, review, audit, attest or assurance, and advisory engagements. Certain content on the AICPA's websites referenced in this guide may be restricted to AICPA members only.

## Select Recent Developments Significant to This Guide

### SEC Rule 17a-5 Revisions

On June 15, 2011, the SEC issued Release No. 34-64676, *Broker-Dealer Reports*, which proposes amendments to the broker-dealer financial reporting rule under the Securities Exchange Act of 1934 (the 1934 Act). The proposed rule revises SEC Rule 17a-5 and includes three sets of amendments that, among other things,

- updates the existing requirements of Rule 17a-5.
- facilitates the ability of the PCAOB to implement oversight of audits of broker-dealers as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).
- enhances oversight of broker-dealer custody practices, including a requirement for broker-dealers to file a new form, Form Custody.
- eliminates potentially redundant requirements for certain broker-dealers affiliated with, or dually registered as, investment advisers.

As of the date of this guide, the rule has not yet been finalized. It is important to be alert for further developments. See appendix A, "Proposed Rulemaking," of chapter 3, "Regulatory Considerations," for more information on rulemaking related to broker-dealers.

### PCAOB Oversight

The Dodd-Frank Act amends SOX to give the PCAOB full oversight authority over audits of all broker-dealers (including nonissuers), which includes standard setting, inspection, and enforcement. PCAOB oversight includes a provision that audits of nonissuer broker-dealers are to be conducted in accordance with PCAOB auditing standards. However, the SEC has issued transitional guidance in Release No. 34-62991, *Commission Guidance Regarding Auditing, Attestation and Related Professional Practice Standards Related to Brokers and Dealers*, which clarifies that audits of nonissuer broker-dealers will continue to be performed under GAAS and any applicable rules of the SEC. As noted in the release, this interpretation will be revisited in connection with pending rule-making projects.

As of the date of this guide, the SEC has approved two rules related to PCAOB oversight. The first is a rule that establishes an interim inspection program

related to audits of broker-dealers. See chapter 5, “Auditing Considerations,” of this guide for more information. The second rule amends PCAOB funding rules to provide for a portion of the accounting support fee (previously assessed on issuers only) to be allocated among a certain class of broker-dealers. See the discussion in chapter 3 of this guide for more information.

## ASB’s Clarity Project

To address concerns over the clarity, length, and complexity of its standards, the ASB has made a significant effort to clarify the SASs. The ASB established clarity drafting conventions and undertook to redraft all its SASs in accordance with those conventions that include the following:

- Establishing objectives for each clarified SAS
- Including a definitions section, when relevant, in each clarified SAS
- Separating requirements from application and other explanatory material
- Numbering application and other explanatory material paragraphs using an “A-” prefix and presenting them in a separate section that follows the requirements section
- Using formatting techniques, such as bulleted lists, to enhance readability
- Including, when appropriate, special considerations relevant to audits of smaller, less complex entities within the text of the clarified SAS
- Including, when appropriate, special considerations relevant to audits of governmental entities within the text of the clarified SAS

In addition, as the ASB redrafted standards for clarity, it also converged the standards with the International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board. As part of redrafting the standards, they now specify more clearly the objectives of the auditor and the requirements the auditor has to comply with when conducting an audit in accordance with GAAS.

With the release of SAS Nos. 117–120 and Nos. 122–127, the project is near completion. An exposure draft was released on April 15, 2013, for the only SAS remaining to be clarified, SAS No. 65, *The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, AU sec. 322). Comments were due on July 15, 2013. Note that SAS No. 122 withdraws SAS No. 26, *Association With Financial Statements*, from *Professional Standards*.

SAS Nos. 122–127 are effective for audits of financial statements for periods ending on or after December 15, 2012. Refer to individual AU-C sections for specific effective date language.

As part of the clarity project, current AU section numbers have been renumbered based on equivalent ISAs. Guidance is located in “AU-C” section numbers instead of “AU” section numbers. Note that AU-C section numbers for clarified SASs with no equivalent ISAs have been assigned new numbers. The ASB believes that this recodification structure will aid firms and practitioners that use both ISAs and GAAS. All auditing interpretations corresponding to a SAS have been considered in the development of a clarified SAS and incorporated accordingly, and have been withdrawn by the ASB except for certain interpretations that the ASB has retained and revised to reflect the issuance of SAS No.

122. The effective date of the revised interpretations aligns with the effective date of the corresponding clarified SAS.

The “AU-C” identifier was established to avoid confusion with references to existing “AU” sections, which will remain in *Professional Standards* through 2013. The AU-C identifier had been scheduled to revert back to the AU identifier at the end of 2013, by which time the previous AU sections would be superseded for all engagements. However, in response to user requests, the AU-C identifier will be retained indefinitely. The superseded AU sections are still scheduled to be removed from *Professional Standards* at the end of 2013.

## International Financial Reporting Standards

The AICPA Governing Council voted in May 2008 to recognize the International Accounting Standards Board (IASB) as an accounting body for purposes of establishing international financial accounting and reporting principles. This amendment to appendix A of Rule 202 and to Rule 203 of the AICPA’s Code of Professional Conduct gives AICPA members the option to use International Financial Reporting Standards (IFRSs) as an alternative to GAAP. As a result, private entities in the United States can prepare their financial statements in accordance with GAAP as promulgated by FASB; an other comprehensive basis of accounting, such as cash or tax basis; or IFRSs, among others. However, domestic issuers are currently required to follow GAAP and rules and regulations of the SEC. In contrast, foreign private issuers may present their financial statements in accordance with IFRSs as issued by the IASB without a reconciliation to GAAP or in accordance with non-IFRSs home-country GAAP reconciled to GAAP as permitted by Form 20-F.

The growing acceptance of IFRSs as a basis for U.S. financial reporting could represent a fundamental change for the U.S. accounting profession. Acceptance of a single set of high-quality accounting standards for worldwide use by public companies has been gaining momentum around the globe for the past few years. See appendix O, “International Financial Reporting Standards,” of this guide for a discerning look at the status of convergence with IFRSs in the United States and the important issues that accounting professionals need to consider now.

## Purpose and Applicability

This AICPA Audit and Accounting Guide has been prepared to assist broker-dealers in preparing financial statements in conformity with GAAP and to assist independent accountants in reporting on financial statements (and other written management assertions) of those entities. It is important to note that the content in this guide is directed toward nonissuer broker-dealers and their auditors.

This guide applies to the preparation and audit of financial statements of entities that are broker-dealers. The activities of broker-dealers are described in chapter 1, “The Securities Industry.” Operations of such entities are subject to the rules and regulations of the SEC and other regulatory bodies.

Broker-dealers are subject to regulation under the 1934 Act. Some broker-dealers are also futures commission merchants for commodity futures and commodity option contracts subject to regulation under the Commodity Exchange Act.

Members of the Financial Industry Regulatory Authority are subject to the rules of that organization, and members of securities exchanges are also subject to the rules of the exchanges of which they are members. Some of these rules,

as currently in effect, are discussed in this guide. However, the rules, regulations, practices, and procedures of the securities and commodities futures industries have changed frequently and extensively in recent years. Still, further changes are under consideration as this guide goes to press, and the auditor should keep abreast of these changes.

## Limitations

The guide is intended to highlight significant matters and establish general guidance. It is not intended to provide a comprehensive discussion of all possible matters of significance in an audit of financial statements or all audit situations that an independent accountant might encounter in an audit of the financial statements of a broker-dealer.

Consulting the accounting and financial reporting and auditing sections of the guide cannot take the place of a careful reading of specified authoritative literature. Further, the nature, timing, and extent of audit procedures applied in a financial audit are ultimately determined by the independent accountant in the circumstances. The procedures discussed in the auditing section of the guide are not intended to be comprehensive and, performed by themselves, would not necessarily constitute an audit in accordance with GAAS nor would omission of certain procedures set forth in the guide necessarily result in a violation of GAAS. Internal control over financial reporting and possible tests of controls are discussed in the context of a financial statement audit. Although they may correspond to controls that are subject to procedures performed in an engagement performed in accordance with PCAOB standards or SSAEs, internal control over financial reporting and possible tests of controls are not presented in that context and are not intended to address the considerations of such engagements.

## Applicability of Requirements of SOX

Publicly held companies and other issuers (see the definition that follows) are subject to the provisions of SOX and related SEC regulations implementing SOX. Their outside auditors are also subject to the provisions of SOX and the rules and standards issued by the PCAOB.

Section 205(c)(2) of SOX amended *Commerce and Trade, U.S. Code (USC)* Title 15 Section 78q of the 1934 Act to require all broker-dealers (both issuer and nonissuer) to be audited by a public accounting firm registered with the PCAOB. For fiscal years ending after December 31, 2008, the financial statements of nonissuer broker-dealers must be certified by a public accounting firm that is registered with the PCAOB.

The following sections summarize certain key areas addressed by SOX, the SEC, and the PCAOB that are particularly relevant to the preparation and issuance of an issuer's financial statements and the preparation and issuance of an audit report on those financial statements. However, the provisions of SOX, the regulations of the SEC, and the rules and standards of the PCAOB are numerous and are not all addressed in this section or guide.

### *Definition of an Issuer*

SOX states that the term *issuer* means an issuer (as defined in Section 3 of the 1934 Act [15 USC 78(c)]), the securities of which are registered under Section 12 of that act (15 USC 781) or that is required to file reports under Section 15(d) (15 USC 78o[d]), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 USC 77[a] et seq.), and that it has not withdrawn.

*Issuers*, as defined by SOX, and other entities when prescribed by the rules of the SEC (collectively referred to in this guide as issuers or issuer) and their public accounting firms (that must be registered with the PCAOB) are subject to the provisions of SOX, implementing SEC regulations, and the rules and standards of the PCAOB, as appropriate.

*Nonissuers* are those entities not subject to SOX or the rules of the SEC. However, nonissuer broker-dealers are subject to regulation by the SEC. See the “Guidance for Nonissuer Broker-Dealers” section of this preface and the discussion beginning in paragraph 1.47. Note that the information in this guide is directed toward nonissuer broker-dealers.

## Guidance for Issuers

### *Management Assessment of Internal Control*

As directed by Section 404 of SOX, the SEC adopted final rules requiring companies subject to the reporting requirements of the 1934 Act, other than registered investment companies and certain other entities, to include in their annual reports a report from management on the company’s internal control over financial reporting. Business development companies, however, do not fall within the scope exception contained in Section 405 of SOX and are required to include a report from management on the company’s internal control over financial reporting. The SEC rules clarify that management’s assessment and report is limited to internal control over financial reporting. The SEC’s definition of *internal control* encompasses the Committee of Sponsoring Organizations of the Treadway Commission (COSO) definition, but the SEC does not mandate that the entity use COSO as its criteria for judging effectiveness.<sup>2</sup>

As established by Rule 12b-2 of the 1934 Act, the auditor’s attestation requirement for large accelerated and accelerated filers is currently effective. The Dodd-Frank Act amended Section 404 of SOX to permanently exclude nonaccelerated filers from the auditor attestation requirement of Section 404(b).

### Guidance for Auditors of Issuer Broker-Dealers

SOX mandates a number of requirements concerning auditors of issuers, including mandatory registration with the PCAOB and, the setting of auditing standards, inspections, investigations, disciplinary proceedings, prohibited activities, partner rotation, and reports to audit committees, among others. The PCAOB continues to establish rules and standards implementing provisions of SOX concerning the auditors of issuers.

### Guidance for Nonissuer Broker-Dealers

Pursuant to the 1934 Act, the SEC developed a comprehensive system to regulate broker-dealers, and the securities industry in general. As a result, broker-dealers, including nonissuer broker-dealers, are subject to regulation by the SEC.

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<sup>2</sup> COSO’s *Internal Control—Integrated Framework* (framework), first developed in 1992, is one of the most widely accepted frameworks for designing and evaluating systems of internal control. The framework has been updated to make it more relevant in the current business environment—one that has become more complex and technologically driven in the 20 years since the original framework was established. Although the updated framework does not alter the fundamental principles found in the original framework, it builds on what has proven effective in the original framework. See further discussion of the updated framework in chapter 6, “Internal Control.”

## **Guidance for Auditors of Nonissuer Broker-Dealers**

As mentioned previously, auditors of nonissuer broker-dealers are required to be registered with the PCAOB in order to audit the financial statements of a broker-dealer for fiscal years ending after December 31, 2008. However, although issuer broker-dealers are required to be audited under PCAOB auditing standards, nonissuer broker-dealers currently are not. A PCAOB-registered auditor of a nonissuer broker-dealer currently performs the audit under GAAS. (See the “PCAOB Oversight,” section of this preface for an update of developments in this area.)

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## Glossary

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## Chapter 1

# The Securities Industry<sup>1</sup>

**1.01** The securities industry has played an important role in the growth of U.S. business by providing a market for the initial offering and subsequent purchase and sale of securities. The industry has made investment in securities more readily available to the public and provided it with many diverse financial products. Through efficient financial markets, the industry has made it possible for business entities and governmental agencies to raise capital.

**1.02** The securities industry has accomplished its role through a variety of financial products, services, and institutions. Capital formation is achieved through public offerings, private placements, asset securitization, and merchant banking activities. Efficient secondary markets are maintained when securities firms act as agents for customers' securities transactions, trading, and arbitrage activities through a broker and dealer's (broker-dealer's) own accounts, market-making, and specialist activities. The securities industry also aids the risk mitigation process through a variety of transactions, products, and techniques, such as futures, forwards, swaps, and options.

**1.03** Many different institutions facilitate the processing of the products and services. The following are some of the key types of institutions that the securities industry comprises:

- Broker-dealers
- The financial markets (exchange markets and over-the-counter [OTC] markets)
- Clearing organizations and depositories
- Transfer agents and registrars
- Qualified custodians
- Regulatory agencies

## Broker-Dealers

**1.04** Pursuant to the Securities Exchange Act of 1934 (1934 Act), the Securities and Exchange Commission (SEC) developed a comprehensive system to regulate broker-dealers and the securities industry in general. As a result, nonissuer and issuer broker-dealers<sup>2</sup> are subject to regulation by the SEC.

**1.05** Audits of the financial statements of *nonissuer broker-dealers* (those broker-dealers that are not subject to the Sarbanes-Oxley Act of 2002 [SOX]), but are subject to the rules of the SEC; generally speaking, this refers to private

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<sup>1</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), passed in July 2010, set in motion a multiyear rulemaking process that changes the structure of federal financial regulation and institutes new requirements for a number of industries and market participants. Rulemaking continues in a number of areas. Upon full implementation of its provisions, the act will have a significant impact on the securities industry. See the preface and appendix A, "Proposed Rulemaking," of chapter 3, "Regulatory Considerations," for more information.

<sup>2</sup> For more information on nonissuer and issuer broker-dealers, see the "Applicability of GAAS and PCAOB Standards" section in the preface of this guide.

entities) are conducted in accordance with generally accepted auditing standards (GAAS), as issued by the AICPA Auditing Standards Board (ASB). Audits of the financial statements of *issuer broker-dealers*, as defined by the SEC (those broker-dealers that are subject to SOX and the rules of the SEC; generally speaking, this refers to public entities), are conducted in accordance with standards established by the Public Company Accounting Oversight Board, a private sector, nonprofit corporation created by SOX to oversee the audits of issuers. Note that this guide is directed primarily toward nonissuer broker-dealers; however, it does contain limited content regarding audits of issuer broker-dealers.

**1.06** Securities broker-dealers perform various functions within the securities industry. Brokers acting as agents facilitate their customers' purchase and sale of securities, commodities, and related financial instruments and usually charge commissions. Dealers or traders acting as principals buy and sell for their own accounts from and to customers and other dealers. Dealers typically carry an inventory and make a profit or loss on the spread between bid and asked prices or on markups from dealer prices, or they make a speculative profit or loss on market fluctuations. Many firms are known as broker-dealers because they act in both capacities. The range of their activities can go far beyond those described previously. For example, many broker-dealers provide such financial services as the following:

- Underwriting, or participating in the underwriting of, publicly offered securities
- Assisting in the private placement of securities
- Providing investment research and advice
- Developing new financial products, including derivative products
- Providing a source of market liquidity (market makers and specialists) and creating a secondary market for many products
- Providing loans and financings, including equity loans and mortgage loans
- Providing the means for companies to hedge foreign currency, interest rate, and other risk
- Accommodating international investing, including U.S. investment in foreign markets and the investment activity of foreign investors in the U.S. markets
- Extending credit to customers who have bought securities on margin and to business entities that need financing for mergers, acquisitions, or leveraged buyouts
- Acting as a depository for securities owned by customers; disbursing to customers dividends and interest received; and informing customers about calls, tenders, and other reorganization activities pertaining to their securities
- Serving in an advisory capacity for public and corporate finance activities (such as mergers and acquisitions and leveraged buyouts) and providing investment and management advisory services to individuals, business entities, and others (such as mutual funds)
- Providing many other financial services (such as credit cards, checking accounts, and insurance products)

**1.07** Many types of broker-dealers exist, and they may be distinguished by the range of activities they perform or the geographical area in which they operate. Full-service broker-dealers do not restrict themselves to particular activities or services. Regional broker-dealers are similar but generally limit their activities to a specific geographical area. Retail broker-dealers focus on individuals, whereas institutional broker-dealers are primarily concerned with nonnatural persons (for example, corporations). Introducing broker-dealers “introduce” their customers’ business—on an omnibus or a fully disclosed basis—to a clearing broker-dealer that may clear or carry introducing firms’ customer accounts. Broker-dealers may also be self-clearing. Boutiques or specialty firms, in contrast, engage in only one or a few activities, such as leveraged buyouts, arbitrage, direct private placements, mergers and acquisitions, customer discretionary accounts, or industry-specific research.

## Discount Brokers

**1.08** On May 1, 1975, fixed commission rates on securities transactions were abolished. With fully negotiated commissions, the discount broker assumed a role in the securities markets. Discount brokers generally charge lower commissions than full-service broker-dealers and provide fewer services. For example, they frequently provide no research support or little, if any, investment advice. Due to technological advances and the growth and popularity of the Internet, the major discount broker-dealers typically have their customers place securities transactions or otherwise manage their brokerage accounts through their websites rather than through a registered representative.

## Investment Bankers

**1.09** *Investment bankers* are broker-dealers who assist in bringing new securities to the investing public. The three major functions of investment bankers are origination, underwriting, and distribution. New securities are created during origination, bought by investment bankers during underwriting, and sold to investors during the distribution phase. Investment banking revenues are derived principally from fees for services and price spreads from underwriting securities issues.

**1.10** Because new security issuances are complex, many security issuers look to the investment banker for investment advice, information, and assistance. Issuers depend heavily on investment bankers who are financial market specialists to create securities that meet most of the issuers’ needs and, simultaneously, are acceptable to investors. For a new issue, the investment banker commonly does the following:

- Advises the issuer on the kind of security, timing of the issuance, pricing, and specific terms that are most acceptable during contemporary financial market conditions
- Prepares and assists in filing a registration statement with the Securities and Exchange Commission (SEC)
- Arranges for the efficient distribution of the new issue
- Arranges for a number of operational requirements, such as trustees, security indentures, and safekeeping

**1.11** Investment banking firms often buy (or underwrite) a new issue or guarantee its sale at a specified price. If the securities are not sold to investors at the offering price, the investment banker may be required to buy the

securities for its own account. To sell the issue quickly, a syndicate of many firms is often formed for each issue, and the securities are distributed through a large network, reaching many potential investors. Historically, large syndicates, comprising many firms, were formed to create networks for selling issues quickly. Although this process continues for initial public offerings of equity securities, the advent of the shelf registration process for certain debt securities has increased the speed with which these issues are brought to market. As a result, the underwriters that usually make up the underwriting group for distributing these securities are fewer and have larger capital bases.

## Government Securities Dealers

**1.12** *U.S. government securities dealers* are a group of dealer firms that underwrite and trade U.S. government and federal agency securities. Certain of these firms are designated by the Federal Reserve Bank of New York as primary dealers in U.S. government securities, and they deal directly with U.S. government fiscal agents (the Federal Reserve Banks) in acquiring new securities issues. These dealers make a market in most U.S. government and federal agency securities and, as such, quote bid and asked prices. In addition to complying with the rules and regulations promulgated by the SEC pursuant to the federal securities laws, these broker-dealers are also subject to certain rules and regulations of the Department of the Treasury. See chapter 3, “Regulatory Considerations,” for specific rule provisions relating to government securities dealers.

## Specialists

**1.13** A *specialist* is a broker-dealer authorized by an exchange to be a party through which all trading on the floor of the exchange in a particular security is transacted. A specialist provides for a fair and an orderly market for the selected list of securities it is authorized to trade. The specialist must generally be ready to take the other side of a transaction if other buyers or sellers are not available. The specialist also maintains a book of limit orders and acts as a broker’s broker in executing these limit orders against incoming market orders.

## Clearing Brokers

**1.14** A *clearing broker* is a broker-dealer who receives and executes customers’ instructions, prepares trade confirmations, settles the money related to the trades, arranges for the book entry (or physical movement) of the securities, and shares responsibility with the introducing brokers for compliance with regulatory requirements. See paragraph 1.41 for a discussion of the delivery of securities.

## Carrying Brokers

**1.15** A *carrying broker* is a broker-dealer that holds customer accounts for introducing broker-dealers. Typically, this type of firm is also a clearing firm for those introducing firms. A carrying broker-dealer is responsible for performing the customer reserve computation and possession and control requirements of SEC Rule 15c3-3. A carrying broker-dealer may carry customer accounts on an omnibus or a fully-disclosed basis. See chapter 5, “Auditing Considerations,” for a discussion of omnibus and fully disclosed accounts.

## Prime Brokers

**1.16** *Prime brokerage* is a system developed by full-service broker-dealers to facilitate the clearance and settlement of securities trades for substantial retail and institutional customers who are active market participants. Prime brokerage involves three distinct parties: the prime broker, the executing broker, and the customer. The *prime broker* is the broker-dealer that clears and finances the customer trades executed by one or more executing broker-dealers at the behest of the customer. Prime brokers typically provide services such as securities lending, financing, customized technology, and operational support. In addition, a prime broker may also offer other value-added services such as capital introduction and risk management. Most prime brokerage agreements are executed with hedge funds and separately managed accounts.

## Introducing Brokers

**1.17** An *introducing broker* is a broker-dealer firm that accepts customer orders but elects to clear the orders through another broker for cost efficiencies (for example, not having to perform all the clearance functions on a small volume of business, thereby eliminating many fixed costs). In this arrangement, the introducing broker accepts the customers' orders and the clearing brokers or other parties clear the trades. Either party may initiate the execution of a trade. The clearing broker-dealer processes and settles the customer transactions for the introducing broker and usually maintains detailed customer records. Essentially, the introducing broker is using the back-office processing of the clearing broker-dealer. The commissions received from the transactions are collected by the clearing broker and divided in any manner agreed to by the introducing and clearing broker-dealers and stipulated in written contracts.

## Brokers' Brokers

**1.18** A *broker's broker* is a broker-dealer firm that acts as an agent for an undisclosed principal (another broker-dealer) for the purchase and sale of treasury, municipal, and corporate debt securities. These firms do not maintain securities inventories. Brokers' brokers play a significant role in the secondary market as intermediaries for trades between broker-dealers. Brokers' brokers typically provide the bid and ask prices for securities of their client on an undisclosed basis on trading screens of the brokers' broker and then match up buyers and sellers. Brokers' brokers commonly deal in treasury, municipal, and corporate bond trading businesses for which no exchanges are available. Some brokers' brokers concentrate in certain kinds of securities and act as intermediaries for registered dealers and receive commissions that are usually determined by the size of the transaction.

## Bank-Owned Brokers (Section 4k4[e] and Section 20 Brokers)

**1.19** A Section 20 broker was established by a bank pursuant to Section 20 of the Glass-Steagall Act of 1933. The Gramm-Leach-Bliley Act of 1999, also known as the Financial Services Modernization Act, repealed Section 20 of the Glass-Steagall Act of 1933 and changed the types of activities that are permissible for bank holding company affiliates and subsidiaries of banks, creating so-called "financial holding companies" that may engage in a broad array of activities. Financial holding company affiliates, as well as direct subsidiaries of banks, may now engage in underwriting, dealing in, or making a market in securities. Broker-dealers of financial holding companies are now subject to the

rules pursuant to Section 4k4(e) of the Gramm-Leach-Bliley Act of 1999. The Gramm-Leach-Bliley Act of 1999 affirmed the concept of functional regulation. Federal banking regulators will continue to be primary supervisors of the banking affiliates of financial holding companies, and the SEC and securities self-regulatory organizations will supervise the securities businesses of those entities.

## The Financial Markets

**1.20** Financial markets comprise many types of participants, both domestic and foreign, in which securities are bought and sold. International financial markets continue to grow and gain in sophistication. Many financial organizations are involved with international trading strategies to gain the advantages of the global marketplace, as well as different tax policies and trading activities. International trading markets vary depending on the country or community in which the market exists, and international settlement procedures vary depending on the exchange or the local country rules. Some exchanges exhibit more sophisticated or faster trade and settlement characteristics than U.S. exchanges; others trade securities in a negotiated fashion with lengthy settlement periods.

**1.21** Financial markets can be categorized according to the kinds of instruments traded (such as futures, options, municipals, equities, and government and corporate debt). Financial markets have primary and secondary market operations. Primary markets provide for the original distribution of new securities. Secondary markets, which consist of exchanges and OTC markets, provide for the resale of securities. In addition, the characteristics of the securities traded may be used to categorize the financial markets. For example, the markets for U.S. Treasury bills, certificates of deposit, federal funds, bankers' acceptances, and commercial paper are commonly referred to as money markets. Money market securities generally have maturities of one year or less, have less credit risk than equivalent long-term securities, and trade in large denominations.

**1.22** Financial markets may also be characterized according to whether a party must find the counterparty to a trade and negotiate with that counterparty directly or whether the counterparty is approached through an intermediary. The intermediary may be an agent who conducts a search for a counterparty (either an individual or institution) to be a buyer or seller of a particular security, may complete the transaction by trading with dealers who hold themselves out as willing to buy and sell (such as in OTC markets), or may transact directly against the orders of other potential counterparties by communicating through a single centralized location (exchange markets).

## Exchange Market<sup>3</sup>

### *Floor-Based Exchange*

**1.23** An *exchange market* is a central meeting place established to facilitate the trading of securities or commodities. A *securities exchange* is an

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<sup>3</sup> Regulation National Market System (NMS) contained four interrelated initiatives designed to modernize the regulatory structure of the national market system for U.S. equity markets. The substantive topics addressed by Regulation NMS are (a) order protection, (b) intermarket access, (c) subpenny pricing, and (d) market data. In addition, Regulation NMS updated the existing Securities Exchange Act of 1934 rules governing the national market



exchange market that provides trading facilities for stocks, bonds, or options. Exchange markets are generally characterized as auction places where bids and offers are directed and executed by brokers or specialists.

**1.24** Transactions in securities executed on an exchange are normally initiated by a customer communicating with a registered representative (salesperson or account executive) of a broker-dealer to request that a specified number of shares of a particular security be bought or sold at a stated price or the current market price. The order is usually communicated to the order room of the broker-dealer and then to its floor clerk, who is stationed at the exchange that trades the security. Securities transactions executed on an exchange may be in round lots (units of trading, normally 100 shares as specified by the exchange that lists the security) or in odd lots (quantities of less than 1 unit of trading).

**1.25** Once the order is conveyed to the floor of the exchange, it is given by the floor clerk to a floor trader, who will attempt to execute it. If the broker-dealer is not a member of the particular exchange, the order is relayed to a correspondent broker who executes the trade on the exchange. Once executed, the details of the transaction (price, quantity, other broker with whom the transaction was consummated, and so forth) are reported back to the order room of the broker-dealer for transmission to the purchase and sales department. A confirmation of the trade is then prepared and sent to the customer.

**1.26** With the advent of advanced technology, certain exchanges have provided their members with the facility of direct order entry to floor specialists, in addition to other electronic enhancements to trading.

### ***Electronic-Based Exchange***

**1.27** An exchange may also operate through electronic trading platforms and networks to create a virtual marketplace for the purpose of trading securities and other financial instruments. When using an electronic stock exchange for trading, computer networks match buyers and sellers, thus providing an efficient and a fast method for executing trades. This may be especially important for those making a large volume of trades. One example of an electronic stock exchange is NASDAQ.

### **OTC Market**

**1.28** Many companies have insufficient shares outstanding, stockholders, or earnings to meet the listing requirements of an exchange or, for other reasons, choose not to be listed. Securities of these companies are traded in the OTC market between dealers who make markets acting as principals or brokers for customers.

**1.29** The OTC market is not a location; rather, it is a communications network linking those dealers that make markets in securities generally not listed on exchanges. The OTC market is regulated by the Financial Industry

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system, and consolidated them into a single regulation. Regulation NMS included two amendments to the joint industry plans for disseminating market information. See Securities and Exchange Commission (SEC) Release No. 34-51808, *Regulation NMS*, and related rulings, for more information.

Regulatory Authority (FINRA).<sup>4</sup> An offer to buy or sell an unlisted security is executed by a broker-dealer entering into a transaction with a customer or another broker-dealer that makes a market in that security.

**1.30** The broker-dealer may be an OTC market maker and act for its own account (dealer as principal) or for the account of a customer (broker as agent) in a purchase or sale transaction with a customer or another broker-dealer. Acting as a dealer, no commission is charged; instead, the broker-dealer realizes a profit or loss based on the spread between the cost and selling price of the securities. Acting as a broker, a commission is charged.

**1.31** The market makers publish quotes for security prices on a bid-and-ask basis (that is, they buy a security at the bid price and sell it at the ask price). The difference between the price for which the dealer is willing to purchase (bid for) the security and the price for which the dealer is willing to sell (ask for) the security is the spread.

**1.32** Firm price quotations for OTC equity securities are available from the interdealer quotation systems, such as FINRA's OTC Bulletin Board and OTC Markets Group's OTC Pink.

## Third Market

**1.33** OTC trading of shares listed on an exchange takes place in the third market by broker-dealers and investors that are not exchange members. Members of an exchange are generally required to execute buy and sell orders in listed securities that are not SEC Rule 19c-3 eligible through that exchange during exchange hours. Rule 19c-3 includes those equity securities that were listed and registered on an exchange on or after April 26, 1979. However, a broker-dealer firm that is not a member of the exchange can make a market in a listed stock in the same way it would make a market in an unlisted stock.

## Alternative Trading Venues

**1.34** Direct trading of securities between two parties with no broker intermediary takes place in the fourth market. In many cases, both parties involved are institutions. For example, securities may trade on a private placement basis whereby the parties negotiate the terms of the placement. Because limited information may be publicly available, a small group of sophisticated investors generally hold privately placed securities.

## Electronic Communication Network

**1.35** An *electronic communication network (ECN)*, a type of alternative trading system, is an electronic system that brings buyers and sellers together for the electronic execution of trades. ECNs are required to be registered with the SEC and may be registered as either a dealer or an exchange. Those who subscribe to ECNs (generally, institutional investors, broker-dealers, and market-makers) can place trades directly on the ECN, typically using limit orders. ECNs post orders on their system for other subscribers to view. The ECN will then automatically match orders for execution. If a subscriber wants to buy a

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<sup>4</sup> The Financial Industry Regulatory Authority (FINRA) was created in July 2007 through the consolidation of the National Association of Securities Dealers and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange. It is the largest nongovernmental regulator for all securities firms doing business in the United States. See the FINRA website at [www.finra.org](http://www.finra.org) for more information.

stock through an ECN, but there are no sell orders to match the buy order, the order cannot be executed until a matching sell order comes in. If the order is placed through an ECN during regular trading hours, an ECN that cannot find a match may send the order to another market center (for example, the New York Stock Exchange [NYSE] or NASDAQ) for execution.

**1.36** The benefits investors get from trading with an ECN include speed; trading after hours; real-time display of orders (whereas on the NYSE, most investors are limited to viewing only the best bid and ask prices); ability to trade among themselves without having to go through a middleman (smaller spreads, lower commissions, better price executions); and anonymity (which is often important for large trades).

## Clearing Organizations and Depositories

**1.37** After orders in securities have been executed, whether on an exchange or in the OTC market, the transactions are compared, cleared, and settled. Comparison occurs when broker-dealers or their agents exchange their trade information (security, number of units, and price) to confirm the existence of a contract and match the buy and sell sides of the trade. *Clearance* is the process of accounting for compared trades in terms of the trading parties' obligations to pay money and deliver securities. *Settlement* is the process of exchanging the money for securities (that is, delivery and payment) that consummates the transaction. In the U.S. equity and corporate markets, settlement generally occurs three business days after the trade. Trade comparison, clearance, and settlement are aspects of posttrade processing.

**1.38** The exchange markets have sponsored central clearing agencies, known as clearing organizations, to assist in the comparison, clearance, and settlement functions. Deliveries and receipts of securities and the related cash settlements are made through these clearing organizations for broker-dealers. The National Securities Clearing Corporation (NSCC), a subsidiary of the Depository Trust & Clearing Corporation (DTCC), is one such U.S. clearing organization. In the OTC market, clearance may be accomplished by a variety of methods, including the buying and selling of broker-dealers' exchange-of-trade tickets directly with one another or through a clearing organization. Introducing broker-dealers operating through clearing brokers settle their transactions through those clearing brokers that in turn, settle the transactions through the clearing organizations. The Options Clearing Corporation and the clearing organizations of the commodity exchanges perform similar functions for options and futures trading. Clearance of securities traded on international markets is accomplished in a variety of ways, ranging from centralized clearing organizations to business entities whose securities are cleared by major banking organizations.

**1.39** Most U.S. government and agency security transactions clear through the use of the book entry safekeeping system maintained by the Federal Reserve Bank of New York. The 12 district Federal Reserve Banks operate a securities transfer system that permits these securities to be transferred between the book entry safekeeping accounts.

**1.40** Settlement of securities transactions can be complex, especially when there is a large volume of transactions in many securities. To avoid duplicated receipt and delivery of securities, the NSCC uses an electronic netting system known as continuous net settlement (CNS). In CNS, a broker-dealer's purchases and sales in the same security are netted, thus leaving the broker-dealer

with one daily net settlement obligation per security. The broker-dealer then settles that obligation with the clearing organization. Unique to CNS, the clearing agency interposes itself between the trading broker-dealers on each trade and guarantees the settlement obligations of each broker-dealer's countertrading party. Thus, the broker-dealer's settlement is with the clearing organization, not the other broker-dealer. Other clearing mechanisms may or may not guarantee settlement. A broker-dealer can settle each day or carry open commitments forward to net against the next day's settlement (hence the continuous nature of CNS).

**1.41** Security deliveries in the current U.S. environment are generally by book entry (that is, by electronic debits and credits to a broker-dealer's account) at a securities depository where the securities certificates are immobilized and where broker-dealers hold the certificates in the street name for their customers. Thus, delivery is accomplished without the physical movement of the securities certificates. The securities depositories, which are similar to banks, pursue the business of custodian operations, including holding securities certificates in physical form or maintaining electronic records of book entry securities holdings for their customers, mainly financial institutions.

**1.42** One of the major depositories for equities, corporate debt securities, certain eligible mortgage-backed securities, and municipal debt securities is the DTCC and its subsidiaries.

## Transfer Agents

**1.43** Although many securities issuers use a bank or trust company as their transfer agent, an issuer may use an independent transfer agent or may act as its own transfer agent. There are two basic functions of a transfer agent: the transfer function and the registrar function. A transfer agent may perform one or both of these functions.

**1.44** The transfer function includes the canceling of old certificates that are properly presented and endorsed in good deliverable form (which usually includes a signature guarantee), making appropriate adjustments in the issuer's shareholder records, establishing a new account in the name of the new owner, and issuing new certificates in the name of the new owner. Transfer agents also review legal documents to ensure that they are complete and in perfect order before transferring the securities. If the legal documents are incomplete, the transfer agent either will notify the presenter that the documents are incomplete and hold the old certificate and accompanying documentation until the presenter sends the transfer agent the proper documents or will reject the transfer and return the securities.

**1.45** For mutual funds, transfer agents enter the amount of securities purchased by a shareholder on the issuer's books and redeem (liquidate) shares upon receipt of the customer's written or wire request. Transfer agents, as part of their transfer function, maintain records of the name and address of each security holder, the amount of securities owned by each security holder, the certificate numbers corresponding to a security holder's position, the issue date of the security certificate, and the cancellation date of the security certificate. Many transfer agents also act as paying agents for cash dividends and the distribution of stock dividends and stock splits.

**1.46** A transfer agent performing the registrar function monitors the issuance of securities in an issue with a view toward preventing the unauthorized issuance of securities. The registrar checks to ensure that the issuance of

the securities will not cause the authorized number of shares in an issue to be exceeded and that the number of shares represented by the new certificate or certificates corresponds to the number of shares on the canceled ones. After the registrar performs these functions, the registrar countersigns the certificate.

## Regulatory Overview

**1.47** Regulatory environments differ from country to country, and the freedom of entry into the marketplace likewise varies depending on the local regulation. In the United States, the 1934 Act provides for the regulation of securities transactions after the securities are initially distributed to public investors in an underwriting. The 1934 Act established the SEC that, among other things, is authorized to promulgate and enforce rules governing the regulation of broker-dealers in securities. The SEC developed, pursuant to the 1934 Act, a comprehensive system to regulate broker-dealers. Under the 1934 Act, all broker-dealers are required to be members of self-regulatory organizations, such as FINRA,<sup>5</sup> which performs routine surveillance and monitoring of its members. A similar regulatory framework was established for commodity broker-dealers under the Commodity Futures Trading Commission Act of 1974, which established the Commodity Futures Trading Commission (CFTC) and gave it exclusive jurisdiction over commodity futures matters.<sup>6</sup> The Commodity Futures Modernization Act of 2000 (CFMA) authorized joint regulation by the CFTC and the SEC of security futures products on individual equity issues and on narrow-based indexes of securities. The CFMA created a flexible structure for the regulation of futures trading, codified an agreement between the CFTC and the SEC to repeal the ban on trading single-stock futures, and provided legal certainty for OTC derivatives markets. The CFMA amended the definition of *security* in the Securities Act of 1933 (the 1933 Act) and the definitions of *security* and *equity security* in the 1934 Act to include a security future. In April 2002, the SEC amended the definition of *equity security* in rules under the 1933 Act and the 1934 Act to conform them to the statutory definitions with respect to security futures.

**1.48** Since its adoption, the 1934 Act has been amended to include virtually all participants in the securities markets and an ever-increasing range of securities-related activities. Originally, the scope of the 1934 Act was limited to the regulation of exchanges, members of exchanges, and trading in securities listed on exchanges. The Maloney Act of 1938 amended the 1934 Act to cover the OTC markets. The Maloney Act of 1938 also established the National Association of Securities Dealers (now FINRA),<sup>7</sup> which is a self-regulatory organization that has responsibility for oversight of the OTC securities markets.

**1.49** In 1975, the 1934 Act was amended to extend the authority of the SEC to include securities transfer agents, clearing organizations, and securities depositories. This amendment also established the Municipal Securities Rule-making Board that was authorized to prescribe rules regulating the activities of municipal securities broker-dealers. In 1986, the 1934 Act was amended by

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<sup>5</sup> See footnote 4.

<sup>6</sup> The second edition of the practice aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools* provides practitioners with nonauthoritative, practical guidance on performing audits on financial statements of futures commission merchants, introducing brokers, and commodity pools. The publication is available on [www.cpa2biz.com](http://www.cpa2biz.com). The practice aid is currently being revised as a result of rulemaking based on Dodd-Frank Act provisions.

<sup>7</sup> See footnote 4.

the Government Securities Act of 1986 to require U.S. government securities broker-dealers to register with the SEC. Under the Government Securities Act of 1986, the SEC has the authority to enforce rules promulgated by the Department of the Treasury that concern U.S. government securities broker-dealers. Thus, the 1934 Act today provides a comprehensive scheme of regulation for virtually all broker-dealers in securities, the exchanges, and the OTC markets, as well as the facilities for clearing and settling transactions among broker-dealers, depositories, transfer agents, and registrars.

**1.50** The Securities Investors Protection Corporation (SIPC) was established when Congress enacted the Securities Investor Protection Act of 1970 (SIPA). SIPC is a nonprofit membership corporation designed to protect, up to a specific maximum amount, customers' cash and securities in the custody of a broker-dealer that fails and is liquidated under SIPA. Broker-dealers registered with the SEC, with some limited exceptions, are required to be members of SIPC. The money required to protect customers beyond that which is available from the customer property in the possession of the failed broker-dealer is advanced by SIPC from a fund maintained for that purpose. The sources of money for this fund are assessments collected from SIPC members and interest on the fund's investments in U.S. government securities made with the funds collected. See chapter 3 for more information on the SIPC assessment and related reporting.

## Business Activities

### Brokerage

**1.51** Broker-dealers can earn commissions by buying or selling securities and commodities on their customers' behalf. Broker-dealers' handling of customers' funds and securities is subject to rules administered by the SEC, the Board of Governors of the Federal Reserve System (Federal Reserve), and the self-regulatory organizations. Although the specific definition of the term *customer* varies in the SEC's rules, a customer is generally any person from whom or on whose behalf a broker-dealer has received, has acquired, or holds funds or securities.

**1.52** Broker-dealers regularly finance the transactions of their customers. The initial extension of credit by broker-dealers is governed by Federal Reserve Regulation T (Regulation T) of the Federal Reserve System. Regulation T classifies transactions into specifically defined accounts. Most transactions with customers are done in cash or margin accounts.

**1.53** *Cash account.* In a cash account, the customer pays in full within a specified settlement period for any security purchased. Regulation T generally requires cash payment by the customer for the purchase of securities within two business days after settlement date; however, a self-regulatory organization or national securities association may grant an extension of time before payment is required. If the customer does not make timely payment for the securities, Regulation T requires the broker-dealer to promptly cancel or liquidate the transaction. In general, the broker-dealer will hold the customer responsible for any resulting loss.

**1.54** If a customer sells securities, the customer must promptly deliver the certificates to the broker-dealer. Either the proceeds of a sale will be credited to the customer's account on the settlement date, or if requested, a check will

be mailed to the customer. In general, under SEC Rule 15c3-3, if the broker-dealer does not receive the securities sold within 10 business days of the settlement date, the broker-dealer is required to close the transaction with the customer by purchasing securities of like kind and quantity. Again, the broker-dealer will hold the customer responsible for any resulting loss.

**1.55** *Margin accounts.* Under Regulation T, the broker-dealer is required to record the purchase or sale of securities by customers on other-than-immediate cash settlement terms in a margin account. A purchase on margin contemplates a prolonged extension of credit to the customer by the broker-dealer. The maximum amount of initial credit is prescribed by Regulation T. The maximum amount of credit the broker-dealer can extend beyond the initial transaction is prescribed by the rules of the appropriate self-regulatory organization. Customer margin requirements relating to securities futures are prescribed by joint final rules issued by the SEC and the CFTC in August 2002.

**1.56** If the amount of equity in the customer's account is below the amount required to cover the initial margin, Regulation T requires the broker-dealer to eliminate the margin deficiency within five calendar days after it was created or increased. When a deficiency arises, the broker-dealer will normally issue a call for margin from the customer.

**1.57** The customer can satisfy the margin call by making additional margin deposits of cash or securities. If the customer does not make the deposits within the specified time, including approved extensions of time by a self-regulatory organization or national securities association, Regulation T requires the broker-dealer to liquidate securities sufficient to satisfy the required margin. Broker-dealers also have self-imposed margin requirements that are generally more stringent than the Federal Reserve System or self-regulatory organization requirements.

**1.58** *Accounts carried for other brokers.* Clearing brokers maintain the customer accounts of introducing brokers. *Fully disclosed accounts* are accounts of the introducing broker's customers that are carried on the books of a clearing broker. In a fully disclosed account, the introducing broker's customers are treated as if they were the clearing broker's own customers, except that correspondence to customers usually refers to the introducing broker by including a phrase such as "through the courtesy of [*the introducing broker's name*]." The clearing broker maintains the customers' accounts and is usually responsible for collecting the purchase price, the commission, and other fees from the customers. However, the introducing broker generally indemnifies the clearing broker for uncollected amounts from any resulting unsecured accounts of the introducing broker's customers. The clearing broker and the introducing broker enter into a contract that describes the distribution of commissions between brokers.

**1.59** In contrast, an *omnibus account* is an account of the introducing broker that is carried on the books of the clearing broker and that represents the sum of the activity of customers of the introducing broker. The introducing broker's customer accounts are carried separately on the books of the introducing broker. For an omnibus account, the introducing broker prepares and sends confirmations and monthly statements to customers, maintains customers' accounts and margin records, and retains most of the responsibility for compliance with regulatory matters.

## Firm Trading

**1.60** Firm trading (also referred to as proprietary trading) involves a full range of activities whereby broker-dealers may take principal positions for their own accounts. Certain broker-dealers make markets in particular OTC securities by standing ready to buy or sell securities to their customers or other broker-dealers. These broker-dealers often carry an inventory of the securities in which they make a market and are exposed to the market risks inherent in such positions. In addition, these broker-dealers may sell securities short in anticipation of decreases in the price of the securities.

**1.61** *Riskless arbitrage.* *Riskless arbitrage* is the simultaneous purchase and sale of the same or an equivalent security in order to profit from price discrepancies. *Convertible arbitrage* is a form of riskless arbitrage that uses convertible securities or warrants versus the underlying equity securities. Broker-dealers can profit from the temporary price differences that exist from the same or similar securities traded in different financial markets. Another kind of basic arbitrage involves purchasing and selling similar securities in like markets.

**1.62** *Risk arbitrage.* *Risk arbitrage* is a term used to describe special situations (such as mergers, reorganizations, recapitalizations, tenders for cash, and tenders for securities) in which the arbitrage trader buys or sells securities without fully hedging or offsetting risk, with the intention of realizing a profit at some future period based on the anticipated market movement when the special situation is completed.

**1.63** *Program trading.* *Program trading* is a term used to describe the simultaneous buying and selling of a large number of different stocks based on their perceived correlation. Program trading may encompass several index-related trading strategies, including hedging, index arbitrage, and portfolio insurance. Program trades are often accomplished through an exchange's high-speed order system. By using a high-speed order system, program trades can be carried out in a matter of minutes. Program trading enables institutions to make broad changes in their portfolios and thus facilitates index arbitrage. Index arbitrage combines the buying and selling of stocks with offsetting trades in stock index futures or options.

**1.64** *Block trading.* *Block trading* is the acquisition or disposition of large quantities of securities by a broker-dealer to facilitate the execution of buy or sell orders of customers, usually institutions. Block traders locate suitable trading partners and assist the buyer and seller in negotiating the terms of the trade. The broker-dealer's assistance is needed because the inflow of orders to the exchange floor is generally too small to execute the trade in a reasonable period of time, and specialists typically do not have sufficient capital to execute such transactions. In addition, specialists are not allowed to communicate directly with public buyers and sellers, whereas block traders may communicate with them. If the broker-dealer has negotiated a trade, it is crossed on the exchange (that is, the broker executes two or more matched orders on the exchange).

**1.65** *When-issued transactions.* *When-issued transactions* are contracts to purchase or sell securities only when, as, and if new securities are issued. Broker-dealers enter into such purchase or sale transactions on pending issues of new securities. Trading in when-issued securities normally begins when the U.S. Treasury, a municipality, a state, or some other issuer of securities announces a forthcoming issue. Such transactions are contingent upon the



issuance of the securities. Because the exact price and terms of the securities are unknown before the issuance date, trading prior to that date is on a yield basis (that is, based on the yields that buyers expect). The exact terms and price of the security become known on the issuance date, and when-issued trading continues until the settlement date, at which time the securities are delivered and the issuer is paid. When-issued transactions may also arise as a result of underwritings, exchanges, and mergers after preliminary agreement to issue the securities is established but before a date for settlement has been set.

**1.66** *To-be-announced (TBA) trades.* TBA is a term used to describe forward mortgage-backed securities trades. The term TBA is derived from the fact that the actual mortgage-backed security that will be delivered to fulfill a TBA trade is not designated at the time the trade is made. The securities are to be announced 48 hours prior to the established trade settlement date.

**1.67** *Delayed delivery.* A *delayed delivery transaction* is a transaction in which both parties to the trade agree on a deferred settlement. Delayed delivery transactions are purchases or sales of securities similar in most respects to regular-way transactions (normal settlement) except that, by agreement, the date of consummation or settlement is extended.

**1.68** *Hedging.* Hedging instruments and techniques have been developed by broker-dealers to offset or minimize the risk of losses that an enterprise may be exposed to because of the effect of price changes on its assets, liabilities, or future commitments. Hedging instruments and techniques were developed in response to the volatility of interest rates, securities and commodity prices, and foreign exchange rates. These instruments may be used for speculative purposes, as well as hedging. The more common hedging instruments used as risk management tools include futures contracts; forward contracts; options; interest rate caps, floors, and collars; and swaps.

**1.69** *Futures and forward contracts.* *Futures contracts* are standardized contracts traded on organized exchanges to purchase or sell a specified financial instrument or commodity on a future date at a specified price. Financial futures include contracts for debt instruments (interest rate futures), foreign currencies, and stock indexes. Forward contracts are individually negotiated and have economic characteristics similar to those of futures contracts, but they are not traded on an organized exchange, and consequently, they are generally referred to as OTC. *Forward contracts* are contracts for forward placement or delayed delivery of financial instruments or commodities in which one party agrees to buy, and another to sell, a specified security or commodity at a specified price for future delivery.

**1.70** Forward contracts and futures contracts both have substantial market risk. A buyer (long position) of a futures contract profits when the value of the underlying financial instrument or commodity increases, whereas a seller (short position) of the futures contract incurs a loss.

**1.71** The credit risk associated with a futures contract is generally less than it is for forward contracts because of the protections afforded by the exchange clearing organization system. All futures contracts cleared through a clearing organization are subsequently measured at fair value (see the glossary of this guide), and the financial result is settled daily between the clearing organization and clearing member. Because of this daily settlement, the amount of unsettled credit exposures is limited to the amount owed the clearing member for any one day.

**1.72** The clearing organization also has a guarantee fund consisting of cash, securities, and bank guarantees that is contributed to by all clearing member firms. In the event the guarantee funds are insufficient to cover a failed member firm's obligations to the clearing organization system, the clearing organization has additional assessment authority over all the other member firms.

**1.73** These protections are intended to permit the clearing organization to fulfill the obligations of any failed clearing member firm to other clearing member firms. However, the exchange clearing organization will not necessarily guarantee the performance or the money balances of the failed member firm with respect to the individual customer accounts of a failed member firm (that is, the clearing organization guarantee is generally limited to the commodities clearing obligations of the failed member firm to the other clearing member firms).

**1.74** *Options.* An option contract conveys a right, but not an obligation, to buy or sell a specified number of units of a financial instrument at a specific price per unit within a specified time period. The instrument underlying the option may be a security; futures contract (for example, an interest rate option); commodity; currency; or cash instrument. Options may be bought or sold on organized exchanges or OTC on a principal-to-principal basis or may be individually negotiated. A call option gives the holder the right, but not the obligation, to buy the underlying instrument. A put option gives the holder the right, but not the obligation, to sell the underlying instrument. The price at which the underlying instrument may be bought or sold during the specified period is referred to as the *strike* or *exercise price*. The option buyer (holder) is the party that obtains the right, by paying a premium, to buy (call) or sell (put) an instrument. The option seller (writer) is the party that is obligated to perform if the option is exercised.

**1.75** The option buyer's profit potential can be virtually unlimited. The option buyer's loss, however, is limited to the cost of the option (premium paid). Unlike the buyer of an option contract, an option seller may be exposed to large and sometimes unlimited market risk; however, the premiums received by the seller may provide a potentially attractive return.

**1.76** After the initial exchange of the premium, the writer of the option is not at risk to a counterparty's default because the buyer is no longer obligated to perform. The buyer of the option, however, is exposed to the writer's ability to perform. The risk of counterparty default can be reduced by trading through an exchange because the clearing organization of the exchange acts as guarantor for the option contracts.

**1.77** When an option is exercised depends on the market price versus the strike price, the outlook on how one option will perform in relation to the other before the expiration date, and the kind of option—European or American. A European option is exercisable only at the maturity date of the option, whereas an American option is exercisable at any time during the option period.

**1.78** *Caps, floors, and collars.* An *interest rate cap* is a contractual agreement between two counterparties in which the buyer, in return for paying a fee, will receive cash payments from the seller at specified dates if rates go above a specified interest rate level known as the strike rate (cap). An *interest rate floor* is a contractual agreement between two counterparties in which the buyer, in return for paying a fee, will receive cash payments from the seller at specified dates if interest rates go below the strike rate. The cap or floor fee (premium)

is generally paid in advance to the seller by the buyer, but it may be paid over the life of the cap or floor agreement. At each settlement date during the term of the cap or floor, the strike rate is compared with the market rate (index rate) to determine whether the seller must make a payment to the buyer. The timing of these payments varies depending on the agreement between the buyer and seller.

**1.79** The economic characteristics of caps and floors are analogous to those of a series of European interest rate options. The risks associated with caps and floors are also similar to those of options (that is, they are asymmetrical). The buyer of a cap or floor is protected against adverse interest rate changes (the loss is limited to the premium) while having the ability to profit from favorable changes in interest rates.

**1.80** As with an option, the writer of a cap or floor has no risk of counterparty default unless the cap or floor fee (premium) is paid over the life of the cap or floor arrangement. The buyer, in contrast, incurs counterparty credit risk because the third party may not fulfill its obligation.

**1.81** The buyer of the interest rate cap can lower the fee paid in advance to the writer by writing a floor (minimum level of a floating rate) on the transaction. If the floating rate goes below the floor, the buyer of the interest rate cap (writer of the floor) has to compensate the counterparty for the difference. An interest rate contract that specifies both a cap and floor for interest rates is referred to as a *collar*.

**1.82** *Swap transactions.*<sup>8</sup> Swaps are financial transactions in which two counterparties agree to exchange streams of payments over time according to a predetermined formula. Swaps are normally used to transform the market exposure associated with a loan or bond borrowing from one interest rate base (fixed term or floating rate) or currency denomination to another (across markets).

**1.83** The typical interest rate swap is an agreement between two parties under which each party agrees to pay the other specified or determinable cash amounts on specified future dates. The cash amounts to be paid by each party are defined in terms of applying a specified interest rate (either fixed or variable) to a hypothetical principal amount, referred to as the notional principal amount. The interest rate swap does not modify preexisting debt instruments, and no securities actually change hands between the parties.

**1.84** Currency swaps are similar to interest rate swaps in that interest streams are exchanged between two counterparties; however, unlike interest rate swaps, they are in two different currencies (either fixed for fixed, fixed for floating, or floating for floating). Further, unlike interest rate swaps, because two different currencies are involved, there is generally an exchange of principal at inception of the agreement and a re-exchange of like principal at maturity.

**1.85** The term *currency swap*<sup>9</sup> is also used to describe arrangements in which spot and forward foreign exchange contracts are entered into with the same counterparty (foreign exchange swap). The forward amount exchanged is

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<sup>8</sup> On July 18, 2012, the SEC issued Release No. 33-9338, *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, which further defines those terms. See SEC Release No. 33-9338 and related rulings for more information.

<sup>9</sup> See footnote 8.

different from the spot amount because the forward amount includes an interest differential between a fixed rate in one currency and a fixed rate in the other currency. Unlike the currency swaps described in the preceding paragraph in which there is a series of forward exchanges (interest flows), a foreign exchange swap has only one forward exchange.

**1.86** In interest rate swaps, there is unlimited market risk and reward to the extent interest rates fluctuate. The fixed-rate receiver loses if interest rates rise, and the fixed-rate payer loses if interest rates fall. There is no market risk in the principal amount of interest rate swaps. The counterparty to a currency swap is exposed to interest rate movements and to foreign exchange risk on the principal and interest.

**1.87** The contractual or notional amounts related to interest rate and currency swaps do not indicate the risk of default of the counterparty. Risk of default varies with the financial strength of the counterparties. Further, the amount at risk at a point in time is limited to the unrealized gain and varies with market conditions. Additional credit protection may be provided through the use of an intermediary who guarantees the payment streams by providing a backup letter of credit, collateral, or some other support arrangement.

**1.88** *Asset securitization.*<sup>10</sup> *Asset securitization* is the process of converting receivables and other assets that are not readily marketable into securities that can be placed and traded in capital markets. Assets that have been securitized include residential mortgages; commercial mortgages; agency securities (including those of Government National Mortgage Association [Ginnie Mae], Federal National Mortgage Association [Fannie Mae], and the Federal Home Loan Mortgage Corporation [Freddie Mac]); consumer receivables (credit card loans and home equity loans); retail installment loans (automobile, recreational vehicle, and mobile home); time-share mortgage loans; trade receivables; insurance-policy-related receivables; leases (equipment, operating, and automobile); student loans; high-yield corporate bonds; and federal assets.

**1.89** Securitization transactions span a wide spectrum. At one extreme are outright sales of assets or interests in assets. At the other extreme are borrowings collateralized by assets. In between are sales of assets with varying degrees of recourse to the seller and nonrecourse borrowings collateralized by assets. Asset-backed securities may be issued through a variety of structures, including pay-through securities; pass-through securities; and commercial paper with multiple classes, differing degrees of subordination, and varying cash flow priorities. The securities are often backed by some form of credit enhancement. Credit enhancement can take the form of letters of credit, third-party guarantees, liquidity facilities, spread accounts, reserve funds, subordinate interests, and overcollateralization.

**1.90** In a typical asset securitization transaction, a company transfers assets to a special-purpose vehicle (SPV) or variable interest entity (VIE) in exchange for cash or securities issued by the SPV or the VIE. The SPV or the VIE might be organized in such a way that the likelihood of its bankruptcy is remote and that the transferred assets are protected from the estate of the transferring company in the event of its bankruptcy.

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<sup>10</sup> The Dodd-Frank Act contains a number of provisions related to asset-backed securities. Rulemaking related to these provisions is not complete as of the date of this guide. See the preface and appendix A of chapter 3 of this guide for more information.

**1.91** One type of asset securitization is a *collateralized mortgage obligation*, a mortgage-backed bond that aggregates individual mortgages or mortgage-backed securities into mortgage pools that are separated into different maturity classes, called tranches. Each tranche has unique risk characteristics for paying interest, paying principal, or retaining residual ownership.

**1.92** Securitization often allows the holder of assets to raise funds at a lower rate than the cost of general obligation borrowings, to free up capital through off-balance sheet financing, to reduce interest rate and credit risk, to limit loss exposure, and to gain access to nontraditional funding sources.

**1.93** Mutual funds, insurance companies, pension funds, banks, thrifts, retail investors, and diverse other foreign and domestic investors participate in the mortgage- and asset-backed securities market. New investment instruments, flexible payment terms, investment-grade credit quality, various degrees of liquidity, and reduced event risk are among the benefits offered by these securities. The market risks affecting these securities include interest rate risk, prepayment risk, and varying degrees of credit risk. Given the multitude of assets and the complexity of securitization structures, an investor must understand both the investment profile and the risks specific to each investment.

**1.94** *International trading.* A number of major broker-dealers have the capabilities for executing purchase and sale orders in securities traded abroad. The recent admission of U.S. broker-dealers to foreign financial markets offers the possibility of 24-hour trading. In addition, many foreign securities are traded by market makers in the United States. Many broker-dealers trade equity securities in the form of American depository receipts (ADRs). An *ADR* is a registered negotiable receipt for shares of a foreign corporation held in custody in the foreign location. Some ADRs are listed on the NYSE, and many others trade in the OTC market.

## Investment Banking

**1.95** Many broker-dealers are engaged in providing investment banking services to their customers. These services typically include the raising of capital through the public offering or private placement of securities. In addition, these broker-dealers counsel companies in the management of their money and advise companies about corporate structuring opportunities.

**1.96** *Public offerings.* Business entities and governmental entities that desire to raise funds through the public sale of securities normally engage securities broker-dealers to underwrite their securities issues. *Underwriting* is the act of distributing a new issue of securities (primary offering) or a large block of issued securities (secondary offering). Underwritings are accomplished on either a firm-commitment or best-efforts basis. The underwriting group for a transaction on a firm-commitment basis agrees to buy the entire security issue from the issuer for a specified price, with the intent to resell the securities to the public at a slightly higher price. The underwriting group for a best-efforts underwriting agrees to sell the issue at a price to be determined, normally with a minimum requirement to complete the underwriting. An underwriting group may also be formed on a standby basis in which there is a commitment to buy the securities if called on.

**1.97** Underwriting subjects the broker-dealer to substantial risks. A broker-dealer underwriting securities on a firm-commitment basis is required to buy a portion of the positions offered. This results in the need to finance the unsold

portions and assume the market risk of ownership. In addition, the broker-dealer may be held liable to the purchasers of the securities under the 1933 Act. The statute holds all persons (including underwriters) connected with a registration statement responsible for any material misstatements contained in the registration statement. An underwriting also exposes the broker-dealer to the risk that its customers or other group members who had committed to buy the securities being underwritten may refuse to honor the transactions.

**1.98** Because the value of a new issue of securities and the liability for successful marketing may be too great for any one dealer, group accounts or syndicates may be formed to spread the risk. In addition, selling groups, which may include broker-dealers other than members of the underwriting group, are sometimes formed to obtain wider distribution of the new issue.

**1.99** The liability of the underwriting group may be divided or undivided. If it is divided, each member of the group has a specified maximum liability to buy a certain number of shares of stock or principal amount of bonds. If it is undivided, each member of the underwriting group has a designated percentage liability for unsold securities.

**1.100** *Advisory services.* Broker-dealers provide advisory services for which they receive fee income. These may include consulting on mergers and acquisitions, reorganizations, tender offers, leveraged buyouts, conversions, swaps, and the pricing of securities to be issued. Fees for these services are generally determined by the transaction size and are often contingent upon results, which may not be final until after the services are completed. In addition, broker-dealers may earn fees by advising investment company asset managers about mutual fund assets and the distribution and maintenance of mutual fund shares.

**1.101** *Private placements.* Broker-dealers may also arrange the private placement of securities by business or government entities. Private placements are usually conducted on a best-efforts, agency basis and, therefore, expose the placement agent to less risk than that associated with the underwriting liability of a public offering. *Private placements* are distributions of securities that do not involve public offerings. Typically, private placements are sold to sophisticated institutional investors and, hence, do not require a registration statement to be filed with the SEC. The securities involved in private placements can be either an initial issuance or a resale of previously issued securities and are generally restricted regarding subsequent resale. For example, they may require registration under state and federal securities laws prior to resale or an opinion of counsel providing an exemption from registration requirements. The company's history, size, stability, and cash needs are factors in determining when the use of a private placement of debt or equity securities might be preferable to registering securities for sale to the public. In many instances, the expertise of the broker-dealer may be essential in analyzing the company's activities and requirements in order to determine the kind of securities to be offered and to assist in structuring the placement to enhance marketability. Because private placements are usually conducted on a best-efforts, agency basis by a broker-dealer, maximum consideration is normally given to locating an investor or a relatively small group of investors whose investment objectives closely parallel the expectations of the issuer.

**1.102** The SEC adopted Rule 144A<sup>11</sup> to provide a safe-harbor exemption from the registration requirements of the 1933 Act for the resale of private placements when the resale is made to a qualified institutional buyer. Broker-dealers can qualify as institutional buyers if they own and invest on a discretionary basis at least \$10 million in the securities of unaffiliated issuers. Broker-dealers with less than \$10 million may buy securities as riskless principals for clients that are themselves qualified institutional buyers.

## Financing

**1.103** Broker-dealers may finance their activities through the use of bank loans, stock loans, and repurchase agreements (repos). In recent years, stock lending and repos have also evolved into firm trading strategies whereby broker-dealers earn interest spreads on the simultaneous borrowing and lending of funds collateralized by securities. A discussion of some of the activities described as broker-dealer financing activities follows.

**1.104** *Bank loans.* One source of financing in the securities industry is bank loans. These loans are callable by the bank and are often collateralized by securities owned by the broker-dealer or, if used to finance loans to the customer, by customer securities that are not fully paid for. The interest rate charged by banks on these loans is called the *brokers' call rate*.

**1.105** In addition to the risks faced by all businesses concerning collateralized bank loans, broker-dealers are subject to a unique requirement resulting from regulations governing collateral. SEC Rule 15c3-3 prohibits broker-dealers from utilizing their customers' fully paid or excess margin securities as collateral for bank loans. Federal Reserve Regulations G, T, U, and X of the Federal Reserve system establish the ratio of collateral value to the amount of loans that must be maintained for loans used to finance customer-related activity and firm-related activity. Thus, firms must maintain separate records for customer and firm loans and related collateral.

**1.106** *Securities lending agreements.* A *stock loan* is an arrangement in which securities are loaned from one broker-dealer to another in exchange for collateral. Broker-dealers may lend securities to enable a borrowing broker-dealer to make deliveries of securities sold that the borrowing broker-dealer does not have available to deliver on the settlement date. Securities lending can be an effective and efficient means of generating funds for financing broker-dealers' operations. Securities lending is usually conducted through open-ended "loan" agreements that may be terminated on short notice by the lender or borrower. Securities lending is generally collateralized by cash, although securities or letters of credit may also be used as collateral. The nature of these transactions is generally governed by Regulation T and SEC Rule 15c3-3.

**1.107** Each stock loan is initially collateralized at a predetermined margin that is slightly in excess of the value of the securities loaned. If the fair value of the security falls below an acceptable level during the time a loan is outstanding, the borrower of the security requests the return of the excess cash collateral. If the value of the security rises, the lender of the security generally requests additional cash collateral to cover potential exposure to credit risk.

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<sup>11</sup> In August 2012, the SEC issued a proposed rule which would amend SEC Rule 144A. See Release No. 33-9354, *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*. See appendix A of chapter 3 for more information.

**1.108** When a stock loan is terminated, the securities are returned to the lender and the collateral or cash to the borrower. Fees (often referred to as rebates) are paid to the cash lender based on the principal amounts outstanding. Such fees are generally calculated at a rate lower than the broker-dealer's call rate, and they fluctuate based on the availability of the particular securities loaned. Some broker-dealers participate in the securities-lending and securities-borrowing market as intermediaries. They conduct a finder or conduit business in which securities are borrowed from one broker-dealer (or other institution) and loaned to another.

**1.109** *Repos or reverse repos.* According to the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary, a *repo* (also known as a repurchase agreement) is a transaction that is accounted for as a collateralized borrowing in which a seller-borrower of securities sells those securities to a buyer-lender with an agreement to repurchase them at a stated price plus interest at a specified date or in specified circumstances.

**1.110** A repo may be made on an overnight or a fixed-maturity basis or with an agreement for the seller to buy back the same securities at an open date to be decided by the buyer and seller. Dollar repurchase agreements (also called dollar rolls) are agreements to sell and repurchase substantially the same but not identical securities.

**1.111** As defined in the FASB ASC glossary, a *reverse repo* (also known as a reverse repurchase agreement) is a transaction that is accounted for as a collateralized borrowing in which a buyer-lender buys securities with an agreement to resell them to the seller-borrower at a stated price plus interest at a specified date or in specified circumstances.

**1.112** The buyer is said to enter into a reverse repo transaction (receiving securities, giving up cash) while the seller enters into a repo transaction (receiving cash, giving up securities). This reciprocal procedure enables the seller to obtain short-term financing while the buyer is able to earn interest on its excess cash and hold securities as collateral. For the buyer, the transaction represents another form of secured lending.

**1.113** Government bond dealers that have large inventories to be financed find it advantageous to execute repos with institutional investors because a repurchase transaction usually has a lower interest rate than the interest rate charged by a bank, and they can finance a greater percentage of their collateral. By using repos, buyers are able, with negligible market risk, to earn interest on their balances. The principal risk to the buyer is the creditworthiness of the seller but only if the collateral is in the possession of the seller or if its value has declined substantially. The possession of the collateral is an important determinant of the credit risk of a repo transaction. There are three kinds of custodial arrangements relating to repo transactions: triparty repos, deliver-out repos, and hold-in-custody repos.

**1.114** In a triparty repo, an independent institution acting in a custodial capacity enters into a tripartite agreement with the two counterparties to the transaction. This third-party custodian assumes certain responsibilities for safeguarding the interests of both counterparties and is involved in transferring funds and securities between those two parties. In a deliver-out repo, the securities are delivered to the investor or its designated custodial agent, who has no relationship with the repo seller. A hold-in-custody repo is characterized by the repo seller retaining control of the securities and serving simultaneously



throughout the transaction not only as principal but also as the investor's custodial agent.

**1.115** Some commonly used terms that describe various kinds of repurchase transactions include *overnight repos*, *term repos*, *repos to maturity*, and *matched repos*. Paragraphs 19–21 of FASB ASC 860-10-05 discuss the nature of these terms. Additionally, the FASB ASC glossary defines *matched repos* as situations in which the broker-dealer has entered into repos and reverse repos using the same securities. Broker-dealers make their profits on the differences between the interest charged on the repos and the interest earned on the reverse repos.

## Other Activities

**1.116** *Commodities*. A commodity may be bought for current delivery or future delivery. Broker-dealers buy and sell commodity contracts for future delivery on the request of their customers or for their own account. In a purchase contract (long position), the buyer agrees to accept a specific commodity that meets a specified quality in a specified month. In a sale contract (short position), the seller agrees to deliver the specified commodity during the designated month.

**1.117** Growers, processors, warehouse operators, and other dealers often buy and sell commodity futures for hedging purposes (that is, they transfer the price risk to speculators). Speculators buy and sell commodity futures because of the potential for a large return that could result from the leverage inherent in commodity futures trading. This leverage exists because a commodity contract controls a substantial amount of the commodity, and only a small money payment (margin deposit) is made.

**1.118** *Investment company shares*. Established under the Investment Company Act of 1940, *investment companies* are institutions that issue shares representing a portfolio of assets. The sale and redemption of investment company shares are often handled by broker-dealers. The AICPA Audit and Accounting Guide *Investment Companies* provides accounting and auditing guidance relevant to these institutions.

**1.119** Broker-dealers may act as agents to offer their customers the opportunity to invest in investment company shares. Brokers act as agents for their customers by placing or redeeming orders with mutual funds. Orders with mutual funds are placed in the customers' names through the shareholders' servicing agent that keeps records of individual share ownership, including additions for the reinvestment of dividends and capital gains. The broker-dealer's financial involvement with mutual funds may be limited to the receipt of commission checks if orders are placed with funds that charge commissions.

**1.120** *Unit investment trusts*. A *unit investment trust* (UIT) registered under the Investment Company Act of 1940 is a pool of securities fixed at the date of origination in which an investor holds an interest. Because it is not a managed investment vehicle, a UIT appeals to investors who, though desiring diversification, do not seek active professional investment advice. A UIT differs from a mutual fund in that it has a fixed termination date, roughly corresponding to the maturities of the securities in its portfolio. In addition, a UIT does not have a board of directors and an investment adviser. Rather, it has a trustee (or custodian) who holds the UIT's assets; a sponsor who establishes, promotes, sells, and makes a secondary market in the UIT's units; and an evaluator who periodically values the UIT's portfolio.

**1.121** *Foreign exchange.* The trading of currencies and bank deposits denominated in various currencies takes place in the foreign exchange market. The largest dealers in foreign exchange are money center banks. These dealers either arrange transactions between each other (in the interbank market) or place bids and offers through a brokerage system wherein brokers (including a number of securities broker-dealers) will attempt to bring buyers and sellers together for a commission. Currencies are traded in either the spot or forward markets and the futures markets. Spot transactions call for the immediate exchange of currencies (typically a two-day settlement), whereas forward transactions settle at a predetermined future date. The spot and forward markets are utilized primarily by large commercial users and institutional traders, whereas the futures market serves smaller commercial users and speculators.

**1.122** *Soft-dollar arrangements.* The FASB ASC glossary defines a *soft-dollar arrangement* as one in which a broker-dealer provides research to a customer in return for trade order flow (a certain volume of trades) from a customer.

**1.123** Most soft-dollar arrangements are triangular. In the first corner of the triangle is a money manager who wants to buy research data without writing a check. In the second corner is a broker with whom the money manager, or the money manager's client, trades. The broker uses a part of the commission (soft-dollars) to pay the research firm on behalf of the money manager. In the third corner is the researcher who is paid by the broker and sends the data to the money manager. Since the 1970s, when soft-dollars were first used, some brokers and money managers have used soft-dollars to cover transactions not associated with research. These types of transactions are governed by Section 28(e) of the 1934 Act that allows the paying of a brokerage commission if the manager determines in good faith that the commission is reasonable in relation to the value of the brokerage and research services received.

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## Chapter 2

# *Broker-Dealer Functions, Books, and Records*

## Introduction

### Overview

**2.01** Accounting by broker-dealer for securities transactions is unique in that two sets of books—the general ledger and the securities record (commonly referred to as the stock record)—are maintained. The general ledger is used to record entries reflecting money balances, and the securities record is used to account for security positions.

**2.02** This chapter discusses the flow of securities transactions, whether manual or automated, and standard departments and records ordinarily found within a broker-dealer. The auditor may find that many of the records and activities are automated, including the execution, clearance, and settlement of trades and the processing of transactions, balancing, and reconciliations of records both within the broker-dealer and with external entities such as the Depository Trust & Clearing Corporation (DTCC) and its subsidiaries.

**2.03** In addition, external service sources, such as market valuation services, provide information that is incorporated into the automated record-keeping system. The extent of automation within the industry varies from company to company.

### Original Entry Journals

**2.04** Original source (trade) data are recorded onto original entry journals. These journals, which are often referred to as blotters, contain the following:

- An itemized daily record of the details for all purchases and sales of securities (by market)
- Receipts and deliveries of securities
- Cash receipts and disbursements
- Other debits and credits, such as listings of floor brokerage receivables or payables, mutual fund commissions earned, and investment counseling fees

**2.05** For each transaction, the blotters or related records generally indicate the following:

- The quantity and description of the securities, including the certificate numbers of the securities
- The unit and aggregate purchase or sales price (if any)
- The trade date
- The name of the broker-dealer from which the securities are purchased or received or to which the securities are sold or delivered

**2.06** A broker-dealer may keep separate blotters to record different types of transactions. For example, a broker-dealer may keep a clearinghouse blotter

to record purchases and sales of cleared securities transacted on an exchange in round lots and several other blotters in which transactions in odd lots, unlisted securities, foreign currencies, bonds, cash receipts and deliveries, and journal entries are recorded. Other types of blotters for special kinds of business include a cash blotter to record cash disbursements and receipts; a receive blotter to record purchases, receipts of securities, and payments of cash; and a deliver blotter to record sales, deliveries of securities, and receipts of cash.

## General Ledger

**2.07** Broker-dealers maintain general ledgers reflecting their assets, liabilities, revenue, expenses, and capital accounts. The general ledger and related subsidiary ledgers (commonly referred to as daily bookkeeping ledgers) (a) provide details relating to all asset, liability, and nominal accounts; (b) enable the broker-dealer to prepare a trial balance in order to prepare financial statements showing the broker-dealer's financial position, results of operations, and cash flows; and (c) facilitate preparation of required regulatory filings. A description of the general ledger accounts is presented in chapter 4, "Financial Statement Presentation and Classification," of this guide. Those records are also used in preparing required net capital and reserve requirement computations.

## Stock Record

**2.08** The *stock record* is a double-entry accounting system for shares of stock or principal amounts of debt by security issue. It is a record of accountability reflecting all securities for which the firm has custodial responsibility or proprietary ownership. The stock record should balance the way a general ledger balances: debits and credits are equal in the general ledger; likewise, long positions and short positions should equal in the stock record. See the "Illustrative Stock Record Entries" section of this chapter, which shows how transactions are recorded in the stock record.

**2.09** A long position in the stock record indicates ownership of the security or the right of possession. The most common positions on the long side of the stock record are the following:

- Customer (securities owned by customer)
- Firm (securities held in inventory for the broker-dealer's own account and risk)
- Reverse repurchase agreements (also known as resale agreements or reverse repos)
- Fail to deliver (securities sold to or through another broker-dealer but not delivered)
- Securities borrowed from another broker-dealer or customer

**2.10** A short position in the stock record indicates either the location of the securities or the responsibility of other parties to deliver them to the broker-dealer. Every security owned or held by the broker-dealer should be accounted for by its location. The following list includes the most common short positions:

- *Box*. Securities are physically located at the broker-dealer's own location, typically in the cashier's cage.
- *Vault*. Securities are physically located at the broker-dealer's own location in a secured area or a bank safe deposit box.

- *Depositories.* Securities are on deposit at a depository, such as the Depository Trust Company (DTC), a subsidiary of the DTCC, or a custodian bank.
- *Transfer.* Securities are at a transfer agent being reregistered.
- *Fail-to-receive.* The broker-dealer has purchased securities that have not yet been received.
- *Securities loaned.* Securities have been loaned to another broker-dealer.
- *Customer short.* A customer sold securities, but delivery has not yet been made.
- *Firm short.* The broker-dealer sold a security it does not own.
- *Repurchase agreements (repos).*
- *Bank loan.* Securities are held on deposit at a bank and pledged as collateral for a loan.

**2.11** The stock record lists securities by security number, normally by Committee on Uniform Security Identification Procedure (or CUSIP) number or International Securities Identification Number, and, for each securities position, the accounts that are long or short in terms of shares (for stocks and mutual funds); principal amounts (for bonds, treasuries, and other debt securities); or number of contracts (for options). A stock record summary indicating all account positions in the security and an activity list indicating daily changes in the stock record are tabulated daily by the broker-dealer.

**2.12** The chart of accounts is the key to reading and understanding the stock record because transactions are recorded by account numbers and quantities. Many accounts can have both securities positions and related money balances. However, certain accounts (such as box, vault, transfer, and depository locations) have only security positions without related money balances.

## Regulatory Recordkeeping Requirements

**2.13** The basic requirements for preparing and maintaining books and records are described in Securities and Exchange Commission (SEC) Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934 (the 1934 Act). In Rule 17a-3, the SEC specifies the minimum books and records a broker-dealer should maintain. They include a complete set of financial accounting books and records, including books of original entry, general and subsidiary ledgers, and the stock record. Rule 17a-3 also sets forth other recordkeeping requirements of broker-dealers. Among other things, Rule 17a-3 states that broker-dealers should maintain a memorandum of each brokerage order and a memorandum for each purchase and sale of securities for its own account, showing the price and, to the extent feasible, the time of execution. The rule also specifies that the broker-dealer should maintain certain records regarding transactions of employees and customers, as well as a periodic trial balance and net capital, reserve formula, and other regulatory computations. Such books and records should be maintained for prescribed periods as set forth in Rule 17a-4.

**2.14** Furthermore, in their constitutions and rules, the Financial Industry Regulatory Authority (FINRA)<sup>1</sup> and many securities exchanges prescribe certain books and records that members keep. Depending on the needs of the individual broker-dealer's business, situations may warrant the maintenance of certain additional records not specifically required under the rules of the various regulatory bodies.

## Trade Date and Settlement Date

**2.15** Prior to computer automation and processing, broker-dealers recorded securities transactions in their trial balances and stock records on the date the securities are due for settlement (settlement date) rather than the date on which the transaction was initiated (trade date). With the advent of automation, many firms now record their proprietary transactions on a trade-date basis. However, customer records are generally still maintained on a settlement date basis (see the "Trade-Date Versus Settlement-Date Accounting" section of chapter 7, "Accounting Standards," of this guide for further discussion of trade date and settlement-date accounting). During the period between trade-date and settlement date, various operational departments are responsible for clearing or settling trades.

**2.16** The time period between trade date and settlement date varies depending on the product and specific transaction. Although any settlement date can be negotiated for any given purchase or sale, the following table provides a reference for the current standardized (regular way) settlement dates by product.

### Standardized Settlement Dates

<i>Product</i>	<i>Settlement Date</i>
Equity Securities	Three business days after trade date
Corporate Bonds	Three business days after trade date
Municipal Bonds	Three business days after trade date
Government Securities	One business day after trade date
Government Agency Securities	Varies depending on product
Futures and Commodities	Same-day settlement
Listed Options (Chicago Board Options Exchange)	One business day after trade date
Money Market Instruments	One business day after trade date
Mutual Funds	Three business days after trade date
Currency Contract Spot	Two business days after trade date

The settlement periods herein refer to the U.S. marketplace. Settlement dates in other countries vary and may not be standardized. Currently, there is an effort to standardize global security settlement periods.

<sup>1</sup> The Financial Industry Regulatory Authority (FINRA) was created in July 2007 through the consolidation of the National Association of Securities Dealers (NASD) and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange (NYSE). It is the largest nongovernmental regulator for all securities firms doing business in the United States. See the FINRA website at [www.finra.org](http://www.finra.org) for more information. Also see footnote 2.

**2.17** Trade-date information, which includes proprietary inventory reports used by a broker-dealer's traders, is normally available in the broker-dealer's internal reporting systems. In addition, customer information is used daily by the broker-dealer to determine the amount of margin required for each customer's account. Trade-date information is also important to the operations departments to assist it in settlement and clearance.

## Trade Execution

### Customer Trades

**2.18** *Sales.* The manner in which trades are initiated varies with the type of broker-dealer (that is, full service or discount). The customers of full-service broker-dealers usually have a designated registered representative or salesperson with whom they place buy or sell orders for securities. The registered representative normally resides at one of the broker-dealer's branch offices that are established to serve a strategic geographic area. Buy and sell orders may be based on the registered representative's recommendations (solicited) or may be initiated by the customers (unsolicited). Orders may also be entered by the broker-dealer pursuant to discretionary powers granted by the customer. In any case, the registered representative is responsible for routing an order to the proper operational department so that the order can be executed and processed. For discount broker-dealers, orders are unsolicited and, in many cases, have been automated to the point that the customer places the order directly into the broker-dealer's system through a personal access code.

**2.19** Before initiating an order, the customer should determine the following:

- The security
- The trading action to be initiated (buy, sell long, or sell short)
- The number of shares or units to be traded
- The type of order
- The price of the transaction
- The disposition of securities purchased or sold
- The method of payment (cash or margin)
- Other incidental information, such as selling against a prior purchase

**2.20** A customer may place many types of orders; the most common are the market order and the limit order. A *market order* is an order to buy or sell a stated amount of a security at the most advantageous price obtainable after the order is received on the exchange floor or in the trading area. A *limit order* is an order to buy or sell a stated amount of a security at a specified price or at a better price if obtainable after the order is received on the exchange floor or in the trading area.

**2.21** Exchange trading is normally done in round lots (usually 100 shares), and a bid and offer on a security is usually made for the minimum unit of trading. A customer may accept a partial execution, in units of trading, unless the order is marked "all or none" or "fill or kill." A customer's order to buy or sell is generally transacted as soon as possible after its receipt on the exchange floor or in the broker-dealer's trading area. An order is considered valid only for

the day of the order; however, a customer can enter an order as good 'til canceled (GTC) or an open order, which is valid for longer than 1 day. The customer can cancel a GTC order if no action has been taken before the cancellation is received. Customers may enter good-through-the-week and good-through-the-month orders for bonds.

**2.22** Customer orders may also be executed by brokers away from an exchange to an electronic communication network (ECN). Institutional customers can execute directly with the ECN. *ECN* is the term used for a type of computer system that facilitates trading of financial products outside of stock exchanges. The primary products that are traded on ECNs are stocks and currencies. ECNs came into existence in 1998 when the SEC authorized their creation. ECNs increase competition among trading firms by lowering transaction costs, giving clients full access to their order books, and offering order matching outside of traditional exchange hours. In order to trade with an ECN, one must be a subscriber or have an account with a broker that provides direct access trading. ECN subscribers can enter orders into the ECN via a custom computer terminal or network protocols. The ECN will then match contra-side orders (that is, a sell order is contra-side to a buy order with the same price and share count) for execution. The ECN will post unmatched orders on the system for other subscribers to view. Generally, the buyer and seller are anonymous, with the trade execution reports listing the ECN as the party.

**2.23** When a customer places an order, an order ticket is completed. The ticket includes the following:

- The security description
- The quantity to buy or sell
- The desired price, if specified
- The type of order
- The customer's name and account number

**2.24** The *order ticket* is the broker-dealer's record of the customer's instructions. SEC Rule 17a-3 states that broker-dealers should maintain a record of each brokerage order given or received for the purchase or sale of securities, regardless of whether the order is executed. The record should show the terms and conditions of the order and any modification or cancellation. The order should indicate the customer account for which the order is entered; the time of entry; the execution price; and, if feasible, the time of execution or cancellation. Orders entered by the broker-dealer pursuant to discretionary powers should be designated as discretionary transactions. Rule 17a-3 has been amended to revise the information to be recorded on order tickets. Among the amendments, a brokerage order ticket should contain the identity of the associated person, if any, responsible for the account and any other person who entered or accepted the order on behalf of the customer and whether it was entered subject to discretionary authority. The brokerage order ticket should also include the time the broker dealer received the customer order. Dealer tickets should include information about any modifications to the order.

**2.25** *Order entry.* The completed order ticket is entered into the system, which accepts and reviews the ticket and relays the customer's instructions to the exchange floor or trading desk where it is to be executed. The exchanges have developed systems whereby an order is routed to an automated order matching system depending on its size or price restriction. In addition, some firms have developed internal order matching systems. Once the order has been



executed, the transaction is confirmed with the customer. Information concerning executed trades is sent to the purchase and sales (P&S) department, which is responsible for ensuring that system-generated trade confirmations are correct and mailed to customers.

**2.26** Orders for over-the-counter (OTC) securities and certain listed securities are generally processed by the trading desk. The trader can either buy or sell the security from the firm's inventory (principal) or can buy from, or sell to, another dealer for the account of the customer (agent). If the trader buys for, or sells from, its own inventory, the price to the customer reflects a dealer spread in lieu of a commission. Alternatively, a trader may initiate an order on the firm's behalf for the benefit of a customer by negotiating the terms with another broker-dealer. This entails agreeing on the price and terms of the trade and executing the transaction, for which the customer is charged a commission.

**2.27** SEC Rule 17a-3 states that broker-dealers should maintain records of each purchase and sale of securities, showing the price and, to the extent possible, time of execution. Records of dealers' quotations or bids or offers made in the course of trading are not required by the rule.

**2.28** An executed trades report containing the terms of the executed orders is generated daily to facilitate further processing. Executed trades reflecting the purchase or sale of securities are recorded on a blotter, but they are generally not posted to the firm's general ledger and stock record until the settlement date. Instead, they are held in a pending file and posted on a memo basis to margin records and a bookkeeping journal. Additionally, to bring better price transparency to the fixed income securities market, the Trade Reporting and Compliance Engine (TRACE) was developed by FINRA to facilitate the mandatory reporting of OTC secondary market transactions in eligible fixed income securities. All broker-dealers who are FINRA member firms have an obligation to report transactions in corporate bonds to TRACE under an SEC approved set of rules. The current reporting time frame of eligible fixed income securities transactions is 15 minutes from execution. Additionally, effective November 4, 2013, firms are now required to report OTC transactions in equity securities to FINRA as soon as practicable, but no later than 10 seconds following execution. FINRA believes firms should automate their trade processing to the greatest extent possible to provide timely trade information to facilitate best execution for customers.

**2.29** *Customer records.* SEC Rule 17a-3 states that broker-dealers should maintain a ledger account or other record for each cash and margin account of every customer, regardless of the frequency of transactions. Transactions in the customer accounts cover both money balances and security positions, with the security transaction and related money generally recorded on the settlement date. Customer accounts should include itemization of the following:

- All purchases and sales
- Securities or commodities received in or delivered out
- Cash receipts and disbursements
- Dividends and interest received or charged
- Other debits and credits

As amended, SEC Rule 17a-3(a)(17) states that broker-dealers should create a customer account record with certain minimum information about each customer. In addition, broker-dealers should furnish account record information to customers on a periodic basis and provide records to regulators when requested.

**2.30** A customer may have several different accounts. Cash and margin accounts, which are the most common accounts, require distinction because they are subject to different rules under Federal Reserve Regulation T (Regulation T) of the Board of Governors of the Federal Reserve System and the regulations of various self-regulatory organizations.

**2.31** A cash account requires a customer to purchase or sell securities strictly on a cash basis. Cash account purchases are limited by Regulation T to purchases for which sufficient funds are held in the account or in reliance on an agreement that the customer will promptly make full cash payment for the security and that the customer does not contemplate selling the security to make such payment. Cash account sales are similarly limited to sales for which the security is held in the account or in reliance on an agreement that the customer owns the security and will make prompt delivery.

**2.32** Under Regulation T, no credit may be extended to a customer with a cash account except for short periods of time between the time an order is executed and the time payment is received from the customer. Full cash payment normally should be made within 5 business days after the date the security is purchased. Assuming a 3-day settlement period, full cash payment should be made no later than 2 business days after the settlement date. However, if an institutional customer purchases a security with the understanding that the security will be delivered promptly and that the full cash payment will be made promptly against such a delivery, meaning a cash-on-delivery or delivery-versus-payment account, the time period for making payment is not to exceed 35 calendar days from the trade date.

**2.33** A customer's failure to make timely payment would ordinarily require the prompt cancellation or liquidation of the transaction. The periods of settlement date plus 2 business days and 35 calendar days may be extended for 1 or more limited periods by applying to the broker-dealer's examining authority.

**2.34** A margin account allows a customer to buy securities without paying in full. The difference between the purchase price and the amount paid by the customer represents a collateralized loan to the customer on which interest is charged. The margin account provides a record of purchase transactions for which the broker-dealer is expected to extend credit for a portion of the purchase price. The amount of credit extended is subject to the limits prescribed under Regulation T. Commodity Futures Trading Commission (CFTC) Rules 41.42–41.49 and SEC Rules 400–406 establish margin requirements for securities futures.

**2.35** Regulation T establishes the maximum loan value of the securities in the account and requires the broker-dealer to obtain a deposit of cash or securities necessary to meet the initial margin requirement within 2 business days after the settlement date. That 2-day period may be extended for 1 or more limited periods by applying to a national securities exchange or FINRA. Maximum loan values for securities and a listing of marginable securities are prescribed periodically by a supplement to Regulation T. Certain securities exchanges have rules establishing minimum maintenance margin requirements (for example, FINRA Rule 4210).<sup>2</sup> After a purchase of stock on margin,

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<sup>2</sup> Following the consolidation of the NASD and the NYSE Member Regulation into FINRA, NASD rules and certain NYSE rules were combined to form the FINRA *Transitional Rulebook*. The incorporated NYSE rules apply only to those members of FINRA who are also members of the NYSE (dual members). FINRA has established a process to develop a new consolidated rulebook that will apply to all FINRA members. Work is continuing on this consolidation of

FINRA Rule 4210 supplements the requirements of Regulation T by placing maintenance margin requirements on margin accounts. Under this rule, as a general matter, and pertaining to long positions in equity securities, broker-dealers require the account holder to maintain equity in the value of the securities of at least 25 percent. If the equity in the account falls below the required amount, the broker-dealer is required to make a maintenance margin call that requires the customer to deposit more funds or securities in order to maintain the equity at the 25 percent level. The failure of the customer to meet the margin call may result in the liquidation of securities in the account. A broker-dealer may establish initial or maintenance margin requirements that are greater than those required by the rules of the regulatory bodies.

**2.36** A *short sale* is a sale of a security that the seller does not own. Before a broker-dealer can execute a short sale for a customer, it must know it can obtain the security. The broker-dealer is expected to borrow the security, if necessary, on behalf of the customer for the purpose of satisfying the delivery requirements. Short sales are governed by the margin requirements of Regulation T and the rules of self-regulatory organizations. A short sale account should be used to record transactions when securities are sold short.

**2.37** In February 2010, the SEC adopted amendments that provide a short sale-related circuit breaker that, if triggered, will impose restrictions on the prices at which securities may be sold short (short sale price test restriction). The amendments also provide that broker-dealers may mark certain short sale orders as “short exempt.” They further require that a trading center establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order of a covered security at a price that is less than, or equal to, the current national best bid if the price of that covered security decreases by 10 percent or more from its closing price, as determined by the listing market for the covered security, as of the end of regular trading hours on the prior day. (See SEC Release No. 34-61595, *Amendments to Regulation SHO*, for more information.) In addition, the rule requires that the trading center establish, maintain, and enforce written policies and procedures reasonably designed to impose this short sale price test restriction for the remainder of the day and the following day when a national best bid for the covered security is calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan.

**2.38** SEC Rule 15c3-3 requires that if a security is sold, other than in a short sale, and not received from the customer within 10 business days after the settlement date, the broker-dealer should close the transaction by purchasing the related security for the account of the selling customer unless an extension is obtained. Certain municipal bonds and government securities are exempt from this buy-in requirement.

**2.39** Naked short selling is prohibited in the United States, as well as other jurisdictions, as a method of driving down share prices. *Naked short selling*, or *naked shorting*, is the practice of short-selling a financial instrument without first borrowing the security or ensuring that the security can be borrowed, as is conventionally done in a short sale. When the seller does not obtain the shares within the required time frame, the result is known as a fail to deliver (as described in paragraph 2.09). The transaction generally remains

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rules. The Securities and Exchange Commission (SEC) must approve the rules that will make up the new *Consolidated FINRA Rulebook*. This information is available on the FINRA website at [www.finra.org/Industry/Regulation/FINRARules/P038095](http://www.finra.org/Industry/Regulation/FINRARules/P038095).

open until the shares are acquired by the seller or the seller's broker, allowing the trade to be settled. In the United States, naked short selling is covered by various SEC regulations that prohibit the practice.

**2.40** A statement of the account should be sent to the customer for any month for which there is activity and at least quarterly if positions or cash are held, as required by regulatory bodies. Broker-dealers should send (pursuant to SEC Rule 10b-10) and retain (pursuant to SEC Rule 17a-4) confirmations of all purchases and sales of securities and notifications of all other debits and credits for cash securities or other items for the accounts of customers.

**2.41** To facilitate the transfer of customer accounts between broker-dealers, the National Securities Clearing Corporation (NSCC), a subsidiary of the DTCC, has developed a system known as the Automated Customer Account Transfer system.

**2.42** *Extension of credit.* After a transaction is recorded, the margin department monitors the customer's trade activity and account balance to ensure that payment and delivery are satisfied in accordance with federal, exchange, and firm requirements. The margin department protects the firm by enforcing collection procedures and policies (checking credit status) and by reviewing customer account activity to ensure that the firm complies with the rules and regulations of various regulatory agencies, such as Regulation T and the rules of self-regulatory organizations. The margin department normally does the following:

- Determines initial margin
- Maintains customer accounts
- Controls the extension of credit
- Checks the credit status of customers
- Controls payments from accounts
- Initiates margin calls
- Processes and monitors applications for extensions of time for cash account customers to pay for securities purchased and for margin account customers to meet initial margin requirements
- Issues instructions for moving securities to or from safekeeping or segregation
- Maintains copies of documents pertaining to transactions

**2.43** Records maintained by the margin department normally indicate the following on a trade-date basis for each margin customer:

- Market value<sup>3</sup> of the securities
- Money balance of the account
- Margin excess or deficit
- Safekeeping and segregation instructions
- Pending trades

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<sup>3</sup> The terms *market value* and *mark-to-market* are used within this chapter as operational terms. Accordingly, in practice they may not necessarily be synonymous to the terms *fair value* and *subsequently measured at fair value*, which are used within the financial statements in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) No. 2012-04, *Technical Corrections and Improvements*.

- Special miscellaneous account balance calculated in conformity with Regulation T and the rules of self-regulatory organizations

**2.44** The margin department advises other departments when they can complete their responsibilities (for example, when a security delivery or cash payment can be completed). Other records and information that may be maintained by the margin department are the following:

- Standing customer instructions regarding the delivery of securities
- The disposition of cash from the sale of securities
- Standing customer instructions regarding the receipt of dividends and interest
- Guarantees of customers' accounts

**2.45** The margin department maintains an account record for each customer and, based on that information, authorizes the cashier's department to make delivery on sales and payments on purchases. The margin department instructs the cashiering department to transfer and deliver securities to customers who have paid in full and want possession of certificates.

**2.46** Generally, the margin department computes the amount of money customers should deposit and when it should be deposited. The functions of the margin department relate not only to margin transactions but also cash accounts and cash transactions. For transactions in cash accounts, the margin department ensures that payment is received from the customers on purchases within the regulatory, specified time periods.

**2.47** For margin and short-sale transactions, the margin department ensures that customers deposit sufficient collateral to meet federal and exchange regulations. The margin department tracks the market value of the collateral; if the value of the collateral falls below firm guidelines or exchange (maintenance) requirements, the customers are required to satisfy the deficiencies. Due to the volatility in securities values, it is essential that up-to-date records be maintained so that the margin department is able to make informed decisions to limit the firm's exposure to losses.

## Proprietary Trades

**2.48 Dealer.** Many broker-dealers attempt to profit from firm trading by selling securities at a higher price than what they paid for them. Firm trading activity can be broadly divided into dealer and positioning strategies.

**2.49** With a dealer strategy, the broker-dealer attempts to balance buy and sell transactions with different customers or other broker-dealers and earn the difference between the price paid on the purchase (bid) and the price received on the sale (ask). If a broker-dealer cannot simultaneously execute a buy and corresponding sell, the firm is at risk to market volatility during the time between execution of the purchase and execution of the sale. Hedging strategies are often employed to minimize that risk; however, hedge accounting is permitted only if the requirements of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 815, *Derivatives and Hedging*, are met.

**2.50** Positioning strategies involve the broker-dealer buying and selling securities in anticipation of certain market movements and holding such positions for longer periods than with dealer strategies. If a trader anticipates that a security's price will rise, the trader may take a long position in that

security; if a security is expected to decline in value, the trader may take a short position. Positioning strategies are riskier than dealer strategies because the security is held for a longer time. If a trader incorrectly forecasts the market, losses can be incurred.

**2.51** *Trader and investor.* Trading desks typically maintain trade date records based on trading strategies that may include different types of instruments. Those records, if not integrated with the accounting department records, should be reconciled periodically to them.

**2.52** In addition to marketable securities, broker-dealers may purchase securities for investment that are not readily marketable or whose sale is restricted by the purchase terms. Securities purchased for investment should be designated and recorded separately in the accounts of a broker-dealer to meet the requirements of the IRS because they are purchased with the expectation of future capital gains. The broker-dealer's records should clearly indicate by the close of the day on which an investment security is acquired (floor specialists currently have seven business days) that it is held for investment.

**2.53** *Underwriter.* A broker-dealer participating in underwriting activities may act as managing underwriter, comanaging underwriter, or participating underwriter. The managing underwriter is responsible for organizing the other participating underwriters and the selling group. This function is often performed jointly by two or more firms as comanagers. A managing underwriter, in addition to being a participating underwriter, typically negotiates the transaction with the issuer of the security and maintains the records of the underwriting group. A comanager takes part in the negotiations but does not maintain the records of the group.

**2.54** Participating underwriters maintain records of each underwriting participation only to the extent they are involved. To spread the risk of an underwriting and facilitate its distribution, the underwriters may sell all or part of the securities directly to the public or a selling group that in turn sells the securities to the public. If an issue is not fully sold, the liability is shared among the participating underwriters through either an undivided or divided arrangement. An *undivided liability* is an arrangement whereby each member of an underwriting syndicate is liable for its proportionate share of unsold securities in the underwriting account regardless of the number of securities it has previously sold. Under divided liability, the member's liability for an underwriting is fixed or definite in amount. Selling groups are not underwriters and have no obligation to sell the securities allocated to them. Accordingly, they are entitled only to a selling concession.

**2.55** The managing underwriter maintains the subscription records for the underwriting and receives from the participating underwriters and members of the selling group reports of orders from their customers so that it knows the status of the offering.

**2.56** The managing underwriter maintains daily position listings of the entire issue and ascertains the status of securities subscribed to and whether they have been delivered to the participating underwriters. Expenses associated with each underwriting are accumulated in the general ledger in separate deferred expense accounts. That is known as running the books. When the underwriting is completed, the profit or loss on the underwriting is determined and distributed to the participating underwriters.

**2.57** The difference between the price to the public and that to the issuer (the gross underwriting spread) represents the underwriters' and selling group's compensation for the risk and cost of selling the issue. The gross underwriting spread is generally apportioned between the underwriters and selling group and consists of a management fee, an underwriting fee, and a selling concession. The underwriters may be entitled to a management fee, an underwriting fee, or both.

**2.58** As noted in FASB ASC 940-605-05-1, the *management fee* is the fee paid to the manager or comanagers of the underwriting for services rendered in organizing the syndicate of underwriters and maintaining the records for the distribution. The underwriting fee is paid to the underwriting participants as compensation for the risk assumed through their agreement to buy a specified portion of the issue. It is usually net of the expenses directly associated with the underwriting. The *selling concession* is the fee paid for selling the offering.

## Clearance and Settlement

### Overview

**2.59** Most transactions on securities exchanges and in certain active unlisted securities are cleared and settled through clearing organizations that were established to simplify and expedite the settlement of transactions between member firms. Clearance is facilitated through continuous net settlement (CNS) systems that minimize paperwork and the movement of securities and money. This results in one net position in each security (either to deliver or receive) between the broker-dealer and clearing organization. Clearing organizations prepare daily reports for members, showing the net security position (beginning balance less sales and plus purchases, plus receipts, and less deliveries) by security and the net money balance that is due to or from the clearing organization.

**2.60** After a trade has been executed, the P&S department enters the trade into the bookkeeping system. Prior to the settlement date, the P&S department determines the amount to be paid or received at settlement. The P&S department determines and maintains records supporting its calculation of the following:

- The contract money (including accrued interest on bonds and other fixed-income securities)
- Commissions
- Taxes
- All other related money amounts

**2.61** FASB ASC 940-320-30-1 explains that accrued interest earned on fixed-income securities is computed from the last coupon payment date up to the settlement date. This amount is paid to the seller of the instrument by the purchaser, who then receives the full periodic interest amount on the next coupon payment date.

**2.62** The P&S department maintains the records of floor brokerage fees that are due to other broker-dealers who execute orders on the firm's behalf and brokerage fees due from other broker-dealers. Floor brokers employed by the firm may execute trades on behalf of other broker-dealers for which the firm is paid a brokerage fee. Broker-dealers often engage floor brokers who are

responsible for executing securities transactions on the exchanges for the account of the broker-dealer.

**2.63** As explained in FASB ASC 940-20-25-8, if the floor broker is employed by the broker-dealer, any costs associated with the floor broker's employment are generally reported as employee compensation. Costs paid to independent floor brokers or floor brokers of other firms for trades on behalf of the broker-dealer are generally reported as floor brokerage expense.

## Comparison

**2.64** Comparison procedures performed by the P&S department vary depending on whether a trade is cleared through a clearing organization, through a clearing bank if it is a government security, or directly with another broker-dealer. After a trade is executed, the terms, conditions, and details of the transaction are compared with those of the clearing organization or other counterparty.

**2.65** On the trade date, each member broker-dealer electronically transmits a list of its day's trades to a clearing organization, detailing the following for each trade:

- The quantity of a security bought or sold
- A description of the security
- The contract price
- The identification number of the contra broker-dealer

**2.66** These data are sorted by a clearing organization's computerized facility, such as that of the Securities Industry Automation Corporation. To qualify for clearing through a clearing organization's CNS system, a trade must be between two member broker-dealers, and the security must be eligible. Eligible securities are fairly active issues that provide high liquidity. Unless both of these requirements are satisfied, the parties cannot use the clearing facilities' CNS system, and the trades are to be settled directly in the trade-for-trade system or between the individual broker-dealers. Contract sheets itemizing the purchases and sales by broker-dealers are prepared for eligible securities cleared through the clearing organization. These contract sheets contain lists of compared and un-compared trades.

**2.67** All trades are compared by the P&S department to verify that all terms and conditions agree before further processing. *Compared trades* are matched transactions in which the information received from both parties agrees. They require no further processing by the P&S department. *Un-compared trades* contain differences between the information supplied by the contracting broker-dealers, such as discrepancies in prices, quantities, descriptions of issues, or counterparties. All un-compared trades are resolved by the P&S department by the second day following the trade date, or they are settled directly between the broker-dealers (ex-clearing). Clearing organization-cleared trades may be corrected by the broker-dealer at fault by advising the clearing organization to correct the discrepancy. Differences not settled in that way are settled directly between broker-dealers.

**2.68** For trades that are not processed through a clearing organization, the P&S department reviews a system-generated broker-to-broker comparison that is sent to the counterparty for verification of all pertinent trade information. If the counterparty agrees with all details of the transaction, the comparison is



signed and returned to the P&S department to evidence its acceptance. If the other broker-dealer disagrees with the details of the transaction, any corrections made in the firm's accounting records are recorded to enable proper settlement to occur.

## Settlement

**2.69** Active securities are those used by the broker-dealer to carry out its daily business and are most typically located in depositories, such as the DTCC, that maintain book entry systems. Active securities include the following:

- Customers' securities not yet paid for
- Securities purchased by customers on margin that collateralize funds advanced by the broker-dealer against the purchase price
- Securities owned by the broker-dealer

**2.70** Any active securities maintained on the broker-dealer's premises are referred to as being "in the box."

**2.71** A clearing organization delivers securities by transferring securities on deposit at a depository such as the DTCC. The selling (delivering) broker-dealer or clearing organization delivers instructions electronically to the depository to transfer the securities by book entry rather than physical movement. This is known as *clearing through book entry*.

**2.72** Money is paid or received daily by the broker-dealer so that the money balance in the account approximates the net market value of the open security positions. Included in the transmittal to the clearing organization are credit lists showing the total dollar amounts due from each of the purchasing broker-dealers.

**2.73** The cashiering department is responsible for receipts and deliveries of securities and money and reconciles on a daily basis the money balance due to or from the clearing organization or the depository with the firm's records. After this is accomplished, a check or draft is used to facilitate net money settlement with the respective clearing organization.

**2.74** Although most securities are held in book entry form, the procedures used in the handling of physical securities are described in the following paragraphs. Procedures performed relating to such settlement of transactions usually begin on the day prior to the settlement date with the receipt of blotters of trades scheduled to be settled the next business day. Accompanying the blotters are receive and deliver tickets for transactions to be settled directly with other broker-dealers and transactions to be settled through the clearing organization. Physical securities are delivered to the clearing organization with the delivery tickets attached on the settlement date.

**2.75** Physical securities received from a selling broker-dealer are counted, verified, matched with the receive ticket, and determined to be in negotiable form. If the delivery is good, a copy of the deliver ticket is authorized for payment, and payment is made.

**2.76** For deliveries to be made directly to other broker-dealers, blotters are examined, and requests for the securities needed for delivery are made, usually on the business day before the settlement date. If the securities are not available after all receipts on the day before settlement, the needed security may be borrowed, in which case the stock loan department would be requested

to borrow the securities from another broker-dealer. If the securities are on hand, the securities are removed from the box, checked for proper negotiability, and delivered to the purchasing broker-dealer. If the delivery matches the purchasing broker-dealer's receive instructions, the selling broker-dealer receives payment.

**2.77** Payment received by the selling broker-dealer is verified for propriety and entered into the cash receipts records. If the purchasing broker-dealer's instructions do not agree with the delivery attempted, the purchasing broker-dealer will DK (don't know) the delivery, which means the broker-dealer does not know the delivery. If the discrepancy is not corrected by the end of the day, the transaction represents a fail to receive for the purchasing broker-dealer and a fail to deliver for the selling broker-dealer.

**2.78** *Fails to receive or fails to deliver.* As noted in the FASB ASC glossary, a *fail to receive* is a securities purchase from another broker-dealer not received from the selling broker-dealer by the close of business on the settlement date. As explained in FASB ASC 940-20-25-5, it is recorded as a liability in the general ledger. As per industry practice, a corresponding entry is recorded for a short position on the stock record.

**2.79** As noted in the FASB ASC glossary, a *fail to deliver* is a securities sale to another broker-dealer that has not been delivered to the buying broker-dealer by the close of business on the settlement date. As explained in FASB ASC 940-20-25-4, it is recorded as an asset in the receivable account. As per industry practice, a corresponding entry is recorded for a long position on the stock record.

**2.80** Most broker-dealers have automatic fail systems that generate pending files containing all unsettled securities after the trade date. As securities are settled, they are removed from the pending files. Any unsettled trades remaining on the day following the settlement date are transferred to fail files. Blotters of all open fails are forwarded to the cashiering department daily to be controlled and monitored.

**2.81** Fails are forwarded for entry to the stock record (securities) and general ledger (money). Normally, an updated file of open fails is produced daily. When a fail is cleared (securities having been either received or delivered versus payment), the date of the clearance is noted, and the fail position is cleared from the broker-dealer's records. A fail position may require the broker-dealer to buy in (see the glossary) the security if the fail is outstanding longer than the time period specified by SEC Rule 15c3-3.

**2.82** Broker-dealers generally record fail-to-receive transactions separately from fail-to-deliver transactions for each broker-dealer with whom they execute transactions. The cashiering department is responsible for resolving fails as quickly as possible because of the market risk exposure and financing implications involved. Broker-dealers continuously monitor their fail exposure by contract and counterparty. A broker-dealer has exposure if the contract value exceeds the market value for a fail to deliver or if the contract value is less than the market value for a fail to receive. Broker-dealers mark their fail positions to market to determine their exposure and calculate any net capital charges pursuant to SEC Rule 15c3-1. In addition to its market risk exposure, a broker-dealer is concerned with securities in its possession that it has failed to deliver because it must then finance its receivables by other means, such as bank loans.

**2.83** Broker-dealers clearing transactions through correspondent brokers maintain fail-to-receive and fail-to-deliver records only for transactions that are self-cleared through U.S. correspondent broker-dealers. For transactions with foreign correspondent brokers, a broker-dealer is required to maintain fail records until notified by the foreign correspondent that the transaction has cleared.

**2.84** *Depositories.* Depositories provide physical custody and transfer of certain securities, as well as the settlement of securities transactions between broker-dealers without the physical movement of securities. Securities held by depositories may be pledged to banks as collateral for loans without the physical transfer of the securities to the banks.

**2.85** Each depository prepares daily reports for member broker-dealers, indicating activity by security, the money balance on deposit, and a statement of the balance of all security positions. Broker-dealers have the responsibility of indicating in their records whether the securities held at a depository are available for clearance and financing activities (that is, as collateral for bank loans) or should be reduced to possession or control, as required by SEC Rule 15c3-3. The status of such securities may be indicated on a stock record or in separate records supporting the total stock record position shown for a depository.

## Bookkeeping

**2.86** The P&S department's responsibilities include ensuring that trades are entered into the bookkeeping system correctly. If a trade is not properly recorded by the settlement date, the difference is posted to a suspense account until it is resolved (for example, a trade ticket not passed, a one-sided entry processed, or a bad account number used).

**2.87** An entry is also made to a P&S suspense account when only one side of a principal-party buy or sell trade ticket is processed. The P&S suspense account item is resolved when the processing of the trade ticket is completed and reflected in the appropriate account. An operations suspense account records unidentified cash receipts and differences in trade billings or cash settlements of trade tickets.

**2.88** Debit money balances and short security positions that cannot immediately be identified and cleared are recorded in suspense accounts. They reflect a potential exposure to the firm and should not be netted against like credits and long positions that are also placed in suspense accounts. Any material balances in suspense accounts should be identified and resolved on a timely basis. This suspense account can subject a broker-dealer to off-balance sheet liability risk if the error is resolved against the broker-dealer and the value of the security is also against the broker-dealer.

## Specialized Clearance Activities

### Mortgage-Backed Securities

**2.89** The books and records maintained by broker-dealers in mortgage-backed securities (MBSs) are somewhat unique because of the requirements for recording receipts and payments of MBS principal and interest (P&I), maintaining records of both the original face value and amortized face value of MBSs, recording the allocation of mortgage pools to fulfill sales commitments,

and maintaining records for trades for forward settlement when underlying pool numbers have yet to be announced (TBA).

**2.90** MBSs or pass-through securities are created when mortgages are pooled together and sold. Payments of P&I on the underlying mortgages are passed through monthly to investors (less certain fees). In some instances, inefficient recordkeeping in registering the owner of an MBS with the paying agent has caused monthly payments of P&I to be forwarded to previous owners, forcing the current owner to submit claim letters to recoup missing P&I funds. The proper recordkeeping of P&I receivables and payables is essential to ensure accurate recording and collection.

**2.91** Monthly payments for P&I are calculated using factors; the factor represents the percentages of each pool's original face value still outstanding. With the increasing application of computer technology to MBSs, the P&I problems are being resolved. By interfacing with a principal paydown factor service, a broker-dealer can automatically calculate the monthly accruals for P&I receivables and payables. Broker-dealers can also efficiently track partial payments and nonpayments to ensure recovery of receivables.

**2.92** Computerized access to factor tapes also allows the broker-dealer to maintain records of the amortized face value of MBSs more efficiently. The amortized face value of MBSs is necessary to allocate pools properly to fulfill sales commitments, as well as amortize properly the purchased premium or discount.

**2.93** A significant amount of MBS trading occurs in TBAs. The broker-dealer maintains accounting subledgers that reflect outstanding TBA buy and sell transactions. TBA transactions can be settled by receiving or delivering pools pursuant to the terms of the trade (within 0.01 percent of the trade amount) or by offsetting the trade through an offsetting TBA purchase or sale. In both cases, accurate subledgers are important to calculate properly the pools received or delivered pursuant to the TBA transactions.

## Government Securities

**2.94** Treasury issues (with the exception of registered securities) and many U.S. government agency securities are available in book entry form through the Federal Reserve's book entry system. Only depository institutions (such as commercial banks, savings and loan associations, credit unions, and certain other depositories, as defined in the Monetary Control Act of 1980) can maintain accounts on the system. A depository institution may have several accounts, including clearing safekeeping accounts and trust safekeeping accounts. The book entry system electronically transfers government and agency securities between accounts based on instructions from its members.

**2.95** Broker-dealers use members of the system to clear and settle transactions because they do not have direct access to Fedwire, the Federal Reserve's communication system. The broker-dealer gives instructions to its clearing bank (member of the Federal Reserve) for the transfer of funds and securities. Broker-dealers that have significant activity can make deliveries electronically through the Federal Reserve member bank by means of a remote access unit, which their clearing bank can supply.

**2.96** All primary government securities dealers and some nonprimary government securities dealers are members of a clearing agency known as the

Government Securities Division (GSD) of the Fixed Income Clearing Corporation (formerly known as the Government Securities Clearing Corporation), which is a subsidiary of the DTCC. Participating government securities dealers use this net settlement system for the clearance and settlement of government securities positions. This net settlement system will net down settlements (including interest) for delivery through the Federal Reserve System. The GSD guarantees all transactions that are already compared between participants. The settlement of transactions for government securities is done using federal funds. Government securities normally settle as regular way trades one business day after the trade date. They can also settle for cash (same day as the trade date) or for any mutually agreed-on settlement date.

## Repos and Reverse Repos

**2.97** Repos and reverse repos are generally traded on a cash settlement basis (same day as the trade date). Executions for repo transactions are usually completed during the morning hours of a business day to allow time for the adequate processing and clearing of trades. The paperwork and delivery of the securities and funds are accomplished during the afternoon. Most securities transfers and the delivery of funds are settled over Fedwire. As noted previously, for government securities, only members of the Federal Reserve have direct access to Fedwire, so the broker-dealer uses its clearing bank for the transfer of funds and securities for repo transactions. Actual written purchase and sale confirmations are also delivered, when applicable. Depending on the arrangement of the repo transaction, the repo collateral may be delivered (transferred) to the buyer, held in safekeeping in a segregated customer account by the seller, or delivered to the buyer's custodial account at the seller's clearing bank.

**2.98** Additional securities transfers or delivery of funds may be necessary over Fedwire depending on changes in the market value of the underlying collateral (mark-to-market). Market value changes can necessitate adjustment of the repo transaction, either by repricing or a margin call. In a repricing, the change requires a delivery of funds, whereas a margin call requires a transfer of collateral.

## Derivative Securities<sup>4</sup>

**2.99** FASB ASC 815 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts. Broker-dealers value investments in trading securities and

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<sup>4</sup> See appendix A, "Proposed Rulemaking," of chapter 3, "Regulatory Considerations," of this guide for information on Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)-related rulemaking regarding swaps. The Dodd-Frank Act divides regulatory authority over swap agreements between the Commodity Futures Trading Commission (CFTC) and the SEC (with other regulators also having a role, such as the Federal Reserve Board, which has an important role in setting capital and margin for swap entities that are banks). Under the comprehensive framework for regulating swaps and security-based swaps established in Title VII, the CFTC is given regulatory authority over swaps, the SEC is given regulatory authority over security-based swaps, and the commissions shall jointly prescribe such regulations regarding mixed swaps as may be necessary to carry out the purposes of Title VII.10. In addition, the SEC is given antifraud authority over, and access to information from, certain CFTC-regulated entities regarding security-based swap agreements, which are a type of swap related to securities over which the CFTC is given regulatory authority. In July 2012, the SEC issued Release No. 33-9338, *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping*. This final rule further defines the terms *swap*, *security-based swap*, and *security-based swap* (continued)

hedges at fair value. This practice is an important one to consider in a review of the provisions of FASB ASC 815. See the “Derivatives” section of chapter 7 of this guide for discussion of FASB ASC 815. Derivative products (such as interest rate and currency swaps, swaptions, caps, and floors) involve certain unique settlement procedures. The settlement of these products does not involve the delivery of physical or book entry securities, but rather only cash exchanges between counterparties based on interest rates and notional or contract accounts. Settlement procedures for interest rate swaps require the monitoring and calculation of the required interest payment for the floating rate cash flow and the calculation of the fixed-rate interest payment for the fixed-rate cash flow. Once these amounts are determined on the interest payment date, the cash payments are then transmitted to the appropriate counterparty by the method specified in the master swap agreement, such as wire or check. Often, a broker-dealer will have more than one swap agreement with a counterparty. If a master netting agreement is in place, the counterparty may net the interest payments or receipts, and one net cash payment will be made to or from the broker-dealer on the interest payment date. The floating rate cash flow of an interest rate swap is continually updated, as specified under the terms of the swap agreement, to enable the broker-dealer to calculate the interest payment or receipt from the contract and also to calculate unrealized gain or loss on a contract.

**2.100** Caps, floors, and swaptions are settled solely for cash and do not require the exchange of physical or book-entry securities. For interest rate caps, upfront payments or premiums are paid to the writer in exchange for the right to receive the excess of a reference interest rate over a given rate. For interest rate floors, premiums are paid to the writer for the right to receive the excess of a given rate over a reference interest rate. The underlying contract is monitored continuously to determine whether the change in the floating rate has triggered the cap or floor. Once triggered, the cash payments or receipts of the amounts in excess of the cap amount and the amounts below the floor amount are calculated. Again, cash payments will be made in accordance with the master swap agreement. On the interest payment date, cash payments or receipts may be netted for counterparties that have a master netting agreement.

**2.101** *Swaptions* are options to enter into an interest rate swap at a future date or to cancel an existing swap in the future. Premiums are paid to the writers of swaptions. Upon exercise of the swaption, the same clearance procedures would apply for interest rate swaps, or the swap would terminate with no further cash payment or receipt.

## Commodity Futures and Options on Futures

**2.102** The underlying commodities in the commodity futures contracts currently traded include grains, soybeans, rice, potatoes, sugar, coffee, and other foodstuffs; cotton; meat products, such as live and feeder cattle, pork bellies and live hogs, and broilers (chickens); precious and other metals, including gold, silver, copper, palladium, and platinum; foreign currencies; and energy products, such as crude oil, heating oil, and leaded and unleaded gasoline. Contracts in financial instruments such as U.S. Treasury bills, bonds and notes, Government National Mortgage Association securities, bank certificates of deposits,

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*(footnote continued)*

agreement and provides further information on mixed swaps and security-based swap agreement recordkeeping. See the SEC and the CFTC websites for more information on swap and derivative rulemaking.

and Eurodollars are traded by those who wish to speculate or hedge using various interest rate futures. Also, stock index futures contracts are used for hedging portfolios or speculating against changes in stock market prices. As previously discussed, hedge accounting is permitted only if the requirements of FASB ASC 815 are met.

**2.103** Most commodity futures contracts can be settled by taking or making delivery of the actual underlying commodity. Futures on stock market indexes and certain other futures are settled in cash. Exchange-traded options on futures contracts are settled through the delivery of the related futures contract by book entry. Although a futures contract may be settled by delivery, virtually all the commodity futures and option contracts are not settled by delivery, but rather with an offsetting purchase or sale of the same futures or options contract.

**2.104** *Clearing organization for settlement of commodity futures and option contracts.* A clearing organization is affiliated with a commodity exchange to clear or match trades executed on that exchange. The clearing organization that comprises clearing members prepares daily settlement reports for each member. The reports show details of the trades cleared and the original margin on futures or premium deposits on options separately for customer and non-customer trades. The open trades at the close of business each day are marked to market (trade price versus settlement price), resulting in a net cash payment to, or collection from, each clearing member as a result of price changes (that is, gains or losses). The payable or receivable is settled by check, draft, or wire transfer before the market opens on the next business day. In addition, the clearing organization may call on the clearing member for additional original margin. The margin and option premiums deposited at the clearing organizations are kept under the control of these clearing organizations as a guarantee against defaults.

**2.105** *Special commodities records.* The CFTC, which regulates activities in futures and options on futures, requires full, complete, and systematic records of all transactions relating to the business. At a minimum, those records include the following:

- Monthly computation of minimum financial requirements
- Daily computation of funds segregated for customers trading on U.S. futures exchanges and reservation of funds for U.S. customers trading on non-U.S. futures exchanges
- Records of all charges and credits in each customer's account and all of the following:
  - Futures transactions executed for such accounts (including the date, price, quantity, market, commodity, and futures month)
  - Options on futures transactions executed for such accounts (including the date; an indication of whether the transaction involved a put or call; the expiration date; the quantity; the underlying contract for future delivery or underlying physical strike price; and details of the purchase price of the option, including premium, mark-up, commission, and fees)
- Details of securities and property received as margin
- Confirmations to each customer of futures and options transactions executed on the customer's behalf

- Purchase and sale statements to each customer for offsetting transactions
- Monthly statements to customers specifying open positions and trade prices, net unrealized profits or losses in all open futures contracts, the market value of all open options on futures contracts, the ending ledger balance reflected in the customer's account, and details of any securities and property deposited by the customer as margin
- The customer name and address file indicating the principal occupation or business of the customer, signature cards, and risk disclosure statements
- Time-stamped order and execution tickets that include the account identification and order number
- Details of investments of customer funds
- A trade register that is a record for each business day, detailing all futures transactions and options on futures transactions executed on that day
- The monthly point balance that accrues, or brings to the official closing price or settlement price fixed by the clearing organization, all open contracts of customers as of the last business day of each month or of any regular monthly date selected (however, although CFTC regulations only require a monthly point balance, a firm with strong internal control would be performing this balancing on a daily basis)

**2.106** A contract position record is usually maintained on a daily basis and shows a balancing of futures contracts by customer and for the broker-dealer's own account, offset by the position with the carrying broker or clearing organization. These positions are typically compared daily with the clearing organization in a procedure referred to as point balancing.

**2.107** Broker-dealers record an accrual for commission income for futures and options on futures transactions on a half-turn basis (see the glossary), although in some instances the round-turn commissions (see the glossary) may be reflected in the customer's account upon entering into the transactions or on the date of the round turn.

## Forward Transactions

**2.108** *Forward transactions (forwards)* are defined as existing trade commitments with settlement dates subsequent to regular-way trades (see the "Trade-Date Versus Settlement-Date Accounting" section of chapter 7). They may have a time differential of up to one year or more, and are thus traded on a delayed delivery or forward basis. These transactions are normally recorded on memo records (such as a pending or when-issued file) that are confirmed on a regular basis similar to other customer positions that have settled. The accounting for those forward transactions is to recognize the gain or loss on a current basis (that is, by valuing the individual transaction on a current basis). See the "Derivatives" section of chapter 7 for a discussion of FASB ASC 815, which establishes the accounting and reporting standards for derivative instruments and hedging activities.



## Municipal Securities

**2.109** The clearance and settlement process for municipal securities is very similar to that for equities and corporate bonds. Most securities clear through the NSCC, and issues that are depository eligible normally settle by book entry.

**2.110** However, certain factors make the municipal securities market unique. The most significant are the following:

- Municipal securities, other than new issues, settle trade for trade rather than CNS because the Municipal Securities Rulemaking Board (MSRB) prohibits partial settlements.
- MSRB real-time transaction reporting requires brokers, dealers, and municipal securities dealers to report most transactions within 15 minutes of execution.
- MSRB rules limit the buy-in period for aged fails to receive to 90 business days without full cooperation with the contra party. If a buy-in has not been completed within that time, the contra broker-dealer cannot be held liable for any losses incurred.
- Many municipal securities are not depository eligible and, therefore, require physical settlements.
- Because of the tax-exempt status of municipal securities, they are generally not sold short and are not actively loaned or borrowed.

## International Securities

**2.111** Certain issues are unique to non-U.S. securities that are traded in foreign markets. Each foreign market should be examined separately because of the following characteristics:

- There are custody issues related to the receipt and delivery of securities corresponding to transactions, the collection and payment of dividends and interest, information gathering, and processing with regard to corporate actions. Foreign custody agents must qualify under SEC Rule 17f-4 governing the eligibility of depositories.
- Custody requirements vary by country. Settlement cycles, as well as holiday schedules, are usually different. Other than in the United States, the exchange of shares for money seldom takes place simultaneously. In some clearing environments, the actual delivery of shares takes place more than 24 hours before payment. Therefore, counterparty risk and the process for choosing counterparties are important factors.
- The means of settling transactions in different countries can be dissimilar. Depending on the marketplace, book shares, physical shares (both registered and bearer), issuers' receipts, or transfer agent receipts may be the norm for transfer of ownership.
- Trading in offshore markets may involve the use of corresponding foreign exchange (FX) transactions to convert into the local currency of the foreign market. Such an FX transaction is another contract with its own risks and liabilities.
- Each country has its own unique rules relating to certain exception-type transactions. The issues may be whether short sales are allowed in the trading environment, if a stock loan is a business in that

market, and what the regulatory issues relating to contract closeouts are.

- Tax and regulatory issues within a foreign market are additional considerations to review. Issues relating to the withholding of taxes, principal and income repatriation, and proper registrations are important within that market. The U.S. rules as they relate to a U.S. broker-dealer transacting business in the international marketplace are also a variable that affects business. Aged foreign fails are treated differently from domestic fails with respect to net capital charges and buy-ins (see SEC Rules 15c3-1 and 15c3-3).
- Cultural differences, although not a quantitative concept, can at times be a factor in doing business internationally. Issues such as language barriers, differences in work habits, and time-zone differences might be considered.

## Options on Securities

**2.112** The books and records required to be maintained by a general securities broker-dealer are also required of an options clearing firm under SEC Rules 17a-3 and 17a-4. An order ticket is required for each option transaction and should contain all relevant information, including the type of account (customer, firm, or market maker); whether the transaction is a put or call; whether it is a purchase or sale; the underlying trading unit; the exercise price; the expiration date; the premium per unit; and the purchasing and writing clearing members. In addition, the clearing firm should maintain a separate P&S blotter and a separate position record for all option transactions for itself and its customers or market makers.

**2.113** Every clearing broker-dealer is required to furnish the following to its customers:

- Confirmations of each trade showing whether it was a purchase or sale, the underlying trading unit, the exercise price, the expiration month, the number of option contracts, the premium, the commission, the trade date, and the settlement date
- Monthly statements showing all purchases and sales during the month, including all commissions, taxes, interest charges and any other special charges, the ending market value of all long and short positions in the account, and the general account equity

**2.114** Listed option trades settle on the next business day. Options Clearing Corporation (OCC) member broker-dealers are required to reconcile all option money and positions on a daily basis. An OCC clearing broker-dealer can exercise a long options contract by notification to the OCC. Exercise notices are assigned by the OCC on a random basis to clearing member firms and are effective the following day. Each assigned clearing member firm is required to allocate assignment notices to proprietary, customer, and market-maker short positions by using established set procedures. The allocation of assignment notices should be either on a random-selection or first-in, first-out basis.

**2.115** The OCC issues a daily position report that lists all option activity and ending positions for all accounts carried by the OCC member broker-dealer and the net daily pay or collect amount due to or from the OCC. The OCC also issues a margin report that shows the OCC margin requirement on the aggregate short option positions and exercised contracts for each account carried by the OCC member broker-dealer. Required margin may be paid by

cash, check, government securities, common stocks with a market value as specified by the rules, or an irrevocable letter of credit issued by an OCC-approved bank or trust company.

**2.116** All OCC member broker-dealers that clear market-maker accounts or floor broker accounts are required to issue an OCC-approved letter of guarantee and a letter of authorization for floor brokers, and such letters are filed with the appropriate exchange. A letter of guarantee provides that the issuing clearing member accepts financial responsibility for all option market-maker transactions guaranteed by the clearing broker-dealer. A letter of authorization provides that the clearing broker-dealer accepts responsibility for the clearance of all option trades by the floor broker.

**2.117** OCC member broker-dealers clearing market-maker transactions are required to “haircut” (see the glossary) the market-maker accounts as required by SEC Rule 15c3-1(c)(2)(X). Because the carrying broker-dealer guarantees the market-maker account to the OCC, the carrying broker-dealer is required to reduce its own net capital by the amount the market maker’s Rule 15c3-1(c)(2)(X) haircut charges exceed the equity in the account. In addition, SEC Rule 15c3-1 requires that the sum of all market-maker Rule 15c3-1(c)(2)(X) haircut charges not exceed 1,000 percent of the carrying broker-dealer’s net capital (the 1,000 percent test).

## Reconciliation and Balancing

**2.118** Daily cash receipts and disbursements are totaled on the journals or blotters, and the closing balance for each bank account is determined. A summary of the postings is prepared showing the distribution to the control accounts in the general ledger. The summary is agreed with the totals of the various source documents and with related items in the summaries prepared by the receive and deliver departments. In addition to the settlement and cash journal summaries, broker-dealers may prepare an overall summary of cash transactions processed by the cashier’s department. Normally, this cash summary sheet contains numerous descriptive categories and columns to which the cash movements are posted. Entries are compiled by summarizing working documents, including blotters, journals, drafts, and other receipt and disbursement forms.

**2.119** The securities record department is responsible for monitoring and controlling the recording of all securities movements under the broker-dealer’s jurisdiction. The stock record department ensures that longs equal shorts for securities positions and is responsible for correcting all breaks in the securities record, just as the accounting department is responsible for ensuring that debits equal credits for money balances. Uncorrected breaks could cause serious losses to the firm, and accordingly, such items should be monitored, aged, and reported to management daily.

**2.120** Securities differences may be caused by inaccurate recordkeeping on the part of a broker-dealer, by an out-of-balance condition in the stock record (a stock record break), or by errors in the receipt and delivery of securities. Such differences are normally disclosed through the automated daily balancing of the stock record, periodic counts of securities on hand, and examination or confirmation of items such as transfers and fails.

**2.121** When a security difference is discovered, it should be recorded in a security difference account (a suspense account) pending research concerning

the reason for the difference. When the difference is resolved, entries are made clearing the difference position from the stock record. If a short difference is not resolved, SEC Rule 15c3-3 requires the broker-dealer to buy-in the shortages. Subject to legal interpretation concerning ownership, the overages may be sold.

## Custody

**2.122** Customers' fully paid and excess-margin securities may be kept at a depository (see the following section, "Possession or Control") or in a vault on the broker-dealer's premises. Securities belonging to customers are recorded on the broker-dealer's records so that the real or beneficial owners (customers) can always be identified. The securities record often provides data concerning customer securities required to be held in segregation or safekeeping, which may be shown on the same securities record by using an additional column or memo entry, thus eliminating the need for a separate listing or summary. Customers' certificates may be registered in the broker-dealer's name (segregation) so that the securities can be delivered quickly. Alternatively, if a customer's certificates are registered in the customer's own name (safekeeping), they are nonnegotiable until a stock power is attached, endorsing a change in the beneficial owner, which would then be signature-guaranteed by attachment of an appropriate medallion.

## Possession or Control

**2.123** Customers' fully paid or excess-margin securities should be reduced to the possession or control of the broker-dealer within the time frame specified in SEC Rule 15c3-3. Permissible control locations include box, segregation, safekeeping, the DTC, or other approved depositories. Safekeeping securities are customers' securities fully paid for and held in custody by the broker-dealer for the accounts of customers. Safekeeping securities are normally registered in the name of the customer. Segregated securities are securities that have been reduced to the possession or control of the broker-dealer for the benefit of customers who have fully paid for them or securities of margin customers in excess of margin requirements. They are registered in the name of the broker-dealer or its nominee.

**2.124** Securities usually are transferred to and from possession or control on the basis of instructions prepared by the margin department. The instructions reflect the following:

- The customer's name
- The quantity and description of the security
- The date the instructions were prepared
- The customer's account number

**2.125** The ownership of securities that should be reduced to possession or control is usually indicated by means of additional columns or codes in the securities record. Instructions for the segregation or release from segregation of securities are issued by the margin department, frequently through an automated system. These instructions are processed into the broker-dealer's stock record, and total customer segregation requirements are compared with the total quantity of specific securities currently in possession or control. This comparison generates a report to the cashier's department indicating, by issue, the number of shares pending to be placed in segregation by the cashier or the

number of shares in excess of requirements that may be removed from segregation by the cashier. The cashier's department carries out the instructions generated by this comparison, which is produced on a daily basis. This system (commonly known as bulk segregation) does not relate certificates to specific customers; as an alternative, some firms may use specific identification for determining their segregation requirements.

**2.126** Securities pending safekeeping or segregation (securities designated to be placed in safekeeping or segregation) may be fail-to-receive items, transfer items, out on loan to another broker, or collateral for bank loans. SEC Rule 15c3-3 limits the length of time during which securities can remain in those locations before the broker-dealer should take action to bring the securities into possession and control.

## Securities Transfer

**2.127** The transfer department is responsible for transfers of ownership, registration, and reissuance of securities in different certificate denominations (usually to meet delivery requirements). Securities are generally registered in the name of the firm, unless the customer specifically requests that fully paid securities be registered in his or her name. If the securities are to be registered in the customer's name, the transfer instructions are issued by the margin department.

**2.128** The transfer or margin department of a broker-dealer normally prepares securities-transfer instructions containing the following:

- The name in which new certificates are to be registered (and the account number and mailing address if they are to be registered in a customer's name)
- The number of shares or principal amount and description of the securities
- Instructions indicating whether the new certificates are to be sent to the customer or held by the broker-dealer for the customer's account
- Certificate numbers of the securities being transferred

**2.129** The instructions from the margin department are recorded, and the security is designated as in transfer on the stock record. The instructions are then kept in an open transfer ticket file, which constitutes the supporting detail for the stock record transfer position. A copy of the instructions is sent to the transfer agent with the securities to be transferred.

**2.130** The transfer department sends registered securities to transfer agents to be reregistered in the new owners' names. Transfer agents (often banks) maintain the company's list of owners. The certificates should be endorsed by the registered holder and authorized by a power of attorney. Reregistration may be made in the name of the beneficial owners or a nominee. Registration of certificates has been curtailed through the use of depositories.

**2.131** Securities received from transfer are matched against the open transfer instructions, and the completed instructions are used as the basis for removing the open transfer position from the stock record. If the certificates are returned, the transfer department records them and returns them to the vault or sends them to the cashier's department for delivery. Those instructions remaining in the transfer department provide the supporting detail for the transfer positions on the stock record.

**2.132** The transfer and reorganization departments maintain an aging of open transfer and reorganization items because any item in excess of 40 calendar days for which a confirmation has not been received from the transfer agent should be reported in the broker-dealer's regulatory monthly net capital and weekly reserve computations.

## Dividends, Interest, and Reorganization

### Dividends and Interest

**2.133** The dividend department records distributions receivable on securities (such as cash dividends, stock dividends, rights, splits, and interest on debt instruments) of customers and the broker-dealer. Key dates are the following:

- *The declaration date.* The date a business entity announces the dividend.
- *The record date.* The date that determines who will be paid (stockholders and bondholders who are registered owners on the record date will be paid the distribution).
- *The payable date.* The date of the dividend and interest payment.
- *The ex-dividend date (or ex-date).* The date the market price of the security is reduced to reflect the amount of the dividend (that is, securities traded on that date do not include rights to the upcoming dividend payment).

**2.134** The principal exchange on which a security is listed sets the ex-date for listed stocks; FINRA sets the date for those securities traded in the OTC market. The ex-date is generally two business days before the record date for cash dividends.

**2.135** On the dividend or interest record date, the dividend department obtains listings that show the record date holders and locations of each security. The record will indicate how the securities are registered (that is, in the name of the broker-dealer or in the name of another broker-dealer or individual from whom the dividend or interest is claimed).

**2.136** To reduce the number of claims, the dividend department usually notifies the cashier's department daily of securities with approaching record dates. The cashier's department checks for securities on hand that are registered in a name other than the broker-dealer's own name and will attempt to deliver such securities to the transfer agent so that the registration may be transferred to the broker-dealer's name as of the record date. Broker-dealers usually use information provided electronically by dividend-reporting services to identify information regarding dividend dates.

**2.137** For each cash dividend or interest payment, the dividend department prepares a memo proof to ascertain the total receipts and disbursements that will be processed in comparison with the total long and short positions for a particular security. The dividend department determines which customers' or firm inventory accounts are to be credited or debited on the payable date for the dividend or interest versus the receivable or payable account. Differences between the amounts received and the receivable amounts should be investigated by the dividend department.

**2.138** For each stock dividend distribution, the dividend department performs procedures similar to those for cash dividends. Long and short entries to customer and firm accounts are made on the payable date and are offset by entries to stock dividend accounts; the stock dividend accounts are flattened (zeroed out) after the actual securities have been received.

**2.139** As noted in FASB ASC 940-20-05-7, the dividend department maintains a record of securities the broker-dealer fails to receive or deliver on the record date. Securities received or delivered against fails that were open on the record date and that are in the name of the delivering broker should be accompanied by due bills. A *due bill* is an official authorization allowing the purchasing broker-dealer to make a legal claim on the selling broker-dealer for a future distribution to which it is entitled. For cash dividends or interest payments, this typically takes the form of a postdated check. It is usually the responsibility of the dividend department to collect or authorize payments for transactions of this nature.

**2.140** Broker-dealers should maintain records for each security by individual declaration date and should not net dividends or interest either by security or between dates.

**2.141** Amounts received that have not been paid or credited because proper account identification cannot be made are considered to be unclaimed dividends and interest (suspense items) and are normally paid only on receipt of valid claims. Balances remaining in dividends or interest payable accounts may be subject to abandoned property (escheat) laws. Aged dividend or interest receivables should be readily identifiable so that appropriate net capital charges can be computed in accordance with SEC Rule 15c3-1 and that appropriate reserve computation treatment can be applied pursuant to SEC Rule 15c3-3.

## Reorganization

**2.142** Reorganization transactions result if an entity undergoes a change in its ownership or structure affecting its outstanding securities. A common example of a reorganization transaction is a tender offer on the part of a third party to purchase a company's shares.

**2.143** Reorganization transactions may be either voluntary offers or mandatory exchanges. Voluntary offers are processed if the broker-dealer is so instructed by customers who have the option to accept or reject a tender; subscribe to an issuance; exercise options, rights, or warrants; or convert convertibles shares.

**2.144** Mandatory exchanges are generally processed for customers on the effective date. They include mergers, splits and reverse splits, subscriptions, consolidations, acquisitions, exchanges of convertible securities into common stocks, and certain called securities.

**2.145** The reorganization department is responsible for processing securities involving corporate reorganizations. The responsibilities include the following:

- Executing corporate calls for redemption of issues in the custody of the brokerage firm
- Converting securities into common stock on request of their underlying owner

- Exchanging one class of security for another class of the same issuer, pursuant to a reorganization of the business entity
- Exchanging one company's securities for another company's securities or money, pursuant to a merger or an acquisition
- Subscribing for new shares in a company, pursuant to a rights offering
- Transmitting securities to an intended purchaser under terms of a tender offer on specific written instructions from its beneficial owner
- Allocating results to customer accounts on partial tenders

**2.146** *Recording customer or proprietary reorganization transactions.* On the effective date of the reorganization, the original security is removed from the customer or proprietary trading account and set up as a long position in the reorganization account. The new security (or cash, in the case of a cash tender) is set up long (credited) in the customer or proprietary trading account and short (debited) to the reorganization account. When the securities or cash are received from the reorganization agent, the reorganization account is flattened.

## Collateralized Financing

### Stock Loan and Stock Borrow

**2.147** Securities not available to be delivered on the settlement date may be borrowed. A stock borrow occurs when a broker-dealer needs a security to deliver against a settling transaction, such as a short sale. A *short sale* is the sale of a security not owned by the firm or a customer. Short sales are often made in anticipation of a market decline or as part of a trading or hedging strategy.<sup>5</sup>

**2.148** A broker-dealer also may be involved in a finder's business, whereby securities are borrowed to relend to another broker-dealer, thus allowing the broker-dealer to earn a spread on the transaction. Broker-dealers may also engage in equity securities borrowed transactions solely for financing the positions of another broker-dealer in which the equity securities are initially borrowed without a permitted purpose pursuant to Regulation T Section 220.10(a), and placed in a box location. These transactions, which are referred to as nonpurpose borrows, have regulatory implications that need to be considered in the computation of net capital. Rule 203 of SEC Regulation SHO contains requirements and guidance for broker-dealers related to the long and short sales of equity securities.

**2.149** In general, broker-dealers borrow securities to deliver them to another broker-dealer or customer, often leveraging utilities like LOANET (see the glossary) to do so. If the cashiering department needs to borrow securities, it instructs the stock loan department to borrow them. The borrowing broker-dealer is required to deposit cash or other collateral that may be in the form of securities issued or guaranteed by the United States or its agencies, certain certificates of deposit or bankers' acceptances, or irrevocable letters of credit. When the borrowing broker-dealer deposits cash, it receives an interest-like rebate on the amount that was exchanged for the securities. This rebate is negotiated, with the rate usually established by the lender and agreed to by the

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<sup>5</sup> Hedge accounting is permitted only if the requirements of FASB *Accounting Standards Codification* 815, *Derivatives and Hedging*, are met.



borrower. If a security is difficult to obtain, a lower rebate would be acceptable. The borrowing broker-dealer records the transaction as a long on the stock record and as an asset in the general ledger (receivable from the lending broker). The lending broker records a short position on the stock record and a liability in the general ledger. FASB ASC 860, *Transfers and Servicing*, provides specific criteria for determining whether a securities lending transaction is to be accounted for as a sale or secured borrowing and provides an illustration of the latter. Among other matters, FASB ASC 860 provides guidance for recognition and reclassification of collateral and for disclosures relating to securitization transactions and collateral. (See chapter 7 of this guide for a discussion of secured borrowing.)

**2.150** For each security borrow or loan position, information may be prepared and retained in the cashiering department to be used as the basis for an out-of-loaned or out-of-borrowed entry and also in the comparison of cashiering department records with the stock record and general ledger for control purposes. The cashiering department records contain details of securities borrowed and loaned transactions, such as the following:

- Date
- Description of the security
- Quantity
- Total amount of the deposit made (securities borrowed) or received (securities loaned)
- Party from whom the securities have been borrowed or to whom they have been loaned

**2.151** As with fail-to-receive and fail-to-deliver items, those records provide the supporting details for the stock record borrow and loan security positions, as well as for the general ledger money control of amounts due to and due from others. It is general practice for broker-dealers to adjust daily the contract value of the securities borrowed and loaned to market value (mark to market).

## Bank Loan Financing

**2.152** The day-to-day financing needs of a broker-dealer are provided by the treasurer's department, which may negotiate short-term loans from banks or other parties.

**2.153** A separate record is generally maintained for each such loan, usually indicating the following:

- The bank's name
- The type of loan (that is, firm, customer, or noncustomer, depending on the collateral pledged)
- The loan amount
- The interest rate
- The quantity, description, and market value of securities used as collateral for the loan

**2.154** A separate file for securities used as collateral may be maintained in certain systems. The loan records are the supporting details of the general ledger and the security positions shown on the stock record as bank loan collateral.

**2.155** From the reports indicating the collateral loan securities are being recalled from the bank, or additional securities are being sent to the bank, either in substitution for securities recalled or as additional collateral, entries are prepared and entered on the stock record. Separate accounts are generally maintained in the general ledger for each loan, with separate positions maintained in the stock record for the securities collateralizing each loan. Broker-dealers are required to differentiate their bank loans as either firm, customer or nonfirm, noncustomer as provided in SEC Rules 8c-1 and 15c2-1. This distinction is also required in determining collateral requirements pursuant to federal regulations and determining amounts to report in the reserve formula, as required by SEC Rule 15c3-3. Securities used to collateralize bank loans of customers cannot be fully paid-for or excess-margin securities because such securities are required to be segregated by the broker-dealer.

## Reverse Repos and Repos<sup>6</sup>

**2.156** Reverse repos are similar to securities-borrowed transactions, except that reverse repos are generally executed with government and government-agency securities. Securities are usually borrowed to make deliveries on short sales, whereas reverse repos are frequently related to investment activities as well as meeting delivery requirements.<sup>7</sup>

**2.157** In a reverse repo transaction, a broker-dealer receives securities for a stated price from another party and agrees to sell them to the same party at a later date (a) at the same price plus interest at a stated rate or (b) at a higher price. The higher price reflects the interest earned on the contract price for the number of days the contract is outstanding.

**2.158** The party entering into a reverse repo does not own the securities. Accordingly, the reverse repo is treated as a collateralized receivable rather than an inventory position. The party selling the securities with the commitment to repurchase maintains most incidences of ownership.

**2.159** In a repo, a broker-dealer sells securities at a stated price to another broker or a customer and agrees to repurchase an identical security at a later date at the same price plus interest at a stated rate or at a higher price, which reflects the interest on the principal amount borrowed.

**2.160** The rights of parties involved in a repo or reverse repo transaction depend on the particular terms and conditions of the transactions that are documented in a written agreement or transaction confirmation. Most firms use a standard agreement developed by the Securities Industry and Financial Markets Association (formerly the Bond Market Association). The use of standardized documentation diminishes uncertainties for such transactions. Written agreements should describe the transaction, the terms and conditions of the contract, and the rights of the parties, including the following:

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<sup>6</sup> On January 15, 2013, FASB issued proposed ASU *Transfers and Servicing (Topic 860): Effective Control for Transfers with Forward Agreements to Repurchase Assets and Accounting for Repurchase Financings*. The intent of the ASU is to clearly identify repurchase agreements, securities lending transactions, and other transactions that involve a transfer of a financial asset and an agreement that both entitles and obligates the transferor to repurchase or redeem the transferred asset that should be accounted for as financing transactions, and to improve the accounting and disclosures for those transactions. Comments were due on March 29, 2013. Readers should be alert for further developments.

<sup>7</sup> Reverse repurchase agreements discussed in this guide are usually referred to as repurchase agreements by the investment company and banking industries.

- The names of the parties
- The quantity and a description of the securities
- Interest, or the formula for determining interest to be paid or received
- The date and terms of delivery or receipt
- Provisions for marking to market
- The terms of loan or the conditions for return or recall
- The capacity of the parties as principal or agent
- The right and ability of the purchaser of the securities to substitute like securities for repurchase on the repurchase date
- A description of events of default that would permit the purchaser or seller to liquidate or purchase the underlying securities
- A description of the rights of any trustee or custodian who may hold the underlying securities during the life of the agreement
- A description of the party that is to have title to the underlying securities during the term of the agreement
- Timely correction of mark-to-market deficiencies or excesses and a description of the method of computing mark-to-market requirements
- The right of offset

**2.161** The accounting records should include details of all securities in repo and reverse repo transactions showing the following:

- Amount of the contract
- Dates of delivery or receipt
- Identification of counterparties
- Dates and amounts of mark to market and dates the securities are to be recalled or returned

## Regulatory Considerations

**2.162** The general presumption of SEC Rule 17a-3 is that the financial accounting records have accounting integrity, be balanced, have an appropriate audit trail, and be posted currently. The rule does not specify the medium or even format of the records. Instead, it simply specifies the generic records to be made and requires that they be kept current. This generally means that financial and regulatory computations can be made promptly using those records.

**2.163** SEC Rule 17a-4 prescribes the period of time that the books and records, as well as certain additional records, should be maintained by the broker-dealer under SEC Rule 17a-3. The rule applies to those records maintained in connection with a broker-dealer's business, not only those required by SEC Rule 17a-3. For example, record retention requirements for correspondence, canceled checks, memorandums, and other records of the broker-dealer's business are included under the rule.

**2.164** The records of a broker-dealer are generally required to be maintained for two years in a readily accessible place at the broker-dealer's principal place of business. Thereafter, the length of time the broker-dealer is required

to maintain the records varies. Basic accounting records should be kept for six years. Records relating to the terms and conditions of opening and maintaining an account should be kept at least six years after closing the account. Other records (such as corporate charters, partnership agreements, minute books, and stock certificate books) should be kept for the life of the broker-dealer. Certain states and other authorities may have additional requirements for keeping books and records.

**2.165** SEC Rule 17a-4 permits the broker-dealer to utilize microfilm or microfiche to preserve the firm's records. Other means, such as electronic files (for example, image processing), have been approved by the SEC as an alternative method of preserving a firm's records, provided certain criteria are met. If records are kept on such media, two copies should be made and kept in separate places to protect against loss. If an outside service bureau or other facility is used by the broker-dealer to prepare the records, the broker-dealer and facility should have an agreement that the facility's records are available to the SEC and self-regulatory organizations.

**2.166** A broker-dealer operating as a sole proprietor should maintain records of all assets and liabilities of the proprietor that are not related to the broker-dealer's operation. Such records are necessary for determining whether the broker-dealer has complied with the net capital rule's (SEC Rule 15c3-1) requirement that the excess of personal liabilities over assets not used in the business be treated as a deduction when computing net capital.

**2.167** SEC Rule 17a-11 under the 1934 Act requires broker-dealers to notify the SEC and their designated examining authority if certain difficulties are experienced. The rule also requires notification if certain minimum net capital requirements are not met. With regard to the books and records, the rule requires a broker-dealer that has failed to keep its books and records current as specified under SEC Rule 17a-3, to give notice of this fact immediately; to specify the books and records that have not been made and kept current; and to file a report within 48 hours of the notification stating the steps taken to correct the situation.

**2.168** SEC Rule 17a-13 under the 1934 Act requires quarterly securities examinations (including physical securities counts, verifications, and comparisons with the records of the firm) and the recording of differences, as well as appropriate documentation of such procedures.

**2.169** The broker-dealer is also required to be in compliance with the net capital rule at all times. At least monthly, a broker-dealer is required to prepare and maintain a record of the proof of money balances for all ledger accounts in the form of trial balances and a record of the computation of aggregate indebtedness (unless the alternative capital computation, which uses aggregate debit items from SEC Rule 15c3-3, is being elected) and net capital under SEC Rule 15c3-1, as of the same date. In addition, SEC Rule 15c3-3 requires that records be maintained of the periodic (weekly or monthly) calculations of aggregate debit and credit items and the deposits required in the special reserve bank account for the exclusive benefit of customers and that compliance with the requirements for maintaining physical possession or control of fully paid and excess-margin securities of customers be documented.

## Tax Information Reporting

**2.170** A broker-dealer is required to file information returns with the IRS for certain customer transactions and to also send the related form(s) to the

customer. Examples of the more common returns and of the information they provide include the following:

- *Form 1099-B (broker transactions).*<sup>8</sup> The gross proceeds from the sale of securities conducted by the broker-dealer during the year.
- *Form 1099-INT (interest).* The amount of interest received by the customer from securities held by the broker-dealer during the year.
- *Form 1099-DIV (dividends).* The amount of dividends received by the customer from equity securities held by the broker-dealer during the year.
- *Form 1099-OID (original issue discounts).* The amount of interest accreted on original issue discount securities (and any interest received on original issue discount securities) held by the broker-dealer during the year.
- *Form 1099-R (retirement funds).* The amounts withdrawn during the year from an individual retirement account (IRA) or a pension account that is held at the broker-dealer's firm (the broker-dealer is also required to provide other information about IRA arrangements on Form 5498).
- *Form 1099-MISC (miscellaneous).* The amount of payments in lieu of dividends earned by the customer but not received because the security was placed by the broker-dealer in a stock loan at the customer's request.

**2.171** The IRS generally matches information returns filed by the broker-dealer to its database to determine whether the payee's name and taxpayer identification number (TIN) correspond to its records. If there is a mismatch, the IRS notifies the broker-dealer (payor) of this fact. The payor is then required to send a letter to the payee informing him or her of the mismatch and request a Form W-9 be returned within 30 business days of the date of the notification from the IRS. If the payee does not return this W-9, all future reportable payments are subjected to backup withholding. If a payor does not withhold when required to do so, the payor becomes responsible for the tax.

**2.172** The IRS has rules regarding what action to take when a payee has provided an incorrect TIN. Certain notices should be sent to the payee. Depending on the situation, the broker-dealer may be required to begin backup withholding and continue backup withholding until notified by either the IRS or the Social Security Administration to stop. Once again, failure to withhold when required to do so will result in the payor being held responsible for the tax. Publication 1281, *Backup Withholding for Missing and Incorrect Name/ TIN(s)*, is available on the IRS website and contains information and forms related to backup withholding.

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<sup>8</sup> The Emergency Economic Stabilization Act of 2008 imposed additional requirements related to stock basis reporting. Internal Revenue Code (IRC) Section 6045 was amended to require that in the case of a covered security, every broker required to report the gross proceeds from the sale of a security under IRC Section 6045(a) must also report the customer's adjusted basis in the security and whether any gain or loss with respect to the security is long term or short term. The reporting is typically done on IRS Form 1099-B. Form 1099-B instructions contain information about a covered security and the additional information required to be reported.

In addition, a broker (and certain other persons that transfer custody of a covered security to a receiving broker) must furnish to the receiving broker a written statement that allows the receiving broker to satisfy the basis reporting requirements. The required statement must be furnished to the receiving broker within 15 days after the date of the transfer. Information regarding this requirement can also be found in Form 1099-B instructions.

**2.173** The IRS requires broker-dealers to file Financial Crimes Enforcement Network (FinCEN) Form 104, *Currency Transaction Report* (formerly Form 4879), for customer deposits, withdrawals, exchanges of currency, or other payments or transfers by, through, or to the broker-dealer if they involve a transaction in currency of more than \$10,000. In addition, FinCEN Form 101, *Suspicious Activity Report by the Securities and Futures Industries*, should be filed to report suspicious activity. The instructions to FinCEN Form 101 outline when and under what circumstances a form should be filed.

## Illustrative Stock Record Entries

**2.174** All stock record entries are recorded on a security-by-security basis on the settlement date. Trade date information is maintained on other files of the broker-dealer. Although not common, some firms maintain their stock record on a trade date basis.

1. Customer A buys 100 shares of ABC at \$20 per share. Note that the entry assumes the securities are not received on the settlement date.

<u>Stock Record</u>	<u>(Quantity)</u>	<u>General Ledger</u>	<u>(\$)</u>
Long—Customer A	100	Dr. Customer A	2,000
Short—Fail to Receive	100	Cr. Fail to Receive	2,000

2. Customer A pays \$2,000 for the securities.

<u>Stock Record</u>	<u>(Quantity)</u>	<u>General Ledger</u>	<u>(\$)</u>
No entry needed		Dr. Cash	2,000
		Cr. Customer A	2,000

3. Because the 100 shares of ABC have not been received, the firm borrows 100 shares of ABC.

<u>Stock Record</u>	<u>(Quantity)</u>	<u>General Ledger</u>	<u>(\$)</u>
Long—Stock Borrow	100	Dr. Stock Borrow	2,000
Short—DTC	100	Cr. Cash	2,000

4. The security failed to receive is now received at the DTC.

<u>Stock Record</u>	<u>(Quantity)</u>	<u>General Ledger</u>	<u>(\$)</u>
Long—Fail-to-Receive	100	Dr. Fail-to-Receive	2,000
Short—DTC	100	Cr. Cash	2,000

5. Instead of being returned, the stock borrow was loaned.

<u>Stock Record</u>	<u>(Quantity)</u>	<u>General Ledger</u>	<u>(\$)</u>
Long—DTC	100	Dr. Cash	2,000
Short—Stock Loan	100	Cr. Stock Loan	2,000

6. Customer B sold 200 shares of DEF at \$30 per share. Note that the entry assumes the securities were in transfer and, therefore, not delivered on the settlement date.

<u>Stock Record</u>	<u>(Quantity)</u>	<u>General Ledger</u>	<u>(\$)</u>
Long—Fail-to-Deliver	200	Dr. Fail-to-Deliver	6,000
Short—Customer B	200	Cr. Customer B	6,000

7. DEF was delivered through the DTC.

<u>Stock Record</u>	<u>(Quantity)</u>	<u>General Ledger</u>	<u>(\$)</u>
Long—DTC	200	Dr. Cash	6,000
Short—Fail to Deliver	200	Cr. Fail to Deliver	6,000

8. The stock record is balanced against the DTC, and it was noted that the firm shows 200 more shares of DEF than does the DTC statement.

<u>Stock Record</u>	<u>(Quantity)</u>	<u>General Ledger</u>	<u>(\$)</u>
Long—DTC	200	No entry needed	
Short—Suspense	200		

9. In addition, the firm's reconciliation showed that the DTC sent the firm a check for \$3,500 when the firm's records showed a receivable of \$5,000.

<u>Stock Record</u>	<u>(Quantity)</u>	<u>General Ledger</u>	<u>(\$)</u>
No entry needed		Dr. Cash	3,500
		Dr. Suspense DTC	1,500
		Cr. Receivable from DTC	5,000

10. The firm decides to buy 5,000 shares of GHI at \$2 per share for its inventory.

<u>Stock Record</u>	<u>(Quantity)</u>	<u>General Ledger</u>	<u>(\$)</u>
Long—Firm Inventory	5,000	Dr. Firm Inventory	10,000
Short—Box or DTC	5,000	Cr. Cash or DTC	10,000

11. The firm decides to repo Treasury bills held at the DTC with a face value of \$10 million. Note that the entry assumes delivery of the security and that the market value of the securities is the same as the face amount.

<u>Stock Record</u>	<u>(Quantity)</u>	<u>General Ledger</u>	<u>(\$)</u>
Long—DTC	10,000,000	Dr. Cash	10,000,000
		Cr. Securities Sold under agreements to repurchase	
Short—REPO	10,000,000		10,000,000
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## Chapter 3

# Regulatory Considerations

### © Update 3-1: Regulatory Rulemaking Related to Broker-Dealers

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) contains a significant number of provisions that affect the broker-dealer industry, including Public Company Accounting Oversight Board (PCAOB) oversight of audits of broker-dealers, reorganization of the over-the-counter (OTC) derivatives market, increased regulation of asset-backed securities, and amendments related to the Securities Investor Protection Act. Rulemaking mandated by the Dodd-Frank Act is extensive, and the rulemaking process continues as the Securities and Exchange Commission (SEC) and other regulators work to finalize the regulations mandated by the Dodd-Frank Act. See the preface of this guide and appendix A, “Proposed Rulemaking,” of this chapter for information on this rulemaking.

**3.01** Pursuant to the Securities Exchange Act of 1934 (the 1934 Act), the SEC developed a comprehensive system to regulate broker-dealers and the securities industry in general. As a result, broker-dealers, including nonissuer broker-dealers, are subject to regulation by the SEC. Note that this guide is directed primarily toward nonissuer broker-dealers; however, it does contain some content regarding audits of issuer broker-dealers.

**3.02** The audit and reporting requirements for securities broker-dealers are regulated by Rule 17a-5 under the 1934 Act. Such requirements for broker-dealers that are also commodities brokers, known as futures commission merchants (FCMs),<sup>1</sup> are regulated by Regulation 1.16 of the Commodity Exchange Act, whereas the requirements for registered broker-dealers in U.S. government securities are regulated by Section 405.2 of the regulations pursuant to Section 15C of the 1934 Act. Those rules are listed in paragraph 3.177. Before undertaking the audit of a broker-dealer in securities, the auditor should obtain an understanding of relevant regulatory factors. This generally includes reading the applicable rules in order to have an understanding of the prescribed scope of the audit and the related reporting requirements.

**3.03** The Dodd-Frank Act, signed into law by the president on July 21, 2010, calls for a number of regulatory changes related to the securities industry. One of the provisions of this act amends the Sarbanes-Oxley Act of 2002 (SOX) to give the PCAOB full oversight authority over audits of all broker-dealers, including nonissuer broker-dealers. The Dodd-Frank Act includes a provision that audits of broker-dealers, including nonissuer broker-dealers, be performed under PCAOB auditing standards. The SEC has issued transitional guidance in Release No. 34-62991, *Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and*

<sup>1</sup> The Commodity Practice Aid Task Force of the AICPA updated the Practice Aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools* in 2009 to reflect changes in accounting and auditing guidance and regulatory rules that occurred since the original issuance of this publication. The revised practice aid provides practitioners with nonauthoritative, practical guidance on the financial statements of futures commission merchants (FCMs), introducing brokers, and commodity pools. The publication is available at [www.cpa2biz.com](http://www.cpa2biz.com). The practice aid is currently being revised as a result of rulemaking based on the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) provisions. Readers should be alert for the superseded information from the 2009 edition.

*Dealers*, that clarifies that audits of nonissuer broker-dealers will continue to be performed under generally accepted auditing standards (GAAS) as issued by the Auditing Standards Board of the AICPA and any applicable rules of the SEC. This interpretation will be revisited in connection with current standard-setting projects; therefore, it is important to watch for further developments. See the preface of this guide and appendix A of this chapter for more information on the Dodd-Frank Act.

## Applicable Rules

**3.04** The SEC's rules require the auditor to be designated by the broker-dealer, in writing, to the SEC and the examining authority, such as the Financial Industry Regulatory Authority (FINRA) or a securities exchange, of which the broker-dealer is a member.

**3.05** SEC Release No. 34-63241, *Risk Management Controls for Brokers or Dealers with Market Access*, requires broker-dealers with access to trading securities directly on an exchange or alternative trading system (ATS), including those providing sponsored or direct market access to customers or other persons, and broker-dealer operators of an ATS that provide access to trading securities directly on their ATS to a person other than a broker-dealer, to establish, document, and maintain a system of risk management controls and supervisory procedures. See paragraphs 3.91–.93 for more information.

**3.06** The primary rules<sup>2</sup> under the 1934 Act and other regulations that are applicable to the audits of broker-dealers in securities are as follows:<sup>3,4</sup>

- Rules 8c-1 and 15c2-1, “Hypothecation of Customers’ Securities”
- Rule 15a-6, “Exemption of Certain Foreign Brokers or Dealers”
- Rule 15c3-1, “Net Capital Requirements for Brokers or Dealers”
- Rule 15c3-1(e), “Limitations on the Withdrawals or Capital Distributions of Liquid Assets from Broker-Dealers”
- Rule 15c3-3, “Customer Protection: Reserves and Custody of Securities”
- Rule 17a-3, “Records to Be Made by Certain Exchange Members, Brokers, and Dealers”
- Rule 17a-4, “Records to Be Preserved by Certain Exchange Members, Brokers, and Dealers”

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<sup>2</sup> In 2007, the Securities and Exchange Commission (SEC) proposed amendments to the financial responsibility rules for broker-dealers, as found in Release No. 34-55431, *Amendments to Financial Responsibility Rules for Broker-Dealers*. In May 2012, the comment period was reopened for the proposed amendments, as found in SEC Release No. 34-66910, *Amendments to Financial Responsibility Rules for Broker-Dealers*. The amendments have not yet been finalized as of the date of this guide. In addition, revisions to Rule 17a-5, as proposed in Release No. 34-64676, *Broker-Dealer Reports*, dated June 15, 2011, are still being deliberated as of the date of this guide. See appendix A, “Proposed Rulemaking,” of this chapter for more information on the proposed revisions. It is important that readers be alert for further developments.

<sup>3</sup> Paragraphs 3.179–.180 provide additional discussion of rules adopted under the the Securities Exchange Act of 1934 (1934 Act) for over-the-counter (OTC) derivatives dealers who register with the SEC under a limited regulatory structure rather than under the usual broker-dealer regulatory regime of Section 15(b) of the 1934 Act. Also, see paragraph 3.178 for a listing of rules under Title 17, *Commodity and Securities Exchanges* U.S. Code of Federal Regulations Chapter IV, that are applicable specifically to government securities broker-dealers.

<sup>4</sup> See [www.finra.org/Industry/Regulation/Guidance/FOR/index.htm](http://www.finra.org/Industry/Regulation/Guidance/FOR/index.htm) to access many of these rules and related interpretations.

- Rule 17a-5, “Reports to Be Made by Certain Brokers and Dealers”
- Rule 17a-11, “Notification Provisions for Brokers and Dealers”
- Rule 17a-13, “Quarterly Security Counts to Be Made by Certain Exchange Members, Brokers, and Dealers”
- Rule 17h-1T, “Risk Assessment Recordkeeping Requirements for Associated Persons of Brokers and Dealers”
- Rule 17h-2T, “Risk Assessment Reporting Requirements for Brokers and Dealers”
- Rule 17Ad-17, “Lost Securityholders and Unresponsive Payees”
- Rule 17Ad-22, “Clearing Agency Standards”
- SEC 17-248–Subpart C, “Regulation S-ID: Identity Theft Red Flags” (Regulation S-ID)
- Federal Reserve Regulation T (Regulation T) of the Board of Governors of the Federal Reserve System
- For broker-dealers that are also FCMs, Commodity Futures Trading Commission (CFTC) Regulations 1.10–1.32, 5.6–5.14, 22.2–22.7, and 30.7 (see paragraph 3.177 and the CFTC website at [www.cftc.gov](http://www.cftc.gov) for more information)
- The Investment Advisers Act of 1940, for broker-dealers that are also registered as investment advisers under said act (see the discussion beginning at paragraph 3.167 for information on new requirements for broker-dealers who are also registered as investment advisers)

**3.07** A general familiarity with the rules of the various exchanges, the Treasury Department, and the CFTC if the broker-dealer is a government securities dealer or an FCM, and FINRA<sup>5</sup> will be helpful to the auditor in understanding the relationships among the rules.<sup>6</sup>

## Interpretations of Rules

**3.08** Interpretive guidance regarding the financial responsibility rules can be accessed at [www.finra.org/Industry/Regulation/Guidance/FOR/index.htm](http://www.finra.org/Industry/Regulation/Guidance/FOR/index.htm). Published interpretations of certain rules of the regulatory bodies<sup>7</sup> may be found in the following reference materials:

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<sup>5</sup> Each year, the Financial Industry Regulatory Authority (FINRA) publishes an *Annual Regulatory and Examination Priorities Letter* to highlight new and existing areas of significance to its regulatory programs. The information in the letter represents FINRA's current assessment of certain key industry issues. The 2013 letter can be found on the FINRA website at [www.finra.org/Industry/Regulation/Guidance/P122861](http://www.finra.org/Industry/Regulation/Guidance/P122861).

<sup>6</sup> Following the consolidation of the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) Member Regulation into FINRA, NASD rules and certain NYSE rules were combined to form the FINRA *Transitional Rulebook*. The incorporated NYSE rules apply only to those members of FINRA that are also members of the NYSE (dual members). FINRA has established a process to develop a new consolidated rulebook that will apply to all FINRA members. Work is continuing on this consolidation of rules. The SEC must approve the rules that will make up the new *Consolidated FINRA Rulebook*. This information is available on the FINRA website at [www.finra.org/Industry/Regulation/FINRARules/P038095](http://www.finra.org/Industry/Regulation/FINRARules/P038095).

<sup>7</sup> Appendix N, “Information Sources,” contains contact information for many of the organizations listed here.

- Financial and Operational Combined Uniform Single (FOCUS) report forms and their general instructions, which include line item references to specific rules. These forms can be accessed at [www.sec.gov/about/forms/secforms.htm](http://www.sec.gov/about/forms/secforms.htm).
- SEC interpretative releases (1934 Act series) and published interpretative and no action letters, which can be accessed at [www.sec.gov/divisions/marketreg/mr-noaction.shtml](http://www.sec.gov/divisions/marketreg/mr-noaction.shtml).
- Treasury Department interpretations, which can be accessed at [www.federalreserve.gov/boarddocs/legalint/](http://www.federalreserve.gov/boarddocs/legalint/).
- FINRA manual and regulatory notices.
- CFTC interpretations and advisories.
- Interpretative instructions distributed to their respective memberships by other self-regulatory organizations.
- Published securities services (Commerce Clearing House, Prentice-Hall, and *Securities Regulation and Law Report*).

**3.09** The auditor may inquire whether the broker-dealer has requested and received specific interpretations from any regulatory agency since the prior audit. This information will assist the auditor in giving the issue appropriate consideration regarding their effect, if any, on the financial statements of the broker-dealer being audited.

## Explanation of Significant SEC Financial Responsibility Rules

### SEC Rule 15c3-3, "Customer Protection: Reserves and Custody of Securities"

**3.10** In SEC Release 34-9856, the SEC announced that the Customer Protection Rule was designed to accomplish the following purposes:

- To make certain that customers' funds held by broker-dealers, including funds derived through the lending, hypothecation, and other permissible uses of customers' securities, are used "in safe areas of the broker-dealers' business related to serving its customers," or otherwise deposited into a reserve account
- To require brokerage firms promptly to obtain possession or control of all fully paid securities and excess-margin securities carried for the accounts of customers
- To effectuate a separation of the brokerage operation from that of dealer activities such as underwriting and trading
- To make sure that broker-dealers keep more current records. In this regard, the rule requires daily computation of security locations and frequent computations of the bank reserve
- To move the entire securities industry into a more efficient mode of operation prohibiting securities from being kept in unacceptable locations
- To require broker-dealers to operate conservatively by way of limiting the expansion of their business through the use of customers' funds

- To continue the program of improving broker-dealer financial responsibility
- To improve the lot of customers in connection with the liquidation of broker-dealers by definition of specifically identifiable property pursuant to the Securities Investor Protection Act of 1970

**3.11** Those objectives are accomplished through the two main sections of the rule that provide for (a) the requirement that the broker-dealer obtain possession or control of fully paid and excess-margin customer securities and (b) the reserve formula computation and the maintenance of a “Special Reserve Bank Account for the Exclusive Benefit of Customers.”

**3.12** National Association of Securities Dealers (NASD) Notice to Members 98-99 extends the requirement to perform a customer reserve computation with respect to proprietary accounts of introducing brokers (PAIB) carried by their clearing brokers in order for an introducing broker (IB) to receive allowable asset treatment under SEC Rule 15c3-1 for proprietary assets held at a carrying and clearing broker. The IB and its carrying and clearing broker must agree in writing to perform the PAIB reserve calculation under the methodology outlined in the no action letter attached to the interpretation memo. Additional guidance on PAIB is found in NASD Notice to Members 99-44. Notices to Members 98-99 and 99-44 are available on the FINRA website at [www.finra.org/Industry/Regulation/Notices](http://www.finra.org/Industry/Regulation/Notices).

**3.13** The restrictions on the use of customers’ funds and securities and the requirement that securities be brought promptly under physical possession or control are designed to protect customer assets in the event that a broker-dealer is liquidated. SEC Rule 15c3-3 also acts as a control over the unwarranted expansion of a broker-dealer’s business by prohibiting the use of customers’ funds and customer-derived funds in other aspects of the broker-dealer’s business, such as underwriting, trading, and travel and entertainment.

**3.14** SEC Rule 15c3-3 offers further customer protection by requiring, under certain circumstances, a broker-dealer to increase the amount of its cash reserve under the formula as a result of undelivered securities (fails and short sales) related to customer positions, aged receivables, security positions that cannot be located or verified, and unresolved security and money differences. Reserve increases related to the latter two conditions are intended to spur improvements in operational practices and controls.

**3.15** Under SEC Rule 15c3-3, the term *customer* is defined as any person from whom, or on whose behalf, a broker-dealer has received, has acquired, or holds funds or securities for the account of that person. It does not include the following:

- Broker-dealers
- Municipal securities dealer or a government securities broker or government securities dealer
- General partner, managing member of a limited liability company, or director or principal officer of the broker or dealer
- A counterparty who has delivered collateral to an OTC derivatives dealer who registers with the SEC under a limited regulatory structure, as discussed in paragraph 3.179, pursuant to a transaction in an eligible OTC derivative instrument or pursuant to the OTC

derivatives dealer's cash management securities activities or ancillary portfolio management securities activities, and who has received certain prominent written notices from the OTC derivatives dealer

- Any person, to the extent they have a claim on property or funds that by contract, agreement, or law are part of the capital or subordinated debt of the broker-dealer

**3.16** Among accounts considered to be held by customers, the following broker-dealer accounts are also considered customer accounts:

- A special omnibus account in compliance with Regulation T
- A special custody account for the exclusive benefit of customers in compliance with SEC Rule 15c3-3(c)(7)
- A special custody account for accommodation transfers for the exclusive benefit of customers in compliance with SEC Rule 15c3-3(c)(7)

**3.17** *Possession or control.* The SEC requires broker-dealers carrying accounts of customers to promptly obtain and thereafter maintain the physical possession or control of fully paid-for securities and excess-margin securities carried for the account of customers. *Fully paid-for securities* are defined to include all securities carried for the account of a customer in a *special cash account*, as defined in Regulation T, as well as certain equity securities within the meaning of Regulation T held in a customer margin account.

**3.18** The rule defines *excess-margin securities* as those customer securities carried in a customer's general or special accounts (referred to in SEC Rule 15c3-3 as margin accounts), as defined in Regulation T, having a market value<sup>8</sup> in excess of 140 percent of the total of the debit balances in the customer's margin account(s).

**3.19** There are two exceptions to the possession or control requirements as found in SEC Rule 15c3-3:

- a. A temporary business lag between the time when a security is required to be in the possession or control of the broker-dealer and the time it is taken into physical possession or control is one exception. The broker-dealer must show it is making a timely and good faith effort to establish prompt physical possession or control.
- b. The broker-dealer borrows from its customer fully paid or excess-margin securities that it is required to have in possession or control and enters into a written securities borrowing agreement with the customer setting forth the compensation for the securities borrowing, the rights or liabilities of the parties, and the identity of the securities borrowed at the time of the borrowing. The agreement should also specify that upon the execution or at least by the close of the business day of the securities borrowing, the broker-dealer is to provide the customer with certain qualified collateral at least equal to the market value of the securities borrowed and must mark the securities borrowed to the market not less than daily. The agreement should

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<sup>8</sup> The terms *market value* and *mark-to-market* are used within this chapter as operational terms; accordingly, in practice they may not necessarily be synonymous to the terms *fair value* and *subsequently measured at fair value*, which are used within the financial statements in accordance with Financial Accounting Standards Board Accounting Standards Update No. 2012-04, *Technical Corrections and Improvements*.

also contain a prominent notice that the provisions of the Securities Investor Protection Act of 1970 may not protect the customer with respect to the securities loaned.

**3.20** *Possession or control requirements.* The broker-dealer should perform the following procedures daily to comply with the rule's possession or control requirements:

- Determine which customer securities are fully paid for or are excess margin.
- Identify which fully paid and excess-margin securities are in physical possession or control.
- Take appropriate action to obtain proper possession or control of fully paid or excess-margin securities not already in physical possession or control.

**3.21** For cash accounts, the broker-dealer should specifically identify customer payments to security purchases and segregate securities when the securities have been paid for.

**3.22** For a margin account, the broker-dealer should determine the customer's net debit balance by adding the market value of securities sold short to the net debit money balance in the account and by multiplying the adjusted net debit balance by 140 percent. On an account-by-account basis, the broker-dealer can select the securities whose market value will comprise the 140 percent of the net debit balance. Such securities are available to the broker-dealer for use in its business. Any remaining securities are deemed excess margin (that is, excess collateral relative to the margin debit) and must be segregated.

**3.23** The time at which instructions (lockups) should be issued to the cashiering section to acquire possession or control on the purchase of securities by customers is on or before the business day following the settlement date or the business day following the actual date of receipt of payment, whichever is later.

**3.24** The time at which instructions (releases) may be issued to the cashiering section to release from possession or control on sales of securities by customers is not earlier than the close of business on the third business day before the settlement date, which is deemed to allow adequate time for processing securities for pending deliveries.

**3.25** Most broker-dealers have fully computerized the task of determining segregation requirements. These systems determine the quantity of fully paid or excess-margin securities in each customer's account as of the close of business each day. These systems generally use memo fields on the stock record to show the amount of securities that need to be segregated.

**3.26** The broker-dealer should determine, by customer, the amount of each security that should be segregated. The broker-dealer should then determine the total securities to be segregated. Securities are considered to be under the control of the broker-dealer if they are held

- a. in the custody or control of a clearing corporation or depository.
- b. in the custody or control of a bank (as defined in Section 3[a][6] of the 1934 Act), provided that the delivery of such securities does not require payment, and the bank acknowledges that it, or another

party through it, cannot impose a lien or claim on such securities. See item (c) regarding foreign depositories because it may apply to U.S.-based banks holding customer foreign securities.

- c. in the custody of a foreign depository, foreign clearing agency, or foreign custodian bank as designated by the SEC. This may be problematic due to the use by the designated domestic or foreign custodian of subcustodians, over which the former has no control.
- d. in transfer for less than 40 calendar days or, if beyond 40 days, confirmed as being in transfer (the securities are the subject of bona fide items of transfer).
- e. in transit for five business days or less between the offices of a broker-dealer (for example, between the main and branch offices).
- f. in a special omnibus account carried for the account of any customer by another broker-dealer and carried in the name of the broker-dealer in compliance with Regulation T (such securities are considered in control to the extent the broker-dealer has instructed the carrying broker-dealer to maintain physical possession or control of them free of any charge, lien, or other claim in favor of the carrying firm).

**3.27** Some common examples of fully paid or excess-margin securities that are not considered to be in a broker-dealer's physical possession or control include the following:

- Securities collateralizing bank loans
- Securities loaned to other broker-dealers
- Securities failed to receive for more than 30 calendar days
- Stock dividend receivables, stock splits or receivables for more than 45 calendar days

**3.28** *Special reserve bank account for the exclusive benefit of customers.* As required by SEC Rule 15c3-3, every broker-dealer, unless otherwise exempt, should maintain a "Special Reserve Bank Account for the Exclusive Benefit of Customers" separate from all other bank accounts of the broker-dealer. In the reserve bank account, the broker-dealer should at all times maintain, through deposits made therein, cash or qualified securities, or both, in an amount not less than the amount computed under the rule's reserve formula.

**3.29** *Reserve formula computation.* Exhibit A of SEC Rule 15c3-3 provides a detailed formula for determining the reserve bank account requirement. The rule requires the reserve to be calculated as the excess of customer-related credits over customer-related debits. The formula is intended to limit the broker-dealer's use of customer funds and encompasses receivables and payables to customers, as well as transactions that involve customer securities. The computation is limited solely to customer-related debits and credits, with a few exceptions and adjustments (such as aged differences and receivables).

**3.30** In addition, SEC Rule 15c3-3 stipulates the designated times for performing the computations. The time frames may need to be adjusted when the broker-dealer is located outside of the time zone that its normal home office (main headquarter) is in. See Interpretation No. 99-5 issued from the SEC to the New York Stock Exchange (NYSE) in May 1999. The designated times are as follows:



- For broker-dealers required to make weekly computations, the computations should be made as of each week's end and at month's end (that is, the last business day of the week or month), with necessary deposits made no later than one hour after the opening of banks on the second business day after the computation date. The computation is not required for the week's end following a computation at month's end.
- Monthly computations should be made only if the broker-dealer does not have aggregate indebtedness in excess of 800 percent of net capital and has less than \$1 million in customer credits. Deposits are also due no later than 1 hour after the opening of banks on the second business day after the computation date.

**3.31** The audit should include a review of the broker-dealer's practices, procedures, and controls, such that the auditor can report on the broker-dealer's compliance with the securities possession or control and the cash reserve elements of the Customer Protection Rule and should include those tests the auditor considers necessary to provide reasonable assurance that any material inadequacies existing at the date of the examination would be disclosed. See also chapter 6, "Internal Control," and appendix D, "Report on Internal Control Required by SEC Rule 17a-5(g)(1)," of this guide.

**3.32** *Bank sweep products.* Broker-dealers that carry customer accounts may offer bank sweep programs as a means to place customer funds in an account subject to Federal Deposit Insurance Corporation (FDIC) coverage while earning interest on those funds. Although broker-dealers may assert that customer funds are better protected, regulators have questioned the large interest rate spreads obtained by broker-dealers in such arrangements, the nature and extent of disclosure that the broker-dealers provide their customers regarding the interest rate differential, and whether the arrangements are structured such that the broker-dealers have satisfactorily given up possession of the customer funds.

**3.33** In a *sweep program*, customer funds are transferred out of a broker-dealer customer account to a money market fund or an interest-bearing account for the customer at a bank often affiliated with the broker-dealer. Broker-dealers that offer sweep programs in which customer funds leave the broker-dealer and are held for any period of time by a party other than the bank must address critical issues relating to customer protection and net capital requirements. Customer credit balances that leave the broker-dealer and are not immediately reinvested in an FDIC-protected account may be deemed to be included as a credit in the reserve formula. In addition, any receivable on the broker-dealer's books resulting from a sweep may be deemed to be a nonallowable asset.

**3.34** In February 2005, the NYSE issued Information Memo No. 05-11, *Customer Account Sweeps to Banks*, which addresses issues involving the adoption of new cash sweep programs and provides procedures designed to safeguard investor interests. Readers should refer to Information Memo 05-11 for more information, and should be alert to further developments.<sup>9</sup>

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<sup>9</sup> The proposed amendments to SEC Rule 17a-5, as found in Release No. 34-64676 dated June 15, 2011, is to require a new form, Form Custody, which would include information on funds swept to a U.S. bank or U.S. money market fund. The release refers to Release No. 34-55431, as proposed in March 2007, that proposes amendments to SEC Rule 15c3-3 related  
(continued)

**3.35** Auditors should obtain from management sufficient and competent evidential matter that, in all material respects, any such arrangement abides by the guidance and certain requirements set forth in Information Memo 05-11. If asserted by management, auditors should verify whether the customer funds under a bank sweep program are covered in full by the FDIC or otherwise recognized by the broker-dealer as customer payables and that such payables and any related receivables are reflected appropriately in the broker-dealer's net capital and customer reserve computations.

**3.36** *Broker-dealers exempt from SEC Rule 15c3-3.* Certain broker-dealers operate completely pursuant to the exemptive provisions of Rule 15c3-3. In doing so, the broker-dealer is not required to comply with the remaining provisions of that rule, such as computations of amounts required to be on deposit in the "Special Reserve Bank Account for the Exclusive Benefits of Its Customers," possession or control requirements, and the related record-keeping. The detailed requirements to be met in order to qualify for this exemption are described in paragraph (k) of Rule 15c3-3 and need to be considered in connection with the rule in its entirety.

**3.37** Due to their emphasis on safeguarding customer assets, regulators have consistently taken a stringent enforcement approach to SEC Rule 15c3-3 without regard to materiality, even to the point of closely scrutinizing any apparent differences between broker-dealer practices occurring at the computation date and those occurring on a day-to-day basis. Stringent enforcement has included significant fines, public censure, and the banning of officers from the security business for periods of time. Accordingly, broker-dealers often retain an additional amount, or "cushion," in the reserve account.

**3.38** In auditing the financial statements of a broker-dealer claiming exemption from SEC Rule 15c3-3, the auditor should perform procedures to determine whether and to what extent the broker-dealer complied with the specific exemption during the audit period and, in addition, consider the quality of the broker-dealer's controls and procedures to ensure ongoing compliance. For example, a broker-dealer whose customers' accounts are carried on a fully disclosed basis at another broker-dealer would not have to comply with the reserve requirements as stated in Rule 15c3-3. However, the independent auditor should ascertain that the broker-dealer did not have possession or control of customer funds or securities such that it would be considered as carrying customer accounts. As discussed in footnote 19, financial statements of broker-dealers, including nonissuer broker-dealers, that are filed with the SEC must be certified by a PCAOB registered public accounting firm. The term *independent auditor*, as used in this guide, assumes the firm is registered with PCAOB, as required.

**3.39** In the event that compliance has not been met, or the controls and procedures are deemed inadequate, the auditor should immediately consider the notification requirements under SEC Rules 17a-5 and 17a-11 pertaining to material inadequacies.

**3.40** In reporting on a broker-dealer exempt from SEC Rule 15c3-3, the schedules titled "Computation for Determination of Reserve Requirements Under Rule 15c3-3" and "Information for Possession or Control Requirements Under Rule 15c3-3" are still required, but such computations and information

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*(footnote continued)*

to the use of sweep programs. See footnote 2 for an update on these revisions. Readers should be alert for further developments. See appendix A of this chapter for information on the proposed amendments.

are not applicable. In lieu of the computations and information, management should include a statement indicating the section under which exemption is claimed. With respect to the effect of the exemption on the “Independent Auditor’s Supplementary Report on Internal Control,” see appendix E, “Report on Internal Control Required by SEC Rule 17a-5 for a Broker-Dealer Claiming an Exemption From SEC Rule 15c3-3,” of this guide.

## SEC Rule 15c3-1, The Uniform Net Capital Rule<sup>10</sup>

**3.41** SEC Rule 15c3-1, “Net Capital Requirements for Brokers or Dealers,” was adopted under the 1934 Act in order to create a uniform capital requirement for all registered broker-dealers and to ensure the liquidity of broker-dealers.

**3.42** The net capital rule requires broker-dealers to maintain minimum levels of liquid assets to support the volume and risk exposures of the businesses in which they are engaged. This is accomplished through the following mechanisms:

- The broker-dealer’s capital (equity plus qualified subordinated indebtedness) is reduced to give effect to the elements of market, credit, or operational risk inherent in the business in which the broker-dealer currently is engaged.
- The minimum capital the broker-dealer is required to maintain pursuant to SEC Rule 15c3-1(a) is established on the basis of the greater of either (a) the amount of the broker-dealer’s aggregate indebtedness (that is, the broker-dealer’s obligations payable in cash, with limited exceptions) or (b) the level of customer-related receivables (aggregate debit items) computed pursuant to SEC Rule 15c3-3 (the alternative method<sup>11</sup>), and a minimum amount based on the broker-dealer’s business activities. Pursuant to SEC Rule 15c3-1(a)(ii), a broker-dealer may elect to be subject to the alternative method rather than the basic method by notifying its examining authority in writing.

If the broker-dealer is also registered as an FCM, it must also always be in compliance with the CFTC regulations, specifically CFTC Regulation 1.17(a)(1). Broker-dealers that are subject to both SEC and CFTC minimum net capital requirements should always maintain net capital equal to the greater of the two regulatory requirements. The CFTC adopted a risk-based capital requirement for FCMs effective September 30, 2004, but the SEC has not yet revised Rule 15c3-1(iii) to reference and reflect this change.<sup>12</sup>

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<sup>10</sup> Refer to paragraphs 3.32–.35 for a discussion of the potential effect of cash sweep account programs on a broker-dealer’s compliance with net capital requirements.

<sup>11</sup> In October 2012, the SEC proposed amendments that would increase the minimum net capital requirements for broker-dealers permitted to use the alternative internal model-based method for computing net capital, as found in Release No. 34-68071, *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers (Corrected to conform to Federal Register version)*. In January 2013 and again in May 2013, the comment period was reopened for the proposed amendments, as found in SEC Release Nos. 34-68660 and 34-69491, respectively. The amendments have not yet been finalized as of the date of this guide. See appendix A of this chapter for more information on the proposed revisions. It is important that readers be alert for further developments.

<sup>12</sup> Commodity Futures Trading Commission (CFTC) Regulation 1.17(a)(1) can be found at [www.ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&rgn=div8&view=text&node=17:1.0.1.1.1.0.2.12&idno=17#17:1.0.1.1.1.0.2.16](http://www.ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&rgn=div8&view=text&node=17:1.0.1.1.1.0.2.12&idno=17#17:1.0.1.1.1.0.2.16).

**3.43** In each case, the level of capital is established to ensure that, in the event of a liquidation, the broker-dealer is maintaining sufficient capital for the payments of (a) its obligations to customers and other broker-dealers and (b) compensation to employees retained to wind up the firm's affairs.

**3.44** By monitoring the maintenance of liquid assets in excess of the minimum requirements, the SEC and relevant examining authority are in a position to take action to protect customers prior to the time when the broker-dealer's assets would be insufficient to satisfy customers' claims in the event of liquidation.

**3.45** An examining authority utilizes the capital rules to provide an early warning of any broker-dealer that may be at risk of not having sufficient capital to stay in operation. Under those rules and various examining authority regulations, broker-dealers should restrict the growth of their business if their regulatory capital fails to meet certain minimums set by the examining authority, reduce the size of current operations if capital falls to a point below other minimums set by the examining authority, and ultimately liquidate if the regulatory minimums are not met. Obviously, it is the intent of the examining authority to identify potential problems early and correct them.

**3.46** The SEC requires all registered broker-dealers to calculate net capital on a periodic basis in order for the examining authority and broker-dealer to ensure that the broker-dealer has adequate liquid assets in the event of sudden adverse business conditions and to maintain compliance with the rule at all times. *Net capital* is the broker-dealer's net worth reduced by illiquid (nonallowable) assets, certain operational capital charges, and potential adverse fluctuations in the value of securities inventory ("haircuts").

**3.47** There are basically two parts to the net capital computation: determination of net capital (as described in paragraphs 3.52–.53) and comparison with aggregate indebtedness or alternative percentage requirements.

**3.48** Under the aggregate indebtedness method, the broker-dealer's net capital requirement is equal to 6⅔ percent of its aggregate indebtedness. A broker-dealer is not permitted to allow its aggregate indebtedness to exceed 15 times its adjusted net capital. If the ratio of aggregate indebtedness to adjusted net capital exceeds 15 to 1, the broker-dealer is prohibited from engaging in any securities transactions. If the ratio exceeds 12 to 1, the broker-dealer may be required to reduce its business. If it exceeds 10 to 1, the broker-dealer may be prohibited from expanding its business.

**3.49** As set forth in SEC Rule 15c3-1, a broker-dealer may elect to compute its net capital requirements under the alternative method. Whereas the aggregate indebtedness approach is a measure of the risk the broker-dealer imposes on its creditors (the extent of its financial leverage), the alternative method is a measure of the credit risk exposure the broker-dealer has to its customers. The minimum net capital percentage required under the alternative method is 2 percent of the aggregate customer debits carried by the broker-dealer and includable in the reserve formula. Such debits result almost entirely from customer margin transactions (that is, from customers borrowing from the broker-dealer to purchase securities).

**3.50** The aggregate indebtedness and alternative standards are one measure of a broker-dealer's net capital requirement; the other measure is the minimum net capital amount required as a result of the broker-dealer's securities activity. A broker-dealer's net capital requirement is the higher of the selected standard or minimum level. For example, if a broker-dealer engages in

proprietary trading<sup>13</sup> and selects the aggregate indebtedness standard, its net capital requirement is the greater of 6 $\frac{2}{3}$  percent of its aggregate indebtedness or \$100,000.

**3.51** Percentage requirements also restrict the withdrawal of equity capital and the repayment of subordinated obligations and the making of any unsecured advance or loan to a stockholder, a partner, a sole proprietor, an employee, or an affiliate.

**3.52** *Computation of net capital.* The net capital of a broker-dealer is equal to its net worth adjusted by certain additions and deductions. The additions include the following:

- Certain liabilities approved by the examining authorities that have been subordinated to the claims of general creditors. The extent to which these liabilities may be included in capital is subject to limitations. Standardized subordination, secured demand note, and secured demand note collateral agreements are available from FINRA, and all executed agreements must be approved by the broker-dealer's designated self-regulatory organization before they qualify for capital purposes. A subordination agreement<sup>14</sup> should meet the following requirements:
  - Be written
  - Have a minimum term of one year
  - Be for a specific dollar amount
  - Effectively subordinate the lender's right to prior payment of all claims of present and future creditors
  - Give the broker-dealer the right to deposit any cash proceeds in its own name in any bank, as well as the right to pledge or hypothecate securities without notice
  - Include certain prepayment restrictions
  - Suspend the repayment or maturity obligation if, after giving effect to the obligation, the aggregate indebtedness of the broker-dealer would exceed 1,200 percent of its net capital or its net capital would be less than 5 percent of aggregate debits if the alternative capital method were used
- Certain discretionary liabilities, such as a noncontractual bonus accrual that is not a fixed payable as of the computation date, is a common type of discretionary liability that may, upon certain criteria, be added back to total equity.
- Deferred income tax liabilities resulting from the recognition for tax purposes of unrealized income or appreciation related to long inventory, investment positions, or assets that are nonallowable for net capital; deferred income tax liabilities related to intangible assets

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<sup>13</sup> Rulemaking is underway for Section 619 of the Dodd-Frank Act (commonly referred to as the Volcker Rule), which prohibits banking entities from proprietary trading; acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund; and sponsoring a hedge fund or private equity fund. Proprietary trading consists of transactions made by an entity that affect the entity's own account but not the accounts of its clients. Note that the Volcker Rule contains an exception for certain market making-related activities. Work continues on the Volcker Rule as of the date of this guide. Readers should watch for further developments.

<sup>14</sup> For more information, see the specific requirements contained in the debt-equity requirements of SEC Rule 15c3-1 and appendix D of SEC Rule 15c3-1.

recognized in a business acquisition and deferred income tax benefits resulting from the recognition for tax purposes of unrealized losses or depreciation related to long inventory or investment positions, but only up to the extent of recognized income tax liabilities. Please see the specific requirements contained in SEC Rule 15c3-1 and related interpretations.

**3.53** Broker-dealers are required to deduct items in the net capital computation to take into account market and liquidity risks. The deductions are in the following three basic forms:

- a. *Nonallowable assets.* These are recognized assets that do not meet liquidity tests or have been defined as nonallowable by SEC Rule 15c3-1. In general, *nonallowable assets* are assets not readily convertible into cash. Examples of the most frequently encountered nonallowable assets are fixed assets, securities not readily marketable, unsecured receivables (certain receivables are allowable for the first 30 days), deficits in customer accounts, good-faith deposits, prepaid expenses, exchange memberships, and intangibles. Broker-dealers that retain cash or securities at their carrying and clearing broker-dealer should treat such assets as nonallowable unless the clearing broker agrees in writing to include the IB's assets in its PAIB computation in accordance with the customer reserve computation.
- b. *Other deductions and charges.* In general, these items are operational in nature and may involve off-balance sheet risk. These items include, for example, aged fails to deliver, over- or under-collateralized secured lending positions, and securities count differences.
- c. *Haircuts on proprietary positions and commitments.* "Haircuts" are percentage deductions that are designed to take into account market and portfolio risk exposures on proprietary positions and commitments. They apply to marketable securities only. An OTC derivatives dealer who registers with the SEC under a limited regulatory structure, as discussed in paragraph 3.179, may apply to the SEC for authorization to compute capital charges for market and credit risk pursuant to appendix F of SEC Rule 15c3-1 in lieu of computing securities haircuts pursuant to Rule 15c3-1(c)(2)(vi).

**3.54** *Computation of aggregate indebtedness.* SEC Rule 15c3-1 states that aggregate indebtedness consists of the total money liabilities of a broker-dealer arising in connection with any transaction whatsoever and includes, among other things, money borrowed, money payable against securities loaned and securities failed to receive, the market value of securities borrowed to the extent to which no equivalent value is paid or credited, customers' and noncustomers' free credit balances, credit balances in customers' and noncustomers' accounts having short positions in securities, equities in customers' and noncustomers' future commodities accounts, and credit balances in customers' and noncustomers' commodities accounts. There are a number of specific exceptions, primarily related to circumstances in which the liability is collateralized or offset by a related proprietary position.

**3.55** In the event that compliance has not been met, or the controls and procedures over the computation of net capital are deemed inadequate, the auditor should immediately consider the notification requirements under SEC Rules 17a-5 and 17a-11 pertaining to material inadequacies. Carrying and clearing brokers should consider the notification requirements in FINRA Rule 4120.

**3.56** *Expense-sharing agreements.* Many broker-dealers enter into what is generally referred to as an expense-sharing agreement with their parent or an affiliated company. The parent or affiliate is usually not registered as a broker-dealer and, accordingly, is unregulated. In certain instances, a parent or an affiliate has established a broker-dealer to conduct limited or specialized securities activities that are coincidental or tangential to the operations of the parent or affiliate. In other instances, the parent or affiliate will have limited operations and will conduct separate financial activities using funds obtained from the broker-dealer's operations. In either case, the broker-dealer and parent or affiliate are likely to incur common costs, such as rent, and, as a result, devise an arrangement to allocate or assign direct or general (or both) overhead costs between them and specify which party will settle the related obligations. Thus, such an arrangement will deal with both cost recognition and payment responsibility.

**3.57** In interpretations related to Rule 15c3-1, the SEC Division of Trading and Markets staff have stated that, for the purpose of computing net capital, broker-dealers are required to recognize costs on their books and records in accordance with accounting principles generally accepted in the United States of America (GAAP) (that is, costs need to be recognized as incurred and in amounts related to the broker-dealer's economic obligations). Because regulatory financial reports submitted by broker-dealers seemed to indicate a number of deviations from this standard, the Division of Trading and Markets staff issued an interpretative letter on July 11, 2003, addressing situations when another party assumes responsibility for payment of a broker-dealer's expenses.

**3.58** The interpretive letter is designed to provide guidance for broker-dealers, such that when computing net capital, broker-dealers would reflect all costs for which they are in any way obligated to pay either contractually or constructively; that is, the broker-dealer serves as the immediate or ongoing source of funds for paying a vendor or creditor, which has a contractual arrangement with the parent or affiliate. Further, in the interpretive letter the Division of Trading and Markets aims to proscribe cost assignment, other than through the use of a reasonable, consistently applied and well-documented allocation process. The interpretive letter presumes that if another party reflects in its financial statements the costs of services or goods benefiting or consumed by the broker-dealer, any amounts the broker-dealer remits to this party represent a reimbursement of all or a portion of such costs and the broker-dealer must reflect the remittance as a liability from the date that the "related" costs were incurred. In October 2003, NASD published Notice to Members 03-63, which provides additional guidance regarding the interpretive letter, discusses the technical issues in greater detail, and includes related examples. (The interpretive letter can be found at [www.sec.gov/divisions/marketreg/mr-noaction/macchiaroli071103.pdf](http://www.sec.gov/divisions/marketreg/mr-noaction/macchiaroli071103.pdf), and NASD Notice to Members 03-63 is available on FINRA's website.)

### **SEC Rule 15c3-1(e), "Limitations on the Withdrawals or Capital Distributions of Liquid Assets from Broker-Dealers"**

**3.59** Because it was concerned that cash or other liquid assets generated in the broker-dealer's business could be removed to support financial obligations of the broker-dealer's parent or affiliates, the SEC adopted amendments to paragraph (e) of SEC Rule 15c3-1, in February 1991, to prevent controlling persons from making material withdrawals of liquid assets from a broker-dealer without first notifying its designated examining authority.

**3.60** Broker-dealers are subject to notifications of, or limitations on, capital withdrawals that reduce the excess net capital by various percentages, as discussed in SEC Rule 15c3-1(e), or are deemed by the SEC or its designated examining authority, to inhibit the ability to sustain the current business activities or meet the financial obligations of the broker-dealer. It is inappropriate for broker-dealers to record withdrawals of equity capital or capital distributions as an expense, a receivable, or an investment.

**3.61** Broker-dealers that are registered with FINRA are required to notify FINRA

- a. 2 days in advance of any withdrawal, which, when aggregated with withdrawals made during the preceding 30 days, exceeds 30 percent of the broker-dealers' excess net capital, and
- b. 2 days following any such withdrawal, which, when aggregated with withdrawals made during the preceding 30 days, exceeds 20 percent of the broker-dealers' excess net capital.

**3.62** SEC Rule 15c3-1(e) precludes any withdrawal if it results in the broker-dealer having unacceptably low levels of net capital relative to the nature of its business activities. For example, the rule prohibits a withdrawal that would result in broker-dealer's net capital amounting to less than 25 percent of its total market risk deductions (haircuts). Specific withdrawal limitations are enumerated in SEC Rule 15c3-1(e)(2). Also, the SEC could prohibit a withdrawal for 20 days if such a withdrawal exceeds the 30 percent test, as described in the preceding paragraph, and the SEC concluded that the withdrawal would impair the financial integrity of the broker-dealer or affect the broker-dealer's ability to repay customers' claims and liabilities.

**3.63** Effective February 2010, FINRA adopted capital withdrawal notification and restriction requirements, as found in FINRA Rule 4110(c). This rule is discussed in Regulatory Notice 09-71, which can be accessed on FINRA's website. Paragraph (1) of FINRA Rule 4110(c) requires a member firm to obtain written approval from FINRA prior to withdrawal of capital, which was contributed within the preceding 12 months. Paragraph (2) of FINRA Rule 4110(c) applies solely to member firms that carry accounts or otherwise clear transactions. Such firms must first obtain written approval from FINRA prior to withdrawal of liquid assets if such withdrawal, when aggregated with withdrawals occurring over the preceding 35 days, exceeds 10 percent of the firm's excess net capital.

## SEC Rule 17a-13, "Quarterly Security Counts"<sup>15</sup>

**3.64** Under SEC Rule 17a-13 of the 1934 Act, most broker-dealers are required to conduct a securities count at least once in each calendar quarter. The rule requires that at least once in each calendar quarter, but not more than four months or less than two months apart, all positions in each security should be accounted for simultaneously, although not all securities are required to be accounted for at the same time. The procedures performed by the broker-dealer would include the following:

- Physically examine and count all securities held.
- Account for all securities in transfer, in transit, pledged, loaned, borrowed, deposited, failed to receive and failed to deliver, subject to

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<sup>15</sup> See the discussion beginning in paragraph 3.167 for additional requirements for broker-dealers that are also registered investment advisers.



repurchase agreements (repos) or reverse repos, or otherwise subject to the broker-dealer's control or direction but not in its physical possession, by examining and comparing the supporting detail records with the appropriate ledger control accounts.

- Verify (through confirmation or other form of outside documentation) all securities in transfer, in transit, pledged, loaned, borrowed, deposited, failed to receive and failed to deliver, subject to repo and reverse repo, or otherwise subject to the broker-dealer's control or direction but not in its physical possession, if such securities have been in such status for longer than 30 days.
- Compare the results of the count and verification with the broker-dealer's records.
- Record in the books and records all unresolved differences resulting from the count and verification (setting forth the security involved and the date of comparison) in a security count difference account no later than seven business days after the date of each securities examination count and verification. This securities difference account is then considered in determining the applicable deduction from net capital.

**3.65** The examination, count, verification, and comparison may be made as of a certain date or on a cyclical basis covering all securities. Cyclical counts enable the broker-dealer to perform the preceding procedures on specific groups of securities at different time intervals.

**3.66** SEC Rule 17a-13 requires that the examination, count, verification, and comparison be made or supervised by persons whose regular duties do not require them to have direct responsibility for the proper care and protection of the securities or for the making or preservation of the books and records.

**3.67** For broker-dealers subject to FINRA rules, paragraph (b) of FINRA Rule 4522 requires that each carrying or clearing member subject to SEC Rule 17a-13 make more frequent counts, examinations, verifications, comparisons, and entries when prudent business practice would so require. Further, each such carrying or clearing member is required to receive position statements monthly with respect to securities held by clearing corporations, other organizations, or custodians and, at such time, reconcile all such securities and money balances by comparison of the clearing corporations' or custodians' position statements to the member's books and records. The carrying or clearing member must promptly report any differences to the contra organization, and both the contra organization and member firm must promptly resolve the differences. When there is a higher volume of activity, the rule provides that good business practice may require a more frequent exchange of statements and performance of reconciliations. Differences from such verifications that are unresolved for seven days, must be recorded to a "Difference" account and reflected in the net capital and customer reserve computations as required.

### **SEC Rule 17a-3, "Records to Be Made by Broker-Dealers"**

**3.68** SEC Rule 17a-3 requires parties to construct and keep current certain books and records. For a further discussion of this rule, refer to chapter 2, "Broker-Dealer Functions, Books, and Records," of this guide.

## SEC Rule 17a-4, "Records to Be Preserved by Broker-Dealers"

**3.69** SEC Rule 17a-4 establishes time requirements for the retention of the books and records constructed pursuant to SEC Rule 17a-3. (For a further discussion of this rule, refer to chapter 2 of this guide.)

## Regulation T and Maintenance Margin

**3.70** Regulation T has been promulgated by the Board of Governors of the Federal Reserve System by authority of the 1934 Act. Regulation T establishes the rules and regulations applicable to the extension of credit to customers and to related transactions. For a customer to enter securities transactions, he or she should open either a cash account or margin account.

**3.71** Section 8 of Regulation T governs cash accounts. This type of account was created by Regulation T for those transactions in which the broker-dealer is not extending credit to the customer. The broker-dealer may purchase for (as agent), or sell to (as principal), a customer any security, provided that either (a) funds sufficient for the purpose are already in the cash account, or (b) the purchase or sale is in reliance on an agreement accepted by the creditor in good faith that the customer will promptly make full cash payment before selling and does not contemplate selling the security prior to such payment.

**3.72** If full cash payment is not made within five business days after the trade date of the purchase, the broker-dealer should cancel or liquidate the transaction or request an extension of time from FINRA or an applicable exchange. Extensions of the payment date are normally granted when both the broker-dealer and customer are acting in good faith, and the circumstances are viewed as warranting such action.

**3.73** A margin account is used to record transactions that result in the customer borrowing money from the broker-dealer. The customer agrees to pay a certain percentage of the purchase price, and the broker-dealer will lend the balance. Extensions of credit by broker-dealers are subject to Regulation T.

**3.74** If a customer purchases securities on margin, the security should remain under the control of the broker-dealer. A customer generally signs a hypothecation agreement with the broker-dealer at the time the margin account is opened. This agreement allows the broker-dealer to hypothecate the securities, pledging them as collateral for money borrowed on a customer bank loan or loaning them to other broker-dealers.

**3.75** In a margin account, the broker-dealer holds the customer's securities as collateral in readily negotiable form, thus enabling the broker-dealer to liquidate the securities if the customer fails to maintain a proper level of margin. A *margin transaction* is an open-ended collateralized loan, with the amount of collateral the customer is required to deposit prescribed by Regulation T. The customer may leave the loan open as long as the broker-dealer remains satisfied with the condition of the account. If the value of the securities in the customer's account appreciates above the Regulation T margin requirement, the broker-dealer can extend to the customer additional credit (referred to as Regulation T excess). The customer may then either withdraw the excess from the account or use it to meet the requirements on additional purchases.

**3.76** FINRA, applicable exchanges, and broker-dealers themselves may set margin requirements that are higher than those specified in Regulation T. For example, FINRA establishes minimum maintenance margin requirements

and more specific initial margin requirements than provided for in Regulation T for certain security positions (such as debt securities) and creditor relationships (such as broker-dealer extending credit to another broker-dealer). FINRA Rule 4210, “Margin Requirements,” sets forth minimum equity requirements that must be maintained in margin accounts. In addition, many broker-dealers maintain “house” margin requirements (both initial and maintenance) that are higher than those established by FINRA.

## SEC and CFTC Rules Governing Customer Margin for Transactions in Security Futures

**3.77** The Commodity Futures Modernization Act of 2000 (CFMA) (see chapter 1, “The Securities Industry,” of this guide) provides for the issuance of rules governing customer margin for transactions in security futures. Specifically, the CFMA directed the Federal Reserve Board to prescribe rules establishing initial and maintenance customer margin requirements. SEC Rules 400–406 and CFTC Rules 41.42–.49 were issued in August 2002 establishing margin requirements for security futures pursuant to joint authority delegated by the Federal Reserve Board.

### SEC Rules 17h-1T and 17h-2T

**3.78** SEC Rules 17h-1T and 17h-2T require broker-dealers to maintain and preserve records and other information related to the associated persons of a broker-dealer and to provide reports to the SEC regarding financial activities of affiliates that could have a material effect on the financial or operational condition of the broker-dealer. Broker-dealers that do not clear customer accounts or are exempt from SEC Rule 15c3-3 and that have less than \$20 million in capital, including subordinated debt, are not required to comply with these rules.

**3.79** SEC Rules 17h-1T and 17h-2T use the term *material associated person* (MAP). Determination of whether an affiliate or other associated person is a MAP requires consideration of the following:

- The legal relationship between the parties
- The financing arrangements of the broker-dealer and the associated person and the degree to which they are financially dependent on each other
- The degree to which the broker-dealer or its customers rely on the associated person for operational support or service
- The level of risk present in the activities of the associated person
- The extent to which the associated person has the authority or ability to cause a withdrawal of capital from the broker-dealer

**3.80** The information to be filed for each MAP on a quarterly basis on or with Form 17-H and for which records should be maintained in a readily accessible place for three years includes the following:

- Financial information
- Firm inventory amounts
- Off-balance sheet items
- Unsecured credit extensions

- Current debt
- Summaries of real estate activities

**3.81** Certain of these disclosures are required for amounts over a materiality threshold. This amount is the greater of \$100 million, 10 percent of the broker-dealer's tentative net capital, or 10 percent of the MAP's tangible net worth. Special exemptions exist regarding the information filed for MAPs that are subject to supervision by other regulatory agencies, such as a federal banking agency or a state insurance commission. In these cases, the broker-dealer is allowed to satisfy the filing requirements by submitting certain reports filed for the MAP with its primary regulator.

## SEC Rule 17Ad-17

**3.82** SEC Rule 17Ad-17 was originally issued in 1997 to address situations in which recordkeeping transfer agents have lost contact with securityholders. The rule requires such transfer agents to exercise reasonable care to obtain the correct addresses of these "lost securityholders" and to conduct certain database searches to locate them. At that time, the SEC noted that such loss of contact can be harmful to securityholders because they no longer receive corporate communications or the interest and dividend payments to which they may be entitled. Additionally, the securities and any related interest and dividend payments to which the securityholders may be entitled are often placed at risk of being deemed abandoned under operation of state escheatment laws. This loss of contact most frequently results from (a) failure of a securityholder to notify the transfer agent of his correct address after relocating; or (b) failure of the estate of a deceased securityholder to notify the transfer agent of the death of the securityholder and the name and address of the trustee or administrator for the estate.

**3.83** The Dodd-Frank Act added a requirement for the SEC to revise Rule 17Ad-17 to extend to brokers and dealers the rule's requirement that recordkeeping transfer agents search for "lost securityholders," as defined in SEC Rule 17Ad-17(b)(2). To comply with this requirement, the SEC issued Release No. 34-68668 in January 2013. Paragraph (a)(1) of SEC Rule 17Ad-17 requires that every broker or dealer that has customer security accounts that include accounts of lost securityholders should exercise reasonable care to ascertain the correct addresses of such securityholders. To meet this requirement, the broker or dealer should conduct two database searches using at least one information database service. The search should be conducted using the taxpayer identification number or name, if a search based on the taxpayer identification number is not reasonably likely to locate the securityholder. Such database searches must be conducted without charge to a lost securityholder and with the following frequency:

- Between 3 and 12 months of such securityholder becoming a lost securityholder
- Between 6 and 12 months after the first search for such lost securityholder

**3.84** SEC Rule 17Ad-17(a)(2) states that a transfer agent, broker, or dealer may not use a search method or service to establish contact with lost securityholders that results in a charge to a lost securityholder prior to completing the searches set forth in paragraph (a)(1) of SEC Rule 17Ad-17.

**3.85** SEC Rule 17Ad-17(a)(3) outlines the circumstances in which a transfer agent, broker, or dealer is not required to conduct the searches set forth in paragraph (a)(1) of SEC Rule 17Ad-17.

**3.86** SEC Rule 17Ad-17(c) discusses the requirements for brokers or dealers when a securityholder is an “unresponsive payee.” A securityholder should be considered an unresponsive payee if a check is sent from the paying agent to the securityholder and the check is not negotiated before the earlier of the paying agent’s sending of the next regularly scheduled check or the elapsing of 6 months (or 180 days) after the sending of the original nonnegotiated check. A securityholder should no longer be considered an unresponsive payee when the securityholder negotiates the check or checks that caused the securityholder to be considered an unresponsive payee.

**3.87** In accordance with SEC Rule 17Ad-17(c)(1), the paying agent must provide a single written notification to each unresponsive payee no later than 7 months (or 210 days) after the sending of any not yet negotiated check to inform the unresponsive payee that a check was sent and that it has not yet been negotiated. SEC Rule 17Ad-17 also (a) provides an exclusion for paying agents from the notification requirements when the value of the not yet negotiated check is less than \$25; and (b) adds a provision to make clear that the notification requirements imposed on paying agents shall have no effect on state escheatment laws.

## SEC Rule 17Ad-22

**3.88** SEC Rule 17Ad-22, issued in October 2012 as SEC Release No. 34-68080, establishes minimum requirements regarding how registered clearing agencies must maintain effective risk management procedures and controls as well as meet the statutory requirements under the Exchange Act on an ongoing basis. Each registered clearing agency should establish, implement, maintain, and enforce written policies and procedures reasonably designed to meet the criteria outlined in SEC Rule 17Ad-22(d), as applicable. Additionally, a registered clearing agency that performs central counterparty services should establish, implement, maintain, and enforce written policies and procedures reasonably designed to meet the criteria outlined in SEC Rule 17Ad-22(b).

**3.89** In accordance with SEC Rule 17Ad-22(c), “Record of financial resources and annual audited financial statements,” (1) each fiscal quarter (based on calculations made as of the last business day of the clearing agency’s fiscal quarter), or at any time upon SEC request, a registered clearing agency that performs central counterparty services should calculate and maintain a record, in accordance with SEC Rule 17a-1, of the financial resources necessary to meet the requirements of SEC Rule 17Ad-22(b)(3), and sufficient documentation to explain the methodology it uses to compute such financial resource requirement; and (2) within 60 days after the end of its fiscal year, each registered clearing agency shall post on its website its annual audited financial statements. Such financial statements should

- include, for the clearing agency and its subsidiaries, consolidated balance sheets as of the end of the two most recent fiscal years and statements of income, changes in stockholders’ equity and other comprehensive income and cash flows for each of the two most recent fiscal years;
- be prepared in accordance with GAAP, except for a clearing agency that is a corporation or other organization incorporated or organized

under the laws of any foreign country, in which the consolidated financial statements may be prepared in accordance with GAAP or International Financial Reporting Standards as issued by the International Accounting Standards Board;

- be audited in accordance with standards of the PCAOB by a registered public accounting firm that is qualified and independent in accordance with Section 2-01, “Qualifications of Accountants,” of SEC Regulation S-X; and
- include a report of the registered public accounting firm that complies with Section 2-02, “Accountants’ Reports and Attestation Reports,” of SEC Regulation S-X.

## SEC Rule 17-248—Subpart C

**3.90** In accordance with the rulemaking mandated by the Dodd-Frank Act, the SEC issued Release No. 34-69359, *Identity Theft Red Flags Rules*, in April 2013. This rule has an effective date of May 20, 2013, and a compliance date of November 20, 2013. This final rule was issued jointly with the CFTC to require certain regulated entities to establish programs to address risks of identity theft. The following are the two main requirements addressed in the rules:

- Financial institutions and creditors<sup>16</sup> are required to develop and implement a written identity theft prevention program designed to detect, prevent, and mitigate identity theft in connection with certain existing accounts or the opening of new accounts. The program must be appropriate to the size and complexity of the financial institution or creditor and the nature and scope of its activities. The rules include guidelines to assist entities in the formulation and maintenance of programs that would satisfy the requirements of the rules.
- Special requirements for any credit and debit card issuers are subject to the commissions’ respective enforcement authorities to assess the validity of notifications of changes of address under certain circumstances.

## SEC Rule 15c3-5, “Risk Management Controls for Brokers or Dealers with Market Access”

**3.91** SEC Rule 15c3-5 addresses the risks that can arise as a result of the automated, rapid electronic trading strategies that exist in the current marketplace. Rule 15c3-5 eliminated the practice known as “naked access” that allowed high-speed traders and others to buy and sell stocks on exchanges using a broker’s computer code without requiring the trades to filter through the broker’s systems or undergo any pretrade checks. Rule 15c3-5 is applicable to broker-dealers with access to trading securities by virtue of being an exchange member, an alternative trading system (ATS) subscriber, or an ATS operator with nonbroker-dealer subscribers.

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<sup>16</sup> *Financial institution or creditor*, as defined in the Fair Credit Reporting Act (Title 15 U.S. Code [USC] Part 1681), is (a) a broker, dealer, or any other person that is registered or required to be registered under the 1934 Act, (b) an investment company that is registered or required to be registered under the Investment Company Act of 1940 that has elected to be regulated as a business development company under that act, or that operates as an employees’ securities company under that act, or (c) an investment adviser that is registered or required to be registered under the Investment Advisers Act of 1940.

**3.92** SEC Rule 15c3-5 requires broker-dealers with access to trading securities directly on an exchange or ATS, including those providing sponsored or direct market access to customers or other persons, and broker-dealer operators of an ATS that provide access to trading securities directly on their ATS to a person other than a broker-dealer to establish, document, and maintain a system of risk management controls and supervisory procedures designed to systematically limit the financial exposure of the broker-dealer that could arise as a result of market access and to ensure compliance with all regulatory requirements that are applicable in connection with market access. The controls and supervisory procedures must be reasonably designed to

- prevent the entry of orders that exceed appropriate preset credit or capital thresholds or that appear to be erroneous.
- prevent the entry of orders unless there has been compliance with all regulatory requirements that must be satisfied on a preorder entry basis.
- prevent orders that the broker-dealer or customer is restricted from trading.
- restrict market access technology and systems to authorized persons.
- assure appropriate surveillance personnel receive immediate post-trade execution reports.

**3.93** A broker-dealer is required to preserve a copy of its supervisory procedures and a written description of its risk management controls as part of its books and records in a manner consistent with SEC Rule 17a-4(e)(7). The financial and regulatory risk management controls and supervisory procedures required by SEC Rule 15c3-5 must be under the direct and exclusive control of the broker-dealer with market access, with limited exceptions as found in Rule 15c3-5(d)(1). In addition, a broker-dealer is required to establish, document, and maintain a system of regularly reviewing the effectiveness of the risk management controls and supervisory procedures and for promptly addressing any issues. The CEO (or equivalent) of the broker-dealer is required to annually certify that the risk management controls and supervisory procedures comply with Rule 15c3-5 and that the regular review has been conducted. The certification is required to be preserved by the broker-dealer as part of its books and records.

## **SEC Rule 17a-5, “Reports to Be Made by Certain Brokers and Dealers”**

**3.94** SEC Rule 17a-5 describes the objectives of an audit of a broker-dealer’s financial statements. Specifically, the audit should be made in accordance with generally accepted auditing standards (GAAS)<sup>17</sup> and should include a review of the accounting system, internal control, and procedures for safeguarding securities, including appropriate tests for the period since the prior examination date. In accordance with the requirements in SEC Rule 17a-5(g), the audit should 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

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<sup>17</sup> See paragraph 3.03.

Rule 15c3-3.” See exhibit 4-9 of chapter 4, “Financial Statement Presentation and Classification,” of this guide for illustrative examples of the supplementary information required to be filed with the financial statements. See appendix A, “Supplementary Information in Relation to the Financial Statements as a Whole,” of chapter 4 of this guide for information related to auditing and reporting on supplementary information under AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*).

**3.95** In addition, the scope of the audit and review of the accounting system, the internal control, and procedures for safeguarding securities should be sufficient to provide reasonable assurance that any material inadequacies existing at the audit date in the accounting system, the internal controls, and the procedures for safeguarding securities would be disclosed. Further, the auditor is required to evaluate the practices and procedures followed by the broker-dealer in

- making the periodic computations of aggregate indebtedness and net capital under SEC Rule 15c3-1 and the reserve required by SEC Rule 15c3-3.
- making the quarterly securities examinations, counts, verifications, and comparisons and the recordation of differences required by SEC Rule 17a-13.
- complying with the requirement for prompt payment for securities under Section 8 of Regulation T.
- obtaining and maintaining physical possession or control of all fully paid and excess-margin securities of customers, as required by Rule 15c3-3.
- if the broker-dealer is also registered as an FCM, making the periodic computations of the minimum financial requirements pursuant to Regulation 1.17 under the Commodity Exchange Act, daily computations of the segregation requirements of Sections 4d(a)(2) and 4d(f) of the Commodity Exchange Act and its regulations, and the secured amount requirements of the Commodity Exchange Act and its regulations.

**3.96** These objectives illustrate the regulatory concerns for a broker-dealer’s capacity to measure and monitor its financial condition and liquidity and to safeguard customers’ funds and securities.

**3.97** The SEC requires independent auditors to issue a report on internal control.<sup>18</sup> To meet this requirement, a report should (a) address what the auditor concluded in their study of the adequacy of the broker-dealer’s practices and procedures in complying with the SEC’s financial responsibility rules in relation to the definition of a *material inadequacy* as stated in Rule 17a-5(g)(3) and (b) disclose material weaknesses in internal control over financial reporting (including procedures for safeguarding securities) that are identified through auditing procedures designed and conducted for the purpose of expressing an opinion on the financial statements.

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<sup>18</sup> Note that the internal control terminology found in SEC Rule 17a-5 differs from the terminology used in AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*). When making reference to Rule 17a-5, this guide uses the internal control terminology contained in Rule 17a-5 in order to remain consistent with SEC regulations.



**3.98** The SEC-required auditor's report regarding internal control is subject to the provisions of AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*). AU-C section 265 provides guidance on written communications related to internal control, including reports on internal control over financial reporting based solely on an audit of financial statements that are intended for the use of management and specific regulatory agencies. AU-C section 265 provides illustrative examples of written communications in exhibit A, "Illustrative Auditor's Written Communication," and exhibit B, "Illustrative No Material Weakness Communication." See chapter 5, "Auditing Considerations," of this guide for more information.

**3.99** According to the rule, a material inadequacy that is expected to be reported includes any condition that has either contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to cause any of the following:

- a. Inhibit a broker-dealer from completing securities transactions or promptly discharging its responsibilities to customers or other broker-dealers or creditors
- b. Result in material financial loss
- c. Result in material misstatements of the broker-dealer's financial statements
- d. Result in violations of the SEC's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in the preceding three items.

**3.100** The auditor's responsibility with respect to material inadequacies is described in SEC Rule 17a-5(h)(2) and CFTC Rule 1.16(e)(2) and includes requirements for the auditor to contact the SEC if he or she is aware that the broker-dealer failed to make appropriate notification about the existence of material inadequacies and material weaknesses. The following is paraphrased from the Rule 17a-5(h)(2):

- If, during the course of the audit or interim work, the independent public accountant determines that any material inadequacies exist in the accounting system, internal control, and its operation including procedures for safeguarding securities, or as otherwise defined in subparagraph (g)(3), then he or she shall call it to the attention of the CFO of the broker-dealer who shall have a responsibility to inform the SEC and the designated examining authority by telegraphic notice within 24 hours thereafter as set forth in paragraphs (d)–(f) of SEC Rule 17a-11.
- The broker-dealer shall also furnish the accountant with a copy of said notice to the regulators within the 24-hour period. If the accountant fails to receive such notice from the broker-dealer within said 24-hour period or if the accountant disagrees with the statements contained in the notice of the broker-dealer, the accountant shall have a responsibility to inform the SEC and designated examining authority by report of material inadequacy within 24 hours thereafter as set forth in Rule 17a-11. Such report from the accountant shall, if the broker-dealer failed to file a notice, describe any material inadequacies found to exist. If the broker-dealer filed a notice, the accountant shall file a report detailing the aspects, if

any, of the broker-dealer's notice with which the accountant does not agree.

**3.101** A determination of a material inadequacy may, in many instances, require expanded audit procedures in the affected area, appropriate review at the decision-making level by management and the independent auditor, and possible consultation with counsel. The length and complexity of any necessary deliberations will depend on the circumstances but should be completed in the shortest time possible.

**3.102** The reports shown in appendix D, appendix E, and appendix G, "Report on Internal Control Required by CFTC Regulation 1.16 and SEC Rule 17a-5(g)(1)," of this guide are appropriate if the auditor has completed the audit of the financial statements. See also the "SEC Requirements for Management's Report on Internal Control Over Financial Reporting Issuers" section in chapter 6 of this guide.

**3.103** If the auditor becomes aware of a material inadequacy that was corrected during the period but not reported by management to the SEC and the broker-dealer's designated examining authority, management's failure to report the condition would constitute a material inadequacy that should be included in the auditor's report on internal control. Pursuant to Rule 17a-5(j), the report on internal control should be filed along with the annual audit report. Rule 17a-5(c)(2)(iii) provides that when the independent auditor has commented on a material inadequacy, the broker-dealer should include in the statement of financial condition furnished to customers a statement that a copy of such report is currently available at the principal office of the SEC and the SEC regional office for the region in which the broker-dealer has its principal place of business. AU-C section 905, *Alert That Restricts the Use of the Auditor's Written Communication* (AICPA, *Professional Standards*), provides guidance to auditors addressing their responsibility when the auditor is required or otherwise elects to include in the auditor's report or other written communication issued by the auditor in connection with an engagement conducted in accordance with GAAS language that restricts the use of the auditor's report or other written communication. See chapter 4 of this guide for more information.

**3.104** The report shown in appendix F, "Letter to the Securities and Exchange Commission When the Broker-Dealer Has Not Made the Required Notification," should be used if an audit has not been completed and if the independent auditor disagrees with the notification made by the broker-dealer or if the broker-dealer has failed to make the notification deemed appropriate by the auditor. Consideration should be given to the possible need to consult with legal counsel and to modify the report based on the particular circumstances. See the preceding paragraph for the auditors' responsibilities in accordance with AU-C section 905.

**3.105** SEC Rule 17a-5 also contains rules relating to the qualification, designation, independence, and replacement of public accountants who audit the financial statements of broker-dealers.

**3.106** *Qualification of accountant.*<sup>19</sup> The SEC does not recognize any person as a CPA who is not duly registered and in good standing as such under

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<sup>19</sup> Although the Sarbanes-Oxley Act of 2002 (SOX) is directed at *issuers* (as defined by SOX) and their auditors, nonissuer broker-dealers also come under the scope of certain provisions of SOX because Section 205(c)(2) of SOX amended *Commerce and Trade*, USC 15, Section 78q of the 1934 Act to require all broker-dealers (both issuer and nonissuer) to be audited by a public accounting firm registered with the Public Company Accounting Oversight Board (PCAOB). For

the laws of his or her place of residence or principal office. The SEC also does not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of his or her place of residence or principal office.

**3.107** *Designation of accountant.* SEC Rule 17a-5 also requires every broker-dealer that is required (by paragraph [d] of Rule 17a-5) to file an annual report of financial statements to also file, by no later than December 10 of each year a statement with the SEC's principal office in Washington, D.C.; with the regional office of the SEC for the region in which its principal place of business is located; and with the principal office of the designated examining authority for such broker-dealer indicating the existence of an agreement dated no later than December 1 with an independent public accountant covering a contractual commitment to conduct the broker-dealer's annual audit during the following calendar year. The agreement may be of a continuing nature, providing for successive yearly audits, in which case no further filing is required. However, if the agreement is for a single audit, or if the continuing agreement previously filed has been terminated or amended, a new statement must be filed by the required date.

**3.108** The statement should be headed "Notice Pursuant to Rule 17a-5(f)(2)" and should contain the following:

- The name, address, telephone number, and registration number of the broker-dealer
- The name, address, and telephone number of the accounting firm
- The audit date of the broker-dealer for the year covered by the agreement

**3.109** Any broker-dealer that is exempted from the requirement to file an annual audited report of financial statements should nevertheless file the notice and indicate the date as of which the unaudited report will be prepared. Every newly registered broker-dealer should file the notice designating its accountant within 30 days following the effective date of its registration as a broker-dealer.

**3.110** *Independence of accountant.* SEC Rule 17a-5 requires that the provisions set forth in SEC Rules 2-01(b) and (c) of Regulation S-X be adhered to when determining whether the accountant is deemed to be independent.

**3.111** In January 2003, the SEC adopted amendments to its requirements regarding auditor independence to enhance the independence of accountants who audit and review financial statements and prepare attestation reports filed with the SEC. Auditors of nonissuer broker-dealers are restricted from performing those services specifically excluded by SOX and are expected to comply with all other SEC independence rules, including those that prohibit book-keeping and the preparation of financial statements for nonissuer broker-dealers. SEC answers to frequently asked questions regarding the independence rules can be found at [www.sec.gov/info/accountants/ocafaquaidind121304.htm](http://www.sec.gov/info/accountants/ocafaquaidind121304.htm).

**3.112** *Replacement of accountant.* A broker-dealer is also required to file a notice with the SEC's principal office in Washington, D.C.; the SEC regional office for the region in which the broker-dealer's principal place of business is

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fiscal years ending after December 31, 2008, financial statements of nonissuer broker-dealers must be certified by a PCAOB-registered public accounting firm. See also paragraph A-5 in appendix A of this chapter.

located; and the principal office of the designated examining authority for such broker-dealer no more than 15 business days after any of the following:

- The broker-dealer has notified the accountant whose opinion covered the most recent financial statements filed under paragraph (d) of SEC Rule 17a-5 that his or her services will not be used in future engagements.
- The broker-dealer has notified an accountant who was engaged to give an opinion covering the financial statements to be filed under paragraph (d) that the engagement has been terminated.
- An accountant has notified the broker-dealer that he or she would not continue under an engagement to give an opinion covering the financial statements to be filed under paragraph (d).
- A new accountant has been engaged to give an opinion covering the financial statements to be filed under paragraph (d) without any notice of termination having been given to or by the previously engaged accountant.

**3.113** SEC Rule 17a-5 requires the notice to state the date of notification of the termination of the engagement (or notification of the engagement of the new accountant, as applicable) and to state the details of any problems that existed during the 24 months (or the period of the engagement, if less) preceding such termination or new engagement relating to any matter of accounting principles or practices, financial statement disclosure, auditing scope or procedure, or compliance with applicable SEC rules and that, if not resolved to the satisfaction of the former accountant, would have caused him or her to make reference to them in connection with his or her report on the subject matter of the problems. The problems required to be reported include both those resolved to the former accountant's satisfaction and those not resolved to the former accountant's satisfaction. Such problems would include those that occur at the decision-making level (that is, between the broker-dealer's principal financial officers and the accounting firm's personnel responsible for rendering its report).

**3.114** The notice should state whether the accountant's report on the financial statements for any of the past two years contained an adverse opinion or a disclaimer of opinion or was modified concerning uncertainties, audit scope, or accounting principles. The notice should also describe the nature of each such adverse opinion, disclaimer of opinion, or qualification. The broker-dealer should also request the former accountant to furnish the broker-dealer with a letter that is addressed to the SEC that states whether he or she agrees with the statements contained in the notice of the broker-dealer and, if not, states the respects in which he or she does not agree. The broker-dealer should file three copies of the notice and the accountant's letter, one copy of which should be manually signed by the sole proprietor (or a general partner or a duly authorized corporate officer, as appropriate) and by the accountant, respectively.

## Anti-money Laundering Regulations<sup>20</sup>

**3.115** The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (or the USA PATRIOT ACT) requires broker-dealers to implement certain recordkeeping and reporting requirements. They should also establish an anti-money laundering (AML) program that, at a minimum, contains the following components: development of internal policies, procedures, and controls; designation of a compliance officer; an ongoing employee training program; and an independent audit function to test programs.

**3.116** Broker-dealers are required to establish, document, and maintain a written customer identification program (CIP). This program should be appropriate for the firm's size and business; be part of the firm's AML compliance program; and, at a minimum, should contain the following four elements: establishing identity verification procedures; maintaining records related to CIP; determining whether a customer appears on any designated list of terrorists or terrorist organizations; and providing customers with notice that information is being obtained to verify their identities. The CIP rule provides that, under certain defined circumstances, broker-dealers may rely on the performance of another financial institution to fulfill some or all the requirements of the broker-dealer's CIP.

**3.117** Among other things, these rules require that firms independently test their AML programs. The independent tests should occur on an annual basis for most firms.<sup>21</sup> Many broker-dealers are concerned about the independent testing requirement and its impact on their auditors' independence. It would be proper for the auditor of the broker-dealer to perform testing of an AML program if it is done in accordance with attestation standards. It can be performed as an agreed-upon procedure or an attestation of management assertions. However, if performed as a consulting service, such as generating working papers or reports for FINRA or the NYSE to review, the SEC staff believes this would be considered a management function and, therefore, would impair the auditor's independence. Firms may use internal staff as long as they are independent from the AML program itself and have the knowledge they need to effectively evaluate a firm's AML system. Training internal staff and establishing procedures to ensure their independence can be expensive. Therefore, some firms may find it more cost effective to use a qualified outside party. Some small firms have coordinated with other small firms to hire an outside auditor at a reduced group rate. In 2009, the SEC approved a FINRA proposed rule change to adopt FINRA Rule 3310, *Anti-Money Laundering Compliance Program*. This rule is substantially the same as the former NASD Rule 3011; however, the rule, as adopted, eliminates the independent testing exception that was in the related NASD rule.

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<sup>20</sup> The SEC has available on its website an anti-money laundering (AML) source tool for broker-dealers. It is a compilation of key AML laws, rules, and guidance applicable to broker-dealers. The tool organizes the key AML compliance materials and provides related source information. It can be accessed at [www.sec.gov/about/offices/ocie/amlsourcectool.htm](http://www.sec.gov/about/offices/ocie/amlsourcectool.htm).

<sup>21</sup> As noted in question 1 of FINRA AML frequently asked questions, as found on the FINRA website at [www.finra.org](http://www.finra.org), if the firm does not execute transactions with customers or otherwise hold customer accounts or act as an introducing broker with respect to customer accounts, the independent testing is required every two years.

## Reporting Requirements

**3.118** Each broker-dealer reports periodically to its designated examining authority in a prescribed format: the FOCUS report. Under the rules, broker-dealers are required to file at the end of each calendar quarter a part II or IIA FOCUS report (although many broker-dealers are required to file at the end of each month). The FOCUS report requires financial information that presents the financial position and results of operations in conformity with GAAP, as well as certain regulatory computations.

**3.119** The FOCUS report (Form X-17A-5) comprises the following parts:

- *Part I.* A monthly report of selected summarized financial and operational data filed by broker-dealers that carry customer securities accounts or clear securities transactions. (Examining authorities may require other broker-dealers to file part I on a monthly basis.)
- *Part II.* A report of general purpose financial information that presents the financial position and results of operations, supplemental schedules, and operational data and is filed each calendar quarter by broker-dealers that file part I.
- *Part IIA.* A quarterly report of financial information that presents the financial position and results of operations, supplemental schedules, and operational data filed by broker-dealers that do not carry customer securities accounts or clear securities transactions.
- *Part IIB.* A quarterly report made by OTC derivatives dealers who register with the SEC under a limited regulatory structure, as discussed in paragraph 3.179, that includes statements of financial condition and income, computation of net capital and net capital required, capital withdrawals, and other schedules of financial and operational data.
- *Part III.* A facing page required as part of all FOCUS filings that contains overall information regarding the filing.
- *Schedule I.* Annual supplementary schedules reflecting certain economic and statistical data of broker-dealers on a calendar-year basis.

**3.120** In certain cases, such as when a broker-dealer exceeds certain parameters of financial and operational conditions, the designated examining authority may require the broker-dealer to file part II or IIA monthly or weekly. In addition, audited financial statements are required to be filed on a fiscal- or calendar-year basis as of a date selected by the broker-dealer. The annual audit for subsequent years should be as of the same date unless the SEC issues prior approval for a change of the broker-dealer's fiscal year.

**3.121** SEC Rule 17a-5 defines *fiscal year* as the broker-dealer's fiscal year for reporting purposes; the fiscal year is not necessarily the same as the tax year. For purposes of defining a time period such as fiscal or calendar quarter, the last Friday or last business day of such period is acceptable.

**3.122** If the broker-dealer selects a date for the annual audited financial statements that does not coincide with the end of a calendar quarter, an additional unaudited part II or IIA of the FOCUS report should be filed by the broker-dealer as of the date of the annual audit (an exemption from this additional filing may be obtained if the fiscal year approximates the calendar year).

**3.123** SEC Release 34-64976, *Large Trader Reporting*, imposes additional requirements for large traders, as found in SEC Rule 13h-1. Rule 13h-1 requires a *large trader*, defined as a person whose transactions in national market system securities equal or exceed 2 million shares or \$20 million during any calendar day or 20 million shares or \$200 million during any calendar month, to identify itself to the SEC and make certain disclosures on Form 13H. In addition, the rule imposes additional requirements on registered broker-dealers related to recordkeeping, reporting, and monitoring with respect to large traders. SEC Release No. 34-66839, *Order Temporarily Exempting Broker-Dealers from the Recordkeeping, Reporting, and Monitoring Requirements of Rule 13h-1 under the Securities Exchange Act of 1934 and Granting an Exemption for Certain Securities Transactions*, had a compliance date of May 1, 2013, at which time all registered broker-dealers were required to maintain the additional data elements for transactions of large traders.

## Consolidation of Subsidiaries

**3.124** Appendix C of SEC Rule 15c3-1 requires a broker-dealer to consolidate the financial accounts of any subsidiary or affiliate for which the broker-dealer guarantees, endorses, or assumes its obligations or liabilities. Whereas consolidation would be reflected on a line-by-line basis in the broker-dealer's audited financial statements, the SEC requires equity investment presentation in broker-dealer FOCUS financial statements (that is, the broker-dealer's ownership in the subsidiary or affiliate would be reflected as a one-line investment adjusted for the broker-dealer's share of that entity's profit or loss).

**3.125** The effect of consolidating any subsidiary or affiliate may result in an increase of the broker-dealer's net capital or a decrease of its minimum net capital requirement under paragraph (a) of SEC Rule 15c3-1. In that circumstance, in order for the consolidation to be permitted for the purpose of computing net capital, the broker-dealer must meet the other requirements of paragraph (b)(2) of appendix C of the rule and obtain an opinion from legal counsel as of the date of the financial statements (such opinion should be renewed annually) that the net assets of the subsidiary can be liquidated and distributed to the broker-dealer within 30 calendar days. See appendix C of the rule for more details. In no event can a broker-dealer rely on a consolidation of any subsidiary or affiliate to meet its minimum net capital requirement.

**3.126** If a broker-dealer guarantees the payment of the financial obligation of a parent, an affiliate, or a subsidiary or is otherwise defined as a primary obligor of such obligation, the broker-dealer must include the current amount of the financial obligation as a reduction in net worth in computing its net capital. Further, if a broker-dealer's assets are included contractually as collateral for the financial obligation of another party, the carrying value of the broker-dealer's allowable assets equal to the amount of the payment obligation are considered encumbered by the SEC and are rendered nonallowable for net capital purposes. Such nonallowable treatment would not occur if the collateral relates to equity interests in the broker-dealer as opposed to the broker-dealer's assets.

## The Annual Audited Report

**3.127** The annual audited financial statements should be filed by the following:

- Every member (with certain narrow exceptions, such as certain specialists who do not do business with customers, as well as option market makers on the Chicago Board Options Exchange) of a national securities exchange who transacts business in securities directly with or for persons other than members of national securities exchanges
- Every broker-dealer (other than a member) who transacts a business in securities through a medium of any member of a national securities exchange
- Every broker-dealer registered in accordance with Section 15 of the 1934 Act
- OTC derivatives dealers registered pursuant to Section 15 of the 1934 Act<sup>22</sup>

**3.128** The annual audited report should consist of a facing page, a table of contents (report checklist), an oath or affirmation, and the following annual audited financial statements with appropriate footnotes:

- Statement of financial condition
- Statement of income (loss)
- Statement of cash flows

**3.129** In addition, SEC Rule 17a-5 requires that the annual audited financial statements also include a statement of changes in stockholders', partners', or sole proprietor's equity, and a statement of changes in liabilities subordinated to claims of general creditors.

**3.130** The contents of each of the annual audited financial statements are discussed in chapter 4 and illustrations are presented in the final section of that chapter. Broker-dealers that have issued securities to the public may also be subject to the disclosure rules that apply to publicly held companies. Such rules require that comprehensive financial information (including statements of income and cash flows) be disseminated to stockholders.

**3.131** The annual audited financial statements should also contain the following supplementary schedules, required by SEC Rule 17a-5 and Regulation 1.10(d)(2) of the CFTC, as applicable:

- Computation of net capital and required net capital under SEC Rule 15c3-1.
- Computation for determination of reserve requirements under exhibit A of SEC Rule 15c3-3.
- Information relating to the possession or control requirements under Rule 15c3-3.
- For broker-dealers that are also registered as FCMs, a schedule of segregation requirements and funds in segregation for broker-dealers with customers trading on U.S. commodity exchanges, as well as a schedule of secured amounts and funds held in separate accounts for customers trading on non-U.S. commodity exchanges.
- Reconciliations (including appropriate explanations) of material differences, if any, between the following:

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<sup>22</sup> SEC Rule 17a-12 includes the requirements for audited annual financial statements of OTC derivatives dealers registered pursuant to Section 15 of the 1934 Act under a limited regulatory structure, as discussed in paragraph 3.179.



- The broker-dealer's computation of net capital under Rule 15c3-1 included in the original unaudited FOCUS filing.
- The broker-dealer's computation for determination of the reserve requirements under exhibit A of Rule 15c3-3 included in the original unaudited FOCUS filing.
- The schedule of segregation requirements and funds in segregation included in the original unaudited FOCUS filing.
- The corresponding computations made by the independent auditor based on the audited financial statements. As permitted under the SEC Letter to the NYSE dated April 24, 1987, if a broker-dealer files an amended FOCUS report that contains the reconciliation and explanation of material differences between the amended report and the original report, the audit report may be reconciled with the amended FOCUS report and would include a statement about whether any material differences are shown in the amendment.

If there are no material differences, a statement that a reconciliation is not necessary pursuant to Rule 17a-5(d)(4) should be made.

**3.132** Two manually executed copies of the annual audited financial statements of the broker-dealer, together with the report of the independent auditor and a supplemental report on internal control, should be filed with the SEC's principal office in Washington, D.C., and one copy should be filed with the regional SEC office for the region in which the broker-dealer has its principal place of business. It is also necessary to provide copies to the designated examining authority<sup>23</sup> for the broker-dealer; to the self-regulatory organizations of which the broker-dealer is a member; and, in certain circumstances, to many of the states in which the broker-dealer is registered.

**3.133** The report must be filed (received by the SEC) within 60 calendar days after the date of the financial statements. If the broker-dealer cannot meet this deadline without undue hardship, an application for an extension of time (to a specified date not more than 90 calendar days after the date of the financial statements) may be filed with the appropriate regional office of the SEC before the due date of the report. Notice of such application should also be sent to the principal office of the designated examining authority.

- 3.134** According to FINRA rules, the application for an extension should
- a. state the reasons for the requested extension.
  - b. indicate that the inability to make a timely filing is due to circumstances beyond the control of the broker-dealer if such is the case and briefly describe the nature of such circumstances.

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<sup>23</sup> As found in Regulatory Notice 11-46, *Annual Audit Reports*, dated October 2011, FINRA has revised the process by which member firms submit the annual audited financial statements required pursuant to SEC Rule 17a-5(d). Firms whose designated examining authority is FINRA are required to submit their annual audit report in electronic form for annual audit reports with a fiscal year end on or after September 30, 2011. Firms must also submit the oath and affirmation electronically and maintain the oath and affirmation page with an original manual signature as part of their books and records in accordance with SEC Rule 17a-4(a). Further information regarding the electronic submission process, including directions for how to submit an amended annual audit report, can be found at [www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125029.pdf](http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125029.pdf).

- c. indicate if the broker-dealer is in violation of SEC Rules 15c3-1 or 15c3-3 or has any significant financial or recordkeeping problems.
- d. contain an agreement to file the report on or before the date specified by the broker-dealer in the application.

**3.135** The application for an extension is required to be accompanied by a letter from the independent public accountant stating the following:

- a. The reasons for the extension request
- b. Whether there is any indication of material inadequacies in the accounting system, the control procedures, or the procedures for safeguarding securities
- c. Whether there is any indication that the condition of the broker-dealer's records is endangering its ability to supervise its registered representatives and their handling of customers' accounts
- d. Whether there is any indication that the broker-dealer is in violation of the net capital requirements specified in SEC Rule 15c3-1 or the requirements of SEC Rule 15c3-3 or has any significant financial or recordkeeping problems

**3.136** Because three of the four questions are answered based on that part of the audit completed to date, if the auditor has not performed any significant audit work, the auditor should so state in his or her letter accompanying the extension request.

**3.137** Similar financial statements should be filed with the SEC (for government securities broker-dealers) within 60 calendar days after the date of the financial statements and simultaneously with the CFTC (for broker-dealers that are also FCMs).

**3.138** All annual audited financial statements that are filed with the SEC are treated as public documents unless the broker-dealer makes separate filings of the reports. If the broker-dealer requests confidential treatment of other than the statement of financial condition (not available for public inspection), the statement of financial condition is required to be bound separately from the balance of the statements. The balance of the annual audited financial statements must be bound separately or placed in a separate package. A facing page marked "Confidential Treatment Requested" should be completed and attached to these statements. The statement of financial condition should not be marked confidential. The public and nonpublic portions of the financial statements must be filed separately in the format required in order for the nonpublic portion of the financial statements to be treated as such. See paragraph 3.103 for the auditors' responsibilities in accordance with AU-C section 905.

**3.139** The filing with the various exchanges of which the broker-dealer is a member should include both (a) the complete annual audited report filed with the SEC and the CFTC on a confidential basis and (b) the additional filing made with the SEC and the CFTC as a public document. See paragraph 3.103 for the auditors' responsibilities in accordance with AU-C section 905.

**3.140** Under CFTC Regulation 1.10(g), the following portions of audited and unaudited financial reports filed by FCMs and IBs with the CFTC will be considered public information and made available to the public upon request:

- The amount of the FCM's or IB's adjusted net capital, the amount of its minimum net capital requirement under CFTC Regulation 1.17, and the amount of its adjusted net capital in excess of its minimum net capital requirement
- The following statements and footnote disclosures:
  - The Statement of Financial Condition in FCM and IB certified annual financial reports but not such statements in their unaudited financial reports
  - The Statements of Segregation Requirements and Funds in Segregation for customers trading on U.S. commodity exchanges and for customers' dealer options accounts (only FCMs file these statements)
  - The Statement of Secured Amounts and Funds held in Separate Accounts for foreign futures and foreign options customers in accordance with CFTC Regulation 30.7 (only FCMs file this statement)
- The independent accountant's opinion filed with FCM and IB certified annual financial reports
- The list, if any, in audited or unaudited FCM financial reports of their "guaranteed IBs"

**3.141** As a matter of administrative convenience, the FCM or IB may submit with its certified annual financial report an additional copy that has been marked "public" and contains only the information that is publicly available upon request under CFTC Regulation 1.10(g). The CFTC will not, however, process any petitions for confidential treatment of any part of the audited or unaudited financial reports filed by FCMs and IBs. In accordance with the Freedom of Information Act, the Government in the Sunshine Act, and Parts 145 and 147 of CFTC regulations, all portions of such financial reports will be treated as nonpublic except for those portions specified as publicly available in Regulation 1.10(g).

**3.142** Under provisions of the Freedom of Information Act, the CFTC may disclose to third parties portions of the nonpublic information in the report under the following circumstances:

- In connection with matters in litigation
- In connection with CFTC investigations
- When the information is furnished to regulatory, self-regulatory, and law enforcement agencies to assist them in meeting responsibilities assigned to them by law
- In other circumstances in which withholding of such information appears unwarranted

**3.143** Pursuant to CFTC Regulation 1.10(g)(5), the independent public accountant's opinion on the public portion of an FCM's financial report filing will be deemed public information.

**3.144** Pursuant to CFTC Regulation 145.5(d)(1)(i), the independent public accountant's supplemental report on material inadequacies filed under CFTC Regulation 1.16(c)(5) will be deemed nonpublic information.

## Filings Concurrent With the Annual Audited Report

### Report on Internal Control Required by SEC Rule 17a-5

**3.145** The procedures performed should be sufficient to provide reasonable assurance that any material inadequacies existing at the audit date would be disclosed.

**3.146** Concurrent with the filing of the annual audited report, the broker-dealer should file a supplemental report on internal control. This report is issued by the independent auditor, and it describes any material inadequacies found to exist or to have existed since the date of the previous audit.

**3.147** The audit is to be made in accordance with GAAS and should include the following:

- A review of the accounting system
- A review of internal control
- A review of procedures for safeguarding securities
- A review of the practices and procedures followed by the broker-dealer with respect to the following:
  - The periodic computations of net capital under SEC Rule 17a-3(a)(11) and the reserve required by SEC Rule 15c3-3(e)
  - The quarterly securities count rule (SEC Rule 17a-13)
  - Regulation T requirements for prompt payment of securities
  - The requirements for safeguarding securities (possession and control)
  - The daily computations of the segregation and foreign set-aside requirements of the Commodity Exchange Act

**3.148** The supplemental report should indicate any corrective action taken or proposed by the broker-dealer. If the audit did not disclose any material inadequacies, the supplemental report on internal control should include a statement to that effect.

**3.149** During the course of the audit, if the independent auditor determines that a material inadequacy exists, he or she should call it to the attention of the CFO of the broker-dealer, who then has the responsibility of informing the SEC within 24 hours. If this notification does not occur, the auditor has the responsibility of informing the SEC.

### Report to State Regulatory Agencies

**3.150** Other filings may be required by various state regulatory agencies. The auditor should obtain through inquiry of the client, management's determination of all the states in which the annual audited report or portions thereof are required to be filed and who (client or auditor) is to make such filings. Some jurisdictions (including California, Connecticut, and others) require a specific form of oath or affirmation to accompany the annual audited report. Others may require the filing of a statement of financial condition only, not the supplemental report on internal control structure, and others may not require any financial statement filings.

## Financial Statements to Be Furnished to Customers of Securities Broker-Dealers

**3.151** Unless the broker-dealer is exempt by reason of SEC rules, a statement of financial condition with appropriate notes, including the amount of net capital and required net capital pursuant to SEC Rule 15c3-1 (the uniform net capital rule), is required to be mailed semiannually to all customers (as defined in the rule) carried by the broker-dealer.

**3.152** The rule requiring that the statement of financial condition be furnished to customers also provides that certain notices be given to each customer concurrently with the statement of financial condition being furnished. These notices advise the customer of the availability at specified locations of (a) the latest audited statement of financial condition filed pursuant to SEC Rule 17a-5 (meaning the public report filed concurrently with the annual audited report) and (b) notification if the auditor had commented on any material inadequacies in connection with the most recent annual audited report.

**3.153** The audited statement of financial condition is required to be sent to customers within 105 days after the date of the financial statement. This statement should be consistent with the statement filed as a public document. An extension of time may be requested from the SEC.

**3.154** Broker-dealers are also required by the SEC to furnish each customer with an unaudited statement of financial condition dated 6 months after the date of the audited financial statements. The unaudited statement should conform to the audited statement with respect to presentation and disclosure requirements and should be furnished within 65 days of the statement date.

**3.155** SEC Rule 17a-5 contains a conditional exemption from the rule's requirement that a broker-dealer that carries customer accounts send its full statement of financial condition and certain other financial information to each of its customers twice per year. Paragraph (c)(5) of the rule provides that the broker-dealer can send its customers summary information regarding its net capital, as long as it also provides customers with a toll-free number to call for a free copy of its full statement of financial condition, makes its full statement of financial condition available to customers over the Internet, and meets other specified requirements.

**3.156** In view of the requirements and definitions relating to the supplemental report on internal control, careful consideration should be given to determining that the suggestions for improving organization, procedures, or efficiency that are included in reports to management upon completion of the audit are not reportable under SEC Rule 17a-5.

## Other Reports

### Reports on Securities Investor Protection Corporation Assessment

**3.157** Broker-dealers registered with the SEC, with some limited exceptions, are required to be members of the Securities Investor Protection Corporation (SIPC).<sup>24</sup> The SIPC imposes an assessment upon members to maintain

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<sup>24</sup> See the discussion in chapter 1, "The Securities Industry," for more information on the Securities Investor Protection Corporation (SIPC).

its fund and to repay any borrowings by the SIPC. For a number of years, the assessment on members was a flat rate of \$150.<sup>25</sup> In March 2009, the SIPC determined that the SIPC fund balance would likely remain less than \$1 billion for a period of 6 months or more. Therefore, beginning April 1, 2009, the SIPC reinstated an assessment rate of 1 quarter of 1 percent (or .0025) per annum of the net operating revenues from the securities business, without regard to any minimum assessment. At its meeting in September 2012, SIPC's board of directors determined the assessment rate for 2013 would continue at .0025 of net operating revenue. SIPC assessment forms and payments are due semi-annually based on the member's fiscal year-end.

**3.158** Membership in the SIPC is automatic upon SEC registration for a broker-dealer, with three exceptions. The SIPC members' website notes that persons registered as a broker-dealer only because it effects transactions in security futures products on a registered exchange is excluded from SIPC membership. In addition, broker-dealers whose business is exclusively the distribution of shares of mutual funds, the sale of variable annuities, the business of insurance, or the business of furnishing investment advice to investment companies or insurance company separate accounts are excluded from membership in the SIPC. Finally, those broker-dealers whose principal place of business, in the determination of the SIPC, is outside the United States and its territories are excluded from membership.

**3.159** SEC Rule 17a-5(e)(4) requires that a registered broker-dealer file a report, covered by an independent accountants' report, supplemental to the annual audited statement report concerning the status of the broker-dealer's membership in SIPC. This requirement applies to broker-dealers who are not exempt from the audit requirement of SEC Rule 17a-5 and whose gross revenues are in excess of \$500,000. The report covering the SIPC-7 should be submitted no later than 60 days after fiscal year-end. The supplemental report should cover the SIPC annual general assessment reconciliation or exclusion from membership forms and should include certain procedures specified in Section (iii) of Rule 17a-5(e)(4). This report requirement did not apply while the SIPC assessment rate was the minimum assessment of \$150. However, with the assessment rate being restored to 1 quarter of 1 percent (or .0025) of a member's SIPC net operating revenues, the reports are required. Appendix H, "Independent Accountants' Report on Applying Agreed-Upon Procedures Related to an Entity's SIPC Assessment Reconciliation," of this guide provides an illustrative example of the agreed-upon procedures report required for those broker-dealers subject to the SIPC assessment.<sup>26</sup> In addition, this report is available at the Stockbrokerage and Investment Banking Expert Panel section of the AICPA website at [www.aicpa.org/interestareas/frc/industryinsights/pages/expert\\_panel\\_stockbrokerage\\_and\\_investment\\_banking.aspx](http://www.aicpa.org/interestareas/frc/industryinsights/pages/expert_panel_stockbrokerage_and_investment_banking.aspx).

## Reports on Agreed-Upon Procedures for Distributions

**3.160** Broker-dealers distribute securities of government-sponsored entities. In connection with those activities, government-sponsored entities may

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<sup>25</sup> The Dodd-Frank Act amended the Securities Investor Protection Act in several areas. Two areas pertain to the SIPC assessment imposed on broker-dealers. See the SIPC website at [www.sipc.org/Members/MemberNews.aspx](http://www.sipc.org/Members/MemberNews.aspx) for more information and for the SIPC-7 form, as revised in July 2010 for the previously mentioned amendments.

<sup>26</sup> At the issue date of this guide, an illustration of an independent accountants' report required under SEC Rule 17a-5(e)(4) that covers an entity's exclusion from SIPC membership is being developed. When the illustrative report is available, it will be posted on the AICPA website at the Stockbrokerage and Investment Banking Expert Panel section.

require that broker-dealers have their auditors issue reports on agreed-upon procedures concerning compliance with selling-agreement covenants. An illustrative report is shown as appendix J, “Agreed-Upon Procedures.”

## PCAOB Accounting Support Fee

**3.161** In order to fund the activities of the PCAOB, SOX provided that funds to cover its annual budget (less registration and annual fees paid by public accounting firms) would be collected from issuers based on each issuer’s relative average monthly equity market capitalization. This amount collected is referred to as an accounting support fee.

**3.162** As discussed in paragraph 3.02 and the preface, the Dodd-Frank Act amended SOX to grant the PCAOB oversight authority with respect to audits of registered broker-dealers. To provide funds for the PCAOB’s oversight of these audits, the Dodd-Frank Act further amended SOX to require the PCAOB to allocate a portion of the accounting support fee to be collected among broker-dealers, or classes of broker-dealers, based on their relative net capital.

**3.163** In order to comply with the provisions of the Dodd-Frank Act, amendments to PCAOB funding rules<sup>27</sup> were made to

- establish classes of broker-dealers.
- describe the methods of allocating the appropriate portion of the accounting support fee to each broker-dealer within each class.
- address the collection of the assessed share of the broker-dealer accounting support fee.

**3.164** The accounting support fee has been divided into an issuer accounting support fee and a broker-dealer accounting support fee. Affiliated entities may be allocated separate shares of both the issuer and broker-dealer accounting support fee.

**3.165** The broker-dealer accounting support fee assessed is based on the average tentative net capital reported at the end of the calendar quarters during the previous calendar year. *Tentative net capital* is defined in the PCAOB amendment to have the same meaning as that term has in SEC Rule 15c3-1(c)(15). Two classes of broker-dealers have been established:

- Those with average quarterly tentative net capital greater than \$5 million
- Those with average quarterly tentative net capital less than or equal to \$5 million or those broker-dealers not filing audited financial statements pursuant to an SEC rule or other action of the SEC or its staff

**3.166** The total accounting support fee to be allocated to broker-dealers will be determined each year by the PCAOB and will be allocated to broker-dealers with tentative net capital greater than \$5 million based on the broker-dealer’s proportional share of the total tentative net capital of that class of broker-dealers. The second class of broker-dealers, which includes those with tentative net capital below the \$5 million threshold, will be allocated a share

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<sup>27</sup> Amendments to issuer funding rules are also included in this amendment. See PCAOB Release No. 2011-002 at [http://pcaobus.org/Rules/Rulemaking/Docket033/PCAOB\\_Release\\_2011-002\\_Rules.pdf](http://pcaobus.org/Rules/Rulemaking/Docket033/PCAOB_Release_2011-002_Rules.pdf) for more information.

of the broker-dealer accounting support fee of zero under current rules. Assigning a broker-dealer a share of the accounting support fee equal to zero when its tentative net capital is less than \$5 million does not affect the board's oversight of the audits of that broker-dealer. See the PCAOB website for more information on the assessment and collection of the broker-dealer accounting support fee.

## Additional Requirements for Registered Investment Advisers<sup>28</sup>

**3.167** The Investment Advisers Act of 1940 provides for the registration and regulation of most persons who render investment advice to individuals or institutions for compensation. Under Section 2(a)(20) of the Investment Company Act of 1940, an *investment adviser* is a company providing investment advice, research, and often administrative and similar services for a contractually agreed-on fee, based on a percentage of net assets.

**3.168** A broker-dealer who is also a registered investment adviser (also known as a dual-registered entity) may be subject to significant requirements as found in Rule 206(4)-2 of the Investment Advisers Act of 1940. As amended, paragraph (a)(4) of Rule 206(4)-2 requires that all registered investment advisers (or an investment adviser required to register) who have custody of client funds or securities, as defined, have an independent public accountant that is registered with, and subject to, inspection by the PCAOB, conduct an examination on a surprise basis once every calendar year. The surprise examination requirement applies even when assets are maintained by an independent qualified custodian. This surprise examination is conducted under AT section 601, *Compliance Attestation (AICPA, Professional Standards)*.

**3.169** The independent public accountant must also file a certificate on Form ADV-E with the SEC within 120 days of the time chosen for the surprise examination by the independent public accountant stating that it has examined the funds and securities and describing the nature and extent of the examination. The independent accountant, upon finding any material discrepancies during the course of the examination, should notify the SEC within one business day of the finding by means of a facsimile transmission or e-mail, followed by first class mail, directed to the attention of the Director of the Office of Compliance Inspections and Examinations. See Rule 206(4)-2(a)(4)(ii) under the Investment Advisers Act of 1940. For purposes of the surprise examination, a *material discrepancy* is material noncompliance with the provisions of either Rule 206(4)-2 or Rule 204-2(b) under the Investment Advisers Act of 1940. Instructions from the SEC for sending independent accountant notification of

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<sup>28</sup> On June 22, 2011, the SEC adopted new rules relating to investment advisers to implement provisions of the Dodd-Frank Act. See SEC final Rules IA-3221 and IA-3222 on the SEC website at [www.sec.gov/rules/final.shtml](http://www.sec.gov/rules/final.shtml) for more information, including compliance dates. The rules and amendments include provisions to

- implement the statutory requirement that certain advisers to hedge funds and other private funds register with the SEC.
- require disclosure of additional information by investment advisers, particularly about the private funds they manage.
- establish reporting requirements for certain advisers relying on new exemptions from SEC registration.
- implement the statutory requirements that reallocate regulatory responsibility for advisers between the SEC and state securities authorities.
- revise the SEC pay-to-play rule.



material discrepancies found during annual surprise examination can be found at [www.sec.gov/about/offices/ocie/awc-instructions.htm](http://www.sec.gov/about/offices/ocie/awc-instructions.htm).

**3.170** The SEC has released frequently asked questions about the custody rule that can be located at [www.sec.gov/divisions/investment/custody\\_faq\\_030510.htm](http://www.sec.gov/divisions/investment/custody_faq_030510.htm).

**3.171** The rule defines *custody* to mean an investment adviser or its related person holding, directly or indirectly, client funds or securities or having any authority to obtain possession of them. Rule 206(4)-2(d)(2) provides that an adviser will not be deemed to have custody of client assets held with a qualified custodian that is a related person of the adviser if the adviser does not provide advice with respect to such assets. Note that custody does not equate to serving as a qualified custodian under the rule. Custody includes

- possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless the investment adviser receives them inadvertently and returns them to the sender promptly but in any case within three business days of receiving them.
- any arrangement (including a general power of attorney) under which the investment adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the investment adviser's instruction to the custodian.
- any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives the investment adviser or his or her supervised person legal ownership of, or access to, client funds or securities.

**3.172** A *qualified custodian* is defined by the rule as (a) a *bank*, as defined in Section 202(a)(2) of the Investment Advisers Act of 1940, or a *savings association*, as defined in Section 3(b)(1) of the Federal Deposit Insurance Act, that has deposits insured by the FDIC under the Federal Deposit Insurance Act; (b) a broker-dealer registered under Section 15(b)(1) of the 1934 Act holding the client assets in customer accounts; (c) an FCM registered under Section 4f(a) of the Commodity Exchange Act holding the client assets in customer accounts, but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and (d) a foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets. Additionally, *related person* is defined in the rule as any person, directly or indirectly, controlling or controlled by the investment adviser, and any person who is under common control with the investment adviser.

**3.173** Rule 206(4)-2 requires that a qualified custodian maintain client funds and securities in a separate account for each client under that client's name or in accounts that contain only the clients' funds and securities under the adviser's name as agent or trustee for the clients. Notice to clients must be provided when an account is opened (and following any changes) with a qualified custodian on their behalf that details the qualified custodian's name, address, and the manner in which the funds or securities are maintained. The investment adviser must also have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each of the investment advisers' clients for which it maintains

funds or securities. See Rule 206(4)-2(b) under the Investment Advisers Act of 1940 for more information and exceptions to these requirements for shares of mutual funds, certain privately offered securities, fee deductions, limited partnerships subject to annual audit, registered investment companies, and certain related persons.

**3.174** Additionally, if the broker-dealer who is a registered investment adviser, or its related person, maintains client funds or securities as a qualified custodian in connection with advisory services provided to clients, Rule 206(4)-2(a)(6) requires that such investment adviser must at least once each calendar year obtain or receive from its related person a written internal control report related to its, or its affiliates' custodial services, including the safeguarding of funds and securities, which includes an opinion from an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB.

**3.175** This requirement could be satisfied with a type 2 service organization control 1 (SOC 1<sup>SM</sup>) report<sup>29</sup> (formerly known as a type 2 SAS No. 70 report) or an examination on internal control conducted in accordance with AT section 801, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*). In addition, as explained in question XIII.3 of the SEC's "Staff Responses to Questions About the Custody Rule," available at the "Frequently Asked Questions" section of the SEC website, a report under AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), would also be acceptable. This internal control report must include an opinion on whether controls have been placed in operation as of a specific date and are suitably designed and operating effectively to meet control objectives relating to custodial services, including the safeguarding of funds and securities held by either the investment adviser or its related person on behalf of the advisory clients during the year. The accountant must also verify that the funds and securities are reconciled to a custodian (for example, the Depository Trust and Clearing Corporation) other than the investment adviser or its related person. The accountant's tests of the custodian's reconciliation should include either direct confirmation, on a test basis, with unaffiliated custodians or other procedures designed to verify that the data used in the reconciliations performed by the qualified custodian is obtained from unaffiliated custodians and is unaltered. Refer to the AICPA Audit and Accounting Guide *Investment Companies* for more information on guidance related to investment advisers and for example illustrative reports required for broker-dealers that are registered as investment advisers under the act. Example illustrative reports are also posted on the AICPA website in the "Industry Expert Panels—Investment Company" section at [www.aicpa.org/InterestAreas/FRC/IndustryInsights/Pages/Expert\\_Panel\\_Investment\\_Companies.aspx](http://www.aicpa.org/InterestAreas/FRC/IndustryInsights/Pages/Expert_Panel_Investment_Companies.aspx).

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<sup>29</sup> This guide refers to this type of report prepared under Statement on Standards for Attestation Engagements No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), as a service organization control 1 (SOC 1) report.

## Rules Applicable to Broker-Dealers in Commodities and U.S. Government Securities<sup>30</sup>

**3.176** The following are the primary regulations under the Commodity Exchange Act<sup>31</sup> and rules under the Government Securities Act of 1986 that are currently applicable to the audit of broker-dealers in commodities and government securities.

### Commodities FCMs<sup>32</sup>

**3.177** Certain sections of the Commodity Exchange Act and CFTC regulations have been, or are in the process of, being revised, as required by the Dodd-Frank Act or in response to recent industry developments. As of the date of this guide the primary regulations applicable to FCMs are as follows:

- Section 4(d)(a)(2), “Segregation requirements”
- Section 4(f)(b), “Minimum financial requirements”
- Part 1 (Title 17 U.S. *Code of Federal Regulations* [CFR] Ch 1 Part 1—General Regulations Under the Commodity Exchange Act) including the following:
  - Regulation 1.10, “Financial reports of futures commission merchants and introducing brokers”
  - Regulation 1.12, “Maintenance of minimum financial requirements by futures commission merchants and introducing brokers”
  - Regulation 1.14, “Risk assessment recordkeeping requirements for futures commission merchants”
  - Regulation 1.15, “Risk assessment reporting requirements for futures commission merchants”
  - Regulation 1.16, “Qualifications and reports of accountants”

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<sup>30</sup> The CFTC staff is drafting amendments to CFTC Regulations 1.10 and 1.16 to require more robust assurances from FCMs and their independent accountants. It should be noted that the SEC proposed similar rules in its proposed revision to SEC Rule 17a-5. Those proposed rules include, among other things, the revocation of the requirement for a report on material inadequacies in internal control (MI letter). Dual-registered FCMs have to comply with both SEC and CFTC regulations. Therefore, if the SEC proposed rules are effective at a date other than the CFTC rule effective date, auditors of those dual-registered entities will be required to issue differing reports.

<sup>31</sup> The Dodd-Frank Act amended the Commodity Exchange Act such that a person, including a broker-dealer, for which there is a federal regulatory agency (such as the CFTC and the SEC, among others), should not enter into or offer to enter into certain foreign exchange transactions (commonly referred to as retail forex transactions) with a person who is not an *eligible contract participant*, as defined by the act, except pursuant to a rule or regulation of a federal regulatory agency allowing the transaction under terms it prescribes. The transactions include an agreement, a contract, or a transaction in foreign currency that is a contract of sale of a commodity for future delivery (or an option on such a contract) or an option (other than an option executed or traded on a national securities exchange registered pursuant to Section 6[a] of the 1934 Act). The SEC issued an interim final temporary rule allowing a registered broker-dealer to engage in retail forex business until July 16, 2012, provided that the broker-dealer complies with the 1934 Act rules and the rules of the self-regulatory organizations of which it is a member. The SEC amended this interim final temporary rule to extend the expiration date to July 31, 2016.

<sup>32</sup> The CFTC issued final regulations concerning off-exchange retail foreign currency transaction, as found in 75 FR 55410, effective October 18, 2010. Readers should refer to the CFTC website [www.cftc.gov](http://www.cftc.gov) under the “Law and Regulation” tab for more information.

- Regulation 1.17, “Minimum financial requirements for futures commission merchants and introducing brokers” (also see NFA financial requirements)
- Regulation 1.18, “Records for and relating to financial reporting and monthly computation by futures commission merchants and introducing brokers”
- Regulations 1.20–1.30, collectively titled “Customers’ Money, Securities, and Property”
- Regulations 1.31–1.37, collectively titled “Recordkeeping”<sup>33</sup>
- Regulation 1.49, “Denomination of customer funds and location of depositories”
- Part 22 (17 CFR Ch 1 Part 22), Cleared Swaps
- Part 23 (17 CFR Ch 1 Part 23), Swap Dealers and Major Swap Participants<sup>34</sup>
- Part 30 (17 CFR Ch 1 Part 30—Foreign Futures and Foreign Options Transactions), including Regulation 30.7, *Treatment of foreign futures or foreign options secured amount*
- Part 32 (17 CFR Ch 1 Part 32), Regulation of Commodity Option Transactions

## Government Securities Broker-Dealers

**3.178** The following are applicable to government securities broker-dealers under 17 CFR Chapter IV:

- Part 402, “Financial Responsibility”
- Part 403, “Protection of Customer Securities and Balances”
- Part 404, “Recordkeeping and Preservation of Records”
- Part 405, “Reports and Audit”

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<sup>33</sup> On December 21, 2012, the CFTC amended Regulations 1.31 and 1.35. The amendments require FCMs, certain introducing brokers (IBs), retail foreign exchange dealers (RFEDs), and certain other registrants that are members of designated contract markets (DCMs) or swap execution facilities (SEFs) to record all oral communications provided or received concerning quotes, solicitations, bids, offers, instructions, trading, and prices that lead to the execution of a transaction in a commodity interest, whether communicated by telephone, voicemail, mobile device, or other digital or electronic media, and to keep those records for one year. These amendments also require FCMs, IBs, RFEDs, and all members of a DCM or SEF to record and keep all written communications provided or received concerning quotes, solicitations, bids, offers, instructions, trading, and prices that lead to the execution of a transaction in a commodity interest or related cash or forward transactions, whether communicated by telephone, voicemail, facsimile, instant messaging, chat rooms, electronic mail, mobile device, or other digital or electronic media, and to keep those written records for five years. See CFTC Release No. 77 FR 75523 for further information.

<sup>34</sup> On September 11, 2012, the CFTC adopted regulations to implement certain provisions of Title VII of the Dodd-Frank Act. Section 731 of the Dodd-Frank Act added a new Section 4s(i) to the Commodity Exchange Act, which required the CFTC to prescribe standards for swap dealers (SDs) and major swap participants (MSPs) related to the timely and accurate confirmation, processing, netting, documentation, and valuation of swaps. These regulations set forth requirements for swap confirmation, portfolio reconciliation, portfolio compression, and swap trading relationship documentation for SDs and MSPs. Accordingly, the CFTC added Sections 23.500–23.505 of 17 CFR Ch 1 Part 23, Swap Dealers and Major Swap Participants.

## OTC Derivatives Dealers

**3.179** An alternative regulatory framework has been created for OTC derivatives dealers.<sup>35</sup> The rules establish a special class of broker-dealers who may choose to register with the SEC under a limited regulatory structure. An OTC derivatives dealer's securities activities are limited to (a) engaging in dealer activities in *eligible OTC derivative instruments*, as defined in Rule 3b-13, that are securities; (b) issuing and reacquiring securities that are issued by the dealer, including warrants or securities, hybrid securities, and structured notes; (c) engaging in cash management securities activities as set out in Rule 3b-14; (d) engaging in *ancillary portfolio management securities activities*, as defined in Rule 3b-15; and (e) engaging in such other securities activities that the SEC designates by order.

**3.180** The rules and rule amendments tailor capital, margin, and other broker-dealer regulatory requirements to OTC derivatives dealers. These tailored requirements include an alternative net capital regime, exemptions from certain provisions of the 1934 Act, and modified rules governing recordkeeping and reporting, substantially the same as for fully regulated broker-dealers, but tailored to the business of OTC derivatives dealers. New rules adopted under the 1934 Act include Rules 3b-12, 3b-13, 3b-14, 3b-15, 11a1-6, 15a-1, 15b9-2, 15c3-4, 17a-12, 36a1-1, and 36a1-2. Various 1934 Act rules have been amended, and Form X-17A-5 was revised.

## Annual Compliance Certification

**3.181** FINRA Rule 3130, *Annual Certification of Compliance and Supervisory Processes*, requires members to designate a chief compliance officer (CCO) and have the CEO or equivalent officer certify annually that the member has in place processes to establish, maintain, review, test, and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable FINRA rules, Municipal Securities Rule-making Board rules, and federal securities laws and regulations, and that the CEO has conducted 1 or more meetings with the CCO in the preceding 12 months to discuss such processes. Additional information is available on the FINRA website at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=6286](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6286).

**3.182** Effective October 1, 2012, FCMs that are regulated by a U.S. prudential regulator or that are also in some capacity registrants of the SEC must also have a designated CCO under CFTC Regulation 3.3, and that person must also be a listed principal of the firm. In addition, those FCMs are required to file the CCO Annual Report<sup>36</sup> as of the date of the firm's first fiscal year end after October 1, 2012. All other FCMs (that is, FCMs that are not currently regulated by a U.S. prudential regulator or that are not also in some capacity registrants of the SEC) were required to comply with the CCO requirement by

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<sup>35</sup> The Dodd-Frank Act includes provisions related to the OTC derivatives market that will significantly change the regulatory framework of that market. Rulemaking to implement these provisions is ongoing as of the date of this guide. See the preface of this guide and appendix A of this chapter for more information.

<sup>36</sup> On March 28, 2013, the CFTC's Division of Swap Dealer and Intermediary Oversight (DSIO) issued a no-action letter that provides certain FCMs with limited relief surrounding the requirement that chief compliance officers of such FCMs prepare and submit an Annual Report, pursuant to Commission Regulation 3.3. Readers are encouraged to consult the full text of CFTC Letter No. 13-03 at [www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-03.pdf](http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-03.pdf).

March 29, 2013. Introducing brokers, commodity pool operators, and commodity trading adviser members are not required to have a designated CCO. However, if the firm appoints a person as a CCO then the person must be a listed principal of the firm.

3.183

## Appendix A — Proposed Rulemaking

**A-1** Rulemaking continues in a number of areas affecting broker-dealers. Although many of the regulations being developed were mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), also being revised are the basic regulations under which broker-dealers operate. The proposed rulemaking will have a significant impact on broker-dealers. Readers should be alert for new developments.

### Securities and Exchange Commission Rule 17a-5 Revisions

**A-2** On June 15, 2011, the Securities and Exchange Commission (SEC) issued Release No. 34-64676, *Broker-Dealer Reports*, that proposes amendments to the broker-dealer financial reporting rule under the Securities Exchange Act of 1934. The proposed rule revises SEC Rule 17a-5 and includes three sets of amendments that, among other things

- update the existing requirements of Rule 17a-5.
- facilitate the ability of the Public Company Accounting Oversight Board (PCAOB) to implement oversight of audits of broker-dealers as required by the Dodd-Frank Act.
- enhance oversight of broker-dealer custody practices, including a requirement for broker-dealers to file a new form: Form Custody.
- eliminate potentially redundant requirements for certain broker-dealers affiliated with, or dually-registered as, investment advisers.

As of the date of this guide the rule has not yet been finalized. It is important to be alert for further developments.

### SEC Financial Responsibility Rules

**A-3** In 2007, the SEC proposed amendments to the financial responsibility rules for broker-dealers, as found in Release No. 34-55431, *Amendments to Financial Responsibility Rules for Broker-Dealers*. Amendments to Rule 15c3-1 (net capital); Rule 15c3-3 (customer protection); Rules 17a-3 and 4 (books and records); and Rule 17a-11 (notification) are proposed. A final rule was never issued. In May 2012, the comment period was reopened for the proposed amendments, as found in Release No. 34-66910, *Amendments to Financial Responsibility Rules for Broker-Dealers*. The amendments have not yet been finalized as of the date of this guide.

### The Dodd-Frank Act<sup>1</sup>

**A-4** The Dodd-Frank Act was signed into law by the president on July 21, 2010. The objective of this legislation is to reshape the U.S. regulatory landscape, reduce systemic risk, and help restore confidence in the financial system. The act directs the SEC and other regulators to write more than 200 regulations in many areas in order to implement its provisions. This rulemaking process continues and the SEC and other regulators continue to work on numerous rules that are mandated by the act. The Dodd-Frank Act contains a significant number of provisions that will affect the broker-dealer industry, including

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<sup>1</sup> For information on the status of Securities and Exchange Commission (SEC) rulemaking related to the Dodd-Frank Wall Street Reform and Consumer Protection Act, go to the SEC website at [www.sec.gov/spotlight/dodd-frank/accomplishments.shtml](http://www.sec.gov/spotlight/dodd-frank/accomplishments.shtml).

PCAOB oversight of audits of broker-dealers, reorganization of the over-the-counter (OTC) derivatives market, increased regulation of asset-backed securities, and amendments related to the Securities Investor Protection Corporation.

### ***PCAOB Oversight***

**A-5** Of particular interest to broker-dealers and their auditors is the Dodd-Frank Act provision that gives the PCAOB full oversight authority over audits of all broker-dealers (including nonissuers), which includes the mandate that audits of nonissuer broker-dealers are to be conducted in accordance with PCAOB auditing standards. To that end, the PCAOB is in the process of revising existing rules to clarify how the rules apply to audits of broker-dealers and issuing new rules regarding audits of broker-dealers, as appropriate. The SEC has issued transitional guidance in Release No. 34-62991, *Commission Guidance Regarding Auditing, Attestation and Related Professional Practice Standards Related to Brokers and Dealers*, that clarifies that audits of nonissuer broker-dealers will continue to be performed under generally accepted auditing standards and any applicable rules of the SEC. As noted in the release, this interpretation will be revisited in connection with pending rulemaking projects. It is anticipated that rulemaking related to the revision of SEC Rule 17a-5 will provide for the use of PCAOB auditing standards in an audit of a broker-dealer.

**A-6** As of the date of this guide, the SEC has approved two rules related to PCAOB oversight of broker-dealers. The first is a rule that establishes an interim inspection program related to audits of broker-dealers. The interim inspection program has two purposes: it enables the PCAOB to assess compliance of registered firms conducting audits of broker-dealers and, in addition, provides information to be considered when setting the scope and elements of a permanent inspection program. Note that interim inspection reports will not contain specific information related to brokers-dealers or the firms that audit them. These inspections are in progress and the first report on the interim program was issued in August 2012. The report is available on the PCAOB website. See appendix C, “Public Company Accounting Oversight Board Interim Inspection Program Report Issued,” of chapter 5 of this guide for information on the report.

**A-7** The second rule amends PCAOB funding rules to provide for a portion of the accounting support fee (previously assessed on issuers only) to be allocated among a certain class of broker-dealers. See the discussion beginning in paragraph 3.161 for more information.

### ***OTC Derivatives***

**A-8** Title VII of the Dodd-Frank Act requires the SEC to work with other regulators—the U.S. Commodity Futures Trading Commission in particular—to write rules that result in a reorganization of the OTC derivatives market. The rules required to be written increase regulation and oversight over that market and include those that

- address, among other things, mandatory clearing, the operation of trade execution facilities and data repositories, business conduct standards for certain market intermediaries, capital and margin requirements, and public transparency for transactional information.
- improve transparency and facilitate the central clearing of swaps.
- increase security-based swap transaction disclosure and help mitigate security-based swap conflicts of interest.



In December 2012, the Commodity Futures Trading Commission (CFTC) issued Release No. 77 FR 74284, "Clearing Requirement Determination Under Section 2(h) of the CEA," which amends Title 17 U.S. *Code of Federal Regulations* Parts 39 and 50. The regulations would require that certain classes of credit default swaps and interest rate swaps, as described, be cleared by a derivatives clearing organization registered with the CFTC. The CFTC also adopted regulations to prevent evasion of the clearing requirement and related provisions.

The rulemaking required to implement the Dodd-Frank Act provisions in this area is extensive and work is continuing by regulators.

### ***Asset-Backed Securities***

**A-9** The Dodd-Frank Act includes provisions to improve the asset-backed securitization process. These provisions include the following:

- Credit risk retention requirements
- Changes in disclosures and reporting for asset-backed securities
- New requirements related to the use of representations and warranties in the market for asset-based securities
- Rules to require any issuer of an asset-backed security to perform a review of the assets underlying the asset-backed security and to disclose the nature of such review

Rulemaking in this area is being done in conjunction with other regulators and work is continuing on the rules required to implement the Dodd-Frank Act provisions.

### **SEC Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers**

**A-10** In accordance with the Dodd-Frank Act, on October 18, 2012, the SEC issued Release No. 34-68071, *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers (Corrected to conform to Federal Register version)*, in which it proposed capital and margin requirements for security-based swap dealers (SBSDs) and major security-based swap participants (MSBSPs), segregation requirements for SBSBs, and notification requirements with respect to segregation for SBSBs and MSBSPs. The SEC also proposed to increase the minimum net capital requirements for broker-dealers permitted to use the alternative internal model-based method for computing net capital. On January 15, 2013, the SEC issued Release No. 34-68660, *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers (Extension of Comment Period)*, which extended the comment period to February 22, 2013. As of the date of this guide the rule has not yet been finalized.

### **SEC Rule 506 of Regulation D and Rule 144A Revisions**

**A-11** In SEC Release No. 33-9354, the SEC proposed amendments to Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933 to implement Section 201(a) of the Jumpstart Our Business Startups Act. The proposed amendment to Rule 506 would provide that the prohibition against general solicitation and general advertising contained in Rule 502(c) of Regulation D would not apply to offers and sales of securities made pursuant to Rule 506, provided that all purchasers of the securities are accredited investors. The proposed amendment to Rule 506 would also require that, in Rule 506 offerings that use general solicitation or general advertising, the issuer take reasonable steps to verify that purchasers of the securities are accredited investors. The

proposed amendment to Rule 144A(d)(1) would provide that securities may be offered pursuant to Rule 144A to persons other than qualified institutional buyers, provided that the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are qualified institutional buyers. The SEC also proposed revisions to Form D to add a separate check box for issuers to indicate whether they are using general solicitation or general advertising in a Rule 506 offering. As of the date of this guide the rule has not yet been finalized.

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## Chapter 4

# Financial Statement Presentation and Classification

### ***Presentation of Pending Content in the Financial Accounting Standards Board Accounting Standards Codification***

Amendments to Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) (issued in the form of Accounting Standards Updates [ASUs]) are initially incorporated into FASB ASC in “Pending Content” boxes located below the paragraphs being amended with links to the transition information. The pending content boxes are meant to provide users with information about how the guidance in a paragraph will change as a result of the new guidance.

Pending content applies to different entities at different times due to varying fiscal year-ends and because certain guidance may be effective on different dates for public and nonpublic entities. As such, FASB maintains amended guidance in pending content boxes within FASB ASC until the “roll-off” date. Generally, the roll-off date is six months following the latest fiscal year end for which the original guidance being amended could still be applied.

### ***Presentation of Pending Content in AICPA Audit and Accounting Guides***

Amended FASB ASC guidance that is included in pending content boxes in FASB ASC on May 1, 2013, is referenced as “Pending Content” in this guide. “Pending Content” referenced or discussed within this guide’s chapter is fully effective as of the date of this guide and should be considered by readers for current reporting periods. “Pending Content” referenced or discussed within this guide’s shaded “Guidance Updates” boxes that follow or within appendix A, “Guidance Updates,” is not fully effective as of the date of this guide. Readers should be aware that “Pending Content” referenced in this guide will eventually be subjected to FASB’s roll-off process and will no longer be labeled as “Pending Content” in FASB ASC (as discussed in the previous paragraph).

## Introduction

**4.01** Broker-dealers are guided in their preparation of financial statements primarily by accounting principles generally accepted in the United States of America (GAAP) for business enterprises in general. However, broker-dealers are further subject to Securities and Exchange Commission (SEC) Rule 17a-5<sup>1</sup> and the Financial and Operational Combined Uniform Single (FOCUS) forms thereunder. That rule requires, in addition to monthly and quarterly filings on the prescribed forms (Form X-17A-5—FOCUS parts I, II, and IIA), annual audited financial statements that include a statement of financial condition, a statement of income or operations, a statement of cash flows, a statement of changes in ownership equity (stockholders’ or members’ equity or partners’ or sole proprietor’s capital), and a statement of changes in liabilities

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<sup>1</sup> The Securities and Exchange Commission (SEC) has proposed amendments to Rule 17a-5 in Release No. 34-64676, *Broker-Dealer Reports*, dated June 15, 2011. See appendix A, “Proposed Rulemaking,” in chapter 3, “Regulatory Considerations,” for more information on the proposed revisions to Rule 17a-5.

subordinated to claims of general creditors. Also required are certain supporting schedules for various specified computations. These are illustrated in exhibits 4-1–4-9.

**4.02** In addition to the disclosures shown in exhibit 4-8, there may be certain other disclosures required under SEC Regulation S-X for those companies that are registered under Section 12(b) or 12(g) of the Securities Exchange Act of 1934 (the 1934 Act). Regulation S-X does not apply to the financial statements filed with the SEC under Rule 17a-5, but certain independence requirements of Regulation S-X do apply.<sup>2</sup>

**4.03** Broker-dealers commonly prepare their financial statements on a single-year basis, which complies with the requirements of SEC Rule 17a-5. Coexisting financial statements for other than regulatory filings (such as bank lending requirements or reports to shareholders) are also generally prepared on a single-year basis.

**4.04** Over-the-counter (OTC) derivatives dealers registered pursuant to Section 15 of the 1934 Act under an alternative regulatory framework<sup>3</sup> as discussed in chapter 3, “Regulatory Considerations,” are subject to SEC Rule 17a-12. SEC Rule 17a-5 states that an OTC derivatives dealer may comply with Rule 17a-5 by complying with the provisions of Rule 17a-12. The rules governing reporting for OTC derivatives dealers remain substantially the same as for fully regulated broker-dealers; however, they have been tailored to the business of OTC derivatives dealers. Rule 17a-12 contains guidance on reports to be made by OTC derivatives dealers.

**4.05** Some of the unique attributes of the financial statements and the accounts or captions appearing therein, as they relate to broker-dealers, are discussed in the following sections. In addition to the information in this chapter, a discussion of a variety of accounting issues that are important to broker-dealers, including a discussion of FASB ASC 820, *Fair Value Measurement*, and FASB ASC 825, *Financial Instruments*, can be found in chapter 7, “Accounting Standards,” of this guide.

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<sup>2</sup> In January 2003, the SEC adopted amendments to its requirements regarding auditor independence to enhance the independence of accountants who audit and review financial statements and prepare attestation reports filed with the SEC. In August 2003, the SEC’s Office of the Chief Accountant provided responses to 35 frequently asked questions (FAQs) regarding the application of these rules. This list of questions was revised in December 2004. The responses to these questions provide guidance in several areas. One response indicates that the scope of services provisions of the Sarbanes-Oxley Act of 2002 (SOX) extends to auditors of nonissuer broker-dealers. Accordingly, auditors of nonissuer broker-dealers are restricted from performing those services specifically excluded by SOX and are expected to comply with all other SEC independence rules, including those that prohibit bookkeeping and the preparation of financial statements for nonissuer broker-dealers. However, as indicated by another response, the auditor rotation rules do not apply to auditors of nonissuer broker-dealers. SEC answers to FAQs regarding the independence rules can be found at [www.sec.gov/info/accountants/ocafaqaudind121304.htm](http://www.sec.gov/info/accountants/ocafaqaudind121304.htm). Independence standards of the Public Company Accounting Oversight Board (PCAOB) do not currently apply to auditors of nonissuer broker-dealers. However, as a result of provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the PCAOB may extend these standards or issue specific standards under its oversight authority of audits of broker-dealers. See the preface for more information.

<sup>3</sup> The Dodd-Frank Act includes provisions related to the over-the-counter derivatives market that will significantly change the regulatory framework of that market. Rulemaking to implement these provisions is ongoing as of the date of this guide. See the preface for more information.

## Financial Statements

### Statement of Financial Condition

**4.06** The statement of financial condition should be in a format and on a basis consistent with the totals reported on the statement of financial condition contained in part II or IIA of the FOCUS report as filed by the broker-dealer. This presentation should conform with GAAP. See paragraph 4.09 for a discussion on subordinated liabilities and ownership equity.

**4.07** However, as discussed in FASB ASC 940-20-45-1, current and non-current classifications are ordinarily not presented in the statement of financial condition because such a distinction normally has little meaning for brokers and dealers.

**4.08** The statement of financial condition should disclose on the face of the statement or in a note the components of ownership equity (for example, preferred stock, common stock, additional paid-in capital, and retained earnings).

**4.09** Subordinated liabilities and ownership equity should be presented separately. Because of the unique characteristics of qualifying subordinated liabilities, disclosure of the amount of subordinated debt for which six months' notice has been given of intent to withdraw should be made in the notes to the financial statements or the separate statement of financial condition.

### Statement of Income or Operations

**4.10** The statement of income or operations should be in a format that is consistent with the statement contained in part II or part IIA of the FOCUS report, and it should disclose separately the sources of the broker-dealer's revenues (such as commissions, trading and investment gains or losses, underwriting profits or losses, fee income, dividends, and interest). Expenses should be reported by major types (such as employee compensation and benefits, communications, occupancy and equipment, interest, floor brokerage, and clearance fees).

### Statement of Cash Flows

**4.11** As noted in FASB ASC 230-10-15-3, a business entity that provides a set of financial statements that presents both the statement of financial condition and statement of income or operations should also provide a statement of cash flows for each period for which a statement of income or operations is provided.

**4.12** FASB ASC 940-320-45-7 states that broker-dealers should report their trading securities activities in the operating section of the statement of cash flows. This presentation is appropriate for the securities industry because, unlike other industries, a broker-dealer's business is to acquire and finance securities and other financial instruments.

### Statement of Changes in Ownership Equity

**4.13** The statement of changes in ownership equity should be in a format that is consistent with the statement contained in part II or part IIA of the FOCUS report. This statement is required regardless of whether the reporting

broker-dealer is a corporation, limited liability company, partnership, or sole proprietorship. It should disclose the principal changes in the equity accounts of the broker-dealer during the periods for which a statement of income or operations is presented.

**4.14** FASB ASC 480, *Distinguishing Liabilities from Equity*, provides guidance regarding certain instruments that should not be considered equity but, instead, should be considered a liability and classified as such (with changes reflected as a component of the income statement). Examples include certain mandatorily redeemable preferred and common stock, general partner buy-sell arrangements, and other similar arrangements. (See chapter 7 of this guide for more information.) Separate classification on the face of the financial statements and disclosure in the footnotes should be made for any redeemable forms of equity. (See “Pending Content” in paragraphs 1–2 of FASB ASC 480-10-45 and paragraphs 1–2 and “Pending Content” in paragraph 4 of FASB ASC 480-10-50 for additional guidance.)

## Statement of Changes in Liabilities Subordinated to Claims of General Creditors

**4.15** The SEC requires a statement showing the increases and decreases to subordinated liabilities for each year being reported on. This statement is required even if no increases or decreases in subordinated liabilities occur during the year; however, no statement is required if no subordinated liabilities exist at any time during the year.

## Consolidation of Subsidiaries

**4.16** Annual audited financial statements of a company and its subsidiaries that are presented in conformity with GAAP are presented on a consolidated basis in accordance with FASB ASC 810, *Consolidation*; FASB ASC 860, *Transfers and Servicing*; and FASB ASC 805, *Business Combinations*. However, audited financial statements filed pursuant to part II or part IIA of the FOCUS report may have different consolidation requirements. If the statement of financial condition filed on part II or part IIA of the FOCUS report is not on a consolidated basis or if consolidation on part II or part IIA of the FOCUS report is on a “one-line” (equity) basis, it may differ from the statement reported on by the independent auditor. The SEC requires that such differences, if material, be disclosed in a note to the audited financial statements or included as supplementary information.

**4.17** In addition, the SEC requires disclosure of summary financial information (including assets, liabilities, and net worth) concerning subsidiaries consolidated in the financial statements presented in conformity with GAAP when that consolidation differs from the presentation in the unaudited part II or part IIA FOCUS filing. Further, for subsidiaries consolidated under the flow-through capital benefits of appendix C of SEC Rule 15c3-1, the effect of the consolidation on net capital and required net capital of the broker-dealer should be disclosed in the notes to the statement of financial condition furnished to customers.

## Supplementary Schedules

**4.18** Certain supplementary schedules are required to be filed along with the financial statements when submitting the financial statements to certain

regulators, such as the SEC and the Commodity Futures Trading Commission (CFTC). These supplementary schedules should be presented in the format that presents the relevant details required by applicable SEC and CFTC rules and should be filed as a part of the FOCUS report. The independent auditors' report is required to cover these schedules, which should be filed as of the audit date. See appendix A, "Supplementary Information in Relation to the Financial Statements as a Whole," of this chapter for more information. See exhibit 4-9 for illustrative examples of these schedules.

**4.19** When performing an audit in accordance with generally accepted auditing standards, see AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), for guidance when reporting on supplementary information required by the SEC and other regulators. See appendix A of this chapter for more information. See also appendix C, "Auditor's Standard Reports," of this guide for illustrative reporting.

### **Computation of Net Capital Pursuant to SEC Rule 15c3-1**

**4.20** This schedule shows the computation of the net capital and required net capital of the broker-dealer. A reconciliation is required if material differences exist between the computation reported on by the independent auditor and the broker-dealer's original unaudited filing of part II or part IIA of the FOCUS report. If no material differences exist, a statement to that effect should be made in the schedule.

**4.21** As permitted under the "SEC Letter to New York Stock Exchange (NYSE)" dated April 24, 1987, if a broker-dealer files an amended FOCUS report that contains the reconciliation and explanation of material differences between the amended report and original report, the auditors' report may be reconciled with the amended FOCUS report and would include a statement about whether any material differences exist between the amended FOCUS report and the audited financial statements.

### **Computation for Determination of Reserve Requirements Pursuant to SEC Rule 15c3-3**

**4.22** This schedule shows the computation of the required deposit in special reserve bank accounts for the exclusive benefit of customers. If the broker-dealer is required to make computations of required deposits in special reserve bank accounts pursuant to agreements under proprietary accounts of introducing broker arrangements, a separate schedule of such computation should be presented. A reconciliation is required if material differences exist between the computation(s) reported on by the independent auditor and the computation(s) filed previously by the broker-dealer in the original unaudited FOCUS report. See paragraph 4.21. If no material differences exist, a statement to that effect should be made in the schedule(s).

### **Information Relating to Possession or Control Requirements Under SEC Rule 15c3-3**

**4.23** This schedule discloses the number of security positions and the related fair value of securities required to be in possession or control that had not been reduced to possession or control in the proper time frame because (a) properly issued segregation instructions were not acted upon, or (b) segregation

instructions were not issued. In addition, for those items not in possession or control, the current status of the reduction of those items to possession and control should be included within the schedule.

## **Schedules of Segregation Requirements and Funds in Segregation Pursuant to the Commodity Exchange Act**

**4.24** The segregation schedule shows the computation of the amount of funds that should be segregated for customers trading on U.S. commodity exchanges and the total funds segregated by the broker-dealer to meet those requirements. In addition, a secured amount schedule that shows the computation of funds required to be set aside in separate accounts for customers trading on non-U.S. commodity exchanges and the amount of funds in such separate accounts should be included in the filing. A reconciliation is required if material differences exist between the computation(s) reported on by the independent auditor and the computation(s) filed previously by the broker-dealer in the original unaudited FOCUS report. See paragraph 4.21. If no material differences exist, a statement to that effect should be made in the schedule(s).

## **Statement of Financial Condition Account Descriptions**

**4.25** Many statement of financial condition accounts contained in a broker-dealer's general ledger are self-explanatory. The captions discussed in the following paragraphs require special comment because they contain certain characteristics that are unique to broker-dealers.

### **Cash**

**4.26** Cash in banks subject to withdrawal restrictions, restricted deposits held as compensating balances, and cash segregated in compliance with federal or other regulations (such as cash deposited in a special reserve bank account for the exclusive benefit of customers pursuant to SEC Rule 15c3-3) should be classified separately in the statement of financial condition or disclosed in the notes to the financial statements. Because of the attributes of segregated cash and related assets under CFTC rules, many futures commission merchants and some broker-dealers disclose in the notes a summary of the funds in segregation.

### **Memberships in Exchanges**

**4.27** As discussed in FASB ASC 940-340-05-1, exchange memberships provide the broker-dealer with the right to do business on the exchanges of which the broker-dealer is a member. Some exchange memberships also represent an ownership interest in the exchange. Due to the demutualization of many exchanges, membership may not be aligned with ownership in the exchange as trading privileges are disaggregated from ownership. Many broker-dealers have memberships in several exchanges and more than one membership in any particular exchange. Memberships are usually registered in the names of individuals who are affiliated with the broker-dealer. FASB ASC 940-340-25-2 states that a membership held in the name of an individual is considered to be an asset of the broker-dealer if it is held by the broker-dealer



under an agreement (such as an ABC agreement)<sup>4</sup> that would require the member, upon leaving the broker-dealer, to do one of the following:

- a. Pay the member organization the amount necessary to purchase another membership (if the named individual wished to retain the membership)
- b. Sell the membership and pay the proceeds over to the member organization
- c. Transfer the membership for a nominal consideration to a person designated by the member organization and satisfactory to the exchange

**4.28** As noted in FASB ASC 940-340-25-1, the accounting for exchange memberships depends on the rights they convey and the reasons they are held as assets, as follows:

- a. *Intangible asset.*<sup>5</sup> If an exchange membership represents only the right to conduct business on an exchange, the entity shall account for the exchange membership as an intangible asset according to the guidance in FASB ASC 350-10. Such memberships may have finite or indefinite lives based on the terms of the arrangement and the estimated life of the membership.
- b. *Ownership interest in the exchange.* An exchange membership shall be accounted for as an ownership interest in the exchange if either of the following conditions is met:
  - i. The exchange membership represents both an ownership interest and the right to conduct business on the exchange, which are owned by a broker-dealer and held for operating purposes.
  - ii. The exchange membership represents an ownership interest, which must be held by a broker-dealer to conduct business on the exchange.
- c. *Contributed interest.* A membership may be considered to be an asset of the broker-dealer if its use has been contributed to the broker-dealer under a formal or informal subordination agreement. An exchange membership contributed for the use of the broker-dealer

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<sup>4</sup> The Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary defines an *ABC agreement* as an agreement between a brokerage firm and one of its employees spelling out the firm's rights when it purchases a New York Stock Exchange (NYSE) (or similar exchange) membership for the employee. Only individuals can be members of the NYSE (and certain other exchanges), and it is common practice for a firm to finance the purchase of a membership, or seat, by one of its employees. The NYSE approved ABC agreement contains the following provisions regarding the future disposition of the seat: (a) the employee may retain the membership and buy another seat for an individual designated by the firm, (b) the employee may sell the seat and give the proceeds to the firm, or (c) the employee may transfer the seat to another employee of the firm.

<sup>5</sup> In July 2012, FASB issued Accounting Standards Update (ASU) No. 2012-02, *Intangibles—Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment*, which is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. ASU No. 2012-02 is intended to reduce costs and complexity by permitting an entity to first make a qualitative assessment about the likelihood that an indefinite-lived intangible asset is impaired to determine whether it is necessary perform a quantitative impairment test. Under ASU No. 2012-02, an entity would not be required to calculate the fair value of an indefinite-lived intangible unless the entity determines, based on a qualitative assessment, that it is more likely than not the indefinitely-lived intangible asset is impaired.

and subordinated to claims of general creditors shall be accounted for as a contributed interest and a liability subordinated to claims of general creditors.

## Receivables From, and Payables to, Broker-Dealers and Clearing Organizations

**4.29** Receivables from broker-dealers and clearing organizations may include amounts receivable for securities failed to deliver, certain deposits for securities borrowed, amounts receivable from clearing organizations relating to open transactions, good-faith and margin deposits, and commissions and floor-brokerage receivables. Payables to broker-dealers and clearing organizations include amounts payable for securities failed to receive, certain deposits received for securities loaned, amounts payable to clearing organizations on open transactions, and floor-brokerage payables. In addition, the net receivable or payable arising from unsettled trades would be reflected in those captions.

**4.30** If a broker-dealer clears transactions on behalf of or through correspondents, there may be balances in the omnibus accounts with one or more of the correspondents. Balances included in this category may be shown separately as due from or to correspondent brokers.

**4.31** *Fail to deliver.* According to FASB ASC 940-20-25-4, a broker-dealer that sells securities, either for its own account or a customer's account, but does not deliver the securities on the settlement date should record the fail to deliver as an asset in the receivable account due from broker-dealers. FASB ASC 940-20-30-1 explains that a fail to deliver asset should be measured initially at the selling price, including any accrued interest.

**4.32** The fail-to-deliver asset discussed in the previous paragraph will be collected upon delivery of the securities.

**4.33** *Fail to receive.* FASB ASC 940-20-25-5 notes that a broker-dealer that purchases securities, either for its own account or a customer's account, but does not receive the securities on the settlement date should record the fail to receive as a liability to the selling broker-dealer. FASB ASC 940-20-30-2 explains that a fail to receive liability should be measured initially at the amount of money representing the purchase price of the securities, including any accrued interest.

**4.34** The fail-to-receive liability discussed in the previous paragraph is paid when the securities are received by the purchasing broker-dealer.

**4.35** *Clearing organizations receivables and payables.* As described in chapter 1, "The Securities Industry," clearing organizations provide efficient and orderly trade clearance and settlement services for which broker-dealers pay fees. Clearing organizations perform post-trade processing and trade comparisons among numerous broker-dealers and act as settlement agents between buying and selling broker-dealers. In general, the majority of financial instrument transactions are compared and cleared through a clearing organization.

**4.36** All continuous net settlement transactions (see chapter 1 for a description of these transactions) are netted at each clearing organization to one cash settlement position. Therefore, if the contract amount of the securities to be received (purchased) is greater than that to be delivered (sold), the

broker-dealer records a payable to the clearing organization for the net movement.

**4.37** *Securities borrowed.* Broker-dealers borrow securities from other broker-dealers or institutions for the following purposes:

- To deliver them in place of securities not available because customers or broker-dealers sell short (sell securities not owned); customers sell securities before they deliver them; or customers deliver securities lacking proper endorsements, preventing their delivery to buyers
- To lend them in connection with finder or conduit transactions
- To be used for other purposes permitted under Federal Reserve Regulation T (Regulation T) of the Board of Governors of the Federal Reserve System

**4.38** Broker-dealers may advance cash, pledge securities as allowed under Regulation T (permitted securities), or issue letters of credit as collateral for borrowed securities. Cash is typically in excess of the fair value of the securities borrowed. The amount of collateral required may increase or decrease depending on changes in the value of the securities. The borrowing broker-dealer normally receives a rebate on the cash it exchanges for the securities borrowed.

**4.39** *Securities loaned.* Securities are loaned to other broker-dealers as a method of financing or in a finder or conduit business. Collateral, generally cash, is received for the securities loaned. A rebate is paid by the lending broker-dealer on the money received for the securities lent. (Note that SEC Rule 15c3-3 specifies that customers' fully paid and excess margin securities may not be lent, except as specifically allowed under the rule.)

**4.40** FASB ASC 210-20-05-1 states that it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except if a right of setoff exists.

**4.41** The FASB ASC glossary defines *right of setoff* as a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. FASB ASC 210-20-45-1 provides that a right of setoff exists when all of the following conditions are met:

- a. Each of two parties owes the other determinable amounts.
- b. The reporting party has the right to set off the amount owed with the amount owed by the other party.
- c. The reporting party intends to set off.
- d. The right of setoff is enforceable at law.

The required disclosures when right of setoff exists are discussed in paragraphs 4.106–.112.

**4.42** FASB ASC 940-405-55-1 states that securities borrowed and securities loaned transactions that do not have explicit settlement dates do not meet the requirement in FASB ASC 210-20-45-1 for a right of setoff. Balances arising from securities borrowed and loaned transactions that are accounted for as secured borrowings are presented gross on the statement of financial condition because they do not have explicit settlement dates.

**4.43** FASB ASC 860 provides specific criteria for determining whether a securities lending transaction is to be accounted for as a sale or secured

borrowing and provides an illustration of the latter. See chapter 7 of this guide for further discussion of secured borrowings. FASB ASC 210-20-45-9 discusses the nature of support required for an assertion in financial statements that a right of setoff is enforceable at law.

## Receivables From, and Payables to, Customers

**4.44** The term *customers* generally excludes other broker-dealers; persons who are principal officers, directors, and stockholders; and persons whose securities or funds are part of the regulatory net capital of the broker-dealer. Another broker-dealer's account can be classified as a customer if the account is carried as an omnibus account in compliance with Regulation T. The accounts of principal officers, directors, and stockholders may be combined in the customer captions if they are not material, and the combination is disclosed in the oath that is required to accompany the annual audited FOCUS report.

## Securities Sold Under Agreements to Repurchase

**4.45** A repurchase transaction (repo) is, in its simplest form, a sale of a security coupled with an agreement by the seller to repurchase the same or substantially the same security from the same counterparty at a fixed or determinable price (generally the original sale price plus accrued interest) within a fixed or variable time period. The meaning of *substantially the same* is explained in "Pending Content" in FASB ASC 860-10-40-24(a).

**4.46** FASB ASC 860 provides specific criteria for determining whether repos should be accounted for as sales or secured borrowings. In April 2011, FASB issued ASU No. 2011-03, *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements*. The amendments in this ASU change the consideration of effective control as it relates to repurchase and other agreements that both entitle and obligate the transferor to repurchase or redeem financial assets before their maturity. See the discussion in chapter 7 of this guide for more information related to transfers of financial assets.

## Securities Purchased Under Agreements to Resell

**4.47** A reverse repurchase agreement (reverse repo or resale) is, in its simplest form, the purchase of a security at a specified price with an agreement to sell the same or substantially the same security to the same counterparty at a fixed or determinable price at a future date. Repos and reverse repos that are accounted for as secured borrowings should be recorded as both assets and liabilities on the statement of financial condition and may be netted if the conditions of FASB ASC 210-20-45-11 are met.

## Securities Owned and Securities Sold, Not Yet Purchased

**4.48** According to FASB ASC 940-320-45-2, proprietary securities transactions entered into by the broker-dealer for trading or investment purposes are included in "securities owned" and "securities sold, not yet purchased."

**4.49** Although proprietary trading is frequently thought of as purchasing securities for sale to others, trading securities for the broker-dealer's own account sometimes leads to a liability for the fair value of securities sold but not yet purchased (that is, sold short). The broker-dealer is then obligated to purchase the securities at a future date at the then-current market price.

**4.50** FASB ASC 940-320-30-2 and FASB ASC 940-320-35-1 state that security positions resulting from proprietary trading are measured initially and subsequently at fair value. According to FASB ASC 940-320-35-2, any unrealized gains or losses resulting from subsequent measurement of these to fair value are included in profit or loss. As noted in FASB ASC 940-320-45-4, the fair value of fixed-income securities owned that were purchased at a discount or premium comprises accreted interest income, changes in the fair value of the securities, or both. Consideration should be given to reporting these components separately as interest income and trading gains and losses, respectively.

**4.51** See chapter 7 for a discussion of fair value measurement under FASB ASC 820.

**4.52** Specific requirements regarding joint accounts with other broker-dealers are included in the instructions to the FOCUS report. For joint accounts carried by the broker-dealer, the applicable portion of the securities or other positions should be included in the appropriate securities owned or other classifications, and the other parties' interests in the ledger balance are included in receivables or payables. If the joint account is carried by another broker-dealer, the share of the broker-dealer being reported on should be determined and disclosed with a contra-liability to, or receivable from, the carrying broker-dealer.

**4.53** Per FASB ASC 940-20-50-1, broker-dealers acting as principals in underwriting and when-issued contracts have contractual commitments. Disclosure should be made of such commitments. As noted in FASB ASC 940-20-45-2, the broker-dealer's share (assuming such share is not merely contingent) in underwriting or joint accounts with other broker-dealers for issued securities should be included with its trading accounts (amounts receivable from, or payable to, broker-dealer).

## Bank Loans

**4.54** Bank loans represent obligations incurred by a broker-dealer to finance securities purchases by customers on margin; to satisfy amounts owed for settling securities purchases, net of sales; to finance the firm's securities inventories; or for other purposes. These loans may be secured or unsecured. Short-term secured bank loans are generally collateralized by marketable securities. Broker-dealers should disclose in the notes to the financial statements the general attributes of the loans, including the collateral pledged.

**4.55** FASB ASC 860-30-25 addresses the accounting for collateral and requires, in some cases, that a debtor reclassify an asset pledged as collateral to indicate it is encumbered. The standards for accounting for noncash collateral in FASB ASC 860-30-25-5 state that if the secured party has the right by contract or custom to sell or repledge the collateral, then the transferor should reclassify that asset and report it in the statement of financial position separately from other assets that are not encumbered. Cash "collateral" sometimes used, for example, in securities lending transactions, should be derecognized by the payer and recognized by the recipient not as collateral but, rather, as proceeds of either a sale or borrowing. FASB ASC 860-30-50 provides guidance on required disclosures for collateral.

**4.56** Customer-owned securities may be used only to collateralize customer loans. Unsecured loans are always firm loans. Only securities belonging to the firm or its subordinated lenders, partners, principal officers, or directors can be used as collateral for firm loans. Loans that are collateralized by

securities not owned by the broker-dealer but that are held pending delivery or for the account of other broker-dealers are considered nonfirm, noncustomer loans. However, securities that have been sold to a delivery versus payment customer or to another broker-dealer and that have not yet been paid for can be pledged as collateral for a firm bank loan. Noncustomer bank loans are typically used to finance positions of a broker-dealer correspondent or an affiliate. Once a customer's securities are fully paid for or constitute excess margin, they should be promptly removed from bank loans and segregated as required by SEC Rule 15c3-3.

## Commitments, Contingencies, and Guarantees

**4.57** FASB ASC 460, *Guarantees*, discusses several transactions that may be interpreted to be a guarantee, which may require specific recognition and measurement within the financial statements. Examples include a parent's guarantee of a subsidiary's debt, indemnifications to service providers or counterparties, certain written options, and certain credit default swaps. This topic elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees it has issued. It also clarifies that a guarantor is required to recognize, at the inception of certain guarantees, a liability for the fair value of the obligation undertaken in issuing the guarantee. FASB ASC 460-10-25-1 lists the types of guarantees that are not subject to its initial recognition and measurement provisions, but are subject to its disclosure requirements.

## Subordinated Borrowings

**4.58** Broker-dealers use subordinated loans as sources of regulatory capital. These loans may be cash loans or secured demand notes. They are often made by persons associated with the broker-dealer, usually a partner; parent entity; or principal shareholder, officer, employee, or family relation of the foregoing. The subordinated loans should be subject to a qualified subordination agreement or qualified secured demand note collateral agreement approved by the broker-dealer's designated examining authority or self-regulatory organization to qualify as capital for purposes of computing the broker-dealer's net capital.

**4.59** In a typical subordinated cash loan agreement, the lender lends cash to the broker-dealer and in return receives from the broker-dealer a written promise in the form of a note that sets forth the repayment terms, interest rate, and provisions under which the lender agrees to subordinate its claims to the claims of the general creditors of the broker-dealer.

**4.60** A *secured demand note* is an interest-bearing promissory note executed by the lender and is payable upon demand of the broker-dealer to which it is contributed. These notes are generally collateralized by marketable securities. Upon demand, the note becomes due and collectible. The right to demand payment may be conditioned upon the occurrence of certain events.

**4.61** The lender actually retains ownership of the collateral, benefiting from increases and bearing the risk for decreases in its value. Securities pledged as collateral should be fully paid and be in bearer form or registered in the name of the broker-dealer or its custodian, which allows the securities to be used by the broker-dealer. The lender may withdraw any excess collateral or substitute cash or other securities as collateral. The securities received as collateral and cash, if any, would be recorded in a secured demand note account

similar to a customer account. (Also see paragraph 4.55, which discusses the financial reporting treatment of collateral.)

**4.62** If a subordinated loan or collateral securing a secured demand note is subject to a *satisfactory subordination agreement*, as defined in appendix D of SEC Rule 15c3-1, it will qualify as capital when computing the broker-dealer's net capital.

## Income Statement Account Descriptions

**4.63** Many income statement accounts of broker-dealers are analogous to those of other entities. This Audit and Accounting Guide discusses those income statement accounts that arise based on transactions that are typical to broker-dealers. The income statement accounts of broker-dealers include the following:

- Commission income
- Interest income and expense
- Dividend income and expense
- Principal transactions
- Underwriting income or loss
- Management and investment advisory income
- Floor brokerage
- Exchange fees
- Occupancy
- Employee compensation and benefits
- Communications and data processing

### Commission Income

**4.64** FASB ASC 940-20-05-3 explains that, acting as an agent, a broker-dealer may buy and sell securities on behalf of its customers. In return for such services, the broker-dealer charges a commission. Each time a customer enters into a buy or sell transaction, a commission is earned by the broker-dealer for its selling and administrative efforts. Commissions are recorded by the broker-dealer on a trade-date basis. As noted in FASB ASC 940-20-25-2, for securities purchased, the commission is recorded as a receivable from customers; for securities sold, it is recorded as reductions in the payable to customers.

**4.65** Commissions earned are usually related to the broker-dealer's customers' trading volume and the dollar amounts of the trades. Those relationships are important when considering analytical procedures relating to commission income.

### Interest Income and Expense

- 4.66** The sources of interest income earned by a broker-dealer include
- interest earned on reverse repurchase transactions.
  - interest charged on debit balances in customer margin accounts. A broker provides financing to its customers by allowing them to purchase on credit in return for which the broker-dealer charges interest.

- interest income earned by the broker-dealer on its trading and investment portfolio, including the accretion of discounts and the amortization of premiums.
- interest earned on securities-borrowed transactions in which the broker-dealer has borrowed securities from another broker-dealer and in return has deposited cash with the other broker-dealer. The other broker-dealer pays interest (commonly known as a rebate) for the use of the cash.

**4.67** Interest expense typically arises from the following:

- Interest on cash borrowings to finance payment for securities purchased
- Interest or rebates paid on cash collateral received for securities loaned to others
- Interest on cash collateral received in repurchase transactions
- Interest to subordinated and other lenders
- Payments in lieu of interest on securities sold short

## Dividend Income and Expense

**4.68** Broker-dealers may earn dividend income from equity securities owned and may incur payments in lieu of dividends from equity securities sold, not yet purchased.

## Trading Gains and Losses (Principal Transactions)

**4.69** As noted in FASB ASC 940-320-05-3, a broker-dealer may buy and sell securities for its own account. FASB ASC 940-320-35-3 states that the profit or loss is measured by the difference between the acquisition cost and the fair value. According to FASB ASC 940-320-45-5, trading gains and losses (also referred to as principal transactions in industry practice), which comprise both realized and unrealized gains and losses, are generally presented net.

## Underwriting Income and Expense

**4.70** FASB ASC 940-605-25-1 describes how a broker-dealer may underwrite a security offering by contracting to buy the issue either at a fixed price or a price based on selling the offering on a best-effort basis. Paragraphs 2–4 of FASB ASC 940-605-25 provide guidance on the timing of recognition of such revenue. The difference between the price paid by the public and the contract price less certain direct related expenses represents the underwriting income or loss. FASB ASC 940-340-35-3 states that underwriting expenses deferred under the guidance in FASB ASC 940-340-25-3 should be recognized at the time the related revenues are recorded. In the event that the transaction is not completed and the securities are not issued, the entities that have agreed to participate in the costs associated with the underwriting will write those costs off to expense.

## Management and Investment Advisory Income

**4.71** Many broker-dealers provide investment advice, research, and administrative services for customers. For such services, the broker-dealer receives a fee that may be based on the net assets of the fund or account.



Therefore, such income may correlate with the size of the funds or accounts managed.

## Floor Brokerage

**4.72** Broker-dealers often use other brokers to execute trades on their behalf. The trading broker-dealer becomes a customer of the executing broker-dealer and pays a floor brokerage fee. Such fees are paid periodically either directly to the executing broker-dealer or through a clearinghouse.

## Exchange Fees

**4.73** Exchange fees are charged by securities exchanges for the privilege of trading securities listed on that exchange. Some fees vary with the related volume, whereas others are fixed. For transaction charges, each broker-dealer submits a monthly report of net commissions earned on transactions executed on the exchange. This report is used for the self-determination of the exchange fee. Floor brokerage and exchange fees generally vary proportionally with the volume of trades executed by the broker-dealer on the exchange.

## Occupancy

**4.74** Occupancy expenses generally include rent, electricity, and depreciation on fixed assets. Rent can be a significant expense for broker-dealers with large retail networks and numerous branch offices. For this reason, retail broker-dealers tend to have higher occupancy costs than large institutional dealers, which tend to have more concentrated office sites.

## Employee Compensation and Benefits

**4.75** Compensation includes commissions paid to account executives based on their production or the revenue they generate for the firm. Commission rates for sales representatives are somewhat standardized but can vary depending on the individual account executive's employment terms; customer base (for example, institutional or retail); production volume; and type of product sold. The production on which account executives are paid includes the following:

- Commission revenue from agency trades
- Fee revenue from assets managed
- Selling concessions from underwriting sales
- Sales credits or trading allowances from principal transactions

**4.76** Employee compensation also includes employee salaries, bonuses, payroll taxes, and employee benefits. These expenses are not significantly different for broker-dealers than for other industries, except that at broker-dealers, bonuses usually represent a greater percentage of an individual's total compensation. Such compensation may be discretionary or nondiscretionary, and proper timing of recognition may involve judgment. In the event account executives or employees of a broker-dealer are compensated with equity of the broker-dealer or a related entity, FASB ASC 718, *Compensation—Stock Compensation*, should be referred to for guidance. This topic generally requires companies to recognize the value of employee stock options and similar awards as compensation expense over the requisite service period (usually the vesting period).

## Communications and Data Processing

**4.77** Communications and data processing expenses tend to be significant for broker-dealers because of their dependence on communication and information networks. Traders, account executives, and investment bankers constantly use the telephone to interact with customers, other broker-dealers, and branch locations; they use communication lines to receive quotation, ticker, and news services; and they use direct computer links to other broker-dealers, branches, clearing organizations, exchanges, analytical services, and major customers.

## Disclosures

### Disclosures Related to Fair Value

**4.78** FASB ASC 820-10-50 discusses the disclosures required for assets and liabilities measured at fair value. As noted in the “Pending Content” in FASB ASC 820-10-50-1, the reporting entity should disclose information that helps users of its financial statements assess both of the following:

- For assets and liabilities that are measured at fair value on a recurring or nonrecurring basis in the statement of financial position after initial recognition, the valuation techniques and inputs used to develop those measurements
- For recurring fair value measurements using significant unobservable inputs (level 3), the effect of the measurements on earnings (or changes in net assets) or other comprehensive income for the period

**4.79** To meet the objectives noted in the preceding paragraph, the “Pending Content” in FASB ASC 820-10-50-1A states that a reporting entity should consider all of the following:

- The level of detail necessary to satisfy the disclosure requirements
- How much emphasis to place on each of the various requirements
- How much aggregation or disaggregation to undertake
- Whether users of financial statements need additional information to evaluate the quantitative information disclosed

If the disclosures set forth in the guidance are insufficient to meet the objectives in the preceding paragraph, a reporting entity should disclose additional information necessary to meet those objectives.

**4.80** The required disclosures related to fair value are extensive and detailed. FASB ASC 820-10-50-2 provides details of the information that should, at a minimum, be disclosed by the reporting entity. The remaining sections of FASB ASC 820-10-50, including the “Pending Content” sections, provide information on other required disclosures related to fair value. “Pending Content” in paragraphs 99–107 of FASB ASC 820-10-55 provides illustrative disclosures about fair value measurements.

**4.81** FASB ASC 940-820-50-1, which contains disclosure requirements specific to broker-dealers, states that notes to the financial statements should disclose all of the following if financial instruments’ fair values are measured at lower than quoted prices (see the example in “Pending Content” in FASB ASC 820-10-55-52):

- Description of the financial instrument
- The quoted price of the financial instrument
- Fair value reported in the statement of financial condition
- Methods and significant assumptions used to value the instrument at lower than the quoted price

## Disclosures of Certain Significant Risks and Uncertainties

**4.82** FASB ASC 275, *Risks and Uncertainties*, requires entities to include in their financial statements disclosures about risks and uncertainties existing as of the date of the financial statements. Two of the areas of disclosure are (a) the nature of their operations and (b) the use of estimates in the preparation of their financial statements. Following are illustrations of the application of these disclosure requirements by a broker-dealer:

- *Nature of operations.* Standard broker-dealer operates seven branches in rural and suburban communities in Minnesota and Nebraska. The broker-dealer's primary source of revenue is providing brokerage services to customers who are predominately small and middle-market businesses and middle-income individuals.
- *Use of estimates in the preparation of financial statements.* The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**4.83** If specified disclosure criteria are met, FASB ASC 275 also requires entities to include in their financial statements disclosures about (a) certain significant estimates and (b) current vulnerability due to certain concentrations. Following is a discussion of the application of FASB ASC 275 by an entity to exemplify events and circumstances that meet the disclosure criteria.

**4.84** *Certain significant estimates.* Paragraphs 7–8 of FASB ASC 275-10-50 require disclosure regarding estimates used in the determination of the carrying amounts of assets or liabilities or disclosure of gain or loss contingencies if known information available prior to issuance of the financial statements indicates that both of the following criteria are met:

- a. It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.
- b. The effect of the change would be material to the financial statements.

**4.85** FASB ASC 275-10-50-9 states that the disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a change in the estimate will occur in the near term.

**4.86** If the estimate involves a loss contingency covered by FASB ASC 450-20, the disclosure should also include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. Paragraphs 3–4 of FASB ASC 450-20-50 state that disclosure of the contingency should be made

if there is at least a reasonable possibility that a loss or an additional loss may have been incurred and either of the following conditions exists:

- a. An accrual is not made for a loss contingency because any of the conditions in FASB ASC 450-20-25-2 are not met.
- b. An exposure to loss exists in excess of the amount accrued pursuant to the provisions of FASB ASC 450-20-30-1.

Such disclosure should include the nature of the contingency and an estimate of the possible loss or range of loss or should state that such an estimate cannot be made.

**4.87** Examples of uncertainties that may fall into one or more of these categories found at certain broker-dealers include the following:

- Significant inventory positions that were valued as of a specific time
- Estimates made regarding the value of securities in markets that are not active (such as valuations made in good faith by management)

**4.88** FASB ASC 275-10-50-15 gives examples of assets and liabilities and related revenues and expenses and of disclosure of gain or loss contingencies included in financial statements that, based on facts and circumstances existing at the date of the financial statements, may be based on estimates that are particularly sensitive to change in the near term.

**4.89** Besides valuations of securities made by management, examples of similar estimates often included in broker-dealers' financial statements include the following:

- Impairment of long-lived assets (for example, assets related to marginal branches)
- Estimates involving assumed prepayments (for example, mortgage-related derivatives)
- Lives of identifiable intangible assets<sup>6</sup>

**4.90** *Current vulnerability due to certain concentrations.* FASB ASC 275-10-50-16 requires entities to disclose the concentrations described in FASB ASC 275-10-50-18 if, based on information known to management prior to issuance of the financial statements, all of the following criteria are met:

- a. The concentration exists at the date of the financial statements.
- b. The concentration makes the entity vulnerable to the risk of a near-term severe impact.
- c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

**4.91** FASB ASC 275-10-50-18 states that concentrations, including known group concentrations, described in the following list require disclosure if they meet the criteria of FASB ASC 275-10-50-16. (Group concentrations exist if a number of counterparties or items that have similar economic characteristics collectively expose the reporting entity to a particular kind of risk.) Some concentrations may fall into more than one of the following categories:

- a. *Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor.* The potential for

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<sup>6</sup> See footnote 5.

the severe impact can result, for example, from total or partial loss of the business relationship. For purposes of this topic, it is always considered at least reasonably possible that any customer will be lost in the near term.

- b. *Concentrations in revenue from particular products, services, or fund-raising events.* The potential for the severe impact can result, for example, from volume or price changes or the loss of patent protection for the particular source of revenue.
- c. *Concentrations in the available sources of supply of materials, labor, or services or of licenses or other rights used in the entity's operations.* The potential for the severe impact can result, for example, from changes in the availability to the entity of a resource or right.
- d. *Concentrations in the market or geographic area in which an entity conducts its operations.* The potential for the severe impact can result, for example, from the negative effects of the economic and political forces within the market or geographic area. For purposes of this topic, it is always considered at least reasonably possible that operations located outside an entity's home country will be disrupted in the near term.

**4.92** Examples of concentrations found at a broker-dealer that could meet the criteria requiring disclosure described in FASB ASC 275-10-50-18 include a significant portion of revenue that is earned from the following:

- Bond underwritings to a particular municipality
- A limited number of customers

## Disclosures About Derivative Instruments

**4.93** Derivative instruments are subject to many disclosure requirements, and those requirements may be located in a number of different FASB ASC topics. FASB ASC 815, *Derivatives and Hedging*, provides guidance on disclosure requirements for derivative instruments. Additional disclosure requirements for derivative instruments may be found in FASB ASC 460, 820, and 825. FASB ASC 825-10-50 addresses the incremental disclosure provisions about the fair value of financial instruments, concentrations of credit risk of all financial instruments, and the market risk of all financial instruments. See chapter 7 for information on FASB ASC 815 and for disclosures required under FASB ASC 820.

**4.94** FASB ASC 815-10-50-1 states that an entity with derivative instruments should disclose information to enable users of the financial statements to understand all of the following:

- How and why the entity uses derivative instruments
- How derivative instruments and related hedged items are accounted for
- How derivative instruments and related hedged items affect the entity's financial position, financial performance, and cash flows

**4.95** For every annual and interim reporting period for which a statement of financial position and statement of financial performance are presented, FASB ASC 815-10-50-1A states that the entity that holds or issues derivatives instruments should disclose the following:

- Its objectives for holding or issuing those instruments
- The context needed to understand those objectives
- Its strategies for achieving those objectives
- Information that would enable users of its financial statements to understand the volume of activity in those instruments

FASB ASC 815-10-50 provides more information about the detail that should be disclosed for a particular situation and the form the disclosure should take (tabular or nontabular format). Additional guidance regarding disclosures may also be found at the subtopic level of FASB ASC 815 (for example, FASB ASC 815-30-50 provides additional guidance regarding disclosures for cash flow hedges).

**4.96** For derivative instruments that are not designated or do not qualify as hedging instruments under FASB ASC 815, FASB ASC 815-10-50-4F notes that if the entity's policy is to include those derivative instruments in its trading activities (for example, as part of its trading portfolio that includes both derivative and nonderivative or cash instruments), the entity can elect to not separately disclose gains and losses as required by FASB ASC 815-10-50-4C(e), provided that certain information is disclosed about its trading activities (including both derivative and nonderivative instruments).

## Disclosures About Guarantees

**4.97** Under FASB ASC 460-10-50-4, guarantors are required to disclose the following for each guarantee, or group of similar guarantees, even if the likelihood of the guarantors having to make any payments under the guarantee is remote:

- a. The nature of the guarantee, including its approximate term, how the guarantee arose, the events and circumstances that would require the guarantor to perform under the guarantee, the current status of the payment or performance risk of the guarantee, and certain information for those using internal groupings
- b. The following information about the maximum potential amount of future payments under the guarantee, as appropriate:
  - i. The undiscounted maximum potential amount of future payments the guarantor would be required to make under the guarantee, not reduced by any recourse or collateralization provisions
  - ii. If the terms of the guarantee provide for no limitation to the maximum potential future payments under the guarantee
  - iii. If the guarantor is unable to develop an estimate of the maximum potential amount of future payments under its guarantee, the reasons why it cannot estimate the maximum potential amount
- c. The current carrying amount of the liability, if any, for the guarantor's obligations under the guarantee
- d. The nature of any recourse provisions that would enable the guarantor to recover from third parties any amounts paid under the guarantee

- e. The nature of any assets held either as collateral or by third parties that, upon the occurrence of any triggering event or condition under the guarantee, the guarantor can obtain and liquidate to recover all or a portion of the amounts paid under the guarantee
- f. If estimable, the approximate extent to which the proceeds from liquidation of assets held either as collateral or by third parties would be expected to cover the maximum potential amount of future payments under the guarantee

**4.98** Freestanding written put options and certain contracts that function as fair value guarantees on a financial asset that is owned by the guaranteed party, even when classified as derivatives under FASB ASC 815, are within the scope of the disclosure provisions of FASB ASC 460.

## Disclosures About Related Parties

**4.99** FASB ASC 850-10 provides guidance when related party transactions exist and should be disclosed. Examples of related party transactions include those between

- a. a parent entity and its subsidiaries;
- b. subsidiaries of a common parent;
- c. an entity and trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of the entity's management;
- d. an entity and its principal owners (as defined), management, or members of their immediate families (as defined); and
- e. affiliates (as defined).

**4.100** Transactions between related parties commonly occur in the normal course of business. Transactions between related parties are considered to be related party transactions even though they may not be given accounting recognition. For example, an entity may receive services from a related party without charge and would not record receipt of the services. In accordance with FASB ASC 850-10-05-4, disclosure of these transactions is required. Examples of common transactions with related parties are

- a. sales, purchases, and transfers of real and personal property;
- b. services received or furnished, such as accounting, management, engineering, and legal services;
- c. use of property and equipment by lease or otherwise;
- d. borrowings, lendings, and guarantees;
- e. maintenance of compensating bank balances for the benefit of a related party;
- f. intra-entity billings based on allocations of common costs; and
- g. filings of consolidated tax returns.

**4.101** In accordance with FASB ASC 850, *Related Party Disclosures*, the financial statements should include disclosures of material related party transactions, other than compensation arrangements, expense allowances, and other

similar items in the ordinary course of business. However, disclosure of transactions that are eliminated in the preparation of consolidated or combined financial statements is not required in those statements. The disclosures should include

- a. the nature of the relationship(s) involved.
- b. a description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements.
- c. the dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period.
- d. amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement.
- e. the information required by FASB ASC 740-10-50-17.

**4.102** FASB ASC 850-10-50 discusses additional considerations regarding related parties. Among other considerations, it discusses arm's-length bases of transactions and control relationship.

## Subsequent Events Disclosures

**4.103** FASB ASC 855, *Subsequent Events*, provides guidance on subsequent events, including the time period through which subsequent events should be evaluated and the disclosures that are required.

**4.104** The guidance in FASB ASC 855 notes that an entity should recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the statement of financial condition, including estimates inherent in the process of preparing the financial statements. See FASB ASC 855-10-55-1 for examples of recognized subsequent events.

**4.105** FASB ASC 855-10-25-1A states that an SEC filer should evaluate subsequent events through the date the financial statements are issued. With respect to the guidance in FASB ASC 855, an *SEC filer* is defined as an entity that is required to file or furnish its financial statements with the SEC. Nonissuer broker-dealers that are registered with the SEC fall under this definition.

## Disclosures About Offsetting

**4.106** In December 2011, FASB issued ASU No. 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities*, which is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. In January 2013, FASB issued ASU No. 2013-01, *Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*. The effective date is the same as the effective date of ASU No.



2011-11, as discussed in the preceding paragraph. The effect of these ASUs is discussed in the following paragraphs.

**4.107** “Pending Content” in FASB ASC 210-20-50 enhances disclosures about financial instruments and derivative instruments that are either offset in accordance with GAAP or are subject to an enforceable master netting arrangement or similar agreement. The objective of the disclosures is to improve comparability between those entities that prepare their financial statements on a GAAP basis and those entities that prepare their financial statements on an International Financial Reporting Standards basis.

**4.108** “Pending Content” in FASB ASC 210-20-50-1 establishes the scope of the disclosure requirements found in “Pending Content” in paragraphs 2–5 of FASB ASC 210-20-50 by stating the disclosures are only applicable to the following recognized assets and liabilities:

- a. Recognized derivative instruments accounted for in accordance with FASB ASC 815, including bifurcated embedded derivatives, repurchase agreements (repos), and reverse repurchase agreements (reverse repos), and securities borrowing and securities lending transactions that are offset in accordance with either FASB ASC 210-20-45 or FASB ASC 815-10-45.
- b. Recognized derivative instruments accounted for in accordance with FASB ASC 815, including bifurcated embedded derivatives, repos, and reverse repos, and securities borrowing and securities lending transactions that are subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in accordance with either FASB ASC 210-20-45 or FASB ASC 815-10-45.

**4.109** When applying this guidance, readers may need to consider the legal structure of master securities lending agreements and determine which parties have the legal right of offset. Legal counsel could be consulted when determining if a legal right of offset exists.

**4.110** Pursuant to “Pending Content” in FASB ASC 210-20-50-3, reporting entities, including broker-dealers, will be required to disclose the following information for applicable financial instruments and derivative instruments:

- a. The gross amounts of those recognized assets and those recognized liabilities
- b. The amounts offset to determine the net amounts presented in the statement of financial position
- c. The net amounts presented in the statement of financial position
- d. The amounts subject to an enforceable master netting arrangement or similar agreement not otherwise included in item (b)
- e. The net amount after deducting the amounts in item (d) from the amounts in item (c)

**4.111** “Pending Content” in FASB ASC 210-20-50-4 explains that presentation of this information in tabular format, separately for assets and liabilities, is required unless another format is more appropriate. “Pending Content” in FASB ASC 210-20-50-5 also requires reporting entities to provide a description of the rights (including the nature of those rights) of setoff associated with an entity’s recognized assets and recognized liabilities subject to an enforceable

master netting arrangement or similar agreement. In addition, the standard requires disclosure of collateral received and posted in connection with master netting agreements or similar arrangements. When applying this disclosure guidance, readers may consider whether previously existing disclosures required by other FASB ASC topics for certain assets and liabilities may also address requirements set forth in “Pending Content” in FASB ASC 210-20-50-3. However, “Pending Content” in FASB ASC 210-20-50-6 explains that cross-referencing is required when the required disclosures exist in more than a single note to the financial statements.

**4.112** “Pending Content” in FASB ASC 210-20-55 explains that the disclosures may be by instrument or by counterparty. Additional implementation guidance is provided in “Pending Content” in paragraphs 1–18A of FASB ASC 210-20-55, and illustrative example disclosure tables are provided in “Pending Content” in paragraphs 19–22 of FASB ASC 210-20-55.

## Financial Statements and Schedules<sup>7</sup>

**4.113** The financial statements required to be filed under SEC Rule 17a-5 are not required to be in comparative form, and the following financial statement exhibits are not prepared on that basis. However, if comparative financial statements are prepared, there is no need to present the supplementary information on a comparative basis.

**4.114** The following financial statement and schedule exhibits include the required facing page and the oath or affirmation form on Form X-17A-5. These exhibits are illustrative only and have been prepared to show how various items might be presented, assuming they are material in the particular circumstances. The financial statements of individual companies may vary from these illustrations depending on facts or circumstances present at the time of issuance.

**4.115** The illustrative financial statements and footnote disclosures included in this guide have been updated to reflect FASB ASC. However, in FASB’s Notice to Constituents, it suggests the use of plain English to describe broad FASB ASC topic references. It suggests a reference similar to “as required by the Derivatives and Hedging Topic of the FASB *Accounting Standards Codification*.” Entities might consider revising their financial statement references to reflect this plain English referencing rather than the use of specific FASB ASC references. We have provided these detailed references in this guide as a learning tool to familiarize constituents with the basis for the disclosures.

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<sup>7</sup> The financial statement disclosures presented here have not been updated for ASU No. 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities*, or ASU No. 2013-01, *Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*, which are effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. These ASUs require expanded disclosures for derivative instruments, repurchase and reverse repurchase agreements, and securities lending transactions that are either offset on the balance sheet or subject to an enforceable master netting agreement. In part, these disclosures are intended to facilitate comparison of balance sheet netting activity between entities that report on the basis of accounting principles generally accepted in the United States of America (GAAP), and those that report using the basis of International Financial Reporting Standards.

**Exhibit 4-1**

U.S. SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

**ANNUAL  
AUDITED  
REPORT  
FORM X-17A-5  
PART III**

Information Required of Brokers and Dealers  
Pursuant to Section 17 of the Securities  
Exchange Act of 1934 and Rule 17a-5 Thereunder

SEC FILE  
8-12345

REPORT FOR THE PERIOD **01/01/X1** AND ENDING **12/31/X1**  
BEGINNING MM/DD/YY MM/DD/YY

**A. REGISTRANT IDENTIFICATION**

NAME OF BROKER-DEALER: OFFICIAL  
USE ONLY

**Standard Stockbrokerage Co., Inc.**

ADDRESS OF PRINCIPAL PLACE OF BUSINESS: (Do not use P.O. Box No.)

**1 Main Street**

(No. and Street)

**New York**

**New York**

**10004**

(City)

(State)

(Zip Code)

NAME AND TELEPHONE NUMBER OF PERSON TO CONTACT IN  
REGARD TO THIS REPORT

**Joseph P.  
Brokestock**

(212) 555-1212

(Area Code - Telephone No.)

**B. ACCOUNTANT IDENTIFICATION**

INDEPENDENT PUBLIC ACCOUNTANT (Whose opinion is contained in this Report \* )  
(Name . . . if individual, state last, first, middle name)

**Accounting Firm**

**2 Main Street**

**New York**

**New York**

**10004**

(Address)

(City)

(State)

(Zip Code)

**CHECK ONE:**

- Certified Public Accountant
- Public Accountant
- Accountant not resident in United States or any of its possessions.

**FOR OFFICIAL USE ONLY**

\*Claims for exemption from the requirement that the annual report be covered by the opinion of an independent public accountant must be supported by a statement of facts and circumstances relied on at the bureau of the exemption. See Section 240.17a-5(e)(2).

## Exhibit 4-2

## Oath or Affirmation

I, JOSEPH P. BROKESTOCK, swear (or affirm) that, to the best of my knowledge and belief, the accompanying financial statements and supporting schedules pertaining to the firm of STANDARD STOCKBROKERAGE CO., INC., as of DECEMBER 31, 20X1, are true and correct. I further swear (or affirm) that neither the Company nor any partner, proprietor, principal officer, or director has any proprietary interest in any account classified solely as that of a customer, except as follows:

SECURITY ACCOUNTS OF PRINCIPAL OFFICERS AND DIRECTORS  
THAT ARE CLASSIFIED AS CUSTOMER ACCOUNTS (DEBITS \$316,513,  
CREDITS \$273,412)

\_\_\_\_\_  
Signature  
VICE PRESIDENT — FINANCE  
Title

Subscribed and sworn  
to before me  
this \_\_\_\_ day of \_\_\_\_  
20X2

\_\_\_\_\_  
JOAN P. NOTARY  
Notary Public

This report\* contains (check all applicable boxes)

- (a) Facing page.
- (b) Statement of financial condition.
- (c) Statement of income (loss).
- (d) Statement of cash flows.
- (e) Statement of changes in stockholders' equity or partners' or sole proprietor's capital.
- (f) Statement of changes in liabilities subordinated to claims of general creditors.
- (g) Computation of net capital for brokers and dealers pursuant to Rule 15c3-1.
- (h) Computation for determination of reserve requirements pursuant to Rule 15c3-3.
- (i) Information relating to the possession or control requirements for brokers and dealers under Rule 15c3-3.
- (j) A reconciliation, including appropriate explanation, of the computation of net capital under Rule 15c3-1 and the computation for determination of the reserve requirements under exhibit A of Rule 15c3-3.
- (k) A reconciliation between the audited and unaudited statements of financial condition with respect to methods of consolidation.
- (l) An oath or affirmation.

- x (m) A copy of the Securities Investor Protection Corporation supplemental report.<sup>8</sup>
- o (n) A report describing any material inadequacies found to exist or found to have existed since the date of the previous audit.
- x (o) Independent auditor's report on internal control.<sup>9</sup>
- x (p) Schedule of segregation requirements and funds in segregation—customers' regulated commodity futures account pursuant to Rule 171-5.

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\* *For conditions of confidential treatment of certain portions of this filing, see Section 240.17a-5(e)(3).*

*Note:* Various exchanges may require an additional letter of attestation.

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<sup>8</sup> SEC Rule 17a-5(e)(4) states that the Securities Investor Protection Corporation supplemental report should be bound separately.

<sup>9</sup> See appendix D, "Report on Internal Control Required by SEC Rule 17a-5(g)(1)," of this guide.

**Exhibit 4-3****Standard Stockbrokerage Co., Inc. and Subsidiaries****Consolidated Statement of Financial Condition****December 31, 20X1***(Dollars in Thousands, Except Share Data)***Assets**

Cash	\$2,647
Cash and securities segregated under federal and other regulations (cash of \$375 and securities with a fair value of \$630)	1,005
Collateralized Agreements:	
Securities borrowed	2,500
Securities purchased under agreements to resell, at fair-value	3,782
Securities received as collateral	200
Deposits with clearing organizations and others (cash of \$345 and securities with a fair value of \$1,400)	1,745
Receivable from broker-dealers and clearing organizations	25,476
Receivable from customers <sup>†</sup>	40,360
Securities owned, at fair value (\$28,468 pledged as collateral)*	31,468
Spot commodities owned, at fair value*	3,278
Secured demand notes	5,215
Memberships in exchanges owned, at adjusted cost (fair value \$2,500)	2,475
Furniture, equipment, and leasehold improvements, at cost, less accumulated depreciation and amortization of \$2,425	4,881
Other assets	523
	<u>\$125,555</u>

**Liabilities and Stockholders' Equity**

## Liabilities:

Short-term bank loans	\$26,900
Drafts payable	2,210
Collateralized Agreements:	
Securities loaned	1,800
Securities sold under agreements to repurchase, at fair value	3,790
Payable to broker-dealers and clearing organizations	19,164
Payable to customers	12,288
Securities sold, not yet purchased, at fair value	1,862
Obligation to return securities received as collateral	200
Income taxes payable, including deferred taxes of \$1,200	2,276
Accounts payable, accrued expenses, and other liabilities	2,449
Long-term notes payable	<u>3,000</u>
	<u>75,939</u>
Commitments, contingencies and guarantees:	
Subordinated borrowings	<u>9,897</u>

## Stockholders' equity:

Preferred stock, \$5 cumulative, \$100 par value, authorized 100,000 shares, outstanding 50,000 shares	5,000
Common stock, \$1 par value, authorized 10,000,000 shares, issued 6,000,000 shares	6,000
Additional paid-in capital	2,200
Retained earnings	<u>27,719</u>
	40,919
Less 199,100 shares of common stock in treasury, at cost	<u>(1,200)</u>
Total stockholders' equity	<u>39,719</u>
	<u><u>\$125,555</u></u>

The accompanying notes are an integral part of these consolidated financial statements.

\* To the extent that collateral has been pledged and the counterparty has the right by contract or custom to sell or repledge the collateral, separate captions or parenthetical disclosures in the statement of financial condition may be needed as illustrated in FASB ASC 860-30.

† Valuation allowances should be shown, if material, either parenthetically or in a note.

**Exhibit 4-4**

**Standard Stockbrokerage Co., Inc. and Subsidiaries**  
**Consolidated Statement of Income**  
**for the Year Ended December 31, 20X1**  
*(Dollars in Thousands, Except Earnings Per Share)*

Revenues	
Commissions	\$26,549
Principal transactions	6,707
Investment banking	5,689
Interest and dividends	4,253
Investment advisory fees	2,420
Other income	400
	<u>46,018</u>
Expenses:	
Employee compensation and benefits	12,815
Floor brokerage, exchange, and clearance fees	7,128
Communications and data processing	5,723
Interest and dividends	3,896
Occupancy	1,625
Other expenses	1,127
	<u>32,314</u>
Income before income taxes	13,704
Provision for income taxes	7,100
Net income <sup>10</sup>	<u><u>\$6,604</u></u>

The accompanying notes are an integral part of these consolidated financial statements.

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<sup>10</sup> FASB issued ASU No. 2013-02, *Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*, which requires an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under GAAP to be reclassified in its entirety to net income. For other amounts that are not required under GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under GAAP that provide additional detail about those amounts. This is the case when a portion of the amount reclassified out of accumulated other comprehensive income is reclassified to a balance sheet account, instead of directly to income or expense in the same reporting period. For public entities, the amendments are effective prospectively for reporting periods beginning after December 15, 2012. For nonpublic entities, the amendments are effective prospectively for reporting periods beginning after December 15, 2013. Early adoption is permitted.



**Exhibit 4-5**

**Standard Stockbrokerage Co., Inc. and Subsidiaries**  
**Consolidated Statement of Changes in Subordinated Borrowings**  
**for the Year Ended December 31, 20X1**

*(Dollars in Thousands)*

Subordinated borrowings at January 1, 20X1	\$4,204
Increases:	
Secured demand note collateral agreements	3,325
Issuance of subordinated notes	3,675
Decreases:	
Payment of subordinated notes	<u>(1,307)</u>
Subordinated borrowings at December 31, 20X1	<u><u>\$9,897</u></u>

The accompanying notes are an integral part of these consolidated financial statements.

## Exhibit 4-6

Standard Stockbrokerage Co., Inc. and Subsidiaries  
 Consolidated Statement of Changes in Stockholders' Equity<sup>11</sup>  
 for the Year Ended December 31, 20X1  
 (Dollars in Thousands, Except Share Data)

	Preferred		Common		Additional Paid-in Capital	Retained Earnings	Treasury Stock— Common		Total Stockholders' Equity
	Shares	Amount	Shares	Amount			Shares	Amount	
Balances at January 1, 20X1	52,500	\$5,250	6,000,000	\$6,000	\$2,212	\$21,365	195,700	\$(1,098)	\$33,729
Net Income					6,604	6,604			6,604
Purchase and retirement of preferred shares	(2,500)	(250)			(12)				(262)

<sup>11</sup> In June 2011, FASB issued ASU No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*, which eliminates the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity. All nonowner changes in stockholders' equity will now be required to be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements (the first statement presents total net income and its components; and the second presents total other comprehensive income, the components of other comprehensive income, and the total of comprehensive income). ASU 2011-05 does not change the items that must be presented in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. In accordance with ASU No. 2011-12, *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*, public entities should apply these requirements for fiscal years, and interim periods within those years, beginning after December 15, 2011. Nonpublic entities should begin applying these requirements for fiscal years ending after December 15, 2012, and interim and annual periods thereafter.

	Capital Stock		Additional Paid-in Capital		Retained Earnings	Treasury Stock—Common		Total Stockholders' Equity
	Preferred	Common	Amount	Shares		Amount	Shares	
	Shares	Amount	Shares	Amount	Amount	Shares	Amount	Amount
Dividends on preferred stock \$5 a share					(250)			(250)
Net purchase of common shares for treasury						3,400	(102)	(102)
Balance at December 31, 20X1	50,000	\$5,000	6,000,000	\$6,000	\$27,719	199,100	\$(1,200)	\$39,719

The accompanying notes are an integral part of these consolidated financial statements.

## Exhibit 4-7

## Standard Stockbrokerage Co., Inc. and Subsidiaries

Consolidated Statement of Cash Flows  
for the Year Ended December 31, 20X1*(Dollars in Thousands)*

## Cash flows from operating activities:

Net income		\$ 6,604
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	\$582	
Deferred taxes	376	
(Increase) decrease in operating assets:		
Cash and securities segregated under federal and other regulations	500	
Deposits with clearing organizations and others	900	
Net receivable from broker-dealers and clearing organizations	4,785	
Net receivable from customers	(11,830)	
Securities borrowed, net of securities loaned	(50)	
Securities purchased under agreements to resell*	2,648	
Securities owned, net	4,605	
Securities received as collateral	50	
Spot commodities owned	(2,914)	
Increase (decrease) in operating liabilities:		
Securities sold under agreements to repurchase*	587	
Obligation to return securities received as collateral	50	
Other, net	(691)	
Total adjustments		<u>(402)</u>
Net cash provided by operating activities		<u>6,202</u>

## Cash flows from investing activities:

Proceeds from sale of long-term investments	110	
Purchase of long-term investments	(50)	
Purchase of furniture, equipment, and leasehold improvements	(75)	
Net cash used in investing activities		<u>(15)</u>

## Cash flows from financing activities:

Payment of short-term bank loans	(7,762)	
Proceeds from issuance of derivatives with a financing element, net <sup>†</sup>	100	
Proceeds from issuance of common stock from treasury	78	
Purchase of common stock for treasury	(180)	
Proceeds from issuance of subordinated notes	3,675	
Payments of subordinated notes	(1,307)	

Payments of long-term notes payable	(500)	
Purchase and retirement of preferred stock	(262)	
Dividend on preferred stock	(250)	
Net cash used in financing activities		<u>(6,408)</u>
Decrease in cash		(221)
Cash at beginning of the year		<u>2,868</u>
Cash at end of the year		<u><u>\$2,647</u></u>
Supplemental cash flows disclosures:		
Income tax payments (paid to parent)		<u>\$6,700</u>
Interest payments		<u>\$3,618</u>
Noncash financing activity— borrowings under secured demand note collateral agreements		<u><u>\$3,325</u></u>

The accompanying notes are an integral part of these consolidated financial statements.

\* Depending on the nature of the activity, securities purchased under agreements to resell can be classified as operating or investing; likewise, securities sold under agreements to repurchase can be classified as operating or financing.

† Paragraphs 11–15 of FASB 815-10-45 require all cash flows associated with a derivative that contains an other-than-insignificant financing element at inception, other than a financing element inherently included in an at-the-market derivative instrument with no prepayments (that is, the forward points in an at-the-money forward contract), to be reported as cash flows from financing activities in the statement of cash flows as opposed to reporting only the cash flows related to a financing element of a derivative as a financing activity.

**Exhibit 4-8****Standard Stockbrokerage Co., Inc. and Subsidiaries****Notes to Consolidated Financial Statements<sup>12</sup>****December 31, 20X1*****(Dollars in Thousands)***

The following notes to financial statements are illustrative only. In some situations, the information in the notes may be better presented within the financial statements; in other situations, information not required by regulation may not be sufficiently material to warrant disclosure. In addition, these notes may not include all disclosures required by Regulation S-X.<sup>13</sup>

**1. Organization and Nature of Business**

Standard Stockbrokerage Co., Inc., (the Company) is a broker-dealer registered with the SEC and is a member of various exchanges and the Financial Industry Regulatory Authority (FINRA). The Company is a Delaware Corporation that is a majority-owned subsidiary of Standard Stockbrokerage Holding Company, Inc. (Parent).

**2. Significant Accounting Policies*****Basis of Presentation***

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. The Company is engaged in a single line of business as a securities broker-dealer, which comprises several classes of services, including principal transactions, agency transactions, investment banking, investment advisory, and venture capital businesses. All material intercompany balances and transactions are eliminated in consolidation.

***Use of Estimates***

The preparation of financial statements in conformity with U.S.GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

***Securities Owned***

Proprietary securities transactions in regular-way trades are recorded on the trade date, as if they had settled. Profit and loss arising from all securities and commodities transactions entered into for the account and risk of the Company are recorded on a trade date basis. Customers' securities and commodities transactions are reported on a settlement date basis with related commission income and expenses reported on a trade date basis.<sup>14</sup>

Amounts receivable and payable for securities transactions that have not reached their contractual settlement date are recorded net on the consolidated statement of financial condition.

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<sup>12</sup> These notes do not reflect all disclosures required under GAAP. The notes will continue to be updated in future editions of this guide to the extent applicable.

<sup>13</sup> A discussion of the disclosures related to significant risks and uncertainties is included in paragraphs 4.82–.92 in this guide.

<sup>14</sup> See chapter 7, "Accounting Standards," of this guide regarding settlement-date-basis versus trade-date-basis accounting.

Securities are recorded at fair value in accordance with FASB ASC 820, *Fair Value Measurement*.

### ***Collateralized Agreements***

Transactions involving securities purchased under agreements to resell (reverse repurchase agreements or reverse repos) or securities sold under agreements to repurchase (repurchase agreements or repos) are accounted for as collateralized agreements or financings except where the Company does not have an agreement to sell (or purchase) the same or substantially the same securities before maturity at a fixed or determinable price. It is the policy of the Company and subsidiaries to obtain possession of collateral with a fair value equal to or in excess of the principal amount loaned under resale agreements. Collateral is valued daily, and the Company may require counterparties to deposit additional collateral or return collateral pledged when appropriate. Reverse repos and repos are carried at fair value. Interest on such contract amounts is accrued and is included in the consolidated statement of financial condition in receivables from and payables to broker-dealers and clearing organizations.<sup>15</sup>

Securities borrowed and securities loaned transactions are generally reported as collateralized financings except where letters of credit or other securities are used as collateral. Securities borrowed transactions require the Company to deposit cash, letters of credit, or other collateral with the lender. With respect to securities loaned, the Company receives collateral in the form of cash or other collateral in an amount generally in excess of the fair value of securities loaned. The Company monitors the fair value of securities borrowed and loaned on a daily basis, with additional collateral obtained or refunded as necessary. Securities borrowed and securities loaned transactions are recorded at the amount of cash collateral advanced or received adjusted for additional collateral obtained or received. Interest on such transactions is accrued and is included in the consolidated statement of financial condition in receivables from and payables to broker-dealers and clearing organizations.

The Company nets certain repurchase agreements and resale agreements with the same counterparty in the consolidated statement of financial condition when the requirements of FASB ASC 210-20-45-11 are met.<sup>16</sup>

### ***Offsetting of Amounts Related to Certain Contracts***<sup>17</sup>

When the requirements of FASB ASC 815-10-45-5 are met, the Company offsets certain fair value amounts recognized for cash collateral receivables or payables against fair value amounts recognized for net derivative positions executed with the same counterparty under the same master netting arrangement.

### ***Investment Banking***

Investment banking revenues include gains, losses, and fees, net of syndicate expenses, arising from securities offerings in which the Company acts as an underwriter or agent. Investment banking revenues also include fees earned

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<sup>15</sup> Alternatively, accrued interest can be reported either on its own line (such as "accrued interest receivable") or as part of the "repurchase agreements" or "reverse repurchase agreements" lines.

<sup>16</sup> See paragraph 4.47.

<sup>17</sup> In December 2011, FASB issued ASU No. 2011-11, which is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. In January 2013, FASB issued ASU No. 2013-01, which has an effective date that is the same as the effective date of ASU No. 2011-11. For more information, see the discussion beginning at paragraph 4.106. See also footnote 7.

from providing merger-and-acquisition and financial restructuring advisory services. Investment banking management fees are recorded on offering date, sales concessions on settlement date, and underwriting fees at the time the underwriting is completed and the income is reasonably determinable. Underwriting expenses that are deferred under the guidance in FASB ASC 940-340-25-3 are recognized at the time the related revenues are recorded, in the event that transactions are not completed and the securities are not issued, the Company expenses those costs.

### ***Commissions***

Commissions and related clearing expenses are recorded on a trade-date basis as securities transactions occur.

### ***Investment Advisory Income***

Investment advisory fees are received quarterly but are recognized as earned on a pro rata basis over the term of the contract.

### ***Translation of Foreign Currencies***

Assets and liabilities denominated in foreign currencies are translated at year-end rates of exchange, whereas the income statement accounts are translated at average rates of exchange for the year. Gains or losses resulting from foreign currency transactions are included in net income.

### ***Income Taxes***

The Company and its subsidiaries are included in the consolidated federal income tax return filed by the Parent. Federal income taxes are calculated as if the companies filed on a separate return basis, and the amount of current tax or benefit calculated is either remitted to or received from the Parent. The amount of current and deferred taxes payable or refundable is recognized as of the date of the financial statements, utilizing currently enacted tax laws and rates. Deferred tax expenses or benefits are recognized in the financial statements for the changes in deferred tax liabilities or assets between years.

The Company recognizes and measures its unrecognized tax benefits in accordance with FASB ASC 740, *Income Taxes*. Under that guidance the Company assesses the likelihood, based on their technical merit, that tax positions will be sustained upon examination based on the facts, circumstances and information available at the end of each period. The measurement of unrecognized tax benefits is adjusted when new information is available, or when an event occurs that requires a change.

### ***Depreciation***

Depreciation is provided on a straight-line basis using estimated useful lives of five to ten years. Leasehold improvements are amortized over the lesser of the economic useful life of the improvement or the term of the lease.

### ***Drafts Payable***

Drafts payable represent amounts drawn by the Company against a bank and sight overdrafts under a sweep agreement with a bank.

### ***Exchange Memberships***

The Company's exchange memberships, which represent ownership interests in the exchanges and provide the Company with the right to conduct business on the exchanges, are recorded at cost or, if an other than temporary impairment in value has occurred, at a value that reflects management's estimate of the impairment. Management believes that such impairment in value occurred in 20W7, at which time the Company wrote down the cost of its exchange



memberships. There were no exchange membership impairments in 20X1. At December 31, 20X1, the fair value of exchange memberships was \$2,500.

### ***Statement of Cash Flows***

For purposes of the Consolidated Statement of Cash Flows, the Company has defined cash equivalents as highly liquid investments, with original maturities of less than three months, that are not held for sale in the ordinary course of business.

## **3. Fair Value**

### ***Fair Value Hierarchy***

FASB ASC 820 defines fair value, establishes a framework for measuring fair value, and establishes a hierarchy of fair value inputs. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market. Valuation techniques that are consistent with the market, income or cost approach, as specified by FASB ASC 820, are used to measure fair value.

The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels:

- *Level 1.* Quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company can access at the measurement date.
- *Level 2.* Inputs other than quoted prices included within level 1 that are observable for the asset or liability either directly or indirectly.
- *Level 3.* Unobservable inputs for the asset or liability.

The availability of observable inputs can vary from security to security and is affected by a wide variety of factors, including, for example, the type of security, the liquidity of markets, and other characteristics particular to the security. To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires more judgment. Accordingly, the degree of judgment exercised in determining fair value is greatest for instruments categorized in level 3.

The inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, for disclosure purposes, the level in the fair value hierarchy within which the fair value measurement falls in its entirety is determined based on the lowest level input that is significant to the fair value measurement in its entirety.

### ***Processes and Structure***

The Fair Valuation Committee (FVC), established by the Parent, is responsible for the Company's fair value valuation policies, processes, and procedures. FVC is independent of the business units and reports to the CFO of the Parent, who has final authority over the valuation of the Company's financial instruments. FVC implements valuation control processes to validate the fair value of the Company's financial instruments measured at fair value, including those derived from pricing models. These control processes are designed to assure that the values used for financial reporting are based on observable inputs wherever possible. In the event that observable inputs are not available, the control processes are designed to assure that the valuation approach utilized

is appropriate and consistently applied and that the assumptions are reasonable.

The Company's control processes for financial instruments categorized in level 3 of the fair value hierarchy include the following:

*Model Review.* FVC, in conjunction with the Risk Department (RD), which reports to the chief risk officer (CRO) of the Parent, independently reviews valuation models' theoretical soundness, the appropriateness of the valuation methodology, and calibration techniques developed by the business units using observable inputs. When inputs are not observable, FVC reviews the appropriateness of the proposed valuation methodology to ensure it is consistent with how a market participant would arrive at the unobservable input. The valuation methodologies utilized in the absence of observable inputs may include extrapolation techniques and the use of comparable observable inputs. As part of the review, FVC develops a methodology to independently verify the fair value generated by the business unit's valuation models. Before trades are executed using new valuation models, those models are required to be independently reviewed. All of the Company's valuation models are subject to an independent annual FVC review.

*Independent Price Verification.* The business units are responsible for determining the fair value of financial instruments using approved valuation models and valuation methodologies. Generally, on a monthly basis, FVC independently validates the fair values of financial instruments determined using valuation models by determining the appropriateness of the inputs used by the business units and by testing compliance with the documented valuation methodologies approved in the model review process described previously.

FVC uses recently executed transactions and other observable market data such as exchange data, broker-dealer quotes, third-party pricing vendors, and aggregation services for validating the fair values of financial instruments generated using valuation models. FVC assesses the external sources and their valuation methodologies to determine if the external providers meet the minimum standards expected of a third-party pricing source. Pricing data provided by approved external sources are evaluated using a number of approaches; for example, by corroborating the external sources' prices to executed trades, by analyzing the methodology and assumptions used by the external source to generate a price and/or by evaluating how active the third-party pricing source (or originating sources used by the third-party pricing source) is in the market. Based on this analysis, FVC generates a ranking of the observable market data to ensure that the highest ranked market data source is used to validate the business unit's fair value of financial instruments.

The results of this independent price verification and any adjustments made by FVC to the fair value generated by the business units are presented to management, the CFO and the CRO on a regular basis.

*Review of New Level 3 Transactions.* FVC reviews the models and valuation methodology used to price all new material level 3 transactions and RD management must approve the fair value of the trade that is initially recognized.

### ***Fair Value Measurements***

Many cash instruments and OTC derivative contracts have bid and ask prices that can be observed in the marketplace. *Bid prices* reflect the highest price that a party is willing to pay for an asset. *Ask prices* represent the lowest price that a party is willing to accept for an asset. For financial instruments whose inputs are based on bid-ask prices, the Company does not require that the fair value estimate always be a predetermined point in the bid-ask range. The Company's policy is to allow for midmarket pricing and to adjust to the point within the bid-ask range that meets the Company's best estimate of fair value. For offsetting positions in the same financial instrument, the same price within the bid-ask spread is used to measure both the long and short positions.

Fair value for many cash instruments and OTC derivative contracts is derived using pricing models. Pricing models take into account the contract terms (including maturity) as well as multiple inputs, including, when applicable, commodity prices, equity prices, interest rate yield curves, credit curves, correlation, creditworthiness of the counterparty, creditworthiness of the Company, option volatility, and currency rates. When appropriate, valuation adjustments are made to account for various factors such as liquidity risk (bid-ask adjustments), credit quality, model uncertainty, and concentration risk. Adjustments for liquidity risk adjust model-derived midmarket levels of level 2 and level 3 financial instruments for the bid-mid or mid-ask spread required to properly reflect the exit price of a risk position. Bid-mid and mid-ask spreads are marked to levels observed in trade activity, broker quotes, or other external third-party data. When these spreads are unobservable for the particular position in question, spreads are derived from observable levels of similar positions. The Company applies credit-related valuation adjustments to its OTC derivatives. For OTC derivatives, the effect of changes in both the Company's and the counterparty's credit standing is considered when measuring fair value. In determining the expected exposure, the Company simulates the distribution of the future exposure to a counterparty, then applies market-based default probabilities to the future exposure, leveraging external third-party credit default swap (CDS) spread data. When CDS spread data are unavailable for a specific counterparty, bond market spreads, CDS spread data based on the counterparty's credit rating or CDS spread data that reference a comparable counterparty may be utilized. The Company also considers collateral held and legally enforceable master netting agreements that mitigate the Company's exposure to each counterparty. Adjustments for model uncertainty are taken for positions whose underlying models rely on significant inputs that are neither directly nor indirectly observable, hence requiring reliance on established theoretical concepts in their derivation. These adjustments are derived by making assessments of the possible degree of variability using statistical approaches and market-based information where possible. The Company generally subjects all valuations and models to a review process initially and on a periodic basis thereafter.

Fair value is a market-based measure considered from the perspective of a market participant rather than an entity-specific measure. Therefore, even when market assumptions are not readily available, the Company's own assumptions are set to reflect those that the Company believes market participants would use in pricing the asset or liability at the measurement date.

A description of the valuation techniques applied to the company's major categories of assets and liabilities measured at fair value on a recurring basis follows.

*U.S. Government Securities.* U.S. government securities are valued using quoted market prices. Valuation adjustments are not applied. Accordingly, U.S. government securities are generally categorized in level 1 of the fair value hierarchy.

*U.S. Agency Securities.* U.S. agency securities are composed of three main categories consisting of agency-issued debt, agency mortgage pass-through pool securities, and collateralized mortgage obligations. Noncallable agency issued debt securities are generally valued using quoted market prices. Callable agency-issued debt securities are valued by benchmarking model-derived prices to quoted market prices and trade data for identical or comparable securities. The fair value of agency mortgage pass-through pool securities is model-driven based on spreads of the comparable to-be-announced (TBA) security. Collateralized mortgage obligations are valued using quoted market prices and trade data adjusted by subsequent changes in related indices for identical or comparable securities. Actively traded noncallable agency issued debt securities are generally categorized in level 1 of the fair value hierarchy. Callable agency issued debt securities, agency mortgage pass-through pool securities, and collateralized mortgage obligations are generally categorized in level 2 of the fair value hierarchy.

*Corporate Bonds.* The fair value of corporate bonds is determined using recently executed transactions, market price quotations (when observable), bond spreads or credit default swap spreads obtained from independent external parties, such as vendors and brokers, adjusted for any basis difference between cash and derivative instruments. The spread data used are for the same maturity as the bond. If the spread data do not reference the issuer, then data that reference a comparable issuer are used. When position-specific external price data are not observable, fair value is determined based on either benchmarking to similar instruments or cash flow models with yield curves, bond, or single-name credit default swap spreads and recovery rates as significant inputs. Corporate bonds are generally categorized in level 2 of the fair value hierarchy; in instances when prices, spreads, or any of the other aforementioned key inputs are unobservable, they are categorized in level 3 of the fair value hierarchy.

*Residential Mortgage-Backed Securities (RMBS) and Asset-Backed Securities (ABS).* RMBS and ABS may be valued based on price or spread data obtained from observed transactions or independent external parties such as vendors or brokers. When position-specific external price data are not observable, the fair value determination may require benchmarking to similar instruments and/or analyzing expected credit losses, default, and recovery rates. In evaluating the fair value of each security, the Company considers security collateral-specific attributes including payment priority, credit enhancement levels, type of collateral, delinquency rates, and loss severity. In addition, for RMBS borrowers, Fair Isaac Corporation scores and the level of documentation for the loan are also considered. Market standard models, such as Intex, Trepp, or others, may be deployed to model the specific collateral composition and cash flow structure of each transaction. Key inputs to these models are market spreads, forecasted credit losses, default and prepayment rates for each asset category. Valuation levels of RMBS indexes are also used as an

additional data point for benchmarking purposes or to price outright index positions.

RMBS and ABS are generally categorized in level 2 of the fair value hierarchy. If external prices or significant spread inputs are unobservable or if the comparability assessment involves significant subjectivity related to property type differences, cash flows, performance, and other inputs, then RMBS and ABS are categorized in level 3 of the fair value hierarchy.

*Exchange-Traded Equity Securities.* Exchange-traded equity securities are generally valued based on quoted prices from the exchange. To the extent these securities are actively traded, valuation adjustments are not applied, and they are categorized in level 1 of the fair value hierarchy; otherwise, they are categorized in level 2 or level 3 of the fair value hierarchy.

*Listed Derivative Contracts.* Listed derivatives that are actively traded are valued based on quoted prices from the exchange and are categorized in level 1 of the fair value hierarchy. Listed derivatives that are not actively traded are valued using the same approaches as those applied to OTC derivatives; they are generally categorized in level 2 of the fair value hierarchy.

*OTC Derivative Contracts.* OTC derivative contracts include forward, swap, and option contracts related to interest rates, foreign currencies, credit standing of reference entities, equity prices, or commodity prices.

Depending on the product and the terms of the transaction, the fair value of OTC derivative products can be either observed or modeled using a series of techniques and model inputs from comparable benchmarks, including closed-form analytic formulas, such as the Black-Scholes option-pricing model, and simulation models or a combination thereof. Many pricing models do not entail material subjectivity because the methodologies employed do not necessitate significant judgment, and the pricing inputs are observed from actively quoted markets, as is the case for generic interest rate swaps, certain option contracts and certain credit default swaps. In the case of more established derivative products, the pricing models used by the Company are widely accepted by the financial services industry. A substantial majority of OTC derivative products valued by the Company using pricing models fall into this category and are categorized in level 2 of the fair value hierarchy; otherwise, they are categorized in level 3 of the fair value hierarchy.

For further information on derivative instruments, see note 12.

*Reverse Repurchase Agreements and Repurchase Agreements.* The fair value of a reverse repurchase agreement or repurchase agreement is computed using a standard cash flow discounting methodology. The inputs to the valuation include contractual cash flows and collateral funding spreads, which are estimated using various benchmarks, interest rate yield curves, and option volatilities. In instances where the unobservable inputs are deemed significant, reverse repurchase agreements and repurchase agreements are categorized in level 3 of the fair value hierarchy; otherwise, they are categorized in level 2 of the fair value hierarchy.

The following table presents the Company's fair value hierarchy for those assets and liabilities measured at fair value on a recurring basis as of December 31, 20X1.

**Fair Value Measurements on a Recurring Basis**  
**As of December 31, 20X1**  
*(Dollars in Thousands)*

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Netting and Collateral</u>	<u>Total</u>
<b>ASSETS</b>					
Cash and securities segregated under federal and other regulations	\$630	\$—	\$—	\$—	\$630
Securities purchased under agreements to resell	—	3,782	—	—	3,782
Securities owned:					
U.S. government and agency	5,321	4,859	—	—	10,180
Corporate bonds	574	3,468	4,198	—	8,240
Residential mortgage and other asset backed securities	—	4,271	1,897	—	6,168
Equities	5,955	—	—	—	5,955
Derivatives	50	709	466	(300)	925
Spot commodities owned	—	3,278	—	—	3,278
<b>TOTALS</b>	<u>\$12,530</u>	<u>\$20,367</u>	<u>\$6,561</u>	<u>\$(300)</u>	<u>\$39,158</u>
<b>LIABILITIES</b>					
Securities sold under agreements to repurchase	\$—	\$3,790	\$—	\$—	\$3,790
Securities sold, not yet purchased:					
U.S. government and agency	430	150	—	—	580
Corporate and other debt	—	10	—	—	10
Equities	622	—	—	—	622
Derivatives	—	500	200	(50)	650
<b>TOTALS</b>	<u>\$1,052</u>	<u>\$4,450</u>	<u>\$200</u>	<u>\$(50)</u>	<u>\$5,652</u>

There were no transfers between level 1 and level 2 during the year.

The following is a reconciliation of the beginning and ending balances for assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (level 3) during the year ended December 31, 20X1:

**Level 3 Financial Assets and Liabilities**  
**Year ended December 31, 20X1**  
*(Dollars in Thousands)*

	<b>Total Gains/Losses Included in Income</b>					
	<b>Principal Transactions</b>					
	<i>Unrealized Gains and (Losses) Related to Assets Held at Year End</i>	<i>Realized Gains and (Losses) Related to Assets No Longer Held</i>	<i>Investment Banking Realized Gains and (Losses) No Positions Held at Year End</i>	<i>Purchases, Issuances, and Settlements</i>	<i>Transfers In (Out)</i>	<i>Ending Balance</i>
<b>ASSETS</b>						
Corporate bonds	\$3,758	\$28	\$182	\$(75)	\$385	\$4,198
Residential mortgages and other asset-backed securities	1,828	(33)	88	70	(81)	1,897
Derivatives	175	45	(10)	(70)	186	466
Total	<u>\$5,761</u>	<u>\$40</u>	<u>\$260</u>	<u>\$(75)</u>	<u>\$550</u>	<u>\$6,561</u>
<b>LIABILITIES</b>						
Derivatives	\$75	\$60	\$(5)	\$(40)	\$110	\$200

**Quantitative Information About and Sensitivity of Significant Unobservable Inputs Used in Recurring Level 3 Fair Value Measurements at December 31, 20X1<sup>18</sup>**

The following disclosures provide information on the valuation techniques, significant unobservable inputs, and their ranges for each major category of assets and liabilities measured at fair value on a recurring basis with a significant level 3 balance. The level of aggregation and breadth of products cause the range of inputs to be wide and not evenly distributed across the inventory. Further, the range of unobservable inputs may differ across firms in the financial services industry because of diversity in the types of products included in each firm's inventory. The following disclosures also include qualitative information on the sensitivity of the fair value measurements to changes in the significant unobservable inputs.

ASSETS	<i>Balance at December 31, 20X1</i>	<i>Valuation Technique(s)</i>	<i>Significant Unobservable Input(s): Sensitivity of the Fair Value to Changes in the Unobservable Inputs</i>	<i>Range</i>
Corporate bonds	\$4,198	Discounted cash flow	Discount rate: Significant increase (decrease) in the unobservable input in isolation would result in a significantly lower (higher) fair value measurement. Comparable bond price: Significant increase (decrease) in the unobservable input in isolation would result in a significantly higher (lower) fair value measurement.	12% to 13%
Residential mortgages and other asset- backed securities	1,897	Comparable pricing	Interest rate volatility skew: Significant increase (decrease) in the unobservable input in isolation would result in a significantly higher (lower) fair value measurement.	72–93 points
Derivatives	466	Option model	Significant increase (decrease) in the unobservable input in isolation would result in a significantly higher (lower) fair value measurement.	10% to 90%

<sup>18</sup> Although not required for nonissuers, for level 3 measurements, issuers are required to provide a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement, in accordance with ASU No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. If there are interrelationships between those inputs and other unobservable inputs are used in the fair value measurement, an issuer should also provide a description of those interrelationships and how they might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement.



<b>LIABILITIES</b>	<u>Balance at December 31, 20X1</u>	<u>Valuation Technique(s)</u>	<u>Significant Unobservable Input(s): Sensitivity of the Fair Value to Changes in the Unobservable Inputs</u>	<u>Range</u>
			At the money volatility: Significant increase (decrease) in the unobservable input in isolation would result in a significantly higher (lower) fair value measurement. There are no predictable relationships between the significant unobservable inputs.	20% to 45%
Derivatives	<u>\$200</u>	<u>Option</u>		

### ***Fair Value Option***<sup>19</sup>

FASB ASC 825, *Financial Instruments*, provides a fair value option election that allows entities to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities. Changes in fair value are recognized in earnings as they occur for those assets and liabilities for which the election is made. The election is made on an instrument by instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument. The fair value option has been elected for certain financial instruments that are not accounted for at fair value under other applicable accounting guidance.

At January 1, 20X1, the Company elected the fair value option on a prospective basis for securities purchased under agreements to resell and securities sold under agreements to repurchase.

The following table presents a summary of financial assets and liabilities for which the fair value option has been elected:

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<sup>19</sup> FASB ASC 825, *Financial Instruments*, states that in annual periods only, an entity should disclose the methods and significant assumptions used to estimate the fair value of items for which the fair value option has been elected. In addition, as of each date for which a statement of financial position is presented, an entity should disclose certain other information that relates the information in the note to the financial statements numbers, and disclosure should be made of certain information regarding any partial elections within a group of similar eligible items. Also, FASB ASC 825 requires disclosures that relate to particular types of assets or liabilities for which the fair value option may be elected. This note is for illustrative purposes only and is not intended include all disclosures required under the topic. See FASB ASC 825-10-50 for more information on the disclosures required.

*Changes in Fair Value for the Year  
Ended December 31, 20X1 for Items  
Measured at Fair Value Pursuant to the  
Fair Value Option*

	<i>Gains/ Losses Principal Transactions</i>	<i>Gains Other Income</i>	<i>Total Changes in Fair Value</i>
<b>ASSETS</b>			
Securities purchased under agreement to resell	\$60	\$5	\$65
<b>LIABILITIES</b>			
Securities sold under agreement to repurchase	\$(42)	\$(17)	\$(59)

#### **4. Cash and Securities Segregated Under Federal and Other Regulations**

Cash of \$275 and U.S. government securities with a fair value of \$630 are segregated under the Commodity Exchange Act and represent funds deposited by customers and funds accruing to customers as a result of trades or contracts.

Cash of \$100 has been segregated in a special reserve bank account for the benefit of customers under Rule 15c3-3 of the SEC or agreements for proprietary accounts of introducing brokers.<sup>20</sup>

#### **5. Receivable From and Payable to Broker-Dealers and Clearing Organizations**

Amounts receivable from and payable to broker-dealers and clearing organizations at December 31, 20X1, consist of the following:

	<i>Receivable</i>	<i>Payable</i>
Deposits for securities borrowed/loaned	\$7,756	\$7,395
Securities failed-to-deliver/receive	13,646	1,014
Payable to clearing broker	—	9,350
Receivable from clearing organizations	2,173	—
Fees and commissions receivable/payable	1,312	1,196
Other	589	209
	\$25,476	\$19,164

The Company clears certain of its proprietary and customer transactions through another broker-dealer on a fully disclosed basis. The amount payable to the clearing broker relates to the aforementioned transactions and is collateralized by securities owned by the Company.

#### **6. Receivable From and Payable to Customers**

Accounts receivable from and payable to customers include amounts due on cash and margin transactions. Securities owned by customers are held as collateral for receivables.

<sup>20</sup> This is possible wording for those situations in which a deposit is required based on SEC Rule 15c3-3 or proprietary accounts of introducing brokers' computations, or both.

**7. Bank Loans**

Customer loans of \$18,400 are collateralized by \$24,000 of customers' margin account securities, and firm loans of \$8,500 are collateralized by \$14,800 of securities owned by the Company and \$3,000 of securities held pursuant to secured demand note collateral agreements.

**8. Long-Term Notes Payable**

The long-term notes payable of \$3,000 bear interest at 6.5 percent and are payable in semiannual installments of \$250 through July 1, 20X6. Furniture and equipment with a net carrying value of \$2,500 has been pledged as sole recourse to secure the notes. The fair value of the long-term notes payable is \$3,300.

**9. Related Party**

The Company is involved in significant financing and other transactions, and has significant related party balances with affiliates.

The following table sets forth the Company's related party assets and liabilities as of December 31, 20X1:

	<i>December 31, 20X1</i>
<b>ASSETS</b>	
Securities borrowed	\$700
Securities purchased under agreements to resell, at fair value	880
Receivable from broker-dealers and clearing organizations	4,280
Receivable from customers	7,240
Securities owned, at fair value	529
Loans receivable from parent and affiliates (included in other assets)	125
Total assets	<u>\$13,754</u>
<b>LIABILITIES</b>	
Securities loaned	\$1,101
Securities sold under agreements to repurchase, at fair value	1,535
Payable to broker-dealers and clearing organizations	8,490
Payable to customers	2,424
Income taxes payable	2,276
Accounts payable, accrued expenses, and other liabilities	1,526
Subordinated borrowings	9,897
Total liabilities	<u>\$27,249</u>

Included in the consolidated statement of income are revenues and expenses resulting from various securities trading and financing activities with certain affiliates, as well as fees for administrative services performed by the Company under the terms of various agreements.

The following table sets forth the Company's related party revenues and expenses for the year ended December 31, 20X1:

	<u>20X1</u>
Commissions	\$724
Principal transactions	529
Investment banking	1,026
Interest	125
Other income	<u>919</u>
<b>Total net revenues</b>	<u>\$3,323</u>
Floor brokerage, clearance, and other operating expenses	<u>\$4,280</u>
<b>Total expenses</b>	<u>\$4,280</u>

### 10. Subordinated Borrowings<sup>21</sup>

The borrowings under subordination agreements at December 31, 20X1, are listed in the following:

Subordinated notes, 10 percent, due December 31, 20X2	\$4,307
Secured demand note collateral agreements, 6 percent, due \$1,000 in March 20X2, \$1,200 in March 20X3, and \$3,015 in December 20X3	5,215
Exchange memberships contributed for the use of the Company	<u>375</u>
	<u>\$9,897</u>

The subordinated borrowings are with related parties and are available in computing net capital under the SEC's uniform net capital rule. To the extent that such borrowings are required for the Company's continued compliance with minimum net capital requirements, they may not be repaid. It is the Company's intention not to renew the secured demand note collateralizing agreements due on March 20X2.<sup>22</sup>

The fair value of subordinated borrowings is \$10,800.

### 11. Preferred Stock

The preferred stock is redeemable at the option of the Company at \$105 a share. There are no calls or puts on the preferred stock.

### 12. Financial Instruments<sup>23</sup>

Derivative financial instruments used for trading purposes, including economic hedges of trading instruments, are carried at fair value. Fair values for exchange-traded derivatives, principally futures and certain options, are based on quoted market prices. Fair values for over-the-counter derivative financial instruments, principally forwards, options, and swaps, are based on internal

<sup>21</sup> Significant restrictive covenants of debt agreements should be disclosed.

<sup>22</sup> Because of the unique characteristics of subordinated borrowings, additional disclosure of the amount for which six months' notice has been given of intent to withdraw is necessary.

<sup>23</sup> Readers should consider all the disclosure requirements of FASB ASC 815, *Derivatives and Hedging*, which may not be necessarily reflected in these financial statements and notes to the financial statements.

pricing models as no quoted market prices exist for such instruments. Factors taken into consideration in estimating the fair value of OTC derivatives include credit spreads, market liquidity, concentrations, and funding and administrative costs incurred over the life of the instruments.

Derivatives used for economic hedging purposes include swaps, forwards, futures, and purchased options. Unrealized gains or losses on these derivative contracts are recognized currently in the statement of income as principal transactions. The Company does not apply hedge accounting as defined in FASB ASC 815 because all financial instruments are recorded at fair value with changes in fair values reflected in earnings. Therefore, certain of the disclosures required under FASB ASC 815 are generally not applicable with respect to these financial instruments.

Fair values of forwards, swaps, and options contracts are recorded in securities owned or securities sold, not yet purchased, as appropriate. Open equity in futures transactions is recorded as receivables from and payables to broker-dealers and clearing organizations, as applicable.

Premiums and unrealized gains and losses for written and purchased option contracts, as well as unrealized gains and losses on interest rate swaps, are recognized gross in the consolidated statement of financial condition. The unrealized gains for delayed-delivery, TBA, and when-issued securities generally are recorded in the consolidated statement of financial condition net of unrealized losses by counterparty where master netting agreements are in place.

#### **Principal Transactions**<sup>24</sup>

The Company's principal transaction by reporting categories, including derivatives, at December 31, 20X1, are the following:

Fixed income	\$2,607
Equity	3,500
Foreign exchange and other derivative financial instruments	600
	\$6,707

#### **Fair Value of Financial Instruments**<sup>25</sup>

The financial instruments of the Company are reported in the consolidated

<sup>24</sup> FASB ASC 815-10-50-4F provides an alternative disclosure option for derivative instruments that are not designated or qualifying as hedging instruments under FASB ASC 815-20. If an entity's policy is to include those derivative instruments in its trading activities, the entity may elect to not separately disclose gains and losses as required by FASB ASC 815-10-50-4C(e) provided that the entity discloses all of the following:

- a. The gains and losses on its trading activities (including both derivative and non-derivative instruments) recognized in the statement of financial performance, separately by major types of items (such as fixed income or interest rates, foreign exchange, equity, commodity, and credit).
- b. The line items in the statement of financial condition in which trading activities gains and losses are included.
- c. A description of the nature of its trading activities and related risks, and how the entity manages those risks.

If this alternative disclosure option is elected, the entity should include a footnote in the required tables referencing the use of alternative disclosures for trading activities.

<sup>25</sup> In February 2013, FASB issued ASU No. 2013-03, *Financial Instruments (Topic 825): Clarifying the Scope and Applicability of a Particular Disclosure to Nonpublic Entities*, which added paragraph 3A to FASB ASC 825-10-50. The amendment states that a nonpublic entity is not required to provide the disclosure in FASB ASC 825-10-50-10(d) for items disclosed at

statement of financial condition at fair values, or at carrying amounts that approximate fair values because of the short maturity of the instruments, except long-term notes payable, and subordinated borrowings. The fair values of these financial instruments at December 31, 20X1, are as follows:<sup>26</sup>

	<i>Assets (Liabilities)</i>	
	<i>Carrying Amount</i>	<i>Fair Value</i>
Long-term notes payable	\$(3,000)	\$(3,300)
Subordinated borrowings	\$(9,897)	\$(10,800)

The fair value of the Company's long-term notes payable and subordinated borrowings are based on current rates offered to the Company for debt with substantially the same characteristics and maturities.

### ***Financial Instruments With Off-Balance-Sheet Risk***

The Company enters into various transactions involving derivatives and other off-balance sheet financial instruments. These financial instruments include futures, forward and foreign exchange contracts, exchange-traded and over-the-counter options, delayed deliveries, mortgage-backed TBAs, securities purchased and sold on a when-issued basis (when-issued securities), and interest rate swaps. These derivative financial instruments are used to meet the needs of customers, conduct trading activities, and manage market risks and are, therefore, subject to varying degrees of market and credit risk. Derivative transactions are entered into for trading purposes or to economically hedge other positions or transactions.

Futures and forward contracts and TBAs and when-issued securities provide for the delayed delivery of the underlying instrument. As a writer of options, the Company receives a premium in exchange for giving the counterparty the right to buy or sell the security at a future date at a contracted price. Interest rate swaps involve the exchange of payments based on fixed or floating rates applied to notional amounts. The contractual or notional amounts related to these financial instruments reflect the volume and activity and do not reflect the amounts at risk. Futures contracts are executed on an exchange, and cash settlement is made on a daily basis for market movements. Accordingly, futures contracts generally do not have credit risk. The credit risk for forward contracts, TBAs, options, swaps, and when-issued securities is limited to the unrealized fair valuation gains recorded in the statement of financial condition. Market risk is substantially dependent upon the value of the underlying financial instruments and is affected by market forces such as volatility and changes in interest and foreign exchange rates.

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*(footnote continued)*

fair value but not measured at fair value in the statement of financial position. Except as noted in FASB ASC 825-10-50-3A, for annual reporting periods, FASB ASC 825-10-50-3 makes the disclosures about fair value of financial instruments optional for entities that meet all of the following criteria:

- a. The entity is a nonpublic entity.
- b. The entity's total assets are less than \$100 million on the date of the financial statements.
- c. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB ASC 815, other than commitments related to the origination of mortgage loans to be held for sale, during the reporting period.

<sup>26</sup> When carrying amounts and fair values are the same, the table may be omitted if that is stated.

The Company had certain other transactions which, in accordance with industry practice, were not recorded on the statement of financial condition. At December 31, 20X1, the Company had commitments to enter into future resale and repurchase agreements. At December 31, 20X1, the Company had also borrowed securities and pledged securities against those borrowed securities.

In addition, the Company has sold securities that it does not currently own and will therefore be obligated to purchase such securities at a future date. The Company has recorded these obligations in the financial statements at December 31, 20X1, at fair values of the related securities and will incur a loss if the fair value of the securities increases subsequent to December 31, 20X1.

In the normal course of business, the Company's customer activities involve the execution, settlement, and financing of various customer securities transactions. These activities may expose the Company to off-balance-sheet risk in the event the customer or other broker is unable to fulfill its contracted obligations and the Company has to purchase or sell the financial instrument underlying the contract at a loss.

The Company's customer securities activities are transacted on either a cash or margin basis. In margin transactions, the Company extends credit to its customers, subject to various regulatory and internal margin requirements, collateralized by cash and securities in the customers' accounts. In connection with these activities, the Company executes and clears customer transactions involving the sale of securities not yet purchased, substantially all of which are transacted on a margin basis subject to individual exchange regulations. Such transactions may expose the Company to significant off-balance-sheet risk in the event margin requirements are not sufficient to fully cover losses that customers may incur. In the event the customer fails to satisfy its obligations, the Company may be required to purchase or sell financial instruments at prevailing market prices to fulfill the customer's obligations. The Company seeks to control the risks associated with its customer activities by requiring customers to maintain margin collateral in compliance with various regulatory and internal guidelines. The Company monitors required margin levels daily and, pursuant to such guidelines, requires the customer to deposit additional collateral or to reduce positions when necessary.

The Company's customer financing and securities settlement activities require the Company to pledge customer securities as collateral in support of various secured financing sources such as bank loans and securities loaned. In the event the counterparty is unable to meet its contractual obligation to return customer securities pledged as collateral, the Company may be exposed to the risk of acquiring the securities at prevailing market prices in order to satisfy its customer obligations. The Company controls this risk by monitoring the fair value of securities pledged on a daily basis and by requiring adjustments of collateral levels in the event of excess market exposure. In addition, the Company establishes credit limits for such activities and monitors compliance on a daily basis.

**Quantitative Disclosures for Derivative Financial Instruments Used for Trading Purposes**

As of December 31, 20X1, the gross contractual or notional amounts of derivative financial instruments are as follows:

	<u>Notional or Contract Amount</u>
Interest Rate:	
Swap agreements, including options, swaptions, caps, collars, and floors	\$50
Futures contracts	5
Options held	2
Foreign Exchange:	
Futures contracts	5
Forward contracts	23
Options held	1
Options written	2
Mortgage-Backed Securities:	
Forward contracts	10
Equity:	
Swap agreements	22
Futures contracts	5
Options held	1
Options written	1
Total	<u>\$127</u>

The majority of the Company's transactions with off-balance-sheet risk are short-term in duration with a weighted average maturity of approximately 1.65 years at December 31, 20X1. The remaining maturities for notional or contract amounts outstanding for derivative financial instruments are as follows:<sup>27</sup>

	<u>Less Than 1 Year</u>	<u>1-3 Years</u>	<u>3-5 Years</u>	<u>Greater Than 5 Years</u>	<u>Total</u>
Swap agreements	\$20	\$25	\$16	\$11	\$72
Futures contracts	9	5	1		15
Forward contracts	33				33
Options held	4				4
Options written	3	—	—	—	3
Total	<u>\$69</u>	<u>\$30</u>	<u>\$17</u>	<u>\$11</u>	<u>\$127</u>
Percent of total	<u>54%</u>	<u>24%</u>	<u>13%</u>	<u>9%</u>	<u>100%</u>

The fair values of derivative financial instruments included in securities owned and securities sold, not yet purchased as of December 31, 20X1, and the average

<sup>27</sup> The disclosure of the remaining maturities for notional or contract amounts for derivative financial instruments is encouraged but not required.



monthly fair value of the instruments for the year ended December 31, 20X1, are as follows:

	<i>Fair Value at Year-End</i>		<i>Average Fair Values</i>	
	<i>Assets</i>	<i>Liabilities</i>	<i>Assets</i>	<i>Liabilities</i>
Swap agreements	\$688	\$348	\$499	\$226
Futures contracts	40		30	
Forward contracts	169	61	31	15
Options held	328		203	
Options written	—	291	—	123
Total derivatives	\$1,225	\$700	\$763	\$364
Cash collateral	(200)	(40)		
Netting	(100)	(10)		
Total carrying value	\$925	\$650		

The following table summarizes the credit quality of the Company's over-the-counter derivatives by showing internal counterparty credit ratings for the net exposure (net of collateral of \$200) of contracts in an asset position at December 31, 20X1.<sup>28</sup>

<i>Rating*</i>	<i>Net Exposure</i>
AAA	\$525
AA	220
A	130
BBB and lower	100
Other <sup>†</sup>	50
Total	\$1,025

\* Rating Agency Equivalent

<sup>†</sup> *Other* indicates counterparties for which no credit was available from an independent third-party source. It does not necessarily indicate the counterparties' credit is below investment grade.

### ***Credit-Risk-Related Contingent Features in Derivatives***

Certain of the Company's derivative instruments contain provisions that require the Company's debt to maintain an investment grade credit rating from each of the major credit rating agencies. If the Company's debt were to fall below investment grade, it would be in violation of these provisions, and the counterparties to the derivative instruments could request immediate payment or demand immediate and ongoing full overnight collateralization on derivative instruments in net liability positions. The aggregate fair value of all derivative instruments with credit-risk-related contingent features that are in a liability position on December 31, 20X1, is \$100 for which the Company has posted collateral of \$40 in the normal course of business. If the credit-risk-related contingent features underlying these agreements were triggered on December 31, 20X1, the Company would be required to post an additional \$15 of collateral to its counterparties.

<sup>28</sup> Qualitative disclosure for derivative financial instruments, such as this table, is encouraged but not required.

### ***Derivative Financial Instruments Used for Purposes Other Than Trading***

The Company enters into derivative contracts to economically hedge exposures or to modify the characteristics of financial instruments or transactions.

Open derivative contracts, which are linked to assets or liabilities that are sold or otherwise disposed of, are terminated at the time of disposition. Unrealized gains or losses on such derivative contracts are recognized in the statement of income currently as revenue from principal transactions.

At December 31, 20X1, the Company had outstanding interest rate and currency swap agreements with a notional principal amount of \$72. The swaps are recorded at fair value, and changes in fair value are included in income currently.

### ***Concentrations of Credit Risk***

The Company and its subsidiaries are engaged in various trading and brokerage activities in which counterparties primarily include broker-dealers, banks, and other financial institutions. In the event counterparties do not fulfill their obligations, the Company may be exposed to risk. The risk of default depends on the creditworthiness of the counterparty or issuer of the instrument. It is the Company's policy to review, as necessary, the credit standing of each counterparty.

### **13. Commitments and Contingent Liabilities**

The Company is contingently liable as of December 31, 20X1, in the amount of \$4,375 under bank guarantees and has outstanding letter-of-credit agreements aggregating \$3,000 used in lieu of margin deposits. The Company has determined that these commitments do not meet the definition of a derivative, as defined by FASB ASC 815. These agreements are generally made for periods of six months to one year and bear interest at rates from 0.5 percent to 1 percent.

The Company and its subsidiaries have obligations under operating leases with initial noncancelable terms in excess of one year. Aggregate annual rentals for office space and equipment at December 31, 20X1, are approximately as listed as follows:

20X2	\$1,492
20X3	1,440
20X4	1,006
20X5	982
20X6	901
Later years	<u>1,164</u>
	<u>\$6,985</u>

Certain leases contain renewal options and escalation clauses. Rent expense for 20X1 aggregated to \$1,519 and is included in the *Occupancy* expense line item on the Consolidated Statement of Income.

The Company and a subsidiary—together with various other broker-dealers, corporations, and individuals—have been named as defendants in several class action lawsuits that allege violations of federal and state securities laws and claim substantial damages. The Company is also a defendant in other lawsuits incidental to its securities and commodities business. Management of the Company, after consultation with outside legal counsel, believes that the resolution of these various lawsuits will not result in any material adverse effect on the Company's consolidated financial position.

In the normal course of business, the Company enters into underwriting commitments. Transactions relating to such underwriting commitments that were open at December 31, 20X1, and were subsequently settled had no material effect on the financial statements as of that date.

#### **14. Guarantees**

FASB ASC 460, *Guarantees*, requires the Company to disclose information about its obligations under certain guarantee arrangements. FASB ASC 460 defines guarantees as contracts and indemnification agreements that contingently require a guarantor to make payments to the guaranteed party based on changes in an underlying (such as an interest or foreign exchange rate, security or commodity price, an index or the occurrence or nonoccurrence of a specified event) related to an asset, liability or equity security of a guaranteed party. This guidance also defines guarantees as contracts that contingently require the guarantor to make payments to the guaranteed party based on another entity's failure to perform under an agreement as well as indirect guarantees of the indebtedness of others.

##### ***Derivative Contracts***

Certain derivative contracts that the Company has entered into meet the accounting definition of a guarantee under FASB ASC 460. Derivatives that meet the FASB ASC 460 definition of guarantees include certain written options and credit default swaps. Because the Company does not track the counterparties' purpose for entering into a derivative contract, it has disclosed derivative contracts that are likely to be used to protect against a change in an underlying financial instrument, regardless of their actual use.

The maximum potential payout for certain derivative contracts, such as written interest rate caps and written foreign currency options, cannot be estimated as increases in interest or foreign exchange rates in the future could possibly be unlimited. Therefore, in order to provide information regarding the maximum potential amount of future payments that the Company could be required to make under certain derivative contracts, the notional amount of the contracts has been disclosed.

The Company records all derivative contracts at fair value. For this reason, the Company does not monitor its risk exposure to derivative contracts based on derivative notional amounts; rather the Company manages its risk exposure on a fair value basis. Aggregate market risk limits have been established, and market risk measures are routinely monitored against these limits. The Company also manages its exposure to these derivative contracts through a variety of risk mitigation strategies, including, but not limited to, entering into offsetting economic hedge positions. The Company believes that the notional amounts of the derivative contracts generally overstate its exposure.

##### ***Indemnifications***

In the normal course of its business, the Company indemnifies and guarantees certain service providers, such as clearing and custody agents, trustees and administrators, against specified potential losses in connection with their acting as an agent of, or providing services to, the Company or its affiliates. The Company also indemnifies some clients against potential losses incurred in the event specified third-party service providers, including subcustodians and third-party brokers, improperly executed transactions. The maximum potential amount of future payments that the Company could be required to make under these indemnifications cannot be estimated. However, the Company believes that it is unlikely it will have to make material payments under these

arrangements and has not recorded any contingent liability in the consolidated financial statements for these indemnifications.

The Company provides representations and warranties to counterparties in connection with a variety of commercial transactions and occasionally indemnifies them against potential losses caused by the breach of those representations and warranties. The Company may also provide standard indemnifications to some counterparties to protect them in the event additional taxes are owed or payments are withheld, due either to a change in or adverse application of certain tax laws. These indemnifications generally are standard contractual terms and are entered into in the normal course of business. The maximum potential amount of future payments that the Company could be required to make under these indemnifications cannot be estimated. However, the Company believes that it is unlikely it will have to make material payments under these arrangements and has not recorded any contingent liability in the consolidated financial statements for these indemnifications.

### ***Exchange Member Guarantees***

The Company is a member of various exchanges that trade and clear securities or futures contracts or both. Associated with its membership, the Company may be required to pay a proportionate share of the financial obligations of another member who may default on its obligations to the exchange. Although the rules governing different exchange memberships vary, in general the Company's guarantee obligations would arise only if the exchange had previously exhausted its resources. In addition, any such guarantee obligation would be apportioned among the other nondefaulting members of the exchange. Any potential contingent liability under these membership agreements cannot be estimated. The Company has not recorded any contingent liability in the consolidated financial statements for these agreements and believes that any potential requirement to make payments under these agreements is remote.

### ***Other Guarantees***

The Company, in its capacity as an agency lender, occasionally indemnifies securities lending customers against losses incurred in the event that borrowers do not return securities and the collateral held is insufficient to cover the fair value of the securities borrowed. In addition, the Company provides letters of credit and other guarantees, on a limited basis, to enable clients to enhance their credit standing and complete transactions.

The following table sets forth the maximum payout/notional amounts associated with the Company's guarantees as of December 31, 20X1:

<i>Type of Guarantee</i>	<b>Maximum Potential Payout/Notional</b>					<i>Carrying Amount</i>	<i>Collateral/ Recourse</i>
	<i>Years to Maturity</i>						
	<i>Less than 1</i>	<i>1-3</i>	<i>3-5</i>	<i>Over 5</i>	<i>Total</i>		
	<i>(dollars in thousands)</i>						
Derivative contracts	\$XX	\$XX	\$XX	\$XX	\$XX	\$XX	\$XX
Securities lending indemnifications	\$XX	\$XX	\$XX	\$XX	\$XX	\$XX	\$XX
Letters of credit and other guarantees	\$XX	\$XX	\$XX	\$XX	\$XX	\$XX	\$XX

## 15. Net Capital Requirements

The Company is subject to the SEC Uniform Net Capital Rule (SEC Rule 15c3-1), which requires the maintenance of minimum net capital and requires that the ratio of aggregate indebtedness to net capital, both as defined, shall not exceed 15 to 1 (and the rule of the “applicable” exchange also provides that equity capital may not be withdrawn or cash dividends paid if the resulting net capital ratio would exceed 10 to 1).<sup>29</sup> The Company is also subject to the net capital requirements of the CFTC Regulation 1.17 and requirements of the National Futures Association, and is required to maintain “adjusted net capital”, equivalent to the greater of \$1,000,000 or 8 percent of customer and noncustomer risk maintenance margin requirements on all positions, as these terms are defined.<sup>30</sup> At December 31, 20X1, the Company had net capital of \$33,584, which was \$29,381 in excess of its required net capital of \$4,203. The Company’s net capital ratio was 1.7 to 1.<sup>31</sup>

## 16. Income Taxes

The Company is included in the consolidated federal income tax return filed by its Parent. Federal income taxes are calculated as if the Company filed a separate federal income tax return. The Company and its subsidiaries file their own state and local tax returns. The current and deferred portions of the income tax expense (benefit) included in the statement of operations as determined in accordance with FASB ASC 740 are as follows:

	<i>Current</i>	<i>Deferred</i>	<i>Total</i>
Federal	\$5,204	\$(304)	\$4,900
State and local	1,280	680	1,960
Foreign	240	—	240
	<u>\$6,724</u>	<u>\$376</u>	<u>\$7,100</u>

A reconciliation of the difference between the expected income tax expense or benefit computed at the U.S. statutory income tax rate and the Company’s income tax expense is shown in the following table:<sup>32</sup>

Expected income tax expense at U.S. statutory tax rate	\$4,659
The effect of:	
Nondeductible expenses	1,309
Increase due to state and local taxes, net of U.S. federal income tax effects	1,293
Tax-exempt income, net of related nondeductible interest expense	(427)
Other, net	266
Income tax expense <sup>33</sup>	<u>\$7,100</u>

<sup>29</sup> Various regulatory agencies and exchanges may impose additional capital requirements, which may be necessary to disclose.

<sup>30</sup> Only applicable if the broker-dealer is a futures commission merchant subject to Regulation 1.17 of the Commodity Futures Trading Commission.

<sup>31</sup> See illustrative schedule I in exhibit 4-9.

<sup>32</sup> This is an optional disclosure for firms not subject to SEC Regulation S-X. An explanation of a disproportionate tax provision, however, is required under GAAP.

<sup>33</sup> See FASB ASC 740-10-50 for additional disclosures required, if material.

The Company recognizes the accrual of any interest and penalties related to unrecognized tax benefits in income tax expense. No interest or penalties were recognized in 20X1. The following is a reconciliation of the beginning and ending amounts of unrecognized tax benefits:

Balance at January 1, 20X1	\$XX
Additions based on tax positions related to the current year	XX
Additions for tax positions of prior years	XX
Reductions for tax positions of prior years	XX
Settlements	XX
Expiration of Statute of Limitations	XX
Balance at December 31, 20X1	<u>    \$XX</u>

Of the balance at December 31, 20X1, approximately \$XX represents the amount of unrecognized tax benefits that, if recognized, would favorably affect the effective tax rate in future years. The Company does not have any tax positions at the end of the year for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date.

The following represents the approximate tax effect of each significant type of temporary difference giving rise to the deferred income tax liability.

Deferred tax asset:	
Employee benefits	\$XX
Other	XX
Total	<u>    \$XX</u>
Deferred tax liability:	
Property, plant, and equipment	XX
Other	XX
Total	<u>    \$XX</u>
Deferred tax liability, net	<u>    \$XX</u>

The Parent and the Company are no longer subject to federal, state, or local tax examinations by taxing authorities for years before 20W4. The IRS commenced an examination of the Parent's federal income tax returns for the years 20W6 and 20W7 in the last quarter of 20W9 that is anticipated to be completed by the end of 20X2. As of December 31, 20X1, the IRS has not proposed any adjustment to the Company's tax position.

**17. Consolidated Subsidiaries**<sup>34,35</sup>

The following is a summary of certain financial information of the Company's consolidated subsidiaries:

	<i>Broker- Dealer Jr.</i>	<i>Investment Advisory</i>	<i>Venture Capital</i>	<i>Total</i>
Total assets	\$12,700	\$1,700	\$5,100	\$19,500
Stockholders' equity	2,800	400	1,800	5,000

The \$2,800 of stockholder's equity and \$1,500 of the subordinated liabilities of the broker-dealer subsidiary are included as capital in a consolidated computation of the Company's net capital, because the assets of the subsidiary are readily available for the protection of the Company's customers, broker-dealers, and other creditors, as permitted by Rule 15c3-1, which resulted in an increase in net capital and required net capital (after nonallowable assets and charges) of \$1,838 and \$500, respectively. The accounts of the other subsidiaries are not included in the computation.

**18. Collateral**

The Company pledges its financial instruments owned to collateralize repurchase agreements and other securities financings. Pledged securities that can be sold or repledged by the secured party are identified in the consolidated statement of financial condition. The carrying value and classification of securities owned by the Company that have been loaned or pledged to counterparties where those counterparties do not have the right to sell or repledge the collateral were as follows:

	<i>At December 31, 20X1</i>
Financial instruments owned:	
U.S. government and agency securities	\$1,000
Corporate and other debt	500
Residential mortgages and other asset backed securities	600
Corporate equities	900
Total	<u><u>\$3,000</u></u>

Under the Company's collateralized financing agreements, the Company either receives or provides collateral. In many cases, the Company is permitted to sell or repledge these securities held as collateral. At December 31, 20X1, the fair value of securities received as collateral where the Company is permitted to sell

<sup>34</sup> Information in this note is presented to comply with FOCUS requirements (total assets and stockholders' equity of consolidated subsidiaries and treatment of the flow-through capital of the broker-dealer subsidiary). Readers should also consider FASB ASC 280, *Segment Reporting*, which requires that public business enterprises report financial and descriptive information about their reportable operating segments.

<sup>35</sup> See FASB ASC 810-10-50 for information on required disclosures related to consolidation. Note that FASB ASC 810-10-15-10 states that a majority-owned subsidiary that is not within the scope of the "Variable Interest Entity" subsections and in which a parent has a controlling financial interest shall not be consolidated if the parent is a broker-dealer within the scope of FASB ASC 940, *Financial Services—Brokers and Dealers*, and the control is likely to be temporary.

or repledge the securities was \$XX and the fair value of the portion that had been sold or repledged was \$XX.

The Company additionally receives securities as collateral in connection with certain securities for securities transactions in which the Company is the lender. In instances where the Company is permitted to sell or repledge these securities, the Company reports the fair value of the collateral received and the related obligation to return the collateral in the consolidated statement of financial condition. At December 31, 20X1, \$200, was reported as *Securities received as collateral* and an *Obligation to return securities received as collateral* in the consolidated statement of financial condition. Collateral received in connection with these transactions that was subsequently repledged was approximately \$XX at December 31, 20X1.<sup>36,37</sup>

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<sup>36</sup> FASB ASC 860-30-50 requires disclosure of information about the sources and uses of that collateral.

<sup>37</sup> See footnote 34.



**Exhibit 4-9**

**Supplementary Information  
Pursuant to Rule 17a-5 of the  
Securities Exchange Act of 1934  
As of December 31, 20X1**

The accompanying schedules are prepared in accordance with the requirements and general format of FOCUS Form X-17A-5. If desired, the preprinted FOCUS forms may be used for presenting the required supplementary information. The auditor should be aware of certain exemptive provisions under SEC Rule 15c3-3 regarding the determination of net capital requirements in the computation of net capital (Schedule I) and the computation for the determination of reserve requirements (Schedule II). If the exemptive provisions apply, a note should be added by the broker-dealer to the schedules, stating the basis under which the broker-dealer claims exemption.

**Schedule I**

**Standard Stockbrokerage Co., Inc.  
Computation of Net Capital Under Rule 15c3-1 of the  
Securities and Exchange Commission\*(Dollars in Thousands)  
As of December 31, 20X1**

Net Capital	
Total consolidated stockholders' equity	\$39,719
Deduct stockholders' equity not allowable for net capital <sup>†</sup>	<u>2,200</u>
Total stockholders' equity qualified for net capital	37,519
Add:	
Subordinated borrowings allowable in computation of net capital	9,897
Other (deductions) or allowable credits-deferred income taxes payable	<u>1,200</u>
Total capital and allowable subordinated borrowings	48,616
Deductions/charges:	
Nonallowable assets:	
Securities not readily marketable	\$1,730
Exchange memberships	2,475
Furniture, equipment, and leasehold improvements, net <sup>‡</sup>	2,381
Other assets <sup>  </sup>	<u>98</u>
	6,684
Additional charges for customers' and noncustomers' security accounts	825
Additional charges for customers' and noncustomers' commodity accounts	78
Aged fails-to-deliver	42

(continued)

Aged short security differences	44	
Secured demand note deficiency	525	
Commodity futures contracts and spot commodities/proprietary capital charges	163	
Other deductions/charges	514	8,875
Net capital before haircuts on securities positions (tentative net capital)		39,741
Haircuts on securities		
Contractual securities commitments	2,520	
Trading and investment securities		
Bankers' acceptances, certificates of deposit, and commercial paper	34	
U.S. government agency and Canadian government obligations	1,155	
State and municipal government obligations	14	
Corporate obligations	1,242	
Stocks and warrants	893	
Options	212	
Undue concentrations	87	6,157
Net capital		<u>\$33,584</u>
Aggregate indebtedness		
Items included in consolidated statement of financial condition:#		
Short-term bank loans (secured by customer's securities)		\$18,400
Drafts payable		2,210
Payable to brokers and dealers		8,110
Payable to clearing broker		9,350
Payable to customers		11,716
Other accounts payable and accrued expenses		3,150
Items not included in consolidated statement of financial condition:		
Fair value of securities borrowed for which no equivalent value is paid or credited		2,532
Other unrecorded amounts		1,158
Total aggregate indebtedness		<u>\$56,626</u>
Computation of basic net capital requirement		
Minimum net capital required:		
Company		\$ 3,775
Broker-dealer subsidiary		428
Total		<u>\$4,203</u>
Excess net capital at 1,500 percent		<u>\$29,381</u>
Excess net capital at 1,000 percent		<u>\$27,493</u>
Ratio: Aggregate indebtedness to net capital		<u>1.69 to 1</u>

Reconciliation with Company's computation\*\* (included in part II of Form X-17A-5 as of December 31, 20X1)

Net capital, as reported in Company's part II (unaudited) FOCUS report	\$35,154
Allowable assets erroneously reported as non-allowable:	
Deposits	582
Accrued interest receivable	378
Difference due to offsetting various asset accounts against related liabilities	(2,518)
Audit adjustments to record additional compensation	(600)
Other audit adjustments (net)	373
Other items (net)	215
Net capital per the preceding	<u>\$33,584</u>
Computation of alternative net capital requirement††	
2% of aggregate debit items (or \$250,000, if greater) as shown in formula for reserve requirements pursuant to Rule 15c3-3 prepared as of date of net capital computation—	
Company	\$1,077
Capital requirement of consolidated broker-dealer subsidiary electing alternative method	250
Total net capital requirement	<u>\$1,327</u>
Excess net capital**	<u>\$32,257</u>
Net capital in excess of	
4 percent of aggregate debit items	<u>\$31,106</u>
5 percent of aggregate debit items	<u>\$30,236</u>

\* Practitioners should consider the impact of recently issued accounting and regulatory pronouncements when preparing or auditing this supplementary schedule.

† Excludes stockholder's equity of investment advisory and venture capital subsidiaries. See note 17.

‡ Excludes \$2.5 million because of sole recourse of the related indebtedness.

|| Excludes \$222 of good-faith deposits for underwritings.

# Excludes balances of consolidated subsidiaries other than wholly-owned broker-dealer subsidiaries included in consolidated computation of net capital.

\*\* If there is no material difference from the Company's computation and a reconciliation is not included, a statement to that effect is required. The following statement can be used to satisfy this requirement:

**Note:** There are no material differences between the preceding computation and the Company's corresponding unaudited part II of Form X-17A-5 as of December 31, 20X1.

This note can be placed at the end of this schedule or on every page of the schedule.

†† To be included if the Company has elected to use the alternative method of computing net capital pursuant to appendix C of Rule 15c3-1. In this case, aggregate indebtedness and the computation of basic net capital may be excluded.

‡‡ Net capital under the alternative method is computed on a basis similar to the basic net capital computation; the broker-dealer would incur a 1 percent charge on fails-to-deliver (offset by fails-to-receive).

## Schedule II

## Standard Stockbrokerage Co., Inc.

Computation for Determination of Reserve Requirements  
Under Rule 15c3-3 of the Securities and Exchange Commission\*

(Standard Stockbrokerage Co., Inc. only)

*(Dollars in Thousands)*

As of December 31, 20X1

## Credit balances

Free credit balances and other credit balances in customers' security accounts (including nonregulated commodity accounts, net of related margin deposits of \$322,300)	\$10,716
Monies borrowed, collateralized by securities carried for the accounts of customers	18,400
Monies payable against customers' securities loaned	1,825
Customers' securities failed to receive (including credit balances in continuous net settlement accounts)	6,276
Credit balances in firm accounts that are attributable to principal sales to customers	1,238
Fair value of stock dividends, stock splits, and similar distributions receivable outstanding over 30 calendar days	327
Fair value of short security count differences over 30 calendar days old <sup>†</sup>	5
Fair value of short securities and credits (not to be offset by "longs" or by debits) in all suspense accounts over 30 calendar days <sup>†</sup>	78
Fair value of securities that are in transfer in excess of forty calendar days and have not been confirmed to be in transfer by the transfer agent or the issuer	38
Total credit items	<u>38,903</u>

## Debit balances

Debit balances in customers' cash and margin accounts excluding unsecured accounts and accounts doubtful of collection net of deductions pursuant to Rule 15c3-3 <sup>‡</sup>	38,988
Securities borrowed to effectuate short sales by customers and securities borrowed to make delivery on customers' securities failed to deliver	1,318
Failed to deliver of customers' securities not older than 30 calendar days (including debit balances in continuous net settlement accounts)	14,782
Other <sup>  </sup>	438
Gross debits	<u>55,526</u>

Less 3 percent charge		1,666
Total debit items <sup>‡</sup>		<u>53,860</u>
Reserve computation <sup>‡</sup>		
Excess of total debits over total credits		<u>\$14,957</u>
Required deposit		<u>None</u>
Reconciliation with Company's computation <sup>#</sup> (included in part II of Form X-17A-5 as of December 31, 20X1)		
Excess debits as reported in Company's part II FOCUS report		\$15,496
Nonregulated commodity margin deposits erroneously excluded from the Company's computation	\$322	
Other items, net	<u>217</u>	<u>(539)</u>
Excess debits per the preceding computation		<u>\$14,957</u>

\* Practitioners should consider the impact of recently issued accounting and regulatory pronouncements when preparing or auditing this supplementary schedule.

† Would be seven calendar days if the broker or dealer had elected the alternative net capital requirement under Rule 15c3-1(f).

‡ Those firms calculating net capital under the basic method must reduce debit balances in customer accounts by 1 percent, whereas those calculating net capital under the alternative method are required to reduce total debits by 3 percent.

|| This caption may only include those interpretive items that do not belong in the captions specified by the rule.

# If there are no material differences from the Company's computation and a reconciliation is not included, a statement to that effect is required. The following statement can be used to satisfy this requirement:

**Note:** There are no material differences between the preceding computation and the Company's corresponding unaudited part II of Form X-17A-5 as of December 31, 20X1.

This note can be placed at the end of this schedule or on every page of the schedule.

## Schedule III

## Standard Stockbrokerage Co., Inc.

Information Relating to Possession or Control Requirements Under  
Rule 15c3-3 of the Securities and Exchange Commission\*

(Standard Stockbrokerage Co., Inc. only)

*(Dollars in Thousands)*

As of December 31, 20X1

1.	Customers' fully paid and excess margin securities not in the respondent's possession or control as of the report date (for which instructions to reduce to possession or control had been issued as of the report date but for which the required action was not taken by respondent within the time frames specified under Rule 15c3-3). <sup>†</sup>	\$18
	A. Number of items	<u>2</u>
2.	Customers' fully paid securities and excess margin securities for which instructions to reduce to possession or control had not been issued as of the report date, excluding items arising from "temporary lags which result from normal business operations" as permitted under Rule 15c3-3. <sup>‡</sup>	\$39
	A. Number of items	<u>5</u>

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\* Practitioners should consider the impact of recently issued accounting and regulatory pronouncements when preparing or auditing this supplementary schedule.

<sup>†</sup> If the customers' fully paid securities are subsequently reduced to possession or control, a statement to that effect should be included.

<sup>‡</sup> In some instances, it may be impractical to determine the number of items in response to item 2. It may also be impractical to determine whether the Company has subsequently issued instructions to reduce those items to possession or control or to determine that such instructions were acted on.

**Schedule IV**  
**Standard Stockbrokerage Co., Inc.**  
**Schedule of Segregation Requirements and Funds**  
**in Segregation for Customers' Regulated**  
**Commodity Futures and Options Accounts\***  
*(Dollars in Thousands)*  
**As of December 31, 20X1**

Segregation requirements	
Net ledger balance:	
Cash	\$976
Securities (at market)	784
Net unrealized profit (loss) in open futures contracts	(367)
Exchange traded options	
Add: fair value of open option contracts purchased on a contract market	143
Deduct: fair value of open option contracts granted (sold) on a contract market	(129)
Net equity (deficit)	1,407
Add: accounts liquidating to a deficit and accounts with debit balances with no open trades	78
Amount required to be segregated	<u>1,485</u>
Funds on deposit in segregation	
Deposited in segregated funds bank accounts:	
Cash	105
Securities representing investments of customers' funds (at market)	141
Securities held for customers in lieu of cash margins (at market)	784
Margins on deposit with clearing organizations of contract markets:	
Cash	170
Securities representing investments of customers' funds (at market)	489
Settlement due from (to) contract market clearing organization	(28)
Exchange traded options:	
Add: unrealized receivables for option contracts purchased on contract markets	143
Deduct: unrealized obligations for option contracts granted (sold) on contract markets	(129)
Net equities with other FCMs	37
Total amount in segregation	<u>1,712</u>
Excess funds (insufficiency) in segregation	<u>\$ 227</u>

\* Practitioners should consider the impact of recently issued accounting and regulatory pronouncements when preparing or auditing this supplementary schedule.

## Appendix A — Supplementary Information in Relation to the Financial Statements as a Whole

### Reporting on Supplementary Information in an Audit of Financial Statements<sup>1</sup>

**A-1** Certain supplementary schedules are required to be filed with the financial statements of a broker-dealer when submitting the financial statements to regulators. These supplementary schedules should be presented in the format that presents the relevant details required by applicable Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission regulations and should be filed as a part of the Financial and Operational Combined Uniform Single report. The independent auditors' report is required to cover these schedules. See exhibit 4-9 for illustrative examples of the schedules required to be included with the financial statements.

**A-2** When performing an audit in accordance with generally accepted auditing standards (GAAS), AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), provides guidance when the auditor is engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. The information presented in the following paragraphs is based on the guidance in AU-C section 725. SEC or other regulations may require additional considerations related to supplementary information.

**A-3** Paragraph .04 of AU-C section 725 defines *supplementary information* as information presented outside the basic financial statements, excluding required supplementary information that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. When the auditor's report is required to cover these schedules with an in relation to opinion, the supplementary schedules qualify as supplementary information subject to the requirements of AU-C section 725. The schedules required under SEC Rule 17a-5 are supplementary information subject to the requirements of AU-C section 725.<sup>2</sup>

**A-4** In order to opine on whether the information in the supplementary information is fairly stated in all material respects, in relation to the financial statements as a whole, the auditor should determine that the conditions found in paragraph .05 of AU-C section 725 are met. In addition, the auditor should obtain the agreement of management that it acknowledges and understands its responsibility related to the supplementary information

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<sup>1</sup> See appendix C, "Auditor's Standards Reports," of this guide for illustrative reports that include reporting on supplementary information.

<sup>2</sup> Paragraph .09 of AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), provides that when an entity presents supplementary information with the financial statements, the auditor should report on the supplementary information in an other-matter paragraph in accordance with AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report* (AICPA, *Professional Standards*), or in a separate report on the supplementary information. Note that a broker-dealer's financial statements that are not a part of a regulatory filing (for example, publicly available financial statements posted on an entity's website) may not contain supplementary information. In this case, the reporting related to supplementary information would not appear in the auditor's report for those financial statements.



- for the preparation of the schedules required under SEC Rule 17a-5 (and, if applicable, other regulatory requirements).
- to provide the auditor with certain written representations (see paragraph A-6).
- to include the auditor's report on the supplementary information in any document that contains this information and that indicates that reported such information.
- to present the supplementary information with the audited financial statements or, if the supplementary information will not be presented with the audited financial statements, to make the audited financial statements readily available<sup>3</sup> to the intended users of the supplementary information no later than the date of issuance of the supplementary information and the auditor's report thereon.

**A-5** In order to opine on whether the supplementary information is fairly stated in all material respects, in relation to the financial statements as a whole, the auditor should perform certain procedures that are in addition to the procedures performed during the audit of the financial statements. AU-C section 725 states that these procedures should be performed using the same materiality level used in the audit of the financial statements. As found in paragraph .07 of AU-C section 725, the auditor should

- inquire of management about the criteria used by management to prepare the supplementary information.
- determine whether the form and content of the supplementary information complies with SEC or other regulatory requirements.
- obtain an understanding about the methods of preparing the supplementary information and determine whether the methods have changed from those used in the prior period and, if those methods of preparing the supplementary information have changed, the reasons for such changes.
- compare and reconcile the supplementary information to the underlying accounting and other records used in preparing the financial statements or to the financial statements themselves.<sup>4</sup>
- inquire of management about any significant assumptions or interpretations underlying the measurement or presentation of the supplementary information.
- evaluate the appropriateness and completeness of the information contained in the supplementary information, considering the results of the procedures performed and other knowledge obtained during the audit of the financial statements.<sup>5</sup>
- obtain certain written representations from management.

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<sup>3</sup> Paragraph .A9 of AU-C section 725 notes that audited financial statements are deemed to be readily available if a third-party user can obtain the financial statements without any further action by the audited entity. Financial statements posted on an entity's website may be considered readily available. However, being available by request is not considered readily available.

<sup>4</sup> Paragraph .A12 of AU-C section 725 notes that the auditor may consider materiality in determining which information to compare and reconcile to the underlying accounting and other records used in preparing the financial statements or to the financial statements themselves.

<sup>5</sup> Paragraph .A13 of AU-C section 725 notes that in evaluating the appropriateness and completeness of supplementary information, the auditor may consider testing accounting or other records through observation or examination of source documents or other procedures ordinarily performed in an audit of the financial statements.

**A-6** In addition to the written representations typically obtained in the audit,<sup>6</sup> certain additional representations should be obtained that are related to the supplementary information. Representations that should be obtained from management with regard to the supplementary information are

- that management acknowledges and understands its responsibility for the presentation of the supplementary information in accordance with regulatory requirements.
- that management believes the supplementary information, including its form and content, is fairly presented in accordance with regulatory requirements.
- that the methods of measurement or presentation have not changed from those used in the prior period or, if the methods of measurement or presentation have changed, the reasons for such changes.
- any significant assumptions or interpretations underlying the measurement or presentation of the supplementary information.
- that when the supplementary information is not presented with the audited financial statements, management will make the audited financial statements readily available to the intended users of the schedule no later than the issuance date by the entity of the supplementary information and auditor's report thereon.<sup>7</sup>

**A-7** Paragraph .A11 of AU-C section 725 states that with respect to the supplementary information, the auditor is not required to obtain a separate understanding of the entity's internal control or to assess fraud risk. Although this provision is relevant in the context of the auditor reporting on the supplementary information in relation to the financial statements as a whole, the auditor may have additional responsibilities relating to the supplementary information in order to satisfy SEC or other regulatory requirements.

**A-8** AU-C section 725 states that the auditor has no responsibility for the consideration of subsequent events with respect to the supplementary information. However, the auditor should apply the relevant requirements of AU-C section 560, *Subsequent Events and Subsequently Discovered Facts* (AICPA, *Professional Standards*), if information comes to the auditor's attention prior to the release of the auditor's report on the financial statements regarding subsequent events that affect the financial statements or subsequent to the release of the auditor's report on the financial statements regarding facts that may have existed at that date that might have affected the report had the auditor been aware of such facts.

### **Reporting Requirements for Supplementary Information**

**A-9** In accordance with AU-C section 725, when the entity presents the supplementary information with the financial statements, the auditor should report on the schedule in either (a) an explanatory paragraph following the opinion paragraph in the auditor's report on the financial statements or (b) a separate report on the supplementary information.<sup>8</sup> The following elements should be included in the explanatory paragraph or separate report:

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<sup>6</sup> See the discussion in the section "Written Representations," in chapter 5, "Auditing Considerations," of this guide and appendix I, "Representation Letter," of this guide for more information.

<sup>7</sup> See footnote 3 in this appendix.

<sup>8</sup> See appendix C of this guide for illustrative reports that include reporting on supplementary information.

- A statement that the audit was conducted for the purpose of forming an opinion on the financial statements as a whole
- A statement that the supplementary information is presented for purposes of additional analysis and is not a required part of the financial statements
- A statement that the supplementary 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
- A statement that the supplementary information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures in accordance with GAAS, 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
- If the auditor issues an unqualified opinion on the financial statements and the auditor has concluded that the supplementary information is fairly stated in all material respects, in relation to the financial statements as a whole, a statement that, in the auditor's opinion, the supplementary information is fairly stated in all material respects, in relation to the financial statements as a whole
- If the auditor issues a qualified opinion on the financial statements and the qualification has an effect on the supplementary information, a statement that, in the auditor's opinion, except for the effects on the supplementary information of (refer to the paragraph in the auditor's report explaining the qualification), such information is fairly stated in all material respects, in relation to the financial statements as a whole

**A-10** When the audited financial statements are not presented with the supplementary information, the auditor should report on the supplementary information in a separate report. This separate report should include the report elements found in paragraph A-9 and should also include (a) a reference to the report on the financial statements, (b) the date of that report, (c) the nature of the opinion expressed on the financial statements, and (d) any report modifications.

**A-11** In applying paragraph .11 of AU-C section 725, when the auditor's report on the audited financial statements contains an adverse opinion or a disclaimer of opinion, and the auditor has been engaged to report on whether the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, the auditor is precluded from expressing an opinion on the supplementary information. When permitted by law or regulation, the auditor may withdraw from the engagement to report on such supplementary information. If the auditor does not withdraw, the auditor's report on the supplementary information should state that because of the significance of the matter disclosed in the auditor's report, it is inappropriate to, and the auditor does not, express an opinion on the supplementary information. The exhibit, "Illustrative Reporting Examples When the Auditor Is Reporting on Supplementary Information in Relation to the Financial Statements as a Whole," of AU-C section 725 provides a number of reporting examples, including when issuing an adverse or a disclaimer of opinion.

**A-12** Paragraph .12 of AU-C section 725 states that the date of the auditor's report on the supplementary information in relation to the financial statements as a whole should not be earlier than the date on which the auditor completed the procedures required in order to opine on such information. Therefore, the date of the auditor's report on the supplementary information may be the same date of the financial statement report or a later date (in no case would it be earlier).

**A-13** If the auditor concludes, on the basis of the procedures performed, that the supplementary information is materially misstated in relation to the financial statements as a whole, the auditor should discuss the matter with management and propose appropriate revision of the supplementary information. If management does not revise the supplementary information, the auditor should either (a) modify the auditor's opinion on the supplementary information and describe the misstatement in the auditor's report or, (b) if a separate report is being issued on the supplementary information, withhold the auditor's report on the schedule.

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## Chapter 5

# Auditing Considerations

## General Considerations<sup>1,2,3</sup>

**5.01** The primary purpose of a financial statement audit of a broker-dealer is to express an opinion on management's financial statements. AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), notes that as the basis for the auditor's opinion on the financial statements, generally accepted auditing standards (GAAS) require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high, but not absolute, level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Reasonable assurance is not an absolute level of assurance because there are inherent limitations of an audit that result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.

**5.02** Certain supplementary schedules are required to be filed with the financial statements of a broker-dealer when submitting the financial statements to regulators. These supplementary schedules should be presented in the format that presents the relevant details required by applicable Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission<sup>4</sup> regulations and should be in a format that is consistent with those filed as a part of the Financial and Operational Combined Uniform Single report. The

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<sup>1</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) amends the Sarbanes-Oxley Act of 2002 (SOX) to give the Public Company Accounting Oversight Board (PCAOB) full oversight authority over auditors of all broker-dealers, including standard setting, inspection, and enforcement. PCAOB oversight includes a provision that audits of nonissuer broker-dealers are to be conducted in accordance with PCAOB auditing standards. The Securities and Exchange Commission (SEC) has issued transitional guidance in SEC Release No. 34-62991, *Commission Guidance Regarding Auditing, Attestation and Related Professional Practice Standards Related to Brokers and Dealers*, that clarifies that audits of nonissuer broker-dealers will continue to be performed under generally accepted auditing standards (GAAS), as issued by the Auditing Standards Board of the AICPA, and any applicable rules of the SEC. This interpretation will be revisited in connection with current standard-setting projects. Consequently, the content in this guide is based on GAAS until such time that nonissuer broker-dealers are subject to audits performed in accordance with PCAOB auditing standards. See the preface of this guide for more information on the Dodd-Frank Act, including information related to PCAOB oversight of auditors of broker-dealers. See appendix A, "Proposed Rulemaking," of chapter 3, "Regulatory Considerations," of this guide for information regarding the audit and attest standards proposed by the PCAOB.

<sup>2</sup> As noted in chapter 3 of this guide, both issuer and nonissuer broker-dealers are subject to SEC regulation. Although this guide is generally directed toward nonissuer broker-dealers and their auditors, it does contain some information related to audits of issuer broker-dealers. Such information is located throughout the chapter in the "Considerations for Audits Performed in Accordance With PCAOB Standards" sections. See also footnote 1 in chapter 3 and paragraph 5.01.

<sup>3</sup> The SEC has proposed amendments to Rule 17a-5 in Release No. 34-64676, *Broker-Dealer Reports*, dated June 15, 2011. See appendix A of chapter 3 of this guide for information regarding the status of this revision. Readers should be alert for further developments.

<sup>4</sup> Commodity Futures Trading Commission regulations are applicable to broker-dealers that are dually registered as futures commission merchants.

independent auditor's report is required to cover these schedules, and additional procedures should be performed with the purpose of determining whether the information in the supplementary schedules is fairly stated in all material respects in relation to the basic financial statements as a whole. Exhibit 4-9 in chapter 4, "Financial Statement Presentation and Classification," of this guide provides illustrative examples of the schedules required to be included with the financial statements. See appendix A, "Supplementary Information in Relation to the Financial Statements as a Whole," of chapter 4 of this guide for a discussion of the guidance in AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*). Appendix C, "Auditor's Standard Reports," of this guide provides illustrative reporting for supplementary information.

**5.03** As discussed in the "Regulatory Environment" section of this chapter, the auditor is also required to report on the adequacy of the broker-dealer's internal control in accordance with SEC Rule 17a-5(g)(1) and on its compliance with specific rules addressing financial responsibility and recordkeeping.

*Considerations for Audits Performed in Accordance With Public Company Accounting Oversight Board (PCAOB) Standards*

Auditors of issuer broker-dealers are required to attest to, and report on, management's assessment of the effectiveness of the company's internal control over financial reporting<sup>5</sup> in conjunction with their audit of the company's financial statements (subsequently referred to as an integrated audit).

PCAOB guidance, as found in Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), establishes requirements and provides directions that apply when an auditor is engaged to audit both an issuer's financial statements and management's assessment of the effectiveness of internal control over financial reporting. This guide is not intended to provide guidance to auditors on how to comply with the requirements of Auditing Standard No. 5, although it highlights, as appropriate, additional requirements imposed by that standard.

**5.04** The objective of the auditing section of this guide is to assist the independent auditor in auditing the financial statements of nonissuer broker-dealers in accordance with both AICPA professional standards, referred to as GAAS, and in complying with regulatory requirements discussed in the subsequent paragraphs. The term *audit* generally refers to the audit of financial statements unless it is indicated that the discussion pertains to the integrated audit or audit of internal controls. This section of the guide focuses on topics of particular relevance to an audit of a broker-dealer. Specifically, this section provides guidance on the risk assessment process (which includes, among other things, obtaining an understanding of the entity and its environment, including its internal control) and general auditing considerations for broker-dealers.

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<sup>5</sup> A company that is an *accelerated filer* or a *large accelerated filer*, as defined in SEC Rule 12b-2, is required to comply with the SEC rules regarding Section 404(b) of SOX that includes providing an auditor's attestation report on internal control over financial reporting in its annual report. Section 989G of the Dodd-Frank Act contains a provision that permanently exempts nonaccelerated filers, those filers that do not meet the definition of an accelerated filer or a large accelerated filer, from complying with Section 404(b) of SOX. SEC Release 33-9142, *Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-accelerated Filers*, issued in 2010, contains conforming amendments to align its regulations to Section 989G of the Dodd-Frank Act, thereby permanently exempting nonaccelerated filers from the provisions of Section 404(b) of SOX.

Chapter 6, “Internal Control,” of this guide discusses the auditor’s understanding of internal control in the audit of a broker-dealer’s financial statements and provides an overview of the types of control and monitoring activities that are unique to broker-dealers.

## Auditor Registration With the PCAOB

**5.05** Financial statements of broker-dealers, including nonissuer broker-dealers, which are filed with the SEC, must be audited by a PCAOB-registered public accounting firm. The auditor must be registered with the PCAOB as of the date of the auditor’s report. Registration with the PCAOB subjects all registered firms, including those that do not audit issuers, to comply with the PCAOB’s annual and special reporting requirements, including payment of an annual fee. The PCAOB adopted amendments to its funding rules to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) provisions that require the board to assess broker-dealers an appropriate portion of the accounting support fees assessed on both issuers and broker-dealers. For more information, see the “PCAOB Accounting Support Fee Considerations” section of this chapter and chapter 3, “Regulatory Considerations,” of this guide. The amendments include a provision that the registered public accountant should not sign an unqualified opinion with respect to a broker-dealer’s financial statements unless the accountant has ascertained that the broker-dealer has no outstanding past due share of the accounting support fee. See PCAOB Rule 7104, *Collection of Accounting Support Fees*, for more information on this and related requirements.

**5.06** PCAOB registration does not change the auditor requirements outlined in SEC Rule 17a-5(g) that require audits of nonissuer broker-dealers be performed in accordance with GAAS.<sup>6</sup> See paragraph 5.01.

**5.07** At this time, auditors of nonissuer broker-dealers are required to register with the PCAOB, but are not subject to the PCAOB’s independence rules.<sup>7</sup> Auditors of nonissuer broker-dealers and investment advisers are, however, subject to most SEC independence requirements, including restrictions on financial and employment relationships, contingent fees, and nonaudit services. Accordingly, such auditors should not perform nonaudit services as specified in Rule 2.01 of Regulation S-X, such as bookkeeping services, including maintaining or preparing the client’s accounting records and financial statements. See Rule 2.01(3)(c)(4)(i-x) of SEC Regulation S-X for detailed guidance related to prohibited nonaudit services. Nonissuer broker-dealers and investment advisers, however, are not subject to the SEC’s partner rotation and compensation requirements because such rules only pertain to *audits of issuers* (as defined by the Sarbanes-Oxley Act of 2002 [SOX]).

**5.08** For additional information on SEC independence rules and frequently asked questions on PCAOB registration of auditors of nonissuer broker-dealers, visit [www.sec.gov/info/accountants/independref.shtml](http://www.sec.gov/info/accountants/independref.shtml) and [www.sec.gov/divisions/marketreg/faq-pcaobregbdauditors.htm](http://www.sec.gov/divisions/marketreg/faq-pcaobregbdauditors.htm). See also the PCAOB website at [http://pcaobus.org/Registration/Auditors/Documents/Staff\\_QAs\\_on\\_the\\_Registration\\_of\\_Broker-Dealers.pdf](http://pcaobus.org/Registration/Auditors/Documents/Staff_QAs_on_the_Registration_of_Broker-Dealers.pdf) for a document containing staff questions and answers related to the registration of broker-dealer auditors.

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<sup>6</sup> In February 2012, the PCAOB proposed amendments to its auditing standards to include audits of nonissuer broker-dealers. As of the date of this guide, the comment period was closed, and work on this proposal is ongoing. Readers should be alert for further developments.

<sup>7</sup> See footnote 3.

## Interim Inspection Program for Audits of Broker-Dealers<sup>8</sup>

**5.09** In August 2011, the SEC approved a rule, effective immediately, adopting an interim inspection program related to audits of broker-dealers. Under the interim inspection program, the PCAOB will inspect audit engagements of all types of broker-dealers. One of the objectives of the interim inspection program is to assess the degree of compliance of registered public accounting firms with the applicable regulatory rules and professional standards in connection with the performance of audits, the issuance of audit reports, and other related matters involving audits of broker-dealers. Another objective is to gather information that will assist in determining the scope and elements of a permanent inspection program, including whether and how to differentiate among classes of broker-dealers, whether to exempt any category of public accounting firm, and the establishment of minimum inspection frequency schedules.

**5.10** During the interim program, the PCAOB will provide public reports annually on the progress of the interim program and specific issues identified. In the absence of unusual circumstances, the board will not issue firm-specific inspection reports before inspection work is performed under a permanent program.

**5.11** The first report on the interim inspection program, *Report on the Progress of the Interim Inspection Program Related to Audits of Broker and Dealers* (report), was issued in August 2012. This report provides an overview of the new program and a summary of the audit deficiencies identified in the initial group of inspected audits of broker-dealers. As is consistent with restrictions imposed by SOX, the report did not identify the broker-dealer when observations related to an inspection are described in a report.

**5.12** A review of this report may assist the auditor in identifying specific audit areas that may need additional consideration in the audit of a broker-dealer. See appendix C, “Public Company Accounting Oversight Board Interim Inspection Program Report Issued,” of this chapter for a summary of the deficiencies noted in the inspection report.

**5.13** The August 2012 report notes that the interim inspection program is expected to include inspections of approximately 100 registered public accounting firms covering portions of more than 170 audits by the end of 2013. Inspections under the interim inspection program will continue until rules for a permanent inspection program take effect, currently anticipated to be sometime after 2013.

**5.14** Auditors of nonissuer broker-dealers are subject to peer review requirements as part of AICPA membership, in addition to their inclusion in the PCAOB interim inspection program. Section 22,160, “Supplemental Checklist for Review of Broker-Dealer Audit Engagements,” of the *AICPA Peer Review Program Manual* is to be used as part of the peer review of a firm that audits broker-dealers and may provide useful information for auditors of broker-dealers relative to their firm’s system of quality control. This checklist is to be used in conjunction with the general checklists used in all peer reviews. The checklists are available to members on the AICPA website, [www.aicpa.org](http://www.aicpa.org).

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<sup>8</sup> Visit the PCAOB website at <http://pcaobus.org/Information/Pages/BrokerDealers.aspx> for information on the interim inspection program for auditors of broker-dealers.



## Regulatory Environment<sup>9,10,11</sup>

**5.15** The regulatory environment has a major effect on the audit of a broker-dealer because of the requirements that the auditor report on the adequacy of the broker-dealer's practices and procedures, at its reporting date, relevant to the objectives stated in SEC Rule 17a-5(g)(1) and its compliance with specific rules addressing financial responsibility and recordkeeping. Accordingly, certain tests of controls are required to be performed on the regulatory function, even if the auditor would not otherwise choose to do so as part of the audit of financial statements. See chapter 6 of this guide for more information.

**5.16** The objectives of the annual audit of the financial statements of a broker-dealer are discussed in SEC Rule 17a-5. The rule currently requires that the audit be made in accordance with GAAS<sup>12</sup> and include a review of the accounting system, the internal accounting control, and procedures for safeguarding securities, including appropriate tests for the period since the prior audit date. Rule 17a-5 requires the audit to include all procedures necessary to enable the auditor to express an opinion on the following:

- The statements of financial condition, results of operations, cash flows, changes in stockholders' or partners' or sole proprietor's equity, and changes in liabilities subordinated to claims of general creditors
- The computation of net capital under SEC Rule 15c3-1
- The computation for the determination of reserve requirements for broker-dealers under SEC Rule 15c3-3 (or claim of exemption pursuant to SEC Rule 15c3-3[k])
- Information relating to the possession or control requirements under SEC Rule 15c3-3 (or claim of exemption pursuant to SEC Rule 15c3-3[k])

**5.17** SEC Rule 17a-5 recommends that auditors consider synchronizing the application of auditing procedures and performing tests in certain areas simultaneously, which can provide greater efficiencies. Accordingly, although auditors may exercise their professional judgment in making those decisions, they may be expected to justify a choice not to synchronize certain substantive tests (such as confirming customer balances and open or unsettled transactions with other broker-dealers and transfer agents and substantiating stock record positions by counting securities or through other appropriate means).

**5.18** In planning and performing the audit of financial statements, the auditor should obtain reasonable assurance that any material inadequacies (defined in paragraph 5.21) existing at the audit report date in the following areas would be disclosed:

- The accounting system
- Internal control

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<sup>9</sup> See chapter 3 of this guide for information on amendments to the Investment Advisers Act of 1940 and its effect on a broker-dealer that is also a registered investment adviser.

<sup>10</sup> See footnote 3.

<sup>11</sup> See paragraph 5.02 for information related to supplementary information required to be filed with a broker-dealer's financial statements.

<sup>12</sup> See footnote 1 for information on the applicability of PCAOB auditing standards to audits of nonissuer broker-dealers.

- Procedures for safeguarding securities
- The practices and procedures whose review is specified by SEC Rule 17a-5 (described in the following paragraph)

**5.19** In addition, as specific objectives, the audit of financial statements should include reviews of the practices and procedures followed by the broker-dealer, as applicable, in the following ways:

- Making the periodic computations, pursuant to SEC Rule 17a-3(a)(11), of aggregate indebtedness or aggregate debit items under the alternative method and net capital under SEC Rule 15c3-1 and the reserve required by SEC Rule 15c3-3 (or claim of exemption pursuant to SEC Rule 15c3-3[k])
- Making the quarterly securities examinations, counts, verifications and comparisons, and recording of differences required by SEC Rule 17a-13
- Complying with the requirements for prompt payment for securities under Federal Reserve Regulation T (Regulation T) of the Board of Governors of the Federal Reserve System
- Obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers, as required by SEC Rule 15c3-3 (or claim of exemption pursuant to SEC Rule 15c3-3[k])
- Reviewing the company's records that are required to be maintained pursuant to SEC Rule 15c3-3(d)(4) related to physical possession or control of fully paid and excess margin securities

**5.20** For a broker-dealer that is exempt from Rule 15c3-3, the auditor should ascertain that the conditions of the exemption were being complied with as of the audit report date and that no facts came to the auditor's attention indicating that the exemption had not been complied with during the period since the last audit. See paragraph 3.38 of this guide for auditing considerations when performing an audit of a broker-dealer claiming exemption from SEC Rule 15c3-3.

**5.21** A material inadequacy in the accounting system, internal accounting controls, procedures for safeguarding securities, and practices and procedures referred to in SEC Rule 17a-5(g)(1) that is expected to be reported under these audit objectives includes any condition that has contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to cause any of the following:

- a. Inhibit a broker-dealer from promptly completing securities transactions or promptly discharging its responsibilities to customers, other broker-dealers, or creditors
- b. Result in material financial loss
- c. Result in material misstatements in the broker-dealer's financial statements
- d. Result in violations of the SEC's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in Rule 17a-5(g)(3)

**5.22** In November 2010, the AICPA Stockbrokerage and Investment Banking Expert Panel received a letter from the SEC reminding auditors of the importance of complying with existing requirements in SEC Rule 17a-5 that

apply when conducting the review of the accounting system, the internal accounting control, and procedures for safeguarding securities in connection with the annual audit of a broker-dealer. The letter noted that the requirements found in Rule 17a-5 clearly state that the scope of the audit and review should be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination would be disclosed. The letter also references chapter 3 of this guide that states the audit should include a review of the broker-dealer's practices, procedures, and controls to ensure compliance with the securities possession or control and the cash reserve elements of the Customer Protection Rule and should include those tests the auditor considers necessary to provide reasonable assurance that any material inadequacies existing at the date of the examination would be disclosed. The letter notes that in order to obtain reasonable assurance to support the reporting of material inadequacies to the SEC, the auditor should follow the requirements contained in existing professional standards, including the AICPA's Statements on Standards for Attestation Engagements (SSAEs). (Auditors should continue to use AICPA professional standards until the completion of proposed rulemaking. See footnote 1 for more information.) Finally, the letter notes that both the annual financial statement audit and the compliance examination procedures performed by the auditor are critical compliance elements relative to the SEC's regulatory oversight of broker-dealers and that auditors performing audits of broker-dealers should ensure they do so in a manner that is in conformity with the requirements of the applicable rules and professional standards. The full letter is available on the SEC website at [www.sec.gov/info/accountants/staffletters/aicpa111810.pdf](http://www.sec.gov/info/accountants/staffletters/aicpa111810.pdf).

## Planning and Other Auditing Considerations

**5.23** The purpose of an audit is to provide financial statement users with an opinion by the auditor on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework, which enhances the degree of confidence that intended users, can place in the financial statements. An audit conducted in accordance with GAAS and relevant ethical requirements enables the auditor to form that opinion. This section addresses general planning considerations and other auditing considerations relevant to broker-dealers.

### Terms of Engagement

**5.24** AU-C section 210, *Terms of Engagement* (AICPA, *Professional Standards*), addresses the auditor's responsibilities in agreeing upon the terms of an audit engagement with management and, when appropriate, those charged with governance. This includes establishing that certain preconditions for an audit are present. The agreed-upon terms of the audit engagement should be documented in an audit engagement letter or other suitable form of written agreement and should include certain elements, as noted in paragraph .10 of AU-C section 210. Among the elements to be included are the objective and scope of the audit of the financial statements and the responsibilities of both the auditor and management.

*Considerations for Audits Performed in Accordance With PCAOB Standards*

When performing an integrated audit, the auditor should refer to paragraph .06 of AU section 310, *Appointment of the Independent Auditor* (AICPA, *PCAOB Standards and Related Rules*, Interim

Standards), that includes requirements specific to the integrated audit related to the objective of the audit; the responsibility of the auditor for conducting the audit in accordance with PCAOB standards; and the responsibility of the auditor for communicating certain matters in writing to various parties, including management.

**5.25** The form and content of an engagement letter may vary for each entity. AU-C section 210 identifies specific matters that generally would be included in an engagement letter and other matters an auditor may wish to include. Paragraph .46 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), provides guidance on establishing the terms of the engagement with the client regarding the services to be performed for attest engagements.

## Audit Planning

**5.26** Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. AU-C section 300, *Planning an Audit* (AICPA, *Professional Standards*), establishes requirements and provides guidance on the auditor's responsibility to plan an audit of the financial statements and includes guidance related to preliminary engagement activities, planning activities, determining the extent of involvement of professionals possessing specialized skills, and documentation of planning activities. The engagement partner and other key members of the engagement team should be involved in planning the audit, including planning and participating in the discussion among engagement team members. The nature and extent of planning will vary according to the size and complexity of the entity, the key engagement team members' previous experience with the entity, and changes in circumstances that occur during the audit engagement.

**5.27** The auditor should develop an audit plan that includes a description of the following:

- a. The nature and extent of planned risk assessment procedures, as determined under AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*)
- b. The nature, timing, and extent of planned further audit procedures at the relevant assertion level, as determined under AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*)
- c. Other planned audit procedures that are required to be carried out so that the engagement complies with GAAS

The auditor should update and change the overall audit strategy and audit plan, as necessary, during the course of the audit. Planning is not a discrete phase of an audit but, rather, a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.

### *Considerations for Audits Performed in Accordance With PCAOB Standards*

When performing an integrated audit of financial statements and internal control over financial reporting in accordance with PCAOB standards, the auditor should refer to paragraph 9 of Auditing

Standard No. 5 regarding planning considerations, in addition to the planning considerations discussed in Auditing Standard No. 9, *Audit Planning* (AICPA, PCAOB Standards and Related Rules, Auditing Standards).

## Audit Risk

**5.28** *Audit risk* is defined in AU-C section 200 as the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. To obtain reasonable assurance that the financial statements as a whole are free from material misstatement, the auditor should obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.

**5.29** Audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The risks of material misstatement exist at two levels:

- The overall financial statement level
- The assertion level for classes of transactions, account balances, and disclosures

The discussion that follows focuses on the risk of material misstatement at the assertion level.

**5.30** Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. The risks of material misstatement consist of two components: inherent risk and control risk. These risks are the entity's risk and exist independently of the audit of the financial statements. The two components of the risk of material misstatement are described as follows at the assertion level:

- *Inherent risk* is the susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of related controls. Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion.
- *Control risk* is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the broker-dealer's internal control. That risk is a function of the effectiveness of the design, implementation, and maintenance of internal control by the broker-dealer to address identified risks that threaten the achievement of the entity's

objectives relevant to preparation and fair presentation of the financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control.

**5.31** GAAS does not ordinarily refer to inherent risk and control risk separately but, rather to a combined assessment of the risks of material misstatement. However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as percentages, or in nonquantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

**5.32** As noted in paragraph 5.29, audit risk is a function of the risks of material misstatement and detection risk. *Detection risk* is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

**5.33** Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. The following matters assist to enhance the effectiveness of an audit procedure and of its application and reduce the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results:

- Adequate planning
- Proper assignment of personnel to the engagement team
- The application of professional skepticism (see paragraphs 5.70 and 5.107)
- Supervision and review of the audit work performed

Detection risk can only be reduced, not eliminated, because of the inherent limitations of an audit. Therefore, some detection risk will always exist.

**5.34** In considering audit risk at the overall financial statement level, the auditor should consider risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level (for example, through management override of internal control). Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud. Risks at the financial statement level may derive, in particular, from a deficient control environment (although these risks also may relate to factors such as declining economic conditions). For example, deficiencies such as

management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

**5.35** In the audit of a broker-dealer, the effect of the regulatory environment; changes in that environment; and the expectations of the client, its customers, and regulators on both audit risk and materiality are important considerations. In assessing the risks of material misstatement, certain aspects of the broker-dealer's operations are typically subject to a greater level of audit risk than others. Some areas to consider are the effectiveness of the broker-dealer's internal control, materiality, and inherent risk. See the "Regulatory" section under the "Audit Areas" column of the table in appendix A, "Securities Broker-Dealers' Auditing Considerations," of this chapter.

**5.36** The auditor's judgment about the level of audit risk may affect engagement staffing, the extent of supervision, and the scope of the audit. For example, an aspect of the audit that is judged to be high risk ordinarily requires a corresponding increase in the extent and timeliness of direction and supervision of engagement team members and a more detailed review of their work. Staffing the engagement with auditors having relevant experience and competence in auditing the aspect assessed to have high risk and increasing the nature, timing, and extent of the audit work may also be an appropriate response.

## Materiality in Planning and Performing the Audit

**5.37** As noted in paragraph .07 of AU-C section 200, the concept of materiality is applied by the auditor when both planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and uncorrected misstatements, if any, on the financial statements. In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users that are taken based on the financial statements. Judgments about materiality are made in light of surrounding circumstances, and involve both qualitative and quantitative considerations. These judgments are affected by the auditor's perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or both. Because the auditor's opinion addresses the financial statements as a whole, the auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by fraud or error, that are not material to the financial statements as a whole, are detected.

### *Considerations for Audits Performed in Accordance With PCAOB Standards*

When performing an integrated audit, refer to paragraph 20 of Auditing Standard No. 5 regarding materiality considerations.

**5.38** In accordance with paragraph .10 of AU-C section 320, *Materiality in Planning and Performing an Audit* (AICPA, *Professional Standards*), the auditor should determine materiality for the financial statements as a whole when establishing the overall audit strategy for the audit.<sup>13</sup>

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<sup>13</sup> SEC Staff Accounting Bulletin (SAB) No. 99, *Materiality*, addresses the application of materiality thresholds in the preparation and audit of financial statements filed with the SEC. Among other matters, SAB No. 99 addresses the evaluation of misstatements discovered in the financial reporting and auditing processes. SAB No. 99 does not create new standards or definitions for materiality but reaffirms the concepts of materiality as expressed in the accounting and auditing literature.

**5.39** If, in the specific circumstances of the entity, one or more particular classes of transactions, account balances, or disclosures exist for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users, then, taken on the basis of the financial statements, the auditor also should determine the materiality level or levels to be applied to those particular classes of transactions, account balances, or disclosures. Factors that may indicate the existence of one or more particular classes of transactions, account balances, or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:

- Whether law, regulation, or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items
- The key disclosures with regard to the industry in which the entity operates
- Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements

The auditor should revise materiality based on information obtained during the audit that would have caused the auditor to have determined a different amount initially.

**5.40** Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark are found in paragraph .A5 of AU-C of section 320. Note that the materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in the aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. Although it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature (that is, qualitative considerations), the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue. See the discussion in paragraph 5.41 for information on materiality as it relates to the evaluation of misstatements identified in the audit.

### ***Performance Materiality***

**5.41** Planning the audit solely to detect individual material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and leaves no margin for possible undetected misstatements. The auditor should determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures. *Performance materiality* (which, as defined, is one or more amounts) is set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability



that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance, or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance, or disclosure exceeds the materiality level for that particular class of transactions, account balance, or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. Performance materiality is updated during the performance of risk assessment procedures and is affected by the auditor's understanding of the entity and the nature and extent of misstatements identified in previous audits and, thereby, the auditor's expectations regarding misstatements in the current period.

**5.42** *Tolerable misstatement* is a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set is not exceeded by the actual misstatement in the population.<sup>14</sup> Tolerable misstatement may be the same amount or an amount smaller than performance materiality (for example, when the population from which the sample is selected is smaller than the account balance). Paragraph .A2 of AU-C section 320 clarifies the relationship of performance materiality to tolerable misstatement by stating that *tolerable misstatement* is the application of performance materiality to a particular sampling procedure. See AU-C section 530, *Audit Sampling* (AICPA, *Professional Standards*), for further guidance.

## Audit Documentation

**5.43** *Audit documentation* is the record of audit procedures performed, relevant audit evidence obtained, and conclusions reached. Paragraph .05 of AU-C section 230, *Audit Documentation* (AICPA, *Professional Standards*), states that the objective of the auditor is to prepare documentation that provides a sufficient and appropriate record of the basis for the auditor's report and evidence that the audit was planned and performed in accordance with GAAS and applicable legal and regulatory requirements. Audit documentation

- a. provides the principal support for the representation in the auditor's report that the auditor performed the audit in accordance with GAAS.
- b. provides the principal support for the opinion expressed regarding the financial information or the assertion to the effect that an opinion cannot be expressed.

### *Considerations for Audits Performed in Accordance With PCAOB Standards*

Auditing Standard No. 3, *Audit Documentation* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), establishes general requirements for documentation the auditor should prepare and retain in connection with engagements conducted pursuant to PCAOB standards. *Audit documentation* is the

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<sup>14</sup> The definition of *tolerable misstatement* under GAAS differs from that under PCAOB standards. See the PCAOB discussion regarding tolerable misstatement in Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards).

written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise. Audit documentation facilitates the planning, performance, and supervision of the engagement and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. Among other things, audit documentation includes records of the planning and performance of the work, procedures performed, evidence obtained, and conclusions reached by the auditor.

Audit documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached. Also, the documentation should be appropriately organized to provide a clear link to the significant findings or issues. Examples of audit documentation include memoranda, confirmations, correspondence, schedules, audit plans, and letters of representation. Audit documentation may be in the form of paper, electronic files, or other media.

**5.44** The auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection to the audit, to understand

- the nature, timing, and extent of the audit procedures performed to comply with GAAS and applicable legal and regulatory requirements.
- the results of audit procedures performed, and the audit evidence obtained.
- significant findings or issues arising during the audit, the conclusions reached, and significant professional judgments made in reaching those conclusions.

**5.45** AU-C section 230 provides guidance related to identifying the preparer, reviewer, and timing of audit documentation; documenting specific items tested; documenting departures from relevant presumptively mandatory requirements; revising audit documentation after the date of the auditor's report; and ownership and confidentiality of audit documentation. Documentation requirements for specific audit areas are found in the applicable AU-C sections. Paragraph .A30 of AU-C section 230 lists the main paragraphs in other AU-C sections that contain specific additional documentation requirements. See the relevant AU-C section for more information.

**5.46** Preparing sufficient and appropriate audit documentation on a timely basis throughout the audit helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared at the time such work is performed or shortly thereafter is likely to be more accurate than documentation prepared at a much later time. Auditors should assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis, no later than 60 days following the audit report release date for nonissuer broker-dealers, and no later than 45 days following the audit report release date for issuer broker-dealers (see paragraph 5.49). Certain state laws may require a shorter time frame for assembling the audit documentation and final audit file. Auditors should comply with applicable legal and regulatory requirements.

The retention period should not be shorter than 5 years from the audit report release date.

**5.47** Audit documentation may be recorded on paper or electronically or on other media. QC section 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*), addresses a firm's responsibility to establish procedures designed to maintain the integrity, accessibility, and retrievability of documentation (for example, when original paper documentation is electronically scanned or otherwise copied to another media for inclusion in the audit file). Audit documentation includes, for example, audit plans, analyses, issues memoranda, summaries of significant findings or issues, letters of confirmation and representation, checklists, abstracts or copies of important documents, and correspondence (including e-mail) concerning significant findings or issues. Paragraph .10 of AU-C section 230 notes that for audit procedures related to the inspection of significant contracts or agreements, the auditor should include abstracts or copies of those contacts or agreements in the audit documentation.

**5.48** Interpretation No. 1, "Providing Access to or Copies of Audit Documentation to a Regulator," of AU-C section 230, *Audit Documentation* (AICPA, *Professional Standards*, AU-C sec. 9230 par. .01–.15), provides guidance related to client confidentiality when the auditor provides audit documentation to a regulator. The guidance addresses situations when the auditor is required by law, regulation, or audit contract to provide the audit documentation and when the auditor provides audit documentation to a regulator when not required.

## Dating of the Auditor's Report

**5.49** Paragraph .41 of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), states that the auditor's report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that the audit documentation has been reviewed; that the entity's financial statements, including disclosures, have been prepared; and that management has asserted that they have taken responsibility for the financial statements. The report release date is the date the auditor grants the entity permission to use the auditor's report in connection with the financial statements. In many cases, the report release date will be the date the auditor delivers the audit report to the entity. When there are delays in releasing the report, a fact may become known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to revise the auditor's report. AU-C section 560, *Subsequent Events and Subsequently Discovered Facts* (AICPA, *Professional Standards*), addresses the auditor's responsibilities in such circumstances. See appendix C of this guide for an illustrative auditor's report.

### *Considerations for Audits Performed in Accordance With PCAOB Standards*

Paragraph 89 of Auditing Standard No. 5 provides guidance related to the dating of both the auditor's report on the financial statements and on internal control over financial reporting, as applicable. It states that the audit report should be dated no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion. The guidance further notes that because the auditor cannot audit internal control over financial reporting without also auditing the financial statements, the reports should be dated the same.

## Use of Assertions in Obtaining Audit Evidence

**5.50** Paragraph .A114 of AU-C section 315 lists the assertions used by the auditor to consider the different types of potential misstatements that may occur. In representing that the financial statements are fairly presented in accordance with accounting principles generally accepted in the United States of America, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of information in the financial statements and related disclosures. Assertions used by the auditor fall into the following categories and may take the forms noted in the following table:

### Categories of Assertions

	<i>Description of Assertions</i>		
	<i>Classes of Transactions and Events During the Period</i>	<i>Account Balances at the End of the Period</i>	<i>Presentation and Disclosure</i>
Occurrence/ Existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and equity interests exist.	Disclosed events, transactions, and other matters have occurred.
Rights and Obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	Disclosed events, transactions, and other matters pertain to the entity.
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, liabilities, and equity interests that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.
Accuracy/ Valuation and Allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments are appropriately recorded.	Financial and other information is disclosed fairly and in appropriate amounts.

	<i>Description of Assertions</i>		
	<i>Classes of Transactions and Events During the Period</i>	<i>Account Balances at the End of the Period</i>	<i>Presentation and Disclosure</i>
Cut-off	Transactions and events have been recorded in the correct accounting period.	—	—
Classification and Understandability	Transactions and events have been recorded in the proper accounts.	—	Financial information is appropriately presented and described, and disclosures are clearly expressed.

**5.51** The auditor is required by paragraph .26*b* of AU-C section 315 to use relevant assertions for classes of transactions, account balances, and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor also is required to use relevant assertions in assessing risks by relating the identified risks to what can go wrong at the relevant assertion, taking account of relevant controls that the auditor intends to test, and designing further audit procedures that are responsive to the assessed risks.

**5.52** The auditor may use the assertions described in paragraph 5.50 or may express them differently, provided that all aspects described previously have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances. As another example, there may not be a separate assertion related to cutoff of transactions and events when the occurrence and completeness assertions include appropriate consideration of recording transactions in the correct accounting period.

## Understanding the Entity, Its Environment, and Assessing the Risks of Material Misstatement<sup>15</sup>

**5.53** AU-C section 315 addresses the auditor's responsibility to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

**5.54** Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. The understanding of the entity establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit when, for example

<sup>15</sup> See chapter 6, "Internal Control," of this guide for an in-depth discussion of the auditor's consideration of internal control in the audit of a broker-dealer.

- assessing risks of material misstatement of the financial statements.
- determining materiality.
- considering the appropriateness of the selection and application of accounting policies and the adequacy of financial statement disclosures.
- identifying areas for which special audit consideration may be necessary.
- developing expectations for use when performing analytical procedures.
- responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence.
- evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and management's oral and written representations.

**5.55** Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures and relevant assertions and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.

## Risk Assessment Procedures

**5.56** The auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion levels. It is important to note that risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion.

**5.57** In accordance with paragraph .06 of AU-C section 315, the auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:

- a. Inquiries of management and others within the entity
- b. Analytical procedures (refer to the “Analytical Procedures” section of this chapter for additional guidance)
- c. Observation and inspection

See paragraphs .A3–.A16 of AU-C section 315 for additional guidance on risk assessment procedures.

**5.58** During planning, the auditor should consider the results of the assessment of the risk of material misstatement due to fraud, along with other information gathered in the process of identifying the risks of material misstatements. AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), provides guidance regarding risk assessment procedures and related activities to obtain information that is used to identify the risks of material misstatement due to fraud. See paragraph 5.104 for a discussion related to the consideration of fraud.

## **Discussion Among the Audit Team**

**5.59** The engagement partner and other key engagement team members should discuss the susceptibility of the entity's financial statements to material misstatement and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner should determine which matters are to be communicated to engagement team members not involved in the discussion. This discussion may be held concurrently with the discussion among the engagement team that is required by AU-C section 240 to discuss the susceptibility of the entity's financial statements to fraud.

## **Understanding of the Entity and Its Environment**

**5.60** AU-C section 315 requires auditors to obtain an understanding of the entity and its environment, including its internal control. Professional judgment is exercised in determining the extent of the required understanding of the entity. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures (tests of controls and substantive tests).

**5.61** The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- a. Industry, regulatory, and other external factors, including the applicable financial reporting framework
- b. Nature of the entity, which includes matters that enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements
- c. The entity's selection and application of accounting policies, including the reasons for changes thereto
- d. Objectives and strategies and those related business risks that may result in risks of material misstatement
- e. Measurement and review of the entity's financial performance

Refer to appendix A, "Understanding the Entity and Its Environment," of AU-C section 315 for examples of matters the auditor may consider in obtaining an understanding of the entity and its environment. Refer to chapters 1–3 of this guide for background on the securities industry, including regulatory considerations that may be helpful in developing an understanding of a broker-dealer.

## **Understanding of Internal Control**

**5.62** Paragraph .13 of AU-C section 315 notes that the auditor should obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement and in designing the nature, timing, and extent of further audit procedures. Obtaining an understanding of internal control relevant to the audit, as well as key control

and monitoring activities of a broker-dealer, are further discussed in chapter 6 of this guide.

## Assessing the Risks of Material Misstatement

**5.63** As noted previously, risk assessment procedures allow the auditor to gather the information necessary to obtain an understanding of the entity and its environment, including its internal control. This knowledge provides a basis for identifying and assessing the risks of material misstatement of the financial statements and in designing further audit procedures (such as tests of controls, substantive tests, or both).

**5.64** Paragraph .26 of AU-C section 315 notes that the auditor should identify and assess the risks of material misstatement at both the financial statement level and at the relevant assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures. For this purpose, the auditor should

- a. identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, by considering the classes of transactions, account balances, and disclosures in the financial statements.
- b. assess the identified risks and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions.
- c. relate the identified risks to what can go wrong at the relevant assertion level, taking account of relevant controls that the auditor intends to test.
- d. consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

**5.65** As part of the risk assessment, the auditor should determine whether any of the risks identified are, in the auditor's professional judgment, a significant risk. In exercising this judgment, the auditor should exclude the effects of identified controls related to the risk. Paragraph .29 of AU-C section 315 provides guidance regarding factors to consider in determining which risks are significant risks. If the auditor has determined that a significant risk exists, the auditor should obtain an understanding of the entity's controls, including control activities, relevant to that risk and, based on that understanding, evaluate whether such controls have been suitably designed and implemented to mitigate such risks.

**5.66** Significant risks often relate to significant nonroutine transactions and matters that require significant judgment. *Nonroutine transactions* are transactions that are unusual, either due to size or nature, and that, therefore, occur infrequently. Matters that require significant judgment may include the development of accounting estimates for which a significant measurement uncertainty exists. Routine, noncomplex transactions that are subject to systematic processing are less likely to give rise to significant risks. Refer to AU-C section 330 for information on audit procedures pertaining to significant risks.

**5.67** The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances in which the auditor obtains audit



evidence from performing further audit procedures or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor should revise the assessment and modify the further planned audit procedures accordingly.

## Designing and Performing Further Audit Procedures

**5.68** AU-C section 330 addresses the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with AU-C section 315 and to evaluate the audit evidence obtained in an audit of financial statements. The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement through designing and implementing appropriate responses to those risks.

**5.69** As part of obtaining sufficient appropriate audit evidence the auditor should design and implement overall responses to address the assessed risks of material misstatement at the financial statement level and design and perform further audit procedures whose nature, timing, and extent are based on, and responsive to, the assessed risks of material misstatement at the relevant assertion level. Designing and performing further audit procedures whose nature, timing, and extent are based on, and are responsive to, the assessed risks of material misstatement at the relevant assertion level provides a clear linkage between the auditor's further audit procedures and the risk assessment.

## Overall Responses

**5.70** The auditor's overall responses to address the assessed risks of material misstatement at the financial statement level may include emphasizing to the audit team the need to maintain professional skepticism. *Professional skepticism* is an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence. Overall responses may also include assigning more experienced staff or those with specialized skills or using specialists, providing more supervision, or incorporating additional elements of unpredictability in the selection of further audit procedures to be performed. Additionally, the auditor may make general changes to the nature, timing, or extent of further audit procedures as an overall response (for example, performing substantive procedures at period-end instead of at an interim date or modifying the nature of audit procedures to obtain more persuasive audit evidence).

**5.71** The assessment of the risks of material misstatement at the financial statement level and, thereby, the auditor's overall responses are affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and, thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period-end. Deficiencies in the control environment, however, have the opposite effect.

## Further Audit Procedures

**5.72** Paragraph .A4 of AU-C section 330 states that the auditor's assessment of the identified risks at the relevant assertion level provides a basis for

considering the appropriate audit approach for designing and performing further audit procedures. For example, the auditor may determine that

- a. in addition to the substantive procedures that are required for all relevant assertions, in accordance with paragraph .18 of AU-C section 330, an effective response to the assessed risk of material misstatement for a particular assertion can be achieved only by also performing tests of controls.
- b. performing only substantive procedures is appropriate for particular assertions, and therefore, the auditor excludes the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion or because testing controls would be inefficient, and therefore, the auditor does not intend to rely on the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures.
- c. a combined approach using both tests of controls and substantive procedures is an effective approach.

**5.73** In designing the further audit procedures to be performed, the auditor should consider the reasons for the assessed risk of material misstatement at the relevant assertion level for each class of transactions, account balance, and disclosure, including (a) the likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (the inherent risk) and (b) whether the risk assessment takes account of relevant controls (the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures). The auditor should obtain more persuasive audit evidence the higher the auditor's assessment of risk.

### **Tests of Controls**

**5.74** Paragraph .08 of AU-C section 330 notes that the auditor should design and perform tests of controls to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls if

- a. the auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures), or
- b. substantive procedures alone cannot provide sufficient appropriate audit evidence at the relevant assertion level.

#### *Considerations for Audits Performed in Accordance With PCAOB Standards*

When performing an integrated audit, the auditor also should evaluate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on management's assessment of the company's internal control over financial reporting when concluding on the effectiveness of controls for the purpose of assessing control risk. Consideration of these results may require the auditor to alter the nature,

timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified control deficiencies. (See paragraph B5 of appendix B, "Special Topics," of Auditing Standard No. 5.)

If, during the audit of internal control over financial reporting, the auditor identifies a deficiency, he or she should determine the effect of the deficiency, if any, on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an appropriately low level. (See paragraph B6 of appendix B of Auditing Standard No. 5.)

In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of all substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. (See paragraph B8 of appendix B of Auditing Standard No. 5.)

**5.75** In designing and performing tests of controls, paragraph .09 of AU-C section 330 notes that the auditor should obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control.

**5.76** In designing and performing tests of controls, the auditor should

- perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls.
- determine whether the controls to be tested depend upon other controls (indirect controls) and, if so, whether it is necessary to obtain audit evidence supporting the operating effectiveness of those indirect controls.

**5.77** The auditor should test controls for the particular time or throughout the period for which the auditor intends to rely on those controls in order to provide an appropriate basis for the auditor's intended reliance. See paragraphs .12–.15 of AU-C section 330 for additional considerations related to testing in interim periods, using audit evidence obtained in previous audits, and testing controls over significant risks.

**5.78** When evaluating the operating effectiveness of relevant controls, the auditor should evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the relevant assertion being tested are effective.

**5.79** If deviations from controls upon which the auditor intends to rely are detected, the auditor should make specific inquiries to understand these matters and their potential consequences and should determine whether

- a. the tests of controls that have been performed provide an appropriate basis for reliance on the controls,
- b. additional tests of controls are necessary, or
- c. the potential risks of misstatement need to be addressed using substantive procedures.

### ***Substantive Procedures***

**5.80** Irrespective of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. A *substantive procedure* is an audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise tests of details (classes of transactions, account balances, and disclosures) and substantive analytical procedures.

**5.81** The auditor's substantive procedures should include audit procedures related to the financial statement closing process, such as

- agreeing or reconciling the financial statements with the underlying accounting records.
- examining material journal entries and other adjustments made during the course of preparing the financial statements.

The nature and also the extent of the auditor's examination of journal entries and other adjustments depend on the nature and complexity of the broker-dealer's financial reporting system and the related risks of material misstatement.

**5.82** If the auditor has determined that an assessed risk of material misstatement at the relevant assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures should include tests of details.

**5.83** If substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing

- a. substantive procedures, combined with tests of controls for the intervening period, or
- b. if the auditor determines that it is sufficient, further substantive procedures only

that provide a reasonable basis for extending the audit conclusions from the interim date to the period-end.

### ***Other Considerations***

**5.84** With respect to the extent and timing of auditing procedures, Rule 17a-5 states, in part

The extent and timing of audit procedures are matters for the independent public accountant to determine on the basis of his (or her) review and evaluation of existing internal controls and other audit procedures performed in accordance with GAAS and the audit objectives set forth in paragraph (g) of this section. In determining the extent of testing, consideration shall be given to the materiality of an area and the possible effect on the financial statements and schedules of a material misstatement in a related account. The performance of auditing procedures involves the proper synchronization of their application and thus comprehends the need to consider simultaneous performance of procedures in certain areas such as, for example, securities counts, transfer verification and customer and

broker confirmation in connection with verification of securities positions.

**5.85** Certain auditing procedures (including security counts and related confirmations) may be performed at a date other than the date of the financial statements. AU-C section 330 provides guidance on factors to be considered before applying substantive procedures at an interim period.

*Considerations for Audits Performed in Accordance With PCAOB Standards*

When performing an integrated audit, the auditor should refer to paragraphs 42–61 of Auditing Standard No. 5 that provide directions about the nature, timing, and extent of testing of the design and operating effectiveness of internal control over financial reporting.

In addition, the audit scope for review and testing of procedures relative to net capital, quarterly security counts, and compliance with Regulation T and Rule 15c3-3 should be sufficient to provide reasonable, but not absolute, assurance that any material inadequacies existing at the audit date would be disclosed as prescribed in Rule 17a-5.

**5.86** Regulatory requirements have a major effect on the audit of a broker-dealer because the auditor is required to issue a report on the adequacy of the broker-dealer's internal control in accordance with SEC Rule 17a-5(g)(1) and on its compliance with specific rules addressing financial responsibility and recordkeeping. Accordingly, some tests of controls are normally performed even if the auditor does not rely on internal control for purposes of rendering an opinion on the financial statements.

**5.87** There is not necessarily a one-to-one relationship between audit objectives and audit procedures. Some procedures may relate to more than one objective. Conversely, a combination of procedures may be needed to achieve a single objective. Appendix A of this chapter provides illustrations of audit assertions, audit objectives, and substantive tests or tests of controls. The table in appendix A of this chapter is not intended to be all-inclusive nor to suggest that specific audit objectives apply or that particular substantive procedures must be performed.

**5.88** The table is arranged by broad audit objectives. Such classifications may be useful in the evaluation process, but the classifications are of secondary importance. Some specific objectives may achieve more than one broad objective. A number of the objectives may not be relevant to a particular broker-dealer because of the nature of its operations or the absence of certain types of transactions.

**5.89** Refer to paragraphs 5.173–.216 for specific guidance on the more significant auditing procedures the independent auditor may consider in the audits of broker-dealers.

**5.90** Refer also to paragraphs 3.88–.89 in chapter 3 of this guide for auditor considerations in accordance with SEC Rule 17Ad-22, "Clearing Agency Standards."

## Evaluating the Sufficiency and Appropriateness of Audit Evidence

**5.91** Based on the audit procedures performed and the audit evidence obtained, the auditor should evaluate, before the conclusion of the audit,

whether the assessments of the risks of material misstatement at the relevant assertion level remain appropriate. The auditor should conclude whether sufficient appropriate audit evidence has been obtained. In forming a conclusion, the auditor should consider all relevant audit evidence, regardless of whether it appears to corroborate or contradict the assertions in the financial statements. If the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion, the auditor should attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, a modified opinion on the financial statements may be appropriate.

## Audit Sampling

**5.92** AU-C section 530 provides guidance for designing and selecting the audit sample, performing tests of controls and tests of details, and evaluating the results from both statistical and nonstatistical audit samples. The objective of the auditor, when using audit sampling, is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected. The AICPA Audit Guide *Audit Sampling* presents guidance to assist auditors in applying the provisions of AU-C section 530.

**5.93** As with any audit, sampling can be utilized in a broker-dealer audit for tests of controls or verifying account balances. Some areas in which sampling may be used in a broker-dealer audit include the following:

- *Verification of customer balances.* The auditor may not need to confirm all account balances; thus, sampling would be appropriate.
- *Verification of the stock record.* Sampling may be used in the following ways:
  - To select securities maintained on the client's premises for physical inspection and counting
  - To confirm securities held by various depositories
  - To test clearing organization reconciliations; confirming street-side accounts (such as fails, stock loan, stock borrow, securities purchased under agreements to resell, and securities sold under agreements to repurchase); or reviewing suspense accounts
- *Report on internal control required by Rule 17a-5(g)(1).* Sampling may be used in the following ways:
  - To test the controls over the broker-dealer's process to determine the adequacy of the broker-dealer's practices and procedures relating to performing the net capital and reserve requirement computations, security counts, and compliance with Regulation T
  - To test the controls over the broker-dealer's process to obtain and maintain physical possession or control of required securities during the year
- *Net capital computation.* Sampling may be used to test the accuracy, completeness, and valuation of the broker-dealer's schedule of aged fails to receive and fails to deliver and short security count differences and to test the fair values of firm inventory and the related regulatory "haircuts" in the broker-dealer's net capital computation as of the balance sheet date.

- *Reserve requirement computation.* Sampling may be used to test the accuracy and completeness of the broker-dealer's allocation of securities between the customer and the firm, and to review adjustments made to certain balance sheet accounts that were previously tested by the auditor.
- *Possession or control requirements.* Sampling may be used to test the accuracy and completeness of information regarding violations, if any, of possession or control requirements as of the balance sheet date.

## Evaluating Misstatements<sup>16</sup>

**5.94** Based on the results of audit procedures, the auditor may identify misstatements in the amount, classification, presentation, or disclosure of a reported financial statement item. Guidance regarding the auditor's responsibility to evaluate the effect of identified misstatements on the audit and also the effect of uncorrected misstatements, if any, on the financial statements is found in AU-C section 450, *Evaluation of Misstatements Identified During the Audit* (AICPA, *Professional Standards*). Paragraph .05 of AU-C section 450 states that the auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial. In addition, the auditor should communicate on a timely basis with the appropriate level of management all misstatements accumulated during the audit and should request management to correct those misstatements.

**5.95** To assist the auditor in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and those charged with governance, paragraph .A3 of AU-C section 450 notes that the auditor may find it useful to distinguish between factual misstatements, judgmental misstatements, and projected misstatements, described as follows:

- *Factual misstatements* are misstatements about which there is no doubt.
- *Judgmental misstatements* are differences arising from the judgments of management concerning accounting estimates the auditor considers unreasonable or the selection or application of accounting policies the auditor considers inappropriate.
- *Projected misstatements* are the auditor's best estimate of misstatements in populations. They involve the projection of misstatements identified in audit samples to the entire population from which the samples were drawn. Guidance on the determination of projected misstatements and evaluation of the results is set out in AU-C section 530.

**5.96** The auditor should determine whether the overall audit strategy and audit plan need to be revised if the nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material or if the aggregate of misstatements accumulated during the audit approaches materiality for the financial statements as a whole determined in

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<sup>16</sup> SEC SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, can be found on the SEC website at [www.sec.gov/interp/account.shtml](http://www.sec.gov/interp/account.shtml) for guidance that may assist auditors in evaluating financial statement misstatements.

accordance with paragraph .10 of AU-C section 320. The auditor should communicate on a timely basis with the appropriate level of management all misstatements accumulated during the audit. The auditor should request management to correct those misstatements.

**5.97** If, at the auditor's request, management has examined a class of transactions, account balance, or disclosure and corrected misstatements that were detected, the auditor should perform additional audit procedures to determine whether misstatements remain. If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor should obtain an understanding of management's reasons for not making the corrections and should take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

**5.98** Prior to evaluating the effect of uncorrected misstatements, the auditor should reassess materiality to confirm whether it remains appropriate in the context of the entity's actual financial results. The auditor should then determine whether uncorrected misstatements are material, individually or in the aggregate. In making this determination, the auditor should consider

- a. the size and nature of the misstatements, both in relation to particular classes of transactions, account balances, or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence.
- b. the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances, or disclosures and the financial statements as a whole.

Each individual misstatement is considered to evaluate its effect on the relevant classes of transactions, account balances, or disclosures, including whether the materiality level for that particular class of transactions, account balance, or disclosure, if any, has been exceeded.

## Consideration of Laws and Regulations

**5.99** It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* (AICPA, *Professional Standards*), addresses the auditor's responsibility to consider laws and regulations in an audit of financial statements. This guidance distinguishes the auditor's responsibilities regarding compliance with two categories of laws and regulations:

- The provisions of laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements.
- The provisions of other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements but compliance with which may be fundamental to the operating aspects of the business, fundamental to an entity's ability to continue its business, or necessary for the entity to avoid material penalties. Although the effect of this category of laws and



regulations on financial statement amounts and disclosures is indirect, noncompliance with these laws and regulations may have a material effect on the financial statements.

**5.100** For laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding material amounts and disclosures in the financial statements that are determined by the provisions of those laws and regulations.

**5.101** For the second category of laws and regulations or those determined to have an indirect effect on financial statement amounts and disclosures, the auditor should perform the following audit procedures that may identify instances of noncompliance with other laws and regulations that may have a material effect on the financial statements:

- a. Inquiring of management and, when appropriate, those charged with governance about whether the entity is in compliance with such laws and regulations
- b. Inspecting correspondence, if any, with the relevant licensing or regulatory authorities

**5.102** The auditor is required by AU-C section 250 to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances of identified or suspected noncompliance with laws and regulations to the auditor's attention. Maintaining professional skepticism throughout the audit is particularly important in this context, given the extent of laws and regulations that affect a broker-dealer. See AU-C section 250 for additional information and requirements.

**5.103** Broker-dealers are affected by many laws or regulations, including those related to fair practice, securities trading, underwriting, and customer transactions. Typically, an audit of financial statements in accordance with GAAS does not include audit procedures specifically designed to detect noncompliance with laws and regulations that have an indirect effect on the financial statements. However, because of the regulatory environment of a broker-dealer, it is important to pay particular attention to compliance with laws and regulations in the audit of a broker-dealer. Risk assessment procedures performed during the audit provide a framework for this consideration. Furthermore, audit procedures should be performed regarding specific SEC rules and other requirements that a broker-dealer is subject to because noncompliance with these requirements may have a significant effect on the broker-dealer's operations. See chapter 3 of this guide for information on regulatory considerations when performing an audit of a broker-dealer.

## Consideration of Fraud in a Financial Statement Audit<sup>17</sup>

**5.104** AU-C section 240 is the primary source of authoritative guidance about an auditor's responsibilities regarding the consideration of fraud in a financial statement audit. AU-C section 240 establishes requirements and

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<sup>17</sup> In March 2013, the Anti-Fraud Collaboration, a collaboration of the Center for Audit Quality, Financial Executives International, The Institute of Internal Auditors, and the National Association of Corporate Directors, published "Hollate Manufacturing Case Study," which is a case study about a potential material fraud at a fictitious public company. The goal is to raise awareness of environments in which financial reporting fraud might flourish. The case study and a companion discussion guide provide a roadmap to help audit committees, *(continued)*

provides guidance to auditors in fulfilling their responsibility in obtaining reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud.

*Considerations for Audits Prepared in Accordance With PCAOB Standards*

When performing an integrated audit, the auditor should refer to paragraphs 14–15 of Auditing Standard No. 5 regarding fraud considerations, in addition to the fraud considerations set forth in GAAS.

**5.105** Two types of intentional misstatements are relevant to the auditor's consideration of fraud in a financial statement audit:

- Misstatements arising from fraudulent financial reporting
- Misstatements arising from misappropriation of assets

**5.106** Fraud, whether fraudulent financial reporting or misappropriation of assets, typically involves certain factors, termed fraud risk factors. First, management or other employees have an incentive or are under pressure, which provides a reason to commit fraud. Second, circumstances exist (for example, the absence of controls, ineffective controls, or the ability of management to override controls) that provide a perceived opportunity for a fraud to be perpetrated. Third, those involved are able to rationalize committing a fraudulent act. Note that fraud risk factors may not necessarily indicate the existence of fraud; however, they often are present in circumstances when frauds have occurred.

## The Importance of Exercising Professional Skepticism<sup>18</sup>

**5.107** In accordance with AU-C section 200, the auditor should maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. Maintaining professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance when relevant. Due to the characteristics of fraud, the auditor's professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

## Discussion Among Engagement Personnel Regarding Fraud

**5.108** Members of the audit team should discuss the potential for material misstatement due to fraud in accordance with the requirements of paragraph .15 of AU-C section 240. The discussion among the audit team members about

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*(footnote continued)*

financial executives, and internal and external auditors engage in interactive discussions on what could have been done to mitigate the risk of fraud. The case study is available at [www.theacq.org/Anti-FraudInitiative/Studyguide/CaseStudy.htm](http://www.theacq.org/Anti-FraudInitiative/Studyguide/CaseStudy.htm).

<sup>18</sup> As previously discussed, PCAOB standards are applicable to issuer broker-dealers. In December 2012, the PCAOB issued Staff Audit Practice Alert No. 10, *Maintaining and Applying Professional Skepticism in Audits* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400 par. 10). Practice Alert No. 10 is intended to emphasize the importance of the appropriate use and application of professional skepticism in performing an audit in accordance with PCAOB standards. Practice Alert No. 10 can be found on the PCAOB website at [www.pcaobus.org/Standards/QandA/12-04-2012\\_SAPA\\_10.pdf](http://www.pcaobus.org/Standards/QandA/12-04-2012_SAPA_10.pdf).

the susceptibility of the entity's financial statements to material misstatement due to fraud should include consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud. Other items that should be discussed include the risk of management override of controls and a consideration of circumstances that might be indicative of earning management or manipulation of other financial measures and how that could occur. Communication among the audit team members about the risks of material misstatement due to fraud should continue throughout the audit.

**5.109** AU-C section 240 provides fraud risk factor examples that have been written to apply to most enterprises. Additional discussion and examples of fraud risk factors for broker-dealers in securities, classified based on the three conditions generally present when material misstatements due to fraud occur, are included in appendix B, "Consideration of Fraud in a Financial Statement Audit: Examples and Considerations for Auditors of Broker-Dealers in Securities," of this chapter. It is important to remember that fraud risk factors are only one of several sources of information an auditor considers when identifying and assessing risks of material misstatement due to fraud.

## Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud

**5.110** AU-C section 315 establishes requirements and provides guidance about how the auditor obtains an understanding of the entity and its environment, including its internal control, for the purpose of assessing the risks of material misstatement. As part of this work, the auditor should perform the following procedures to obtain information that is used (as described in paragraphs .17–.24 of AU-C section 240) in identifying the risks of material misstatement due to fraud:

- a. Make inquiries of management and others within the entity regarding their assessment of the risk that the financial statements may be materially misstated due to fraud; how the risks of fraud are identified, addressed, and monitored; and about any communications made to those charged with governance or employees related to fraud. In addition, inquiries of management and others within the entity should be made to determine whether they have knowledge of any actual, suspected, or alleged fraud affecting the entity. (See paragraphs .17–.19 of AU-C section 240.)
- b. Obtain an understanding of how those charged with governance exercise oversight of management's processes and internal controls around the risks of fraud and inquire about their views regarding the risks of fraud and whether they have any knowledge of actual, suspected, or alleged fraud. (See paragraphs .20–.21 of AU-C section 240.)
- c. Evaluate whether any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit indicate risks of material misstatement due to fraud. (See paragraph .22 of AU-C section 240.)

- d. Consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. (See paragraph .23 of AU-C section 240.)
- e. Evaluate whether one or more fraud risk factors are present. Although fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances in which frauds have occurred, and therefore, may indicate risks of material misstatement due to fraud. (See paragraph .24, appendix A, “Examples of Fraud Risk Factors,” and appendix C, “Examples of Circumstances That Indicate the Possibility of Fraud,” of AU-C section 240 and appendix B of this chapter.)

## Identifying Risks That May Result in a Material Misstatement Due to Fraud

**5.111** In accordance with AU-C section 315, the auditor should identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances, and disclosures. The auditor’s risk assessment should be ongoing throughout the audit, following the initial assessment. The auditor should treat the assessed risks of material misstatement due to fraud as significant risks and, accordingly, to the extent not already done so, the auditor should obtain an understanding of the entity’s related controls, including control activities, relevant to such risks, including the evaluation of whether such controls have been suitably designed and implemented to mitigate such fraud risks.

**5.112** Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Paragraph .26 of AU-C section 240 provides that when identifying and assessing the risks of material misstatement due to fraud, the auditor should, based on a presumption that risks of fraud exist in revenue recognition, evaluate which types of revenue, revenue transactions, or assertions give rise to such risks. This includes consideration of those risks as significant risks, as defined in paragraph .28 of AU-C section 315. Paragraph .46 of AU-C section 240 specifies the documentation required when the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud.

**5.113** Even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk (see paragraph .31 of AU-C section 240) apart from any conclusions regarding the existence of more specifically identifiable risks. Procedures should be designed and performed, as described in paragraph .32 of AU-C section 240, to further address the risk of management override of controls. These procedures include examining journal entries and other adjustments for evidence of possible material misstatement due to fraud, reviewing accounting estimates for biases that could result in material misstatement due to fraud, and evaluating the business rationale for significant unusual transactions.

## Responding to the Results of the Assessment

**5.114** Paragraph .26 of AU-C section 315 states that to provide a basis for designing and performing further audit procedures, the auditor should identify and assess the risks of material misstatement at both the financial statement level and at the relevant assertion level for classes of transactions, account balances, and disclosures. This requirement provides a link between the auditor's assessment of risk, including his or her consideration of fraud, and the audit procedures performed in response to those assessed risks.

**5.115** Paragraphs .28–.33 of AU-C section 240 provide requirements and guidance related to an auditor's response to the assessed risks of material misstatement due to fraud. The auditor responds to risks of material misstatement due to fraud in the following ways:

- a. The auditor should determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level.
- b. Audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level should be designed and performed. Examples of auditing procedures that could be performed by auditors of broker-dealers in securities are provided in appendix A of this chapter.
- c. Audit procedures responsive to risks related to management override should be performed as described in paragraph .32 of AU-C section 240. Although the level of risk of management override of controls will vary from entity to entity, the risk is present in all entities.
- d. The auditor should determine whether, in order to respond to the identified risks of management override of controls, the auditor needs to perform other audit procedures in addition to those specified paragraph .32 of AU-C section 240.

## Evaluating Audit Evidence

**5.116** Paragraphs .34–.37 of AU-C section 240 provide requirements and guidance for evaluating audit evidence. The auditor should evaluate, at or near the end of the audit, whether the accumulated results of auditing procedures (including analytical procedures that were performed as substantive tests or when forming an overall conclusion) affect the assessment of the risks of material misstatement due to fraud made earlier in the audit or indicate a previously unrecognized risk of material misstatement due to fraud.

## Responding to Misstatements That May Be the Result of Fraud

**5.117** If the auditor identifies a misstatement, the auditor should evaluate whether such a misstatement is indicative of fraud. If such an indication exists, the auditor should evaluate the implications of the misstatement with regard to other aspects of the audit, particularly the auditor's evaluation of materiality, management and employee integrity, and the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence.

**5.118** If the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is, or may be, the result of fraud

and that management (in particular, senior management) is involved, the auditor should reevaluate the assessment of the risks of material misstatement due to fraud and its resulting effect on the nature, timing, and extent of audit procedures to respond to the assessed risks. The auditor should also consider whether circumstances or conditions indicate possible collusion involving employees, management, or third parties when reconsidering the reliability of evidence previously obtained.

**5.119** If the auditor concludes that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the auditor should evaluate the implications for the audit. If, as a result of identified fraud or suspected fraud, the auditor encounters circumstances that bring into question the auditor's ability to continue performing the audit, the auditor should consider the information found in paragraph .38 of AU-C section 240, which may include withdrawing from the engagement.

## Communicating About Possible Fraud to Management, Those Charged With Governance, and Others

**5.120** When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of the appropriate level of management as soon as practicable. This is true even if the matter might be considered inconsequential. In addition, if the auditor has identified or suspects fraud involving management, employees who have significant roles in internal control, or others, when the fraud results in a material misstatement in the financial statements, the auditor should communicate these matters to those charged with governance on a timely basis.

## Documenting the Auditor's Consideration of Fraud

**5.121** Paragraphs .43–.46 of AU-C section 240 require certain items and events to be documented by the auditor related to the auditor's consideration of fraud. Some of the items and events the auditor should document are as follows:

- Discussion among engagement personnel in planning the audit related to fraud
- Identified risks of material misstatement due to fraud at the financial statement level and the assertion level
- The auditor's response to the assessed risks of material misstatement due to fraud and the results of the audit procedures performed in response to the risks
- Communications about fraud made to management, those charged with governance, and others

If the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is overcome in the circumstances of the engagement, the auditor should include in the audit documentation the reasons for that conclusion.

## Written Representations

**5.122** AU-C section 580, *Written Representations* (AICPA, *Professional Standards*), establishes the requirement that an auditor, performing an audit in accordance with GAAS, obtain written representations from management for

all financial statements and periods covered by the auditor's report. AU-C section 580 provides guidance regarding the representations to be obtained, along with an illustrative management representation letter. In addition to the representations discussed in AU-C section 580, exhibit D, "List of AU-C Sections Containing Requirements for Written Representations," of AU-C section 580 lists other AU-C sections containing subject matter-specific requirements for written representations.

**5.123** The auditor should obtain representations related to management's responsibilities for the financial statements. The auditor should request management to provide a written representation that it has fulfilled its responsibility, as set out in the terms of the audit engagement

- for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.
- for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

In addition, paragraph .11 of AU-C section 580 notes that the auditor should request management to provide written representations that it has provided the auditor with all relevant information and access, as agreed upon in the terms of the audit engagement, and that all transactions have been recorded and are reflected in the financial statements. See AU-C section 580 for more information on representations required to be obtained. Certain other representations related to a broker-dealer's operations are normally obtained. (See appendix I, "Representation Letter," of this guide.)

*Considerations for Audits Performed in Accordance With PCAOB Standards*

When performing an integrated audit, the auditor should refer to paragraphs 75–77 of Auditing Standard No. 5 for additional required written representations to be obtained from management related to the audit of internal control over financial reporting.

**5.124** In August 2002, the SEC adopted the final rule "Certification of Disclosure in Companies' Quarterly and Annual Reports."<sup>19</sup> In response to Section 302(a) of SOX, CEOs and CFOs or persons performing similar functions are now required to certify the financial and other information contained in quarterly and annual reports and make certain disclosures. This certification includes (among other things) the accuracy of the filed report, the design of the issuer's internal accounting controls, and the disclosure to the audit committee of any material weaknesses in those controls.

**5.125** As part of the certification of financial statements required by SOX, the CEO and the CFO of a publicly held broker-dealer are required to disclose to the broker-dealer's audit committee and independent auditors all significant deficiencies in the design or operation of internal controls that could adversely affect the broker-dealer's ability to record, process, summarize, and report financial data and to identify to the auditors any material weaknesses in internal controls. Further, they are to disclose to the audit committee and the auditors any fraud, regardless of whether material, that involves management

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<sup>19</sup> The "Certification of Disclosure in Companies' Quarterly and Annual Reports" rule, as issued by the SEC, is applicable to issuer broker-dealers; nonissuer broker-dealers are not subject to this rule.

or other employees who have a significant role in the broker-dealer's internal controls.

**5.126** Paragraph .15 of AU-C section 580 notes that the auditor should request management to provide written representations that all known actual or possible litigation and claims whose effects should be considered by management when preparing the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable financial reporting framework. AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), provides additional guidance related to this. Paragraph .16 of AU-C section 501 requires the auditor to design and perform audit procedures to identify litigation, claims, and assessments involving the entity that may give rise to a risk of material misstatement and includes related procedures. AU-C section 501 notes that unless the audit procedures required by paragraph .16 of AU-C section 501 indicate that no actual or potential litigation, claims, or assessments that may give rise to a risk of material misstatement exist, the auditor should, in addition to the procedures required by other AU-C sections, seek direct communication with the entity's external legal counsel. The auditor should do so through a letter of inquiry prepared by management and sent by the auditor requesting the entity's external legal counsel to communicate directly with the auditor. See AU-C section 501 for more information.

**5.127** See paragraph 5.22 for information relating to a letter sent by the SEC to the AICPA Stockbrokerage and Investment Banking Expert Panel. The letter notes that in order to obtain reasonable assurance to support the reporting of material inadequacies to the SEC, the auditor should follow the requirements contained in existing professional standards, including the AICPA's SSAEs. As a result, an auditor may consider obtaining representations found in paragraph .68 of AT section 601, *Compliance Attestation* (AICPA, *Professional Standards*), as discussed in the preceding paragraph, in addition to representations obtained as part of the financial statement audit.

**5.128** An auditor may consider obtaining representations found in paragraph .68 of AT section 601 in addition to representations obtained as part of the financial statement audit. AT section 601 provides information on the written representations that should be obtained in an examination engagement or agreed-upon procedures engagement. The representations include

- a. acknowledging the responsible party's responsibility for complying with the specified requirements.
- b. acknowledging the responsible party's responsibility for establishing and maintaining effective internal control over compliance.
- c. stating that the responsible party has performed an evaluation of the entity's compliance with specified requirements or the entity's controls for ensuring compliance and detecting noncompliance with requirements, as applicable.
- d. stating the responsible party's assertion about the entity's compliance with the specified requirements or about the effectiveness of internal control over compliance, as applicable, based on the stated or established criteria.
- e. stating that the responsible party has disclosed to the practitioner all known noncompliance.



- f. stating that the responsible party has made available all documentation related to compliance with the specified requirements.
- g. stating the responsible party's interpretation of any compliance requirements that have varying interpretations.
- h. stating that the responsible party has disclosed any communications from regulatory agencies, internal auditors, and other practitioners concerning possible noncompliance with the specified requirements, including communications received between the end of the period addressed in the written assertion and the date of the practitioner's report.
- i. stating that the responsible party has disclosed any known noncompliance occurring subsequent to the period for which or date as of which the responsible party selects to make its assertion.

## Analytical Procedures

**5.129** *Analytical procedures* are defined in AU-C section 520, *Analytical Procedures* (AICPA, *Professional Standards*), as evaluations of financial information through analysis of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass such investigation, as is necessary, of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. Analytical procedures are used in both the risk assessment process and as substantive procedures in addressing the risks of material misstatement. The AICPA Audit Guide *Analytical Procedures* provides practical guidance to auditors on the effective use of analytical procedures. The audit guide includes a discussion of AU-C section 520, concepts and definitions, a series of questions and answers, an illustrative case study, and an appendix that includes useful financial ratios.

**5.130** AU-C section 315 provides information on the use of analytical procedures as part of risk assessment procedures performed. Paragraph .06 of AU-C section 315 notes that analytical procedures are among the procedures that should be used in the risk assessment process. When used as a risk assessment procedure, analytical procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. They may also enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior audit and also may help identify the existence of unusual transactions or events and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

**5.131** Paragraph .A9 of AU-C section 315 notes that when analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures provide only a broad initial indication about whether a material misstatement may exist. Accordingly, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may

assist the auditor in understanding and evaluating the results of the analytical procedures.

**5.132** AU-C section 520 addresses the use of analytical procedures as substantive procedures and includes information on designing and performing analytical procedures, either alone or in combination with tests of details. The auditor's substantive procedures to address the assessed risk of material misstatement for relevant assertions may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's professional judgment about the expected effectiveness and efficiency of the available audit procedures to reduce the assessed risk of material misstatement to an acceptably low level.

**5.133** Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, components, and individual elements of information. *Scanning* is a type of analytical procedure involving the auditor's exercise of professional judgment to review accounting data to identify significant or unusual items to test. This type of analytical procedure is described further in AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*).

**5.134** The expected effectiveness and efficiency of a substantive analytical procedure in addressing risks of material misstatement depends on, among other things, the nature of the assertion, the plausibility and predictability of the relationship, the availability and reliability of the data used to develop the expectation, and the precision of the expectation. If analytical procedures performed identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor should investigate such differences by

- a. inquiring of management and obtaining appropriate audit evidence relevant to management's responses.
- b. performing other audit procedures as necessary in the circumstances.

**5.135** Paragraph .06 of AU-C section 520 notes that the auditor should design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion about whether the financial statements are consistent with the auditor's understanding of the entity.

**5.136** Analytical procedures may be useful during the engagement to do the following:

- Corroborate the results of substantive tests of details applied to an account or group of related accounts
- Be used instead of substantive tests of details applied to accounts or portions of accounts when a low level of audit assurance would be desired
- Be used instead of substantive tests of details applied to accounts over which controls operate and have been found to be effective or to accounts related to other accounts that have been tested through other substantive procedures

- Highlight the need for, or assist in, the design of specific substantive tests
- Assess the risks of further misstatements in accounts

**5.137** Specifically, auditors of broker-dealers may use the following information in performing analytical procedures:

- Internally prepared budgets
- Prior-period financial information
- Forecasts
- Extrapolations from interim data
- Comparisons with industry statistics, broker-dealer financial information, or statistical data prepared by the Securities Industry and Financial Markets Association or other industry groups
- Comparisons of financial information with relevant nonfinancial information

**5.138** Specific analytical procedures that may be applicable to a broker-dealer include the following:

- Interest income as a percentage of the average balances of resale transactions, customers' margin receivables, and stock borrows (separately computed) to compare with the average earnings yield on resale transactions, customer margin receivables, and stock borrows, respectively
- Interest expense as a percentage of the average balances of repurchase (repo) transactions, customer payables, and stock loans (separately computed) to compare with the yields incurred on repo transactions, customer payables, and stock loans, respectively
- Mutual fund fees by type compared with transaction volume (such as front-end load-fee income compared with the volume of mutual funds sold to customers or redemption fee income compared with the volume of mutual funds redeemed by customers)
- Management fees compared with the amount of funds under management
- Exchange fees, listed commission income, and expenses as compared with the trading volume on exchanges
- Sales credits on over-the-counter (OTC) trades compared with OTC trading volume
- For nonclearing broker-dealers, the level of interest income or interest expense compared with their money balance at the clearing broker-dealer.

## Auditing Accounting Estimates

**5.139** As part of the scope of audit procedures to be performed, it is important to take into consideration that certain areas of a broker-dealer's operations include estimates that may be material in the preparation and presentation of the broker-dealer's financial statements. AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*), defines *accounting estimate* as an approximation of a monetary amount in the absence of a precise

means of measurement. This term is used for an amount measured at fair value when there is estimation uncertainty, as well as for other amounts that require estimation. *Estimation uncertainty* is the susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.

**5.140** Although significant accounting estimates may affect many elements of a broker-dealer's financial statements, they often affect the following:

- Valuation of securities that are not readily marketable or have unobservable inputs, or both, or other investments
- Valuation of derivative contracts, including swaps, options, forwards, futures, and other unsettled transactions and commitments
- Estimates of compensation for deferred 12b-1 fees
- Customer reserves
- Estimates of the useful lives of plant, property, and equipment
- Impairment of assets
- Underwriting costs accrued and capitalized based on a high percentage of recovery
- Employee compensation plans, including share-based compensation
- Valuation of exchange memberships
- Valuation of goodwill
- The estimate of deferred taxes
- Litigation reserves

**5.141** As it relates to accounting estimates, the objective of the auditor is to obtain sufficient appropriate audit evidence about whether, in the context of the applicable financial reporting framework

- accounting estimates, including fair value accounting estimates, in the financial statements, whether recognized or disclosed, are reasonable.
- related disclosures in the financial statements are adequate.

**5.142** When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, the auditor should obtain an understanding of certain elements related to estimates in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates. (See paragraph .08 of AU-C section 540). In identifying and assessing the risks of material misstatement, the auditor should evaluate the degree of estimation uncertainty associated with an accounting estimate. The auditor should determine whether, in the auditor's professional judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks.

**5.143** Based on the assessed risks of material misstatement, the auditor should determine

- a. whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate.

- b. whether the methods for making the accounting estimates are appropriate and have been applied consistently and whether changes from the prior period, if any, in accounting estimates or the method for making them are appropriate in the circumstances.

Professional judgment is required in determining the nature, timing, and extent of the procedures necessary to conclude whether management appropriately applied the requirements of the financial reporting framework, including that the methods used for making the estimates are appropriate.

**5.144** Paragraph .13 of AU-C section 540 states that in responding to the assessed risks of material misstatement, the auditor should undertake one or more of the following, taking into account the nature of the accounting estimate:

- Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.
- Test how management made the accounting estimate and the data on which it is based.
- Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.
- Develop a point estimate or range to evaluate management's point estimate. The auditor's point estimate or range is the amount or range of amounts, respectively, derived from audit evidence for use in evaluating the recorded or disclosed amount(s).

**5.145** The auditor should evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework or misstated. The auditor should consider whether specialized skills or knowledge with regard to one or more aspects of the accounting estimates is required in order to obtain sufficient appropriate audit evidence. AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*), provides guidance when auditors consider the work done by a specialist.

**5.146** As investment strategies increasingly include investing in more complex and higher-risk securities, the values of securities may not be readily available through market quotations. Such securities are often valued at amounts determined by the broker-dealers' management in accordance with Financial Accounting Standards Board *Accounting Standards Codification* 820, *Fair Value Measurement*. Auditing the valuation of such securities is an area that requires a high degree of judgment and scrutiny to determine that the valuation procedures are reasonable, and underlying support is appropriate. There is no single method for determining fair value because fair value depends on the facts and circumstances of each individual case. AU-C section 501 provides additional guidance to auditors related to investments in securities and derivative instruments, including securities when valuations are based on the investee's financial results.

## Alternative Investments

**5.147** The AICPA Audit Guide *Special Considerations in Auditing Financial Instruments* (which replaces the Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*) provides practical guidance on those investments it terms *alternative investments*, which are those investments for which a readily determinable fair value does not exist.

For example, an entity may have an investment in a hedge fund that it reports at fair value but for which a readily determinable fair value does not exist. Further, the hedge fund may own interests in investments in limited partnership interests or other private equity securities for which a readily determinable fair value does not exist. When alternative investments are accounted for at fair value, the valuation assertion generally involves significant judgment by management in the assessment of the estimate of fair value. The more complex or illiquid the investment or lack of sufficient management processes and records over valuation, the greater the risk of misstatement and the more persuasive the audit evidence needed.

**5.148** The higher the assessed risk of material misstatement, the greater the need for the auditor to utilize a combination of the following approaches:

- *Confirm the alternative investment.* If the auditor determines that the nature and extent of auditing procedures should include testing the measurement of the investor entity's investment, simply receiving a confirmation from the alternative investment of its investments in financial instruments, either in aggregate or on a security-by-security basis, does not, in and of itself, constitute sufficient appropriate audit evidence in addressing the valuation assertion. The extent of the additional audit procedures is directly related to the assessed risk of material misstatement of the financial statements.
- *Review and test the investor entity's significant assumptions and the underlying data in its valuation or its analysis of the assumptions and data obtained from the fund manager.* A confirmation on a security-by-security basis may provide support of the data used by investor's management in its valuation process. In drafting a confirmation, the auditor may consider requesting a description of each investment, ownership percentage, or shares owned and estimated fair value. If detailed information is not available, the auditor may look to the other data that management used in its valuation and performs tests on such data. The nature of the tests depends on the types of data used by management and the auditor's assessment of the risk of material misstatement of the financial statements.
- *Reconcile to audited financial statements as of the same date.* If audited financial statements of the alternative investment are available as of the date of the investor entity's year-end, and the alternative investment follows fair value accounting, the audited financial statements and an accompanying auditors' report may provide significant audit evidence regarding the valuation of the investment. However, the investor entity and the fund often have different fiscal year-ends. In lower- or moderate-risk situations, the auditor might be able to perform additional procedures, such as obtaining interim financial information and testing management's tracking analysis.
- *Review transactions at or near the balance sheet date.* Evidence of an actual transaction, such as an investment in, or liquidation of, a portion of its alternative investment as of a date close to the investor entity's fiscal year-end, may provide information for management to support the valuation of the alternative investment. The auditor may consider how often settlements occur and the terms used to determine the value of the settlement. Issues to consider include whether the process used for the settlement is the same process used for financial reporting; whether there are holdbacks or potential true-ups subsequent to the balance sheet date; and the possibility that the

parties to the transactions were not both willing buyers and sellers, such as in a distress sale.

## Communication of Matters Related to Internal Control

**5.149** AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*), establishes requirements and provides guidance on communicating matters related to an entity's internal control over financial reporting identified in an audit of financial statements performed in accordance with GAAS. In particular, AU-C section 265

- defines the terms *deficiency in internal control*, *significant deficiency*, and *material weakness*.
- provides guidance on evaluating the severity of deficiencies in internal control identified in an audit of financial statements.
- requires the auditor to communicate, in writing, to management and those charged with governance on a timely basis significant deficiencies and material weaknesses identified in an audit.

**5.150** A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A *significant deficiency* is a deficiency, or combination of deficiencies, in internal control, that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

**5.151** Deficiencies identified during the audit that, upon evaluation, are considered significant deficiencies or material weaknesses should be communicated in writing on a timely basis to those charged with governance, including those that were remediated during the audit. Paragraph .12 of AU-C section 265 states that the auditor also should communicate to management at an appropriate level of responsibility on a timely basis

- a. in writing, significant deficiencies and material weaknesses the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances.
- b. in writing or orally, other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. If other deficiencies in internal control are communicated orally, the auditor should document the communication.

**5.152** The written communication is best made by the *report release date*, which is the date the auditor grants the entity permission to use the auditor's report in connection with the financial statements, but should be made no later than 60 days following the report release date. Paragraph .14 of AU-C section 265 provides guidance on what should be included in communication. Nothing precludes the auditor from communicating to management and those charged with governance other matters related to an entity's internal control that the

auditor believes may be of potential benefit to the entity. This includes deficiencies identified that are not considered to be significant deficiencies or material weaknesses. The auditor should not issue a written communication stating that no significant deficiencies were identified; however, the communication may state that no deficiencies were identified that are considered to be material weaknesses. See paragraph .15 of AU-C section 265 for information on what should be included in this type of communication. If an entity is required to furnish such auditor communications to a governmental authority, specific reference to such governmental authorities may be made. When this is the case, the auditor's written communication may identify such governmental authorities in the paragraph containing the alert that restricts the use of the auditor's written communication.

*Considerations for Audits Performed in Accordance With PCAOB Standards*

Auditing Standard No. 5 provides guidance on communicating deficiencies in the company's internal control over financial reporting in an audit in accordance with PCAOB standards. It states that the auditor must communicate in writing to both management and the audit committee all material weaknesses identified during the audit. Such written communication should be made prior to the issuance of the auditor's report on internal control over financial reporting. Significant deficiencies identified must also be communicated in writing to the audit committee. The auditor also should communicate to management in writing all deficiencies (those deficiencies that are of a lesser magnitude than material weaknesses) in internal control over financial reporting identified during the audit and should inform the audit committee that such communication has been made. Note that when making this communication, it is not necessary for the auditor to repeat information about such deficiencies that has been included in previously issued written communications, regardless of whether those communications were made by the auditor, internal auditors, or others within the organization. When the auditor concludes that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that conclusion in writing to the board of directors.

## Communication With Those Charged With Governance

**5.153** AU-C section 260, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*), provides that the auditor should communicate with those charged with governance the responsibilities of the auditor regarding the financial statement audit and an overview of the planned scope and timing of the audit. In addition, significant findings from the audit should be communicated. Paragraph .06 of AU-C section 260 defines *those charged with governance* as the person(s) or organization(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the reporting process. AU-C section 260 provides guidance regarding the determination of the appropriate person(s) with whom to communicate. AU-C section 260 is applicable to all broker-dealers being audited under GAAS, regardless of their governance structure or size.

**5.154** When the auditor communicates matters in accordance with AU-C section 260 in writing, the communication is considered a by-product report and



is therefore subject to the requirements of AU-C section 905, *Alert That Restricts the Use of the Auditor's Written Communication* (AICPA, *Professional Standards*). Accordingly, the auditor should indicate in the communication that it is intended solely for the information and use of those charged with governance and, if appropriate, management and is not intended to be and should not be used by anyone other than these specified parties. AU-C section 260 provides additional information on the communication process, timing of communications, and specific examples of what should be communicated. The exhibit "Requirements to Communicate With those Charged With Governance in Other AU-C Sections" of AU-C section 260 lists other AU-C sections with requirements regarding specific items to be communicated to those charged with governance.

*Considerations for Audits Performed in Accordance With PCAOB Standards*

Auditing Standard No. 16, *Communications with Audit Committees* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), seeks to improve auditors' communications with audit committees. Among other audit committee communication requirements, Auditing Standard No. 16 establishes guidance about the timing of communications between the auditor and the audit committee. Paragraph 26 of Auditing Standard No. 16 states:

All audit committee communications required by this standard should be made in a timely manner and prior to the issuance of the auditor's report. The appropriate timing of a particular communication to the audit committee depends on factors such as the significance of the matters to be communicated and corrective or follow-up action needed, unless other timing requirements are specified by PCAOB rules or standards or the securities laws.

Note: An auditor may communicate to only the audit committee chair if done in order to communicate matters in a timely manner during the audit. The auditor, however, should communicate such matters to the audit committee prior to the issuance of the auditor's report.

Auditing Standard No. 16 also amended paragraphs 78–84 of Auditing Standard No. 5, which provide guidance for the communication of internal control deficiencies, significant deficiencies, and material weaknesses, identified during the audit. Specifically, paragraph 80 of Auditing Standard No. 5 requires significant deficiencies to be communicated to the audit committee, in writing, prior to the issuance of the of the auditor's report on internal control over financial reporting. Paragraph 81 of Auditing Standard No. 5 requires the auditor to communicate to management, in writing, all deficiencies in internal control over financial reporting identified during the audit and inform the audit committee when such a communication has been made. The auditor should communicate this information to the audit committee in a timely manner and prior to the issuance of the auditor's report on internal control over financial reporting. When making this communication, it is not necessary to repeat for the auditor to repeat the information about such deficiencies that has been included in previously issued written communications, whether those communications were made by the auditor, internal auditors, or others within the organization.

## Going-Concern Considerations

**5.155** AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), provides guidance to the auditor with respect to evaluating whether there is substantial doubt about the broker-dealer's ability to continue as a going concern. Continuation of a broker-dealer as a going concern is assumed in the absence of significant information to the contrary. Ordinarily, information that significantly contradicts the going-concern assumption relates to the broker-dealer's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, noncompliance with various rules and regulations, externally forced revision of its operations, or similar actions. The ability of a broker-dealer to meet statutory net capital requirements is a major factor to consider in assessing the going-concern assumption.

**5.156** AU-C section 570 states that the auditor should consider whether the results of the procedures performed during the course of the audit identify conditions or events that, when considered in the aggregate, indicate there could be substantial doubt about the broker-dealer's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. The auditor should consider the need to obtain additional information about conditions or events, as well as the appropriate audit evidence to support information that mitigates the auditor's doubt. Examples of procedures that may identify a going concern issue include review of compliance with debt agreements, analytical procedures, confirmation with related or third parties regarding arrangements to provide or maintain financial support, and a review of subsequent events. If, after considering the identified conditions and events in the aggregate, the auditor believes there is substantial doubt about the ability of a broker-dealer to continue as a going concern, he or she should obtain information about management's plans that are intended to mitigate the adverse effects of current conditions and events. See AU-C section 570 for guidance on auditor responsibilities when the auditor concludes there is substantial doubt about the entity's ability to continue as a going concern.

## Considerations When Using a Service Organization

**5.157** A broker-dealer may use outside service organizations (sometimes referred to as service centers) to perform services that are part of the broker-dealer's operations. AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations.

*Considerations for Audits Performed in Accordance With PCAOB Standards*

When performing an integrated audit, the auditor should refer to paragraphs B17–B27 of appendix B of Auditing Standard No. 5 regarding the use of service organizations.

**5.158** Paragraph .03 of AU-C section 402 notes that services provided by a service organization are relevant to the audit of a user entity's financial statements when those services and the controls over them affect the user entity's information system, including related business processes, relevant to

financial reporting. Although most controls at the service organization are likely to relate to financial reporting, other controls also may be relevant to the audit, such as controls over the safeguarding of assets. The nature and extent of work to be performed by the user auditor regarding the services provided by a service organization depend on the nature and significance of those services to the user entity and the relevance of those services to the audit.

**5.159** AU-C section 402 does not apply to services that are limited to processing an entity's transactions that are specifically authorized by the entity, such as the processing of checking account transactions by a bank or processing securities transactions by a broker (that is, when the user entity retains responsibility for authorizing the transactions and maintaining the related accountability). In addition, AU-C section 402 does not apply to the audit of transactions arising from an entity that holds a proprietary financial interest in another entity, such as a partnership, corporation, or joint venture, when the partnership, corporation, or joint venture performs no processing on behalf of the entity.

**5.160** See chapter 6 of this guide for additional information regarding the auditor's consideration of an entity's use of a service organization.

## Consideration of the Work of Internal Auditors

**5.161** In audits of broker-dealers, independent auditors may consider using the work of internal auditors. If the independent auditor will be considering or using the work of, or receiving direct assistance from, the broker-dealer's internal auditors, the provisions of AU-C section 610, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*),<sup>20</sup> provide guidance relating to the independent auditor's consideration of internal auditors' competence and objectivity and in evaluating their work.

**5.162** AU-C section 610 also provides guidance concerning the independent auditor's use of work performed by the internal audit function. Reviewing and testing internal control is often an important responsibility of the internal audit function. Thus, the work of the internal auditors may have an important bearing on the independent auditor's procedures. If the independent auditor intends to consider or use the work of, or receive direct assistance from, the broker-dealer's internal auditors, the independent auditor should follow the guidance in AU-C section 610 in considering the competence and objectivity of the internal auditor and in evaluating their work.

### *Considerations for Audits Performed in Accordance With PCAOB Standards*

When performing an integrated audit, the auditor should refer to paragraphs 16–19 of Auditing Standard No. 5 for a discussion on using the work of others to alter the nature, timing, and extent of the work that otherwise would have been performed to test controls.

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<sup>20</sup> Statement on Auditing Standards No. 122, *Statements on Auditing Standards: Clarification and Recodification* (AICPA, *Professional Standards*), redesignates AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*), as AU-C section 610, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*). The guidance in AU-C section 610 has not yet been clarified. When it is redrafted for clarity, the current guidance in AU-C section 610 (former AU section 322) will be superseded.

**5.163** The broker-dealer's internal auditors or other personnel can also be used to prepare schedules, obtain documentation, and research matters. As objectivity and competence increase, the level of utilization of broker-dealers' personnel may also increase. For certain internal audit procedures that are objective, competent, and well supervised, independent audit procedures may also consist of reviewing and testing internal audit work.

## PCAOB Accounting Support Fee Considerations

**5.164** The PCAOB adopted amendments to its funding rules to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act that require the PCAOB to assess broker-dealers an appropriate portion of the accounting support fees to fund the PCAOB temporary inspection program of broker-dealer audits. See the discussion in chapter 3 for more information. The amendments include a provision that a registered public accountant should not sign an unqualified opinion with respect to an entity's financial statements unless the accountant has ascertained the entity has no outstanding past due share of the accounting support fee.

**5.165** The PCAOB has posted the FAQ *The Issuer Accounting Support Fee and the Funding Process* on its website at <http://pcaobus.org/About/Ops/Pages/SupportFeeFAQ.aspx>. Among the topics discussed are ways an auditor can ascertain that an entity has no outstanding past-due share of the PCAOB accounting support fees. Suggested procedures are to obtain a representation from the entity or, as an alternative, an affirmation from the staff that no past-due share of the accounting support fee is outstanding. Note that the PCAOB posts a list of entities that have no outstanding past-due share of the accounting support fee that can be reviewed to see if the entity is listed. This document, which is scheduled to be updated at least biweekly, states that a registered public accounting firm may take the inclusion of an entity on the list as an indication that the entity has no outstanding past-due share of the accounting support fee for the purpose of item (b) of PCAOB Rule 7104, *Collection of Accounting Support Fees*.

**5.166** Although the inclusion of an entity on the list can be taken as an indication that it has no past-due share of accounting support fees, its absence on the list does not mean it does have past-due accounting support fees. Obtaining a representation or affirmation from the entity that the issuer has no outstanding past-due support fee is sufficient evidence that will allow the auditor to sign an unqualified opinion. See the PCAOB website at <http://pcaobus.org/Pages/default.aspx> for more information on this and related requirements.

## Omnibus and Fully Disclosed Accounts

**5.167** The following paragraphs provide a discussion of certain unique auditing procedures to consider when testing omnibus and fully-disclosed accounts.

### Omnibus Accounts

**5.168** *Carrying or clearing broker.* A broker-dealer may perform clearing functions for other brokers (the initiating or introducing brokers). Such transactions are recorded in accounts designated as omnibus or fully disclosed accounts. Confirmation of material balances in omnibus accounts generally

provides the auditor with the most reliable evidence of the balance. An explanation from the broker-dealer of any differences that exist between the books and confirmation responses and tracing any reconciling items to supporting documentation will assist the auditor in verifying the correct balance. Testing of the clearing broker's segregation, transfer, and cashiering operations and of the controls pertaining to transactions of the initiating broker will assist the auditor in determining that the instructions of the initiating broker were carried out on a timely basis, in compliance with their agreement, and in accordance with the prescribed rules and regulations of applicable regulatory agencies. In addition, the auditor may want to trace selected trades in the omnibus accounts to underlying documentation furnished by the initiating broker and test that the clearing fee is in conformity with the applicable agreement.

**5.169** *Introducing broker.* Confirmation of the balance in the omnibus account by the clearing broker will assist the auditor in verifying that the balance is valid and complete. Investigating any differences between the confirmation response and the client's records to underlying documentation will assist in verifying the reconciling items. The auditor may consider testing the computation of the clearing fee for compliance with the related agreement in addition to considering the introducing broker-dealer's obligations, pursuant to the clearing agreement as to guaranteeing the deficits of its introduced customers.

## Fully Disclosed Accounts

**5.170** *Carrying or clearing broker.* Because the accounts of the introducing broker's customers are maintained on the books of the carrying broker as if they were customers of the carrying broker, the auditing procedures for those accounts are the same as those performed on other customers' accounts. In addition, the auditor may consider testing the fees earned for carrying the other broker's accounts.

**5.171** *Introducing broker.* Tests to determine that the introducing broker is credited with the agreed-on fee for trades generated by its customers, testing of the introducing broker's system to verify that all trades were executed in accordance with its instructions, and tests that the fees received comply with the applicable agreement provides the auditor with audit evidence regarding customer transactions. Such tests would ordinarily include reconciling daily trading activity summaries prepared by the carrying broker with memorandums of the introducing broker. In addition, the auditor may consider testing the computation of the clearing fee for compliance with the related agreement in addition to the introducing broker-dealer's obligations pursuant to the clearing agreement as to guaranteeing the deficits of its introduced customers.

**5.172** When auditing an introducing broker, omnibus, and fully-disclosed accounts, the auditor typically considers both the relationship with, and the financial viability of, the clearing or carrying broker, respectively, and may consider whether, under the guidelines of AU-C section 402, it would be appropriate to request a service auditor's report from the clearing or carrying broker. See the discussion beginning in paragraph 5.157 as well as chapter 6 of this guide.

## Substantive Audit Procedures

**5.173** Certain auditing procedures unique to an audit of a broker-dealer are discussed in the following paragraphs. The table in appendix A of this chapter provides illustrations of audit assertions, audit objectives, and substantive tests. In accordance with paragraph .06 of AU-C section 330, the nature, timing, and extent of these procedures should be based on, and responsive to, the assessed risks of material misstatements at the relevant assertion level. In addition, other auditing procedures need to be performed in the audits of broker-dealers that are not unique to such audits or that do not require special application in them. Such procedures are not discussed in this chapter, and auditors can refer to other sources for those requirements.

### Stock Record

**5.174** The specific audit objective related to the stock record is to determine that positions are in balance (meaning that total long positions equal total short positions). Verifying that a balanced stock record exists is similar to verifying that the trial balance balances. It provides evidence of completeness and acts as a reference tool for audit procedures applied to accounts with securities positions and as additional assurance that general ledger account balances are accurate.

**5.175** The auditor generally tests the stock record to validate that positions are in balance and to test the balancing of selected items. Audit evidence for stock record positions may be obtained by physical inspection, through confirmation, or by a combination of both.

### Securities in Physical Possession

**5.176** The auditor would normally account for securities in physical possession by counting them or observing and testing the broker-dealer's procedures for physical inspection as part of the quarterly security count requirements of SEC Rule 17a-13.

**5.177** If the auditor observes the broker-dealer's security count, items to consider are the following:

- Evaluate whether procedures employed result in a complete and accurate count.
- Review the procedures used and the execution of those procedures.
- Perform test counts, to the extent necessary, and follow-up procedures to clear exceptions.

**5.178** If the securities on hand are tested at interim dates, the auditor may want to be involved in the quarterly count made on the date closest to the date of the financial statements. This involvement could be limited to discussions with the broker-dealer and to a review of the procedures to be followed during the count to determine whether they are consistent with those the auditor has previously reviewed, tested, and determined to be reasonable.

**5.179** Depending on the significance of the security count (considering the volume of securities on hand or the involvement of internal auditors), the auditor may want to be present during portions of the count to be satisfied that those procedures are being followed and that there has been no change from the

procedures tested. If the auditor is not present for any portion of the count, they auditor may perform alternative procedures to test the balance.

**5.180** The auditor typically inquires about the results of the count and determines whether there are any material unresolved differences. If there are such differences, testing may be performed so that the auditor is satisfied, to the extent he or she considers necessary, concerning the reason, nature, and ultimate disposition of the differences and their effect on the financial statements and other regulatory reporting requirements.

## Securities in for Transfer, Exchange, or Redemption

**5.181** A broker-dealer, particularly one that engages in a substantial volume of transactions, may have a separate transfer department or division to handle securities held for transfer.

**5.182** Securities out for transfer may be audited, to the extent the auditor deems necessary, by direct correspondence with the transfer agents or corporate issuers or by physical inspection of the securities when they are returned to the broker-dealer. In determining the procedures to be applied, consideration may be given to the extent to which transfers are being processed through a depository or, if they are being processed by a transfer agent, the length of time that such items have been in transfer. An audit of the securities when they are returned implies it is reasonable to assume that such returns suggest that the securities were held by the transfer agent on the date being tested.

## Securities Serviced at Depositories

**5.183** The auditor should ordinarily consider confirming directly with depositories and clearing organizations security positions serviced on behalf of the broker-dealer as of the date of the security count. A reconciliation prepared by the broker-dealer of positions serviced by these organizations can be tested by comparing it to the statement received directly from the organizations.

**5.184** For the continuous net settlement accounts, there is a direct relationship between the net fair value of the securities to be settled and the money to be settled. Testing can be performed through a review of this relationship, in addition to explanations being provided by the broker-dealer for any differences noted during testing. Because most of the securities serviced by broker-dealers will be located at depositories, the auditor needs to consider internal control in effect at such organizations. The auditor may do so by obtaining the most recent type 1 or type 2 service organization control <sup>21</sup> report, as appropriate, issued by that organization's independent auditors on the organization's internal control. (See paragraph 5.157 as well as chapter 6 of this guide for more information.)

## Securities Failed to Receive and Failed to Deliver, Securities Borrowed and Loaned, Securities Held Under Repos and Reverse Repos, and Securities Held as Collateral for Bank Loans

**5.185** The auditor would normally test the positions of securities failed to receive, failed to deliver, borrowed and loaned, held under repos and reverse

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<sup>21</sup> The report prepared under Statements on Standards for Attestation Engagements No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), is referred to in this guide as a service organization control 1 (SOC 1) report.

repos, and held as bank loan collateral through confirmation with the other party to the transaction. The following factors affect the extent of the confirmation procedures to perform:

- The auditor's judgment concerning internal control
- The size of the accounts
- The types of error or fraud that have occurred in the past

## Securities Held by Branch Office

**5.186** The auditor typically inquires about securities held by branch offices and, if they are material, considers whether to inspect them in coordination with the inspection at the main office. Upon consideration of this information, the auditor can determine whether a review of the broker-dealer's procedures for controlling and accounting for securities at branch offices would be sufficient.

### *Considerations for Audits Performed in Accordance With PCAOB Standards*

When performing an integrated audit, the auditor should refer to paragraphs B10–B16 of appendix B of Auditing Standard No. 5 for considerations when a company has multiple locations or business units.

## Securities Position Differences

**5.187** All differences disclosed through the comparison of counts and confirmations with the records of the broker-dealer normally are examined and resolved by the broker-dealer, with adjustments being reviewed by the auditor to the extent considered necessary.

## Customers' Accounts (Including Partners, Officers, Directors, Employees, and Shareholders)

**5.188** The auditor normally confirms account positions and balances. Sampling techniques may be suitable if there are many accounts. In selecting customers' accounts for confirmation, the auditor needs to consider the value of the security positions in such accounts, as well as the ledger (money) balances; the auditor also typically considers confirming some accounts with zero balances. AU-C section 505, *External Confirmations* (AICPA, *Professional Standards*), provides guidance to the auditor on using confirmations, including electronic confirmations.

**5.189** The broker-dealer might, for its own purposes, request that the auditor extend the confirmation of customers' accounts beyond those necessary for purposes of the audit. In those cases, the auditor can consider the implications on his or her auditing procedures of misstatements discovered in performing the additional confirmations at the request of the client.

**5.190** The auditor can also test customers' accounts for evidence of undermargined, partly secured, or unsecured conditions that may affect the net capital computation under SEC Rule 15c3-1 and the reserve and possession-or-control requirements of SEC Rule 15c3-3, as well as the collectibility of accounts. In performing such a review, it may be helpful to obtain an *equity run*, which is a report that indicates, for each customer's account, the ledger balance



and the fair values of all securities positions in the account. In performing audit procedures in the customer area, review of the broker-dealer's practices and procedures that are established to comply with Regulation T and Rules 15c3-1 and 15c3-3 is normally included.

## Trading and Investment Accounts<sup>22</sup>

**5.191** The auditor will likely want to verify that the trading department position records are in agreement with, or have been reconciled to, the stock record and that accruals on the broker-dealer's inventory positions related to unsettled trades and related profit or loss are recorded. For further details, see the "Trade-Date Versus Settlement-Date Accounting" section of chapter 7, "Accounting Standards," of this guide. In addition, the auditor usually tests the values of such securities, with all pricing sources being indicated in the audit documentation.

**5.192** For securities with no ready market, the auditor does not function as an appraiser and is not expected to substitute his or her judgment for that of the management of the broker-dealer in determining fair value. When auditing the valuation of such securities, the auditor utilizes a variety of approaches to evaluate the reasonableness of the valuations determined by management. This includes developing his or her own valuation model, understanding trading activity, analyzing the trading breadth and depth of the market, and reviewing the information relied on by management to determine whether the procedures followed are reasonable in the circumstances. For further discussion, see the "Auditing Accounting Estimates" section of this chapter.

**5.193** The auditor performs those test calculations he or she deems necessary in the circumstances. As partial substantiation for the valuation of such securities, the auditor may also wish to review purchases or sales made shortly before and after the valuation date being tested. The auditor may also request a valuation from other broker-dealers or consider the use of an independent valuation service. When requesting a valuation from other broker-dealers, the auditor should ascertain the reliability of such broker quotes. This could be achieved by considering the broker-dealer's involvement in the market and understanding market liquidity and trading activity, among other things.

**5.194** Management's valuation procedures of securities that are not readily marketable are designed to approximate the fair value. Those procedures are generally a good-faith estimate by management. If the auditor concludes that the procedures used to estimate value are reasonable, and the documentation is appropriate, the opinion need not be modified. However, if the auditor concludes otherwise, an emphasis of matter paragraph or a modified opinion may be appropriate.

**5.195** AU-C section 540 provides guidance on auditing fair value measurements and disclosures contained in financial statements. AU-C section 501 provides additional guidance for auditors regarding auditing investments in securities and derivative instruments. See the discussion beginning in paragraph 5.139 for more information. In addition, the companion Audit Guide *Special Considerations in Auditing Financial Instruments* (which replaces the

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<sup>22</sup> See the discussion of Financial Accounting Standards Board *Accounting Standards Codification* 820, *Fair Value Measurement*, in chapter 7, "Accounting Standards," of this guide.

Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*) provides practical guidance when auditing financial instruments and includes a number of case studies for particular types of financial instruments.

## Good-Faith Deposits

**5.196** Normally, good-faith deposits accompany bids to purchase new issues of securities. The deposit and related commitment can normally be confirmed at the same time. The broker-dealer may be acting as the manager of a group making a bid for a new issue of securities; in such cases, the other participating members usually deposit proportionate amounts of the required deposit with the managing dealer. The auditor may request that the participants confirm in writing the amount of their deposits.

## Subordinated Accounts and Borrowings

**5.197** The auditor performs tests so that he or she obtains information concerning cash subordination or secured demand note agreements and also determines whether they have been approved by the appropriate regulatory bodies. That may be done through direct confirmation. The auditor can also determine through confirmation the expiration dates of the agreements, the amounts subordinated, any collateral, any limits in relation to those amounts, and the nature of the liability to the subordinating party. In addition, the auditor usually examines whether the broker-dealer is in compliance with any restrictive covenants contained in the subordination agreement. This information is needed to determine the proper carrying value of the accounts and the appropriate treatment under net capital rules.

## Dividends Receivable or Payable

**5.198** Dividends receivable in cash or securities can be analyzed by the auditor and reviewed for age and collectibility, and those that are material in amount may be confirmed, as deemed necessary. The auditor may review the procedures for recording dividends receivable and payable to determine the extent of material unrecorded amounts.

## Unclaimed Dividends, Coupons, and Securities

**5.199** The auditor generally reviews the procedures followed by the broker-dealer for recording material transactions in accounts for unclaimed dividends, coupons, and securities. Detailed accounts maintained for unclaimed items can be compared with control accounts. Charges against unclaimed items can be examined on a selected basis and compared with claims or correspondence, particularly charges against older items. The auditor can perform a review of the broker-dealer's procedures for determining its compliance with state escheat laws. Market action affecting underlying items may give rise to contingent liabilities and net capital charges, and such activity is typically reviewed.

## Exchange Memberships

**5.200** The ownership of exchange memberships can be confirmed through direct correspondence with the exchange. It is not unusual for a broker-dealer to have more than one membership on a particular exchange. The propriety of considering exchange memberships as assets of the broker-dealer is typically

ascertained by referring to partnership agreements or other documents of the broker-dealer. The propriety of the carrying value of the memberships and whether the carrying value has been impaired are factors and may need to be tested. Due to the demutualization of some exchanges, membership may not be aligned with ownership in the exchange. In a demutualization, trading privileges are disaggregated from ownership, and valuation of memberships and other forms of ownership and trading privileges need to be carefully evaluated by the auditor.

## Open Contractual Commitments

**5.201** The auditor may wish to confirm contractual commitments on a test basis. In many cases, the commitments of customers will appear in their accounts and be confirmed when those accounts are confirmed. In other cases, information concerning purchases and sales of securities on a when-issued or when-distributed basis may not appear in the customers' accounts or the stock record but may be maintained instead in a subsidiary record (such as tickets in an open contract file). In such cases, the open contracts may be confirmed in the same manner as are other accounts.

**5.202** Sometimes, if a settlement date (subsequent to the date of the financial statements) has been fixed for an open contract transaction, the broker-dealer will clear the open contract file and enter the transactions on the settlement blotter for the day of settlement. Such transactions are not regular-way transactions and may be confirmed separately.

**5.203** Another type of contract involves the broker-dealer's interest in joint accounts in issued or to-be-issued securities carried by other broker-dealers. In many cases, the interest in those security positions contained within the accounts is not recorded in the general ledger of the noncarrying member of the joint account. In such cases, an adjustment is usually recorded in the trial balance to reflect such accounts in the financial statements. Details of the joint accounts may be confirmed in writing with the carrying broker-dealers to the extent the auditor considers necessary.

**5.204** Broker-dealers that engage in underwriting securities for issuers may incur an open contractual commitment in the event the firm definitively and conclusively agrees or contracts to underwrite an issuer's securities prior to its offering. Typically, this type of commitment occurs immediately prior to the offering. However, broker-dealers may enter into a contract with an issuer that provides a firm commitment to underwrite securities several days or weeks prior to the actual offering. The auditor may wish to look at a broker-dealer's underwriting function to validate the identification and proper recording, including regulatory capital charges, of any underwriting open contractual commitments.

## Private Placements

**5.205** The audit of private placement transactions may include a review with management of agreements between the broker-dealer and entities for which debt or equity securities have been placed. The auditor typically reviews the status of the individual contracts to determine any existing broker-dealer obligations that may require disclosure in the financial statements. In addition, the auditor may want to consider confirming outstanding contractual agreements offsetting customers' commitments to purchase such securities.

## Mutual Funds

**5.206** Procedures for testing mutual fund transactions will differ depending on the amount of activity and the method of accounting for customer purchases and redemptions. Few auditing procedures are necessary in cases in which the broker assists a customer in the purchase or redemption of mutual fund shares in the name of the customer. However, if a broker-dealer acting in a custodial capacity for customers maintains an active account in its name with one or more mutual funds, certain procedures may be considered, including confirming the number of shares held by the mutual funds in the name of the broker-dealer and comparing those quantities with safekeeping records of the broker-dealer. The auditor may consider testing the accrual of 12b-1 fees, as well as the methodology used in deferring and amortizing deferred sales charges, by reviewing the broker-dealer's control over customer-owned mutual fund shares it has sold. Depending on the materiality of open purchases or redemptions, those amounts may also be confirmed.

## Municipal Refunding Bond Underwritings

**5.207** The auditor's objectives in examining municipal refunding bond underwritings generally are similar to those for regular underwritings and open contractual commitments. However, the auditor usually also performs tests to determine whether the broker-dealer has met its commitment to the issuer to purchase U.S. government securities that are to be placed in escrow. Often, U.S. government securities may not be available in the quantities desired or at the same price as anticipated at the time the underwriting agreement was executed. In such cases, the broker-dealer may sustain losses in satisfying its obligation to the issuer. These losses are recorded in the accounts.

## Suspense Accounts

**5.208** The purchase and sales and the operations suspense accounts are typically analyzed by the broker-dealer at the end of the period, and these amounts are then charged to income or expense or reclassified as appropriate to accounts such as inventory, customer, receivable, or payable or to other accounts for financial reporting purposes. The auditor reviews the analysis for propriety of aging and classification and might also test specific items by confirmation with third parties, comparison with underlying records, or other procedures.

## Related Party Transactions

**5.209** Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. For example

- related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.

- information systems may be ineffective at identifying or summarizing transactions and outstanding balances between an entity and its related parties.
- related party transactions may not be conducted under normal market terms and conditions (for example, some related party transactions may be conducted with no exchange of consideration).
- related party transactions may be motivated solely or in large measure to engage in fraudulent financial reporting or conceal misappropriation of assets.

**5.210** Because related parties are not independent of each other, financial reporting frameworks establish specific accounting and disclosure requirements for related party relationships, transactions, and balances to enable users of the financial statements to understand their nature and actual or potential effects on the financial statements. Therefore, in accordance with AU-C section 550, *Related Parties* (AICPA, *Professional Standards*), the auditor has a responsibility to perform audit procedures to identify, assess, and respond to the risks of material misstatement arising from the entity's failure to appropriately account for or disclose related party relationships, transactions, or balances.

## Computation of the Formula for the Determination of the Reserve Requirement, Possession or Control of Securities, and Net Capital

### Reserve Requirement and Possession or Control of Securities

**5.211** SEC Rule 15c3-3 requires every broker-dealer who carries customer accounts to maintain a "Special Reserve Bank Account for the Exclusive Benefit of Customers" with a bank (at all times when deposits are required). That account should be separate from any other bank account of the broker-dealer and should contain deposits in cash and qualified securities in amounts computed in accordance with the formula attached in exhibit A of Rule 15c3-3.

**5.212** SEC Rule 15c3-3 provides a detailed formula for determining the reserve bank account requirement and designates when such computations should be made. The rule also requires a broker-dealer to promptly obtain physical possession or control of all fully paid securities and excess-margin securities carried for the accounts of customers, and it requires the broker-dealer to act within a specified time period when possession or control has not been established.

**5.213** The auditor should gain an understanding of the broker-dealer's procedures and controls required by SEC Rule 15c3-3 and perform those tests considered necessary to be satisfied that the procedures and controls (including the written documentation) provide reasonable assurance that the broker-dealer is in compliance with the rule. If appropriate, the auditor may also want to consider the effect on the supplemental schedules of differences identified as a result of the audit of the basic financial statements. See chapter 4 of this guide.

**5.214** If the broker-dealer is claiming an exemption from SEC Rule 15c3-3, the auditor should obtain audit evidence to provide reasonable assurance that

the broker-dealer is complying with the exemptive provisions in SEC Rule 15c3-3(k). See paragraph 3.38 in chapter 3 for further discussion.

## Net Capital

**5.215** SEC rules require all registered broker-dealers to comply at all times with the net capital requirements and to calculate net capital on a periodic basis to demonstrate compliance. *Net capital* is the broker-dealer's net worth, including allowable subordinated liabilities and other credits adjusted for nonliquid (nonallowable) assets, capital charges for operational items, and possible adverse fluctuations in the value of inventory ("haircuts"). The purpose of the net capital computation is to determine the broker-dealer's net liquid assets (minimum capital base) in the event of adverse business conditions. This minimum capital base is designed to protect customers, creditors, and other broker-dealers.

**5.216** The auditor should test the broker-dealer's procedures and controls covered by SEC Rule 15c3-1 and perform those tests considered necessary to be satisfied that the procedures and controls (including the written documentation) provide reasonable assurance that the broker-dealer is in compliance with the rule. If appropriate, the auditor may also want to consider the effect on the supplemental schedules of differences identified as a result of the audit of the basic financial statements. See chapter 4 of this guide.

5.217

## Appendix A — Securities Broker-Dealers' Auditing Considerations<sup>1</sup>

The following table provides examples of substantive tests and tests of internal control, and the related audit objective and audit assertion(s) that an auditor may consider in the audit of a broker-dealer. This information is for illustrative purposes only. The tests actually performed in each audit engagement are based on an assessment of risk and other factors specific to the entity being audited.

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<sup>1</sup> AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*), provides guidance on auditing fair value measurements and disclosures contained in financial statements. AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), provides additional guidance for auditors regarding auditing investments in securities and derivative instruments. See the discussion beginning in paragraph 5.139 for more information. In addition, a companion Audit Guide *Special Considerations in Auditing Financial Instruments* provides practical guidance when auditing financial instruments and includes a number of case studies for particular types of financial instruments.

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Cash/Drafts Payable	Existence/Completeness	Balances in cash (including segregated funds) and drafts payable accounts are fairly stated.	<ul style="list-style-type: none"> <li>• Confirm balances (including accounts with zero balances).</li> <li>• Confirm compensating balance arrangements.</li> <li>• Test reconciliations.</li> <li>• Obtain subsequent bank statements, and determine that transactions were recorded in the proper period.</li> </ul>
	Completeness	Controls over cash receipts and disbursements are sufficient.	<ul style="list-style-type: none"> <li>• Test compliance with controls, including the following:               <ul style="list-style-type: none"> <li>— Daily cash balancing procedures.</li> <li>— Segregation of duties (for instance, independent reconciliation procedures; authorization; and controls over disbursements, including check and wire transfers).</li> <li>— Periodic independent reconciliation of accounts.</li> </ul> </li> </ul>
	Valuation and Allocation	Reserves are adequate to cover exposure resulting from aged reconciling debit items.	<ul style="list-style-type: none"> <li>• Perform analytical procedures on aged reconciling items.</li> <li>• Understand reserve policy.</li> <li>• Determine that reserves are sufficient relative to exposures related to aged reconciling items.</li> </ul>
	Classification	Cash (including segregated funds) and drafts payable are properly classified in the financial statements.	<ul style="list-style-type: none"> <li>• Determine the appropriateness of financial statement presentation and related disclosures:               <ul style="list-style-type: none"> <li>— Drafts payable and cash accounts are only netted when right of setoff exists.</li> </ul> </li> </ul>



<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
			<ul style="list-style-type: none"> <li>— Cash segregated for regulatory purposes is correctly disclosed.</li> <li>— Marketable securities that are classified as cash equivalents satisfy the requirements for such classifications.</li> </ul>
Completeness	Cash- and drafts-payable balances reflect transactions recorded in the proper period.		<ul style="list-style-type: none"> <li>• Obtain a schedule of deposits made prior to year-end but not recorded until subsequent to year-end. Agree items to year-end bank reconciliation. Items should appear as reconciling items.</li> <li>• For interbank transfers, ascertain that receipts and corresponding disbursements are both entered in cash records in the same period, noting dates of deposits and dates that transfer checks were down.</li> </ul>
Bank Loans	Existence/ Completeness	All bank loans have been identified and fairly stated.	<ul style="list-style-type: none"> <li>• Confirm balances (including accounts with zero balances and collateral pledged).</li> <li>• Confirm letter-of-credit agreements.</li> <li>• Test reconciliations of bank statements to company records.</li> <li>• Obtain subsequent bank statements and determine that loans were recorded in the proper period.</li> </ul>
	Classification	Bank loans are properly classified in financial statements.	<ul style="list-style-type: none"> <li>• Determine the appropriateness of financial statement presentation and related disclosures:</li> </ul>

(continued)

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Customer Receivables and Payables	Completeness/Existence/Completeness	<ul style="list-style-type: none"> <li>• Bank loan balances are recorded in the proper period.</li> <li>• Customer-receivable and customer-payable amounts are fairly stated.</li> </ul>	<ul style="list-style-type: none"> <li>— Bank loan balances are properly classified.</li> <li>— Letters of credit and assets pledged are properly reported.</li> <li>• Obtain and test interbank transfers and subsequent payments.</li> <li>• Confirm selected customer account balances and positions through either positive or negative requests or a combination of both:               <ul style="list-style-type: none"> <li>— With positive confirmations, follow up with second requests for customer accounts not replying.</li> <li>— Follow up on the resolution of exceptions.</li> <li>— Perform alternate procedures when confirmations are not received.</li> </ul> </li> <li>• Perform analytical procedures on balances by account type, such as delivery versus payment/receipt versus payment versus hold/custody accounts and margin versus cash accounts.</li> </ul>
	Completeness/Rights and Obligations	<ul style="list-style-type: none"> <li>• Controls over customer receivables and payables are sufficient.</li> </ul>	<ul style="list-style-type: none"> <li>• Test compliance with controls, including the following:               <ul style="list-style-type: none"> <li>— For openings of new accounts, appropriate customer approvals are obtained (for example, hypothecation loan agreement for margin accounts).</li> </ul> </li> </ul>

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
			<p>— Trading and other activity in customer accounts are adequately monitored to ensure that unauthorized transactions are detected.</p> <p>— Transactions recorded in no-name (invalid) accounts are adequately monitored and resolved on a timely basis.</p> <p>— Procedures for monitoring trades and journal entries at branch offices are in effect.</p> <p>— Controls over changes to the name and address file are adequate.</p> <p>— Hold-all-mail (holdout) statements are supported by valid customer instructions.</p> <p>— Procedures for monitoring and resolving error statements are adequate.</p> <p>— Procedures for abandoned property accounts and compliance with state escheat laws are adequate.</p> <p>— Procedures for monitoring and resolving customer complaints are adequate.</p> <p>— Employee accounts are properly identified, monitored, and reported.</p> <p>— Customer statements are periodically mailed.</p>
	Completeness	Trades are inputted timely and accurately.	<p>• Determine that order-matching procedures are adequate.</p>

(continued)

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Receivables From/ Payables to Broker-Dealers	Valuation and Allocation	Reserves are properly established to adequately reflect exposure from uncollectible receivables (debit balances plus short market value [SMV] is greater than credit balances and long market value [LMV]).	<ul style="list-style-type: none"> <li>• Determine that trade confirmations are sent to customers on a timely basis.</li> <li>• Test selected accounts for as-of-trades.</li> <li>• Analytically determine exposure and reserve amounts for undermargined, partly secured, and unsecured customer accounts.</li> <li>• Obtain reserve policy, and determine compliance.</li> <li>• Determine that reserves are sufficient relative to exposure.</li> </ul>
	Classification	Customer-receivable and customer-payable amounts are properly classified in the financial statements.	<ul style="list-style-type: none"> <li>• Determine the appropriateness of financial statement presentation and related disclosures:               <ul style="list-style-type: none"> <li>— Amounts are appropriately classified.</li> <li>— Customer receivables and customer payables are shown gross as appropriate.</li> <li>— Allowance for doubtful accounts is disclosed.</li> </ul> </li> </ul>
	Completeness	Customer transactions are accurately recorded in the appropriate period.	<ul style="list-style-type: none"> <li>• Understand internal procedures associated with processing customer transactions.</li> <li>• Confirm selected customer account balances and positions.</li> </ul>
	Existence/Completeness	Receivables from, and payables to, broker-dealers are fairly stated.	<ul style="list-style-type: none"> <li>• Confirm selected open fail-to-receive and fail-to-deliver transactions with the counterparties, and resolve all exceptions.</li> </ul>

<i>Audit Areas</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
		<ul style="list-style-type: none"> <li>• Confirm balances in omnibus accounts for clearing and initiating brokers, and resolve all exceptions.</li> <li>• Perform analytical procedures on fail balances by counterparty and product type (equities, corporate bonds, and so forth.)</li> <li>• Vouch documentation supporting the subsequent settlement of open transactions.</li> <li>• Test compliance with controls, including the following:               <ul style="list-style-type: none"> <li>— Comparison and reconciliation procedures with custodian and clearing organizations such as the Depository Trust Company, the National Securities Clearing Corporation, and the Options Clearing Corporation.</li> <li>— Reconciling pending and settled trades.</li> <li>— Resolving uncomparared trades.</li> <li>— Aging of open items</li> <li>— Identifying, monitoring, and reporting exposure items.</li> </ul> </li> <li>• Test reconciliations:               <ul style="list-style-type: none"> <li>— Agree total position and money to stock record and trial balance.</li> <li>— Determine the resolution of reconciling items.</li> </ul> </li> </ul>
Completeness	Controls over the clearance, settlement, balancing, and reconciliation of transactions are sufficient.	
Existence/ Completeness	Reconciliations of subsidiary fail blotters to the general ledger and stock record are prepared completely and accurately and are timely; out of balances are researched and resolved timely.	

*(continued)*

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
	Completeness	Money and securities received/delivered do not differ from recorded amounts.	<ul style="list-style-type: none"> <li>• Test balancing procedures by comparing recorded cash activity and securities movements with banks and depositories with actual activity and movements.</li> </ul>
	Valuation and Allocation	Reserves are properly established to adequately reflect exposure (that is, debit is greater than LMV and SMV is greater than credit).	<ul style="list-style-type: none"> <li>• Test procedures for determining exposure to loss.</li> <li>• Perform analytical procedures on aged items.</li> <li>• Obtain reserve policy, and determine compliance.</li> <li>• Determine that reserves are sufficient relative to exposure.</li> </ul>
	Classification	Receivables from, and payables to, broker-dealers are properly classified in the financial statements.	<ul style="list-style-type: none"> <li>• Determine the appropriateness of financial statement presentation and related disclosures: <ul style="list-style-type: none"> <li>— Amounts are properly classified.</li> <li>— Amounts are appropriately shown gross.</li> </ul> </li> <li>• Determine that trade date adjustments are appropriately recorded.</li> <li>• Vouch subsequent receipts to the counterparty statement on a test basis.</li> </ul>
Securities Borrowed and Loaned	Existence/Completeness	Receivables from, and payables to, broker-dealers are accurately recorded in the appropriate period. Securities loaned and securities borrowed are fairly stated.	<ul style="list-style-type: none"> <li>• Confirm selected open transactions with the counterparty for money and related securities positions, and resolve all exceptions.</li> <li>• Confirm selected noncash borrow/loan (meaning, securities for securities).</li> </ul>

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Completeness		Controls over securities borrowed and loaned are sufficient.	<ul style="list-style-type: none"> <li>• Test compliance with controls, including the following:               <ul style="list-style-type: none"> <li>— Procedures for processing, settling, balancing, and reconciling regular and matched-book securities borrowed/loaned transactions</li> <li>— Comparison procedures with LOANET or other system (see the glossary)</li> <li>— Procedures related to credit review policies</li> </ul> </li> </ul>
Existence/ Completeness		Reconciliations of subsidiary loan/borrow blotters to the general ledger and stock record are prepared completely and accurately and are timely; out of balances are researched and resolved timely.	<ul style="list-style-type: none"> <li>• Test reconciliations:               <ul style="list-style-type: none"> <li>— Agree total position and money to stock record and trial balance.</li> <li>— Review the resolution of out of balances and reconciling items.</li> </ul> </li> </ul>
Completeness		Money and securities received/delivered do not differ from recorded amounts.	<ul style="list-style-type: none"> <li>• Test house balancing procedures. Compare recorded cash activity and securities movements with banks and depositories with actual activity and movements.</li> </ul>
Valuation and Allocation		Collectability and collateralization of receivables and short positions are adequate.	<ul style="list-style-type: none"> <li>• Test the mark-to-market and collection procedures for additional margin requirements. Test procedures for determining exposure to loss.</li> <li>• Determine that noncash collateral received in exchange for securities loaned is properly valued.</li> </ul>

(continued)

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Valuation and Allocation		Reserves are properly established to adequately reflect exposure (that is, debits are greater than LMV, and SMV is greater than credits).	<ul style="list-style-type: none"> <li>• Obtain reserve policy and test compliance.</li> <li>• Determine that reserves are sufficient relative to exposure.</li> </ul>
Classification	Securities loan and securities borrowed are properly classified in the financial statements.		<ul style="list-style-type: none"> <li>• Determine the appropriateness of financial statement presentation and related disclosures:               <ul style="list-style-type: none"> <li>— Securities-loaned and securities-borrowed amounts are appropriately classified.</li> <li>— Amounts are shown gross.</li> </ul> </li> </ul>
Completeness	Securities-borrowed and securities-loaned transactions are recorded in the proper period.		<ul style="list-style-type: none"> <li>• Test listing of securities-borrowed and securities-loaned transactions entered into prior and subsequent to year-end. Determine that transactions are recorded in the proper periods.</li> </ul>
Securities Owned and Securities Sold, Not Yet Purchased	Existence/Completeness	Trade date inventory positions are accurate.	<ul style="list-style-type: none"> <li>• Perform analytical procedures on account balances by product type.</li> <li>• Test internal control to ensure the following:               <ul style="list-style-type: none"> <li>— Trader records are reconciled with the general ledger and stock record.</li> <li>— Branch orders are matched with trader order.</li> <li>— Trading limits and concentration restrictions are properly established and monitored.</li> <li>— Trader activity is adequately monitored by management.</li> </ul> </li> </ul>



<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
			<ul style="list-style-type: none"> <li>— When-issued, forward trades, financial futures, and standby commitments are properly monitored and reported.</li> </ul>
Completeness	Trades are timely and accurately inputted.	Trades are timely and accurately inputted.	<ul style="list-style-type: none"> <li>• Determine that trades are properly time stamped.</li> </ul>
Valuation and Allocation	Trade date inventory is fairly stated at fair value.	Trade date inventory is fairly stated at fair value.	<ul style="list-style-type: none"> <li>• Test select accounts for as of trades.</li> <li>• Test pricing procedures.</li> <li>• Agree prices for selected securities to independent sources with emphasis on positions with manual or override prices. Develop alternative procedures to determine the reasonableness of prices if no independent prices are available; examine recent/subsequent trading activity; or compare prices with similar securities based on maturity, rating, or other criteria.</li> </ul>
Valuation and Allocation	Reserves are properly established to adequately reflect exposure (that is, debits are greater than LMV, and SMV is greater than credits).	Reserves are properly established to adequately reflect exposure (that is, debits are greater than LMV, and SMV is greater than credits).	<ul style="list-style-type: none"> <li>• Recalculate interest and dividend accruals for selected securities in inventory.</li> <li>• Test inventory positions for concentrations in particular securities.</li> <li>• Test aging of inventory.</li> <li>• Understand risk management procedures for monitoring overall exposure, including the use of hedges to reduce exposure to market risk.</li> <li>• Determine that reserves are sufficient relative to exposure.</li> </ul>

**Auditing Considerations**

*(continued)*

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Rights and Obligations	Classification	Joint inventory positions are properly identified.	<ul style="list-style-type: none"> <li>• Confirm selected joint inventory positions, and test related controls.</li> </ul>
		Accruals for inventory positions relating to unsettled trades are properly classified.	<ul style="list-style-type: none"> <li>• Test controls over the generation of trade and date and settlement date inventory positions.</li> </ul>
	Classification	Inventory positions are properly classified in the financial statements.	<ul style="list-style-type: none"> <li>• Test trade date/settlement date adjustment.</li> </ul>
			<ul style="list-style-type: none"> <li>• Determine the appropriateness of financial statement presentation and related disclosures:               <ul style="list-style-type: none"> <li>— Securities inventory positions are properly classified as                   <ul style="list-style-type: none"> <li>• securities on deposit in compliance with regulatory requirements.</li> <li>• securities owned.</li> <li>• securities not readily marketable.</li> <li>• securities sold, not yet purchased.</li> <li>• joint inventory owned by other broker-dealers.</li> </ul> </li> <li>— Determine the appropriateness of financial statement presentation and related disclosures for securities measured at fair value measurement.</li> </ul> </li> </ul>
	Completeness	Securities owned and securities sold, not yet purchased are accurately recorded in the appropriate period.	<ul style="list-style-type: none"> <li>• Test “as of” trades subsequent to year-end to ensure that they are reflected in the proper period.</li> </ul>

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Securities Purchased Under Agreements to Resell and Securities Sold Under Agreements to Repurchase	Existence/Completeness	Repurchase (repo) and reverse repurchase (resale) amounts are fairly stated in financial statements.	<ul style="list-style-type: none"> <li>• Confirm selected open repo and resale transactions with the counterparty based on cash balances and related securities positions, and resolve all exceptions.</li> </ul>
	Existence/Completeness	Controls over securities purchased under agreements to resell and securities sold under agreements to repurchase are sufficient.	<ul style="list-style-type: none"> <li>• Test compliance with controls, including the following:                             <ul style="list-style-type: none"> <li>— Procedures for processing, settling, balancing, and reconciling repo and resale transactions.</li> <li>— Identifying and resolving all out of balances.</li> <li>— Monitoring and reporting aged items.</li> <li>— Procedures related to credit review and collection policies.</li> </ul> </li> </ul>
	Completeness	Money and repo and resale positions do not differ from recorded amounts.	<ul style="list-style-type: none"> <li>• Test house balancing procedures; compare anticipated cash activity and securities movements with banks and depositories to actual activity and movements.</li> </ul>
	Valuation and Allocation	The collateralization of resales is adequate to cover exposure.	<ul style="list-style-type: none"> <li>• Test procedures for the following:                             <ul style="list-style-type: none"> <li>— Appropriateness of the market value of collateral positions.</li> </ul> </li> </ul>

(continued)

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Valuation and Allocation		Reserves are properly established to adequately reflect exposure.	<ul style="list-style-type: none"> <li>— Calculating interest accruals on collateral positions.</li> </ul>
Classification		Matched book repo and resale agreements are separately disclosed on the statement of cash flows.	<ul style="list-style-type: none"> <li>• Obtain reserve policy, and determine compliance.</li> <li>• Determine that reserves are sufficient relative to exposure.</li> <li>• Determine the appropriateness of financial statement presentation and related disclosures:               <ul style="list-style-type: none"> <li>— Repurchase and resale amounts are appropriately classified.</li> <li>— Amounts are netted only if appropriate.</li> <li>— Matched book transactions are properly recorded.</li> <li>— Amounts are properly classified on the statement of cash flows.</li> </ul> </li> </ul>
Completeness		Off balance sheet risks are sufficiently disclosed.	<ul style="list-style-type: none"> <li>• Determine the appropriateness of financial statement presentation and related disclosures.</li> </ul>
Completeness		Securities purchases under agreements to resell and securities sold under agreements to repurchase are recorded in the proper period.	<ul style="list-style-type: none"> <li>• Test procedures and controls over the processing of resale and repo transactions, which will include cash and security movements, segregation procedures, and balancing.</li> <li>• Perform analytical procedures on repo and resale balances and related interest income and expense based on average balances and interest rates.</li> </ul>

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Suspense and Processing Accounts	Existence/Completeness	Suspense and processing amounts are fairly stated.	<ul style="list-style-type: none"> <li>• On a test basis, sample these items, determining if the transaction was recorded in the proper period.</li> <li>• Perform analytical procedures on suspense account positions, money balances, and exposure amounts.</li> <li>• Understand controls for processing the following:               <ul style="list-style-type: none"> <li>— Cash receipts and disbursements and securities movements from cash and box accounts with customer accounts and other general ledger accounts, such as fail and offset accounts.</li> <li>— Transactions in equities, fixed income, mutual funds, and foreign securities.</li> <li>— Conversion of foreign currency balances into U.S. dollars.</li> <li>— Intercompany transactions.</li> <li>— Unidentified and miscellaneous transactions.</li> </ul> </li> </ul>
	Completeness	Controls regarding procedures for researching and resolving items in suspense accounts on a timely basis are sufficient.	<ul style="list-style-type: none"> <li>• Determine the appropriateness of procedures for moving money and securities positions into suspense accounts:               <ul style="list-style-type: none"> <li>— Test the reconciliation of suspense accounts.</li> <li>— Test the resolution of selected suspense items.</li> </ul> </li> </ul>

(continued)

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Valuation and Allocation		Reserves are established to adequately reflect exposure (money and position) based on the nature and aging of individual suspense items.	<ul style="list-style-type: none"> <li>• Understand procedures for monitoring and reporting the aging of suspense items.</li> <li>• Test procedures for identifying and resolving money balances and positions in invalid accounts.</li> </ul>
Classification		Suspense and processing accounts are properly classified in the financial statements.	<ul style="list-style-type: none"> <li>• Monitor the periodic reduction of suspense-related exposure items.</li> <li>• Determine that reserves are sufficient relative to exposure.</li> </ul>
Reorganization Accounts	Existence/Completeness	Reorganizations are properly identified.	<ul style="list-style-type: none"> <li>• Determine the appropriateness of financial statement presentation and related disclosures.</li> <li>• Test the classification of suspense and processing account balances.</li> <li>• Intercompany transactions are properly eliminated for financial statement purposes.</li> <li>• Perform analytical procedures on reorganization-related positions, money, and exposure amounts</li> <li>• Test compliance with internal controls, including the following: <ul style="list-style-type: none"> <li>— Procedures for processing, balancing, and reconciling reorganization account.</li> <li>— Proper notification of customers.</li> </ul> </li> </ul>

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
	Completeness	Reorganization money and positions do not differ from recorded amounts.	<ul style="list-style-type: none"> <li>• Test house balancing procedures; compare anticipated cash activity and securities movements with banks and depositories versus actual activity and movements.</li> </ul>
Valuation		Controls are adequate over the reconciliation of reorganization accounts, including the identification of conversion ratio, and ratio out-of-balance conditions.	<ul style="list-style-type: none"> <li>• Test controls over the reconciliation of reorganization accounts.</li> <li>• Test individual reorganizations for timely notification, proper processing of securities movements, and customer-related receipts/disbursements.</li> <li>• Determine the appropriateness of conversion ratios for selected reorganizations to independent sources.</li> <li>• Confirm selected reorganization transfers, and test the related aging of these items.</li> </ul>
Valuation and Allocation		Reserve amounts are sufficient relative to exposure resulting from suspense-related and aged items.	<ul style="list-style-type: none"> <li>• Calculate exposure, and monitor the reduction of such exposure.</li> <li>• Test the determination of exposure for ratio out-of-balance conditions in reorganization accounts.</li> <li>• Discuss pending litigation relating to missed tender offers with client's counsel.</li> <li>• Determine that reserves are sufficient relative to exposure.</li> </ul>

(continued)

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Deferred Investment Banking Revenues and Expenses/ Good Faith Deposits	Classification Existence/ Completeness/ Cutoff	Reorganization-related amounts are properly classified in the financial statements. Deferred revenues, expenses, and good-faith deposits from investment banking/underwriting deals are recorded in the proper period.	<ul style="list-style-type: none"> <li>• Determine the appropriateness of financial statement presentation and related disclosures.</li> <li>• Perform analytical procedures on deferred debits/credits and good-faith deposit amounts.</li> <li>• Test compliance with controls for the following:               <ul style="list-style-type: none"> <li>— Expensing or recognizing deferred debits (expenses) and credits (revenues) on underwriting deals.</li> <li>— Performing final accountings on underwriting deals.</li> <li>— Communicating significant information relating to pending deals to the accounting department.</li> <li>— Allocating and recording expenses to be charged to syndicate members.</li> </ul> </li> <li>• Test selected deals recorded immediately before or after year-end to determine that the proper cutoff has been accomplished.</li> <li>• Confirm selected good-faith deposits, and resolve exceptions.</li> <li>• Test the aging of deferred debits.</li> <li>• Test selected items for propriety.</li> </ul>
Valuation and Allocation	Valuation and Allocation	Deferred debits and credits are properly aged.	



<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Valuation and Allocation		Reserves are properly established relative to exposure.	<ul style="list-style-type: none"> <li>• Obtain reserve policy, and determine compliance.</li> <li>• Determine the adequacy of reserves.</li> </ul>
Cutoff		Revenues and expenses related to investment banking activity are recorded in the proper period.	<ul style="list-style-type: none"> <li>• Test procedures for performing final accounting on underwriting deals, including revenue and expense allocations and the timeliness of their procedures.</li> </ul>
Dividend and Interest Receivables/Payables	Existence/Completeness	Dividend and interest receivables/payables are fairly stated.	<ul style="list-style-type: none"> <li>• Test procedures for communicating significant information relating to pending deals to the appropriate financial units.</li> <li>• Perform analytical procedures on dividend and interest receivable/payable amounts.</li> </ul>
			<ul style="list-style-type: none"> <li>• Understand the compliance with controls over recording, collecting, and disbursing dividends and interest to firm and customer accounts.</li> <li>• Test the resolutions of selected dividend (stock and cash) and interest receivable and payable amounts by monitoring subsequent collections and payments.</li> <li>• Test procedures for complying with state es-cheat laws.</li> </ul>
	Completeness	Notification of dividends are properly detected, and only authorized transactions are recorded.	<ul style="list-style-type: none"> <li>• Test controls related to                             <ul style="list-style-type: none"> <li>— accurately recording dividend and interest accruals on record date and payments on pay date.</li> </ul> </li> </ul>

(continued)

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Valuation and Allocation	Cash and stock dividend and interest receivables are properly aged, and reserves that adequately reflect exposure are established.	<ul style="list-style-type: none"> <li>• — identifying and recording unannounced dividends received.</li> <li>• Test selected items for propriety to ensure that only authorized dividend and interest transactions are processed (that is, exclude customers who will receive payments directly from the paying agent).</li> <li>• Perform analytical procedures on aged items.</li> <li>• Test procedures for aging dividends and interest items and determining collectibility.</li> <li>• Determine that reserves are sufficient relative to exposure.</li> <li>• Determine the appropriateness of financial statement presentation and related disclosures:               <ul style="list-style-type: none"> <li>— Dividend and interest amounts are properly classified.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Test procedures for recording dividends and interest receivables and payables.</li> <li>• Test that the amounts recorded for dividends and interest are recorded in the proper period by recalculating stock dividends and bond interest on test basis and agreeing those amounts to the general ledger.</li> </ul>
Cutoff	Dividends and interest receivables and payables are recorded in the proper period.	<ul style="list-style-type: none"> <li>• Test procedures for recording dividends and interest receivables and payables.</li> <li>• Test that the amounts recorded for dividends and interest are recorded in the proper period by recalculating stock dividends and bond interest on test basis and agreeing those amounts to the general ledger.</li> </ul>	<ul style="list-style-type: none"> <li>• Test procedures for recording dividends and interest receivables and payables.</li> <li>• Test that the amounts recorded for dividends and interest are recorded in the proper period by recalculating stock dividends and bond interest on test basis and agreeing those amounts to the general ledger.</li> </ul>

<i>Audit Areas</i>	<i>Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Securities Locations: • Physical/Vault • Depositories • Custodians • In Transit	Existence/Completeness	Positions listed on the stock record as physically on hand, at depositories, at custodians, or at transfer agents are accurate.	<ul style="list-style-type: none"> <li>• Test the periodic count of securities on hand, on deposit, and in transit through observation and confirmation.</li> <li>• Confirm selected transfer positions with transfer agents for securities pending transfer of title, exchange, or redemption.</li> <li>• Reconcile positions from stock record to custodian/depository statements.</li> </ul>
Existence/Completeness	Differences discovered as a result of security counts or verifications are recorded and resolved on a timely basis.	Differences discovered as a result of security counts or verifications are recorded and resolved on a timely basis.	<ul style="list-style-type: none"> <li>• Test compliance with controls for the following:                             <ul style="list-style-type: none"> <li>— Balance the stock record</li> <li>— Performing box reconciliations between actual positions and recorded positions</li> </ul> </li> <li>• Resolving security count differences</li> </ul>
Rights and Obligations	Withdrawals of securities from vault or box locations are authorized and valid.	Withdrawals of securities from vault or box locations are authorized and valid.	<ul style="list-style-type: none"> <li>• Test compliance with controls for the following:                             <ul style="list-style-type: none"> <li>— Withdrawal of securities from the vault or box for deliveries by authorized personnel</li> <li>— Segregation of duties between personnel responsible for balancing cash and related securities positions</li> </ul> </li> </ul>
Rights and Obligations	The movement of securities is properly recorded.	The movement of securities is properly recorded.	<ul style="list-style-type: none"> <li>• Test procedures for recording securities movements among branches, custodians, and transfer agents.</li> </ul>

(continued)

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Stock Record	Completeness	Positions listed on the stock record are complete.	<ul style="list-style-type: none"> <li>• Test reconciliations of branch box positions with the recorded positions on the stock record.</li> </ul>
Commission Revenue	Occurrence/Completeness/Accuracy	Commission revenue is fairly stated.	<ul style="list-style-type: none"> <li>• Test the stock record to ensure it balances.</li> <li>• Test the arithmetic accuracy of the stock record for select securities.</li> <li>• Perform analytical procedures on commission revenue based on independent variables, such as the following:               <ul style="list-style-type: none"> <li>— Commission rates (full and discounted)</li> <li>— Number of transactions and the average shares per trade</li> <li>— The retail/institutional mix</li> <li>— Industry trends</li> </ul> </li> <li>• Perform detail test of commission amounts for selected trades (test of transactions):               <ul style="list-style-type: none"> <li>— Agree to commission per trade ticket to approved commission rate schedule.</li> <li>— Agree to commission from ticket to daily summary.</li> <li>— Agree total per summary to appropriate general ledger account.</li> </ul> </li> </ul>
	Cutoff	Commission revenue is recorded in the proper period.	<ul style="list-style-type: none"> <li>• Perform analytical procedures, and analyze unusual variations:               <ul style="list-style-type: none"> <li>— Quarter to quarter</li> <li>— Year to year</li> </ul> </li> </ul>

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Principal Transaction Revenue	Classification Occurrence/ Completeness/ Accuracy	Commission revenue is properly classified in the financial statements. Principal transaction revenue earned from firm trading is fairly stated.	<ul style="list-style-type: none"> <li>• Beginning with source documentation, recalculate the commission revenue on a sample basis, and agree the amounts to those recorded in the general ledger.</li> </ul> <p>Determine the appropriateness of financial statement presentation and related disclosures.</p> <ul style="list-style-type: none"> <li>• Perform detail test of realized revenue recognized on selected principal transactions:               <ul style="list-style-type: none"> <li>— Agree selected transactions to general ledger and stock record activity.</li> <li>— Determine the opening market value (cost basis) and the transaction price to recalculate the gain or loss on the selected transactions.</li> <li>— Agree the realized gain or loss to the daily summary.</li> </ul> </li> <li>• Perform detail test of unrealized gains and losses by verifying closing prices to independent price sources and recalculating daily profit and loss for selected principal transactions.</li> </ul>
	Cutoff	Principal transaction revenue is recorded in the proper period.	<ul style="list-style-type: none"> <li>• Perform analytical procedures, and analyze unusual variances:               <ul style="list-style-type: none"> <li>— Quarter to quarter</li> <li>— Year to year</li> </ul> </li> </ul>

(continued)

*Examples of Substantive Tests and Tests of Control*

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Control</i>
Interest Revenue/Expense	Classification Occurrence/ Completeness/ Accuracy	Principal transaction revenue is properly classified in the financial statements. Interest revenue/expense on firm positions and customer margin accounts are fairly stated.	<ul style="list-style-type: none"> <li>Beginning with source documentation, recalculate the principal transactions revenue on a sample basis, and agree the amounts to the general ledger.</li> </ul> <p>Determine the appropriateness of financial statement presentation and related disclosures.</p> <ul style="list-style-type: none"> <li>Perform analytical procedures on interest revenue/expense based on the following:               <ul style="list-style-type: none"> <li>Weighted average balances in customer margin, firm inventory, stock borrowed/loaned, and repo/resale accounts</li> <li>Weighted average balances outstanding in commercial paper and bank loans</li> <li>Average interest rates</li> </ul> </li> </ul>
	Cutoff	Interest revenue and expenses are recorded in the proper period.	<ul style="list-style-type: none"> <li>Perform analytical procedures and analyze unusual variances:               <ul style="list-style-type: none"> <li>Quarter to quarter</li> <li>Year to year</li> </ul> </li> <li>For interest revenue, beginning with source documentation, recalculate interest revenue on a sample basis, and agree the amounts to the general ledger.</li> <li>For interest expense, beginning with the general ledger balances, agree the amounts to source documentation and recalculations.</li> </ul>

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Investment Banking Underwriting Revenue	<p>Classification</p> <p>Occurrence/Completeness/Accuracy</p>	<p>Interest revenue and expenses are properly classified in the financial statements.</p> <p>Revenues, expenses, and good-faith deposits from underwriting deals are fairly stated.</p>	<p>Determine the appropriateness of financial statement presentation and related disclosures.</p> <ul style="list-style-type: none"> <li>• Perform analytical procedures on investment banking revenue as it relates to the following:                             <ul style="list-style-type: none"> <li>— Number and average size of transactions</li> <li>— The equity/fixed-income underwriting mix</li> <li>— Industry trends for underwriting fee percentages</li> </ul> </li> <li>• Perform detail test of selected deals, as follows:                             <ul style="list-style-type: none"> <li>— Obtain client files for selected deals.</li> <li>— Agree all pertinent details from prospectus to client files (that is, amount of issue and fees per unit).</li> <li>— Recalculate underwriting fees for the selected deals based on independent documentation.</li> <li>— Agree to appropriate general ledger account, and investigate material variance.</li> </ul> </li> </ul>
	Completeness	Final accounting for managed underwriting deals, including the allocations of expenses, is completed on a timely basis.	<ul style="list-style-type: none"> <li>• Test procedures for performing final accountings on underwriting deals (that is, expense allocations and timeliness).</li> </ul>

(continued)

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Valuation and Allocation	Classification	Reserves are properly established to adequately reflect exposure.	<ul style="list-style-type: none"> <li>• Determine whether reserves are adequate relative to exposure (that is, litigation contingencies).</li> </ul>
Cutoff	Classification	Investment banking revenue and expenses are properly classified in the financial statements.	<ul style="list-style-type: none"> <li>• Determine the appropriateness of financial statement presentation and related disclosures.</li> </ul>
Compensation Expense	Occurrence/Completeness/Accuracy	Investment banking revenue is accurately recorded in the proper period.	<ul style="list-style-type: none"> <li>• Recalculate the recorded revenue amounts, and determine whether the amounts were recorded in the proper period.</li> </ul>
Compensation Expense	Occurrence/Completeness/Accuracy	Compensation expense is fairly stated.	<ul style="list-style-type: none"> <li>• Perform analytical procedures on compensation amounts for salaries and commission employees based on the following:               <ul style="list-style-type: none"> <li>— Number of employees</li> <li>— Average salary increases</li> <li>— Total commission revenue versus commission payouts</li> <li>— Additional incentive compensation plans</li> </ul> </li> </ul>
Classification	Classification	Compensation expense is properly disclosed in the financial statements.	<ul style="list-style-type: none"> <li>• Perform test of compensation expense based on independent records maintained by the personnel department.</li> <li>• Test incentive compensation schedule, and reconcile payroll amounts to the general ledger and financial statements.</li> <li>• Determine the appropriateness of financial statement presentation and related disclosures:</li> </ul>



<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Cutoff	Compensation expenses incurred are recorded in the proper period.	<ul style="list-style-type: none"> <li>• Pension-related amounts are properly disclosed.</li> <li>• Applicable amounts are confirmed with an actuary.</li> </ul>	<ul style="list-style-type: none"> <li>• Test subsequent payroll checks to employees on a sample basis to ensure that the compensation expense related to the payment was recorded in the proper period.</li> </ul>
Other Expenses: • Brokerage and Clearing • Depreciation • Occupancy • Communica- tions • Professional Fees • Advertising • Supplies	Occurrence/ Completeness/ Accuracy	Other expenses are fairly stated.	<ul style="list-style-type: none"> <li>• Perform analytical procedures on expense amounts based on relevant variables and relationships.</li> <li>• Perform test of transactions on selected expense items; agree supporting documentation to recorded amounts.</li> <li>• Recalculated depreciation and amortization amounts.</li> </ul>
Taxes	Cutoff	All other expenses incurred are recorded in the proper period.	<ul style="list-style-type: none"> <li>• Test subsequent payments to determine that expenses paid are recorded in the proper period.</li> </ul>
	Occurrence/ Completeness/ Accuracy	Tax expense is fairly stated.	<ul style="list-style-type: none"> <li>• Test the reconciliation of book income to taxable income.</li> </ul>

(continued)

*Examples of Substantive Tests and Tests of Control*

*Audit Objectives*

*Audit Assertions*

*Audit Areas*

Regulatory	Securities and Exchange Commission (SEC) Rule 15c3-1	Net capital is properly computed and minimum requirements met, in accordance with Rule 15c3-1.	<ul style="list-style-type: none"> <li>• Determine whether documentation supports permanent and temporary tax differences.</li> <li>• Test procedures for compliance with the net capital requirements of Rule 15c3-1.</li> <li>• Perform analytical procedures on the net capital computation, including the following:             <ul style="list-style-type: none"> <li>— Nonallowable assets</li> <li>— Subordinated debt added to capital</li> <li>— “Haircuts” and capital charges deducted</li> </ul> </li> <li>• Test nonallowable (illiquid) assets deducted in the net capital computation as follows:             <ul style="list-style-type: none"> <li>— Other broker-dealer receivables</li> <li>— Loans to affiliates</li> <li>— Property, plant, and equipment</li> <li>— Other nonallowable assets</li> </ul> </li> <li>• Test procedures for determining and reporting the following items:             <ul style="list-style-type: none"> <li>— Net debit cash reconciling items aged over seven business days</li> <li>— Dividend and interest related aged items</li> <li>— Fail to receive/deliver, securities loaned/borrowed, and repo/resale items</li> <li>— Suspense-related aged items</li> <li>— Unsecured and partly secured amounts in margin customer accounts</li> </ul> </li> </ul>
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<i>Audit Areas</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
		<ul style="list-style-type: none"> <li>• Determine that allowable receivables from other broker-dealers are covered by proprietary account of introducing brokers agreements.</li> <li>• Test the procedures for compliance with capital charges related to buy-in provisions for foreign securities.</li> <li>• Read agreements from the examining authority supporting selected subordinated liabilities treated as good capital for the net capital computation.</li> <li>• Confirm subordination agreements.</li> <li>• Determine for fixed assets collateralizing intercompany loans that the net book value is sufficient to meet regulatory requirements.</li> <li>• Test selected "haircuts" deducted in the net capital computation, as follows:               <ul style="list-style-type: none"> <li>— Determine that classifications are proper based on type of securities and maturity for fixed-income products.</li> <li>— Determine that securities with a limited market, unregistered securities, and securities with below-investment-grade ratings are properly reported and receive the proper "haircut."</li> </ul> </li> </ul>
	<p>Net capital is properly reduced for "haircuts" on firm inventory positions.</p>	

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<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
			<ul style="list-style-type: none"> <li>— Recalculate “haircuts” using percentages found in Rule 15c3-1, including reductions for hedges.</li> </ul>
			<ul style="list-style-type: none"> <li>• Read the Financial and Operational Combined Uniform Single (FOCUS) report, and agree totals from the general ledger to supporting schedules and totals from such schedules to the FOCUS report.</li> </ul>
Rule 15c3-3	Possession and control requirements are met in accordance with Rule 15c3-3.		<ul style="list-style-type: none"> <li>• Test compliance with procedures for obtaining and maintaining possession or control of all fully paid and excess-margin securities of customers:           <ul style="list-style-type: none"> <li>— For tests and coding of accounts on the company’s segregation system, determine that accounts coded as good control satisfy the requirements of Rule 15c3-3; determine that other short positions are properly coded (for example, stock loan, fails to receive, bank loan); verify that the customer margin and cash account are appropriately classified (select accounts); and determine that other accounts that are required to be segregated are appropriately coded (for example, suspense, difference, and unclaimed dividends should be treated as fully paid by the customer).</li> </ul> </li> </ul>

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
			<ul style="list-style-type: none"> <li>— Recompute the value of securities required to be segregated for select accounts, and verify that instructions were issued.</li> <li>— Recompile the allocation of securities for determining whether the appropriate quantity of securities are segregated.</li> <li>— Test the pricing of securities.</li> <li>• Test procedures for recording due bill repos and compliance with possession or control requirements.</li> <li>• Test procedures to prevent the creation or increase of a segregation deficit. Select individual deliveries to verify that deficits are not created or increased.</li> <li>• Test procedures for buying-in fails to receive and aged stock dividend receivables and recalls of securities loaned.</li> <li>• Test procedures for identifying and buying-in customer cash shorts (sales not long) aged over 10 business days from the settlement date.</li> <li>• Perform analytical procedures on the reserve formula computation.</li> <li>• Test computation for determination of reserve requirements.</li> </ul>
		<p>Segregated cash is sufficient to meet the requirements of the reserve formula computation in accordance with Rule 15c3-3.</p>	

(continued)

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Federal Reserve Regulation T and Financial Industry Regulatory Authority (FINRA) Rule 4210	Requirements of Regulation T and FINRA Rule 4210 are being complied with for all customer cash and margin accounts.	<ul style="list-style-type: none"> <li>• Test that cash or qualified securities are deposited as required on a timely basis.</li> <li>• Recompute the allocation of fails, securities loaned/borrowed, bank loans, firm inventory and customer shorts, and repos and resales for select securities.</li> <li>• Determine that documentation demonstrates that the special reserve bank account is for the exclusive benefit of customers.</li> </ul>	<ul style="list-style-type: none"> <li>• Test initial and maintenance margin requirements under "house rules" for various products to determine compliance with Regulation T and FINRA Rule 4210.</li> <li>• Test the pricing of securities used in the margining of customer accounts.</li> <li>• Test selected customer margin accounts to determine that a minimum amount of equity is maintained in the account.</li> </ul>
		<ul style="list-style-type: none"> <li>• Test selected transactions recorded in customer cash accounts to determine that funds/securities (for purchase/sales) have been received within seven days of trade date.</li> <li>• Test procedures for determining and issuing maintenance calls for funds collections.</li> <li>• Test selected calls to determine that funds/securities have been received within five business days from the date of issue.</li> </ul>	

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Off-Balance Sheet Items	Existence/ Completeness	<p>Quarterly examinations, counts, verifications, and comparisons of securities on hand, on deposit, in transit, out of transfer, and pledged as collateral are performed as required by Rule 17a-13.</p> <p>Fails, securities loaned and borrowed, and securities pledged aged over 30 calendar days and transfer items over 40 days are subject to verification through confirmation.</p> <p>All items with off-balance sheet risk are valid and properly identified and monitored. Products classified as off-balance sheet items are entitled to such treatment.</p>	<ul style="list-style-type: none"> <li>• Test procedures for filing extensions with the regulatory agencies if maintenance calls are not paid on a timely basis.</li> <li>• Observe and test the quarterly count/comparison of securities on hand, on deposit, in transfer, or in transit.</li> <li>• Test confirmation replies of security positions over 30 calendar days old.</li> </ul>
			<ul style="list-style-type: none"> <li>• Test compliance with relevant controls, including the following:               <ul style="list-style-type: none"> <li>— Documentation that is maintained for each contract</li> <li>— Authorization structure for approving off-balance sheet transactions</li> <li>— Review procedures in place for periodically monitoring open commitments to determine if all commitments are valid and properly authorized and valued</li> </ul> </li> </ul>

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<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Valuation and Allocation		Reserves are properly established to adequately reflect exposure due to credit and market risks.	<ul style="list-style-type: none"> <li>• Confirmed terms of each transaction on a sample basis, based on exposure relative to each of the open commitments.</li> <li>• Test selected signed contracts.</li> </ul>



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## Appendix B — Consideration of Fraud in a Financial Statement Audit: Examples and Considerations for Auditors of Broker-Dealers in Securities

### Risk Factors and Auditor Responses

Two types of fraud are relevant to the auditor's consideration: fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: incentives and pressures, opportunities, and attitudes and rationalizations. Although the risk factors cover a broad range of situations, they are only examples, and accordingly, the auditor may wish to consider additional or different risk factors. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

#### *Part 1: Fraudulent Financial Reporting*

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions are present in entities when specific circumstances do not present a risk of material misstatement. Also, specific controls may exist that mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

#### **A. Incentives and Pressures**

1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by)
  - a. a high degree of competition or market saturation, accompanied by declining margins.
    - i. High degree of competition relating to bank-owned broker-dealers that have been granted expanded powers to engage in securities activities or registered investment companies or mutual funds, accompanied by declining margins.
  - b. a high vulnerability to rapid changes, such as changes in technology, or interest rates.
    - i. A failure or inability to keep pace with the rapid growth in electronic trading, if the financial stability or profitability of the particular entity is placed at risk due to that failure or inability.
    - ii. Concentration in a particular type of financial instrument.
  - c. an unusually high level of "soft-dollar" brokerage activities.
2. Excessive pressure exists for management to meet the requirements or expectations of analysts and rating agencies or parents (for broker-dealers that are subsidiaries of banks or overseas entities).

3. Management or those individuals charged with governance's personal net worth is threatened by the entity's financial performance arising from the following:
  - a. The structure of incentive plans induces traders to take unusually greater risks.
  - b. There is an unusually high level of internal competition for capital allocation among product types and trading desks.
4. Research analysts are not independent. Their compensation is controlled by investment banking or other areas for which the firm receives fees from covered companies.
5. Extensive benefits are provided to money managers that may drive fraudulent behavior. The value of such benefits is included in the commissions generated by customers on trades directed by money managers.
6. There are certain arrangements between the broker who directs the trade and the market maker who executes the trade that are not in the best interest of the customer.

## **B. Opportunities**

1. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:
  - a. A failure by management to have an adequate understanding of the entity's trading and investment strategies as conducted by the entity's traders, including the types, characteristics, and risks associated with the financial products purchased and sold by the entity.
  - b. Significant, unusual, or highly complex transactions, especially those close to year-end that pose difficult substance-over-form questions.
    - i. An unusually significant increase in unsettled trades at year-end.
    - ii. A high degree of complex accounting standards relating to, for example, financial instruments and off-balance sheet transactions.
    - iii. Transactions (straddling) year-end in similar securities.
2. Internal control components are deficient as a result of the following:
  - a. Inadequate monitoring of controls, including automated controls and controls over interim financial reporting.
    - i. Failure by management and those charged with governance to set parameters (for example, trading limits, credit limits, and aggregate market risk limits) and to continuously monitor trading activities against those parameters.
    - ii. Lack of sufficient access controls for front-office and back-office systems.

- iii. Lack of adequate “Chinese Wall” between investment banking and trading (that is, potential for insider trading).
  - iv. Failure to monitor the filling of customer orders from the firm’s inventory (for example, front-running and excessive mark-up).
  - v. Lack of review of customer lists and insufficient controls surrounding the customer account approval and maintenance processes for both cash and margin accounts.
  - vi. Lack of sufficient controls over the review process for new products, structured finance, and off-balance sheet transactions.
  - vii. Lack of sufficient controls over the valuation process for less liquid securities, including controls over the changes of valuation pricing and the appropriate segregation of duties.
- b. High turnover rates or employment of ineffective accounting, internal audit, or IT staff.
- i. Failure by management to ensure that the brokers are properly trained, appropriately licensed, and adequately supervised.
  - ii. Lack of policies and training over the range of product offerings.
  - iii. Failure by management to assess the quality and breadth of the company’s internal audit department and to ensure that the department receives adequate training and resources to match the sophistication and progression of the company.
  - iv. Improper reporting lines for internal audit.
- c. Ineffective accounting and information systems, including situations involving deficiencies in internal control and material weaknesses.
- i. Lack of approval by those charged with governance and a specialist’s independent evaluation of in-house developed valuation models.
- d. Use of error accounts to hide trading errors, made to meet commitments to clients, particularly for block trades in meeting a predetermined value-weighted average price.
- e. Use of valuation reserves for other purposes, such as to hide errors or expenses. Assumptions in valuation reserves may be changed without adequate approval. Lack of proper approval for the establishment of valuation reserves.
- f. Inappropriate use of customer collateral for firm purposes (tested by possession or control procedures).
- g. Intercompany transactions designed to improperly manage earnings.

- h. Transactions accounted for as sales as opposed to financing.
- i. Use of different valuations of the same product in two related companies.
- j. Use of a borrowed security to cover a theft of a customer-related security.
- k. Poor controls over corporate actions in which the client fails to receive the entire benefit.
- l. Not properly valuing collateral or reflecting the extent of cross-collateralization on rate swaps.
- m. Weak controls causing a failure to record trades on a timely basis, which may facilitate customers' poor trading activity.
- n. Lack of controls over the execution of customer transactions.

### C. Attitudes and Rationalizations

Risk factors reflective of attitudes and rationalizations by those charged with governance, management, or employees that allow them to engage in or justify fraudulent financial reporting may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

1. Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
  - a. Unusually aggressive interpretations of regulatory rules (for example, net capital rules and weekly reserve formula) when the company is reaching minimum net capital required by the Securities and Exchange Commission (SEC).
  - b. Lax attitude toward regulatory compliance (example: security segregation requirements).

### D. Auditor Responses

In addition to the sample responses presented in AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), an auditor may want to consider the following responses:

- Extend confirmation procedures concerning agreements with counterparties (for example, leases, clearing, custody, margin, and subordinated debt).
- Extend confirmation procedures concerning the terms of selected transactions (for example, swaps, financing transactions, and fails) with counterparties.
- Review the results of valuation testing performed by departments of the company (for example, controllers, internal audit, and middle office).
- Review background information about those individuals charged with governance and management to determine if they have the capacity to understand trading and investment strategies. Conversations with appropriate people and review of the experience and credentials of those charged with governance and management may be necessary.

- Review management summary reports on performance and meet with management to discuss trading and business direction.
- Perform periodic reviews of valuation methodologies by independent specialists throughout the year.
- Meet with middle office personnel to gain an understanding of the company's policies concerning managing risk (for example, stress testing and valuations).
- Extend testing on regulatory computations for companies barely meeting the minimum net capital requirements.
- Extend testing of the entity's "soft-dollar" arrangements to verify compliance with the SEC rules and regulations.
- Evaluate how management dealt with regulatory issues in the past.
- Evaluate how management responded to past regulatory examinations.
- Inquire whether there is a code of conduct.

### ***Part 2: Misappropriation of Assets***

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions are present in entities when specific circumstances do not present a risk of material misstatement. Also, specific controls may exist that mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

Risk factors that relate to misstatements arising from misappropriation of assets are also classified along the three conditions generally present when fraud exists: incentives and pressures, opportunity, and attitudes and rationalizations. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and weakness in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exists. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

#### **A. Opportunities**

1. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:
  - a. Securities (for example, bearer instruments) held in the company's vault
  - b. Commingling of customer securities with the entity's securities at a custodian bank
2. Inadequate internal control over assets may increase the susceptibility to misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
  - a. Inadequate management oversight of employees responsible for assets

### Brokers and Dealers in Securities

- i. Lack of management oversight of extensive retail branches, or overseas branches and subsidiaries
  - ii. Inadequate supervision of traders' trading practices and limits, especially for those generating a large proportion of the entity's total revenue
  - iii. Large amounts of cash or securities at branches or branch offices
  - iv. Poor control over wire transfers
- b.* Inadequate segregation of duties or independent checks
- i. Lack of segregation of duties between the front-office (that is, execution of trades) and the back-office (that is, settlement and accounting for trades)
  - ii. Lack of independent review of periodic reconciliations (for example, settlement accounts, cash accounts, and stock records)
  - iii. Failure to confirm failed transactions on a timely basis
  - iv. Failure to periodically review items in suspense accounts
  - v. Failure to review the aging of items, including failed transactions and receivables
  - vi. Lack of or infrequent independent pricing of inventory performed by middle-office or back-office (that is, risk management and controller's group)
  - vii. Poor controls over journal entries to customer accounts
  - viii. Failure to confirm customer transactions on a timely basis
- c.* Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
- i. Lack of safeguarding and insuring securities in transfer
  - ii. Lack of sufficient access controls for cash wiring systems
- d.* Lack of timely and appropriate documentation of transactions
- i. Lack of documentation related to "soft-dollar" brokerage activities
  - ii. Lack of documentation related to derivative transactions with counter parties, such as International Swaps and Derivatives Association master agreements
- e.* Lack of controls relating to the rehypothecation of securities

### **B. Auditor Responses**

In addition to the sample responses presented in AU-C section 240, an auditor may want to consider the following responses:

- Review exception and break reports for settlement activities.
- Verify that the compliance function reviews the personal account statements of the company's employees.

- Extend testing of access controls of online fund-wiring system terminals.
- Review revenue trends of an individual trader over a period of time.
- Review level of errors and broker chargebacks of commissions.
- Look at controls over dealing with customer complaints.

### **Unusual or Unexpected Relationships**

Examples of unusual or unexpected relationships that may indicate a material misstatement due to fraud may include the following:

- Recognition of unusually high unrealized gains on financial instruments at financial statement date
- High volume of transactions around financial statement date

### **Accounts, Classes of Transactions, and Assertions**

Examples of accounts, classes of transactions, and assertions that may have high inherent risk, involve a high degree of management judgment and subjectivity, and be susceptible to manipulation by management:

- Valuation of inventory
- Litigation reserves
- Intercompany transactions
- Valuation of collateral
- Bonus determinations
- Use of special-purpose entities

### **Improper Revenue Recognition**

Examples of improper revenue recognition may include

- incorrect valuation of inventory.
- transactions between related entities designed to improperly manage earnings.
- accelerating or deferring revenue to other periods.

### **Key Estimates**

Examples of key estimates for broker-dealers in securities may include

- valuation of inventory.
- litigation reserves.
- bonus determinations.
- determination of carrying amount of goodwill.
- realization of deferred tax assets.

### **Programs and Controls**

Examples of programs and controls for broker-dealers in securities may include

- code of conduct.
- risk monitoring procedures for credit risk and market risk.

## Appendix C — Public Company Accounting Oversight Board Interim Inspection Program Report Issued<sup>1</sup>

On August 20, 2012, the Public Company Accounting Oversight Board (PCAOB) released its first inspection report on the interim inspection program for broker-dealers. *Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers*, as found in PCAOB Release No. 2012-005, is based on inspections of 23 broker-dealer audits performed by 10 firms. Of the 10 firms, 3 were already subject to PCAOB inspection because they audited public companies.

To give some context to the numbers, note that approximately 4,400 broker-dealers filed audited financial statements with the Securities and Exchange Commission (SEC) for fiscal periods ended during 2011. Approximately 800 registered public accounting firms audited broker-dealer filings for these periods. Of those, it is estimated that 300 of the firms auditing broker-dealers also audit issuers; therefore, approximately 500 firms performing audits of broker-dealers are registered with the PCAOB only because they audit nonissuer broker-dealers.

The report notes that deficiencies were identified in all the audits. In response to the report findings, PCAOB Chairman James Doty stated, “While the results of these initial inspections cannot be generalized to all securities broker and dealer audits and represent only a small portion of the inspections planned for the interim program, the nature and extent of the finding are of concern to the Board.” The deficiencies were observed in a number of areas, including auditing compliance with the applicable regulatory requirements and in other audit areas not specific to an audit of a broker-dealer. A summary of the deficiencies follows.

Audit deficiencies were found related to the customer protection and net capital rules as follows:

- *Accountant’s supplemental report on material inadequacies (internal control report)*. In 21 of the 23 audits and for at least 1 audit performed by each of the firms inspected, the firms failed to perform sufficient audit procedures to obtain reasonable assurance that any material inadequacies in the accounting system, internal accounting controls, and procedures for safeguarding securities found to exist since the date of the last examination would have been disclosed in the auditor’s supplemental report. Although firms performed a risk assessment and made inquiries of management regarding internal controls, the firms did not test or sufficiently test controls related to areas covered in the report.
- *Exemption from provisions of the Customer Protection Rule*. For all of the 14 audits of broker-dealers that claimed an exemption from Rule 15c3-3, firms did not perform sufficient procedures to ascertain that the broker-dealer complied with the conditions of the exemption.
- *Customer Protection Rule*. For two of the nine audits that were required to maintain a customer reserve, firms failed to verify that the special reserve bank accounts were designated for the exclusive benefit of customers and that the account agreements contained the required restrictive provisions.

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<sup>1</sup> See paragraph 5.09 for information regarding the interim inspection program.



- *Net Capital Rule.* In 7 of 23 audits, firms failed to sufficiently test components of the broker-dealer's minimum net capital computation.

Deficiencies found related to the financial statement audit were as follows:

- *Consideration of risks of material misstatement due to fraud.* In 13 of the 23 audits, firms did not perform sufficient procedures to identify, assess, and respond to the risks of material misstatement of the financial statements due to fraud.
- *Related-party transactions.* In 10 of the 23 audits, firms did not perform sufficient procedures to identify the existence of related parties and material related-party transactions or, in instances when evidence of related parties existed, did not perform sufficient procedures regarding material related-party transactions.
- *Revenue recognition.* In 15 of the 23 audits, firms did not perform sufficient procedures to test the occurrence, accuracy, and completeness of revenue.
- *Establishing a basis for reliance on records and reports.* In 12 of the 23 audits, firms did not perform sufficient procedures to place reliance on records and reports of the broker-dealer or reports from service organizations that were used in audit procedures.
- *Fair-value measurements.* In six of nine audits in which securities valuation was included in the inspection, the firms did not perform sufficient procedures to test the valuation of securities.
- *Evaluation of control deficiencies.* In 4 of the 23 audits, firms did not sufficiently evaluate identified control deficiencies to assess the risk of material misstatement or did not evaluate identified errors to determine whether a control deficiency existed.
- *Financial statement disclosures.* In 7 of the 23 audits, firms did not perform sufficient audit procedures to test the accuracy and completeness of certain financial statement disclosures.

In addition to the audit deficiencies noted in the preceding paragraphs, in two audits, the auditors failed to maintain independence in accordance with SEC rules regarding independence. In each case, the failure resulted from the firm preparing, or assisting in the preparation of, the financial statements that were being audited.

During the interim inspection program, it is anticipated that 100 firms and over 170 broker-dealer audits will be selected for inspection by the end of 2013. The program is designed to cover a cross-section of audits of SEC-registered broker-dealers. The inspection program will continue until new rules for a permanent program are adopted and become effective.

In accordance with the temporary rule regarding the interim inspection program, a report containing results of the inspections performed must be issued yearly. As directed by the rule, the report does not name audit firms inspected, unlike the individual inspection reports of public company auditors. However, during an inspection, the deficiencies were discussed with the firm being inspected. Any deficiencies that were considered to be significant were communicated to the firm in writing.



## Chapter 6

# Internal Control<sup>1</sup>

## Auditor's Understanding of Internal Control in a Financial Statement Audit

**6.01** The regulatory environment has a major effect on the audit of a broker-dealer due to the requirements that the auditor report on the adequacy of the broker-dealer's internal control in accordance with Securities and Exchange Commission (SEC) Rule 17a-5(g)(1)<sup>2,3</sup> and on its compliance with specific rules addressing financial responsibility and recordkeeping. Therefore, in addition to gaining an understanding of internal control in conjunction with the audit of the financial statements, further work is performed related to the regulatory requirements. See the discussion beginning in paragraph 6.90 for information on the reporting required by Rule 17a-5(g)(1).

### *Considerations for Audits Performed in Accordance With Public Company Accounting Oversight Board (PCAOB) Standards*

Auditors of issuer broker-dealers that meet the definition of an accelerated filer or large accelerated filer are required to attest to, and report on, management's assessment of the company's internal control over financial reporting in conjunction with their audit of the company's financial statements. PCAOB guidance, as found in Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), establishes requirements and provides direction that applies when an auditor is engaged to audit both an issuer's financial statements and management's assessment of the effectiveness of internal control over financial reporting. Paragraph 6 of Auditing Standard No. 5 states that the audit of internal control over financial reporting should be integrated with the audit of the financial statements. The objectives of the audits are not identical, however, and the auditor must plan and perform the work to achieve the objectives of both audits. The auditor should design his or her testing of controls to simultaneously accomplish the objectives of both audits to

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<sup>1</sup> As noted in chapter 3, "Regulatory Considerations," of this guide, both issuer and nonissuer broker-dealers are subject to Securities and Exchange Commission (SEC) regulation. Although this guide is generally directed toward nonissuer broker-dealers and their auditors, it does contain some information related to audits of issuer broker-dealers. Such information is located in the "Considerations for Audits Performed in Accordance With Public Company Accounting Oversight Board (PCAOB) Standards" sections. Refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers.

<sup>2</sup> The SEC has proposed revisions to Rule 17a-5, as found in Release No. 34-64676, *Broker-Dealer Reports*, that will change the requirements for broker-dealers. See the preface and appendix A, "Proposed Rulemaking," of chapter 3 of this guide for more information.

<sup>3</sup> See paragraph 5.22 in chapter 5, "Auditing Considerations," for information on a November 2010 letter from the SEC to the AICPA Stockbrokerage and Investment Banking Expert Panel that emphasizes the importance of complying with existing requirements in SEC Rule 17a-5 related to the review of the accounting system, the internal accounting control, and procedures for safeguarding securities in connection with the annual audit of broker-dealers.

- obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of the year-end.
- obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of financial statements.

The role of risk assessment is noted in paragraph 10 of Auditing Standard No. 5, which states that risk assessment underlies the entire audit process, including the determination of significant accounts and disclosures and relevant assertions, the selection of controls to test, and the determination of the evidence necessary for a given control. Moreover, paragraph B2 of appendix B, "Special Topics," of Auditing Standard No. 5 states that in order to express an opinion on internal control over financial reporting taken as a whole, the auditor must obtain evidence about the effectiveness of selected controls over all relevant assertions. This requires the auditor to test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.

In August 2010, the PCAOB adopted a suite of eight auditing standards related to audit risk. PCAOB Auditing Standard Nos. 8–15 (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), set forth requirements that enhance the effectiveness of the auditor's assessment of, and response to, the risks of material misstatement in an audit. The standards address audit procedures performed throughout the audit, from the initial planning stages through the evaluation of audit results.

In December 2012, the PCAOB issued Auditing Standard No. 16, *Communications with Audit Committees, and Amendments to Other PCAOB Standards* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), which establishes requirements that enhance the relevance and timeliness of the communications between the auditor and the audit committee and intends to foster constructive dialogue between the two on significant audit and financial statement matters.

**6.02** The early sections of this chapter discuss the auditor's understanding of internal control in auditing a broker-dealer's financial statements. The "Broker-Dealer Control and Monitoring Activities" section provides an overview of the types of control and monitoring activities that are unique to brokers-dealers. The term *audit* generally refers to the audit of financial statements unless it is indicated that the discussion pertains to the integrated audit or audit of internal controls.

**6.03** AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), notes that the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement and in designing the nature, timing, and extent of further audit procedures.

**6.04** AU-C section 315 defines *internal control*<sup>4</sup> as a process effected by those charged with governance, management, and other personnel that is designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives.

**6.05** The discussion of internal control in this guide recognizes the definition and description of *internal control* contained in *Internal Control—Integrated Framework*, published by COSO.<sup>5</sup> That document sets forth five components of internal control; the division of internal control into five components provides a useful framework for auditors when considering how different aspects of an entity's internal control may affect the audit. The following are the five interrelated internal control components:

- a. *Control environment* sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control and provides discipline and structure.
- b. *Risk assessment* process is the entity's identification, analysis, and management of risks relevant to the preparation and fair presentation of financial statements.
- c. *Information and communication systems* consist of the many procedures and records designed and established to initiate, authorize, record, process, and report entity transactions. It includes the related business processes relevant to financial reporting.
- d. *Control activities* are the policies and procedures that help ensure that management directives are carried out.
- e. *Monitoring* is a process that assesses the effectiveness of internal control performance over time.

**6.06** The division of internal control into components does not necessarily reflect how an entity designs, implements, and maintains internal control or how it may classify any particular component. Auditors may use different terminology or frameworks to describe the various aspects of internal control and their effect on the audit other than those used in this section, provided that all the components described in AU-C section 315 are addressed. Refer to

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<sup>4</sup> See paragraph 6.91 for the definition of *internal control over financial reporting*, as defined by the SEC.

<sup>5</sup> In May 2013, COSO issued the 2013 *Internal Control—Integrated Framework* (framework). The framework was originally published in 1992 to provide guidance for designing, implementing, and conducting internal control and assessing its effectiveness. COSO has updated the framework to reflect changes in the business environment, particularly in the areas of technology, global activities, and outsourced service providers. The changes to the framework are intended to provide better guidance to management and the board of directors in fulfilling their internal control responsibilities, while still meeting the entity's operations and financial performance goals, as well as compliance with laws and regulations. In addition to addressing the known changes that have occurred over the past two decades, the updated framework helps entities address future changes, including economic and competitive environments, organization leadership, business priorities, and evolving business models. Many of the updates to the framework have significant implications for small businesses. COSO is encouraging users to transition their applications and related documentation to the updated framework as soon as is feasible under their particular circumstances. The original framework will be available during the transition period extending to December 15, 2014, after which time COSO will consider it as superseded by the 2013 framework. Readers are encouraged to consult the full text of the framework.

paragraphs .A42–.A107 of AU-C section 315 for a detailed discussion of the internal control components, in addition to the guidance provided in this chapter. See chapter 5, “Auditing Considerations,” of this guide for guidance on designing and performing further audit procedures, including tests of controls.

**6.07** Paragraph .13 of AU-C section 315 states that the auditor should obtain an understanding of internal control relevant to the audit. A direct relationship exists between an entity’s objectives and the controls it implements to provide reasonable assurance about their achievement. Although the entity’s objectives and therefore, controls, relate to financial reporting, operations, and compliance, not all of these objectives and controls are relevant to the auditor’s risk assessment. When obtaining an understanding of controls that are relevant to the audit, the auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity’s personnel. Additionally, paragraph .30 of AU-C section 315 states that if the auditor has determined that a significant risk exists, the auditor should obtain an understanding of the entity’s controls, including control activities, relevant to that risk and, based on that understanding, evaluate whether such controls have been suitably designed and implemented to mitigate such risks.

**6.08** Paragraph .A68 of AU-C section 315 notes that evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. Assessing the implementation of a control that is not effectively designed is of little use, and so the design of a control is considered first. An improperly designed control may represent a significant deficiency or material weakness in the entity’s internal control.

**6.09** Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include the following:

- Inquiring of entity personnel
- Observing the application of specific controls
- Inspecting documents and reports
- Tracing transactions through the information system relevant to financial reporting

Inquiry alone, however, is not sufficient for such purposes.

**6.10** Obtaining an understanding of an entity’s controls is not sufficient to test their operating effectiveness, unless some automation provides for the consistent operation of the controls. For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, because of the inherent consistency of IT processing, performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control’s operating effectiveness, depending on the auditor’s assessment and testing of controls, such as those over program changes. Tests of the operating effectiveness of controls are further described in AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*). See also the discussion in chapter 5 for more information regarding tests of controls.

## Service Organizations and Using Statement on Standards for Attestation Engagements No. 16 Reports

**6.11** The auditor's consideration of internal control includes controls at service organizations that perform significant functions of the broker-dealer. An example is an introducing broker's use of a clearing broker to process transactions and provide the broker-dealer with information used in financial statement assertions. AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), provides guidance on the factors a user auditor (broker-dealer auditor) should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions that are part of the entity's information system. Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), provides guidance for independent auditors (service auditors) who issue reports on the processing of transactions by service organizations for use by other auditors. A report prepared in accordance with SSAE No. 16, hereinafter referred to as service organization control 1 (SOC 1) report, may be useful in providing user auditors with a sufficient understanding of controls at the service organization to assess the risks of material misstatement in accordance with AU-C section 315.

**6.12** The type of SOC 1 report (type 1 or type 2) provided by the service organization may affect the nature, timing, and extent of the audit procedures performed by the user auditor.

**6.13** A *type 1 SOC 1 report, Report on Management's Description of a Service Organization's System and the Suitability of the Design of Controls*, is a report that encompasses management's description of the service organization's system, management's written assertion, and the service auditor's report in which the service auditor expresses an opinion on the fairness of the presentation of management's description of the service organization's system and the suitability of the design of the controls to achieve the related control objectives included in the description as of a specified date. Such reports may be useful in providing the broker-dealer auditor with an understanding of the service organization's controls sufficient to assess whether there are any deficiencies in the design of the controls that could affect relevant financial statement assertions in the entity's financial statements. This would assist the broker-dealer auditor in assessing the risks of material misstatement and in designing the nature, timing, and extent of further audit procedures. However, a type 1 SOC 1 report is not intended to provide auditors with a basis for reducing their assessment of control risk to low or moderate for relevant financial statement assertions affected by the controls.

**6.14** A *type 2 SOC 1 report, Report on Management's Description of a Service Organization's System and the Suitability of the Design and Operating Effectiveness of Controls*, is a report that includes management's description of the service organization's system, management's written assertion, and the service auditor's report in which the service auditor expresses an opinion on the fairness of the presentation of management's description of the service organization's system and the suitability of the design and operating effectiveness of the controls to achieve the related control objectives included in the description throughout a specified period. Such reports may be useful in providing the broker-dealer auditor with an understanding of the service organization's controls that is sufficient to assess the risks of material misstatement and design the nature, timing, and extent of further audit procedures. In addition,

because a type 2 SOC 1 report contains an auditor's opinion on the operating effectiveness of the described controls, it may also provide the broker-dealer auditor with a basis for reducing his or her assessment of control risk to low or moderate for relevant financial statement assertions affected by the controls.

**6.15** Although a type 2 SOC 1 report may be used to reduce substantive procedures, neither a type 1 SOC 1 nor a type 2 SOC 1 report is designed to provide a basis for assessing control risk sufficiently low to eliminate the need for performing any substantive tests for all of the assertions relevant to significant account balances or transaction classes. Paragraph .18 of AU-C section 330 states that irrespective of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.

**6.16** If the type 2 SOC 1 report identifies internal control deviations, the auditor may consider the effect of the findings on the assessed level of control risk for the audit of the financial statements and, as a result, the auditor may decide to perform additional tests at the service organization or, if possible, perform additional audit procedures at the broker-dealer. In certain situations, the type 2 SOC 1 report may identify an internal control deviation, but the broker-dealer auditor concludes that no additional tests or audit procedures are required because the deviation does not affect the assessment of control risk. It is important for the auditor to read and consider both the report and the evidence provided by the tests of operating effectiveness and relate them to the relevant assertions in the user entity's financial statements.

**6.17** Service organizations are not required to furnish SOC 1 reports. If a SOC 1 report is not available, information about the nature of the services provided by the service organization that are part of the user entity's information system and the service organization's controls over those services may be available from a wide variety of sources, such as user manuals, system overviews, technical manuals, the contract between the user entity and the service organization, and reports by internal auditors or regulatory authorities on the service organization's controls. If the services and the service organization's controls over those services are highly standardized, information obtained through the broker-dealer auditor's prior experience with the service organization may be helpful in assessing the risks of material misstatement. If the broker-dealer auditor concludes that the available information is not adequate to obtain a sufficient understanding of the service organization's controls to assess the risks of material misstatement and design the nature, timing, and extent of further audit procedures, the broker-dealer auditor may consider contacting the service organization through the user entity to obtain specific information or request that a service auditor be engaged to perform procedures at the service organization. If the broker-dealer auditor is unable to obtain sufficient evidence to achieve the audit objectives, the broker-dealer auditor should qualify the audit opinion or disclaim an opinion on the financial statements because of a scope limitation.

**6.18** A SOC 1 report prepared for the service organization for use by auditors of financial statements of a user entity will typically address in that report the control objectives that are relevant to the specific objectives of the user entity. However, certain operations of the service organization may not be addressed in the SOC 1 report and those operations may be significant to the broker-dealer audit. In these instances, the broker-dealer auditor will need to obtain an understanding of the controls in the relevant areas excluded from the scope of the SOC 1 report.



**6.19** In some cases, a SOC 1 report may cover a period that is different from the broker-dealer's fiscal year. A report on controls placed in operation that has an as of date outside the broker-dealer's reporting period may be useful in providing the broker-dealer auditor with a preliminary understanding of the controls placed in operation at the service organization if the report is supplemented by additional current information. In this situation, it is important for the service organization to be contacted to discuss any system changes, major changes in controls, or mergers or acquisitions that occurred during the year. If these changes have occurred, it is important for the broker-dealer auditor to obtain an understanding of the changes and consider the effect of the changes on the audit. Some service organizations provide a "gap letter" that addresses changes in internal controls or other matters affecting the service organization for the period from the date of the service auditor's report through the most recent calendar year-end. Using this information, the auditor may perform additional procedures, such as making inquiries of the service organization about any major changes in the controls or processes, any noted issues, or any changes in programs or software at the service organization since the period covered by the service auditor's SOC 1 report.

**6.20** If the broker-dealer auditor determines that the service organization had effective controls in place for processing broker-dealer transactions during the reporting period, the auditor generally would conclude that it is not necessary to visit or perform additional procedures at the service organization. If, however, the broker-dealer auditor believes that the service auditor's report may not be sufficient to meet his or her objectives, the broker-dealer auditor may supplement his or her understanding of the service auditor's procedures and conclusions by discussing with the service auditor the scope and results of the service auditor's work. Also, if the broker-dealer auditor believes it is necessary, he or she may contact the service organization through the user entity to request that the service auditor perform agreed-upon procedures at the service organization, or the broker-dealer auditor may perform such procedures.

**6.21** It is not uncommon for a type 2 SOC 1 report to have deviations in tests of operating effectiveness. Those deviations may result in a modification of the report. The broker-dealer auditor may consider the following when a type 2 SOC 1 report contains deviations to determine if an expansion of the scope of detailed testing is necessary:

- Whether the deviation is related to user entity activities
- The nature of the deviation based on details provided in the type 2 SOC 1 report and inquiries of the user entity personnel or the service auditor, or both
- Whether any follow-up procedures and additional testing has been performed by the user entity or service organization to address the deviation
- Whether compensating controls exist that would mitigate the effect of the deviation

Consideration of these factors will assist the auditor in deciding whether he or she is able to rely on controls at the service organization if deviations are noted in the type 2 SOC 1 report.

## Effect of IT on Internal Control

**6.22** The use of information systems and related technology is often an important element of a broker-dealer's processing and control environment, regardless of the size of the business. The large volume of transactions and the need to maintain accountability for security positions (both ownership and location) are among the reasons broker-dealers have automated their record-keeping systems. The type and complexity of methods the broker-dealer uses to process accounting information influences the nature, timing, and extent of the audit procedures to be performed.

**6.23** IT provides potential benefits of effectiveness and efficiency for an entity's internal control and also poses specific risks to an entity's internal control. The extent and nature of the specific risks to internal control vary depending on the nature and characteristics of the entity's information system. As part of obtaining an understanding of the information system in accordance with AU-C section 315, which includes the related business processes relevant to financial reporting and communication, the auditor considers the procedures within both IT and manual systems by which classes of transactions significant to the financial statements are initiated, authorized, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements. Paragraph .22 of AU-C section 315 notes that as part of understanding an entity's control activities, the auditor should obtain an understanding of how the entity has responded to risks arising from IT.

**6.24** The auditor, when assessing the risks of material misstatement in terms of financial statement assertions, should consider, among other things, the nature and complexity of the systems, including the use of IT, by which the entity processes and controls information supporting the assertion. When routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures regarding the risk. For example, the auditor may consider this to be the case when a significant amount of an entity's information is initiated, authorized, recorded, processed, or reported only in electronic form, such as in an integrated system. In such cases,

- audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness.
- the potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively.

**6.25** Paragraph .08 of AU-C section 330 notes that when substantive procedures alone cannot provide sufficient appropriate audit evidence at the relevant assertion level, the auditor should design and perform tests of controls to obtain sufficient appropriate evidence about the operating effectiveness of the relevant controls. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process and when they include effective general IT controls and application controls.

**6.26** The auditor may consider whether specialized skills are needed for the auditor to determine the effect of IT on the audit, to understand the IT controls, or to design and perform tests of IT controls or substantive tests. A professional possessing IT skills may be either on the auditor's staff or an

outside professional. See paragraph 6.11 for a discussion of the auditor's responsibilities when the entity uses a service organization for IT functions.

## The Control Environment

**6.27** The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the following:

- Communication and enforcement of integrity and ethical values
- Commitment to competence
- Participation of those charged with governance
- Management's philosophy and operating style
- Organizational structure
- Assignment of authority and responsibility
- Human resource policies and practices

**6.28** The control environment comprises the conditions under which the broker-dealer's information and communication system, the risk assessment process, monitoring, and control activities are designed, implemented, and function.

**6.29** The control environment represents the collective effect of various factors on the overall effectiveness of the broker-dealer's internal control. These factors include the following:

- Management's personal characteristics, philosophy, and operating style and their commitment to accurate financial reporting have a significant influence on the control environment, particularly if management is dominated by one or a few individuals. A positive tone at the top is an important prerequisite to accurate and complete financial reporting. In a broker-dealer, compliance and control over legal matters are important indicators of the overall philosophy held by senior management. Management's approach to taking and monitoring business risks and its commitment to accurate financial reporting are other indications of the tone at the top. Management's commitment to accurate financial reporting may influence the activities of employees throughout the organization. Likewise, the types of activities that a broker-dealer engages in, as well as the amount of risk management is willing to take, affect the operating style. For example, the following business activities may affect management's operating style:
  - Retail brokerage
  - Discount brokerage
  - Trading and market making
  - Venture capital
  - Merchant banking
  - Underwriting initial public offerings (IPOs)
- The external business and regulatory environment requires management to establish and maintain effective internal control in a broker-dealer. For example, examinations by self-regulatory bodies

and their enforcement powers, as well as review of compliance reports by the SEC and other governmental bodies, require management of broker-dealers to establish effective controls. In addition, regulatory minimum books and records requirements mandate that certain control activities be in place and documented. Additionally, Financial Industry Regulatory Authority (FINRA) rules require every broker-dealer to establish and maintain a system to supervise the activities of personnel, including developing and maintaining a set of supervisory control procedures that will reasonably ensure compliance with FINRA and SEC rules and regulations. The supervisory procedures are required to be written and annually certified by the broker-dealer. A broker-dealer's written supervisory procedures and related annual certification may provide the auditor with valuable summary information about the broker-dealer's compliance controls.

- Management's commitment to designing and maintaining reliable accounting and stock record systems has a significant influence on the control environment. A low level of management concern about acceptable business practices, as well as deficiencies in controls, may lead a broker-dealer's employees either to adopt a similarly low level of concern or attempt to take advantage of deficient controls. The reliability of information systems and the effectiveness of controls may be impaired as a result. Personnel policies may enhance or inhibit the competence and continuity of the broker-dealer's employees. An inadequate or incompetent staff that is unable to process transactions and perform control activities may lead to a reduction in the reliability of information systems and the effectiveness of controls. In order to understand the degree of management's commitment to the design and maintenance of effective internal control and reliable accounting and stock record systems, the auditor might review the guidance in AU-C section 315 related to the following broker-dealer policies:
  - Systems security (including logical access and change management controls)
  - Trading limits
  - Sales practices
  - Hiring practices
  - Risk monitoring
  - Management's response and corrective action taken with respect to material inadequacies in internal control
- Management's ability to control the business also influences the control environment. In addition, the responsibilities of those charged with governance are of considerable importance. The auditor should consider such matters as the independence of the directors, their ability to evaluate the actions of management, and whether there is a group of those charged with governance that understands the entity's business transactions and evaluates whether the financial statements are presented fairly in conformity with . accounting principles generally accepted in the United States of America (GAAP). The control environment will generally be stronger when those charged with governance take an active role in overseeing a broker-dealer's accounting and financial reporting practices, as well as those practices regarding the prevention of illegal acts and compliance with

laws and regulations. To understand the ability of a broker-dealer's management to control the business, an auditor should consider the following:

- The broker-dealer's organizational and governance structures
- The methods used by the broker-dealer in assigning authority and responsibility
- The ability of the broker-dealer's management to supervise and monitor operations effectively
- The methods used by senior management to monitor and control the effectiveness of the accounting system and controls

## Understanding the Control Environment

**6.30** When obtaining an understanding of the control environment, the auditor should consider the collective effect on the control environment of strengths and weaknesses in various control environment elements. Management's strengths and weaknesses may have a pervasive effect on internal control. For example, an active and independent board of directors may influence the philosophy and operating style of senior management. Alternatively, management's failure to commit sufficient resources to address security risks presented by IT may adversely affect internal control by allowing improper changes to be made to computer programs or data or by allowing unauthorized transactions to be processed. Similarly, human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may not mitigate a strong bias by top management to overstate earnings.

**6.31** The auditor should obtain sufficient knowledge of the control environment to understand the attitudes, awareness, and actions of management and those charged with governance concerning the broker-dealer's internal control and its importance in achieving reliable financial reporting. In understanding the control environment, the auditor should concentrate on the implementation of controls because controls may be established but not acted upon. For example, management may establish a formal code of conduct but act in a manner that condones violations of that code.

**6.32** In obtaining an understanding of the control environment, the auditor gains knowledge about the overall attitude, awareness, and actions of management, those charged with governance, and others concerning the importance of control and its emphasis within the broker-dealer. The consideration of these items (management's attitudes, awareness, and actions related to compliance matters that might affect the broker-dealer's financial statements and supplementary schedules) is of particular importance in the design of a smaller entity's control environment. See paragraph 6.22 for a discussion of the effect of IT on internal control.

## Risk Assessment for Financial Reporting Purposes

**6.33** A broker-dealer's risk assessment for financial reporting purposes is its identification, analysis, and management of risks relevant to the preparation of financial statements that are fairly presented in conformity with GAAP. For example, risk assessment may address how the broker-dealer considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements. Risks relevant to reliable financial reporting also relate to specific events or transactions. Risks relevant

to financial reporting include external and internal events and circumstances that may occur and adversely affect a broker-dealer's ability to initiate, authorize, record, process, and report financial data consistent with the assertions of management in the financial statements. Once risks are identified, management considers their significance, the likelihood of their occurrence, and decides upon actions to manage them. Management may initiate plans, programs, or actions to address specific risks, or they may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:

- *Changes in operating environment.* Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
- *New personnel.* New personnel may have a different focus on or understanding of internal control.
- *New or revamped information systems.* Significant and rapid changes in information systems can change the risk relating to internal control.
- *Rapid growth.* Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- *New technology.* Incorporating new technologies into operating processes or information systems may change the risk associated with internal control.
- *New business models, products, or activities.* Entering into business areas or transactions with which a broker-dealer has little experience may introduce new risks associated with internal control.
- *Corporate restructurings.* Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- *Expanded foreign operations.* The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control (for example, additional or changed risks from foreign currency transactions).
- *New accounting pronouncements.* Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.
- *Changes in economic conditions.* Changes in economic conditions can increase manipulation of earnings and inappropriate management override of internal control.

**6.34** Broker-dealers devote a significant amount of time and resources toward the identification, quantification, analysis, and control of risk. A broker-dealer's control and monitoring activities are concerned with mitigating business risks and exposures. Risk refers to the likelihood that a loss might occur, whereas exposure refers to an amount (or other element) at risk. The decision to incur business risk rests with the broker-dealer's management. The following is an overview of the major risks and exposures facing a broker-dealer.

**6.35** *Operational risk.* Operational risk arises in processing broker-dealer transactions. Exposure can be created by a failure to either process transactions properly or safeguard securities adequately. If operational risk is properly managed, other risks will be mitigated. In viewing operational exposure, it is important to look at the broad exposure within particular accounts, such as

suspense accounts, difference accounts, reconciling items (for any accounts), and aged transfers and fails. For instance, within a particular suspense account, the exposure is frequently not the net balance in the account. A more accurate view of exposure is to identify debit-only items (no related security positions), short-fair-value-only items (no related money balance), debit money with long fair value, and credit money with short fair value. By viewing each of those items separately, the auditor will better understand the total exposure.

**6.36** *Credit risk.* Credit risk refers to potential losses arising from the failure of another party to perform according to the terms of a contract (counterparty default).

**6.37** Credit risk can be customer- or broker-related. The exposure to the broker-dealer is for the amount of extended credit that is not fully collateralized. Therefore, obtaining adequate collateral from the counterparty could help minimize credit risk. An extension of credit can result in any of the following transactions: margin transactions, cash transactions prior to settlement, stock borrows and stock loans, resale and repurchase agreements (repos), swaps, futures, forwards, options, and similar items. Broker-dealers will usually have credit committees that set limits for total credit lines, exposure, and collateral requirements for any particular counterparty.

**6.38** *Market risk.* Market risk refers to potential losses from fluctuations in market prices that may make a financial instrument less valuable or more onerous. A change in market price may occur (for example, for interest-bearing financial instruments) because of changes in general interest rates (interest rate risk), changes in the relationship between general and specific market interest rates (an aspect of credit risk), or changes in the rates of exchange between currencies (foreign exchange risk). Broker-dealers may have risk committees that establish trading limits in order to manage market risk.

**6.39** *Litigation risk.* Litigation risk refers to the risk of losses resulting from lawsuits and the cost of defending against such claims. Lawsuits can arise from the various aspects of the broker-dealer's business. Areas of particular concern include underwriting activities, employment matters, and the maintenance of customer accounts. Broker-dealers can help mitigate litigation risk in many ways, including the following:

- Establishing policies regarding a code of professional conduct, the employer's responsibilities, and due diligence and establishing a system to monitor compliance with such policies
- Establishing a compliance function to review the activities of the sales departments and branch office operations

**6.40** *Regulatory risk.* Regulatory risk refers to potential losses that might arise for failing to comply with applicable statutes, regulations, and rules. Broker-dealers operate in a highly regulated industry that requires close attention to compliance matters. Not only may such matters affect a broker-dealer's reputation and growth, but noncompliance may also lead to fines, limitation on activities the broker-dealer is allowed to carry out, or even the suspension or revocation of the broker-dealer's registration.

**6.41** *Liquidity and funding risk.* Liquidity and funding risk refers to a broker-dealer's ability to secure funding to satisfy its settlement or other obligations. Market and other factors may affect the broker-dealer's ability to secure funding to satisfy his or her obligations. Understanding and evaluating this issue, especially in a highly competitive or unstable market, is important in assessing the going-concern assumption.

## Understanding Risk Assessment

**6.42** The auditor should obtain sufficient knowledge of the broker-dealer's risk assessment process to understand how management considers risks relevant to financial reporting objectives and decides about actions to address those risks. In evaluating the design and implementation of the entity's risk assessment process, the auditor should consider how management identifies business risks relevant to financial reporting, estimates the significance of the risks, assesses the likelihood of their occurrence, and decides upon actions to manage them. The use of IT may be an important part of a broker-dealer's risk assessment process, including providing timely information to facilitate the identification and management of risks.

**6.43** A broker-dealer's risk assessment differs from the auditor's consideration of audit risk in a financial statement audit. The purpose of a broker-dealer's risk assessment is to identify, analyze, and manage risks that affect the broker-dealer's objectives. In a financial statement audit, the auditor assesses risks to evaluate the likelihood that material misstatements could occur in the financial statements. See chapter 5 for information related to the auditor's assessment of the risk of material misstatement.

## Information and Communication System

**6.44** An information system consists of infrastructure (physical and hardware components), software, people, procedures (manual and automated), and data. Infrastructure and software will be absent or have less significance in systems that are exclusively or primarily manual. Many information systems, particularly within the financial services industry, make extensive use of IT. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether IT or manual, and records established to initiate, authorize, record, process, and report the broker-dealer's transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. Transactions may be initiated manually or automatically by programmed procedures. Authorization includes the process of approving transactions by the appropriate level of management. Recording includes identifying and capturing the relevant information for transactions or events. Processing includes functions such as edit and validation, calculation, measurement, valuation, summarization, and reconciliation, whether performed by IT or manual procedures. Reporting relates to the preparation of financial reports, as well as other information, in electronic or printed format that the entity uses in measuring and reviewing the entity's financial performance and in other functions. The accuracy and completeness of system-generated information affects management's ability to make appropriate decisions in managing and controlling the broker-dealer's activities and to prepare reliable financial reports. Accordingly, an information system encompasses methods and records that

- identify and record all valid transactions.
- describe, on a timely basis, the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.



- present properly the transactions and related disclosures in the financial statements.

**6.45** Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the broker-dealer. Open communication channels help ensure that exceptions are reported and acted on. Communication can take the form of policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

## Understanding the Broker-Dealer's Information and Communication System

**6.46** The auditor should obtain sufficient knowledge of the broker-dealer's information system,<sup>6</sup> including the related business processes relevant to financial reporting, to understand the following:

- The classes of transactions in the broker-dealer's operations that are significant to the financial statements
- The procedures within both automated and manual systems by which transactions are initiated, authorized, recorded, processed, and reported from their occurrence to their inclusion in the financial statements
- The related accounting records, whether electronic or manual; supporting information; and specific accounts in the financial statements involved in initiating, recording, processing and reporting transactions
- How the information system captures other events and conditions that are significant to the financial statements
- The financial reporting process used to prepare the broker-dealer's financial statements, including significant accounting estimates and disclosures

**6.47** When IT is used to initiate, record, process, or report transactions or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for significant accounts or may be critical to the effective functioning of manual controls that depend on IT.

**6.48** In obtaining an understanding of the financial reporting process (including the closing process), the auditor should obtain an understanding of the automated and manual procedures an entity uses to prepare financial statements and related disclosures and how misstatements may occur. Such procedures include

- the procedures used to enter transaction totals into the general ledger.
- the procedures used to initiate, authorize, record, and process journal entries in the general ledger.

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<sup>6</sup> Evaluation of the process for ensuring that important static reference data is adequately controlled is a consideration for automated systems.

- other procedures used to record recurring and nonrecurring adjustments to the financial statements.
- the procedures to combine and consolidate general ledger data.
- the procedures to prepare financial statements and disclosures.

**6.49** The auditor also should obtain sufficient knowledge of the means the broker-dealer uses to communicate financial reporting roles and responsibilities and significant matters relating to financial reporting.

## Control Activities

**6.50** *Control activities* are the policies and procedures that help ensure that management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the broker-dealer's objectives. Control activities, whether automated or manual, have various objectives and are applied at various organizational and functional levels. Each control activity is designed to accomplish a specific control objective. Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:

- Performance reviews (that is, ensuring that controls are performing as expected)
- Information processing
- Physical controls
- Segregation of duties

**6.51** Many of the activities of broker-dealers are unique, and consequently, many of the control activities are also unique. Control activities that may address the following audit concerns include the following:

- *Validity*. Control activities designed to reasonably ensure that recorded transactions include only those that have actually occurred.
- *Completeness*. Control activities designed to reasonably ensure that valid transactions are not omitted entirely from the accounting records.
- *Authorization*. Control activities intended to reasonably ensure that transactions are approved before they are executed and recorded.
- *Valuation (accuracy)*. Control activities designed to reasonably ensure that dollar amounts and values are correctly determined.
- *Classification*. Control activities intended to reasonably ensure that transactions are recorded in the proper accounts, charged and credited to the appropriate customers, and so on.
- *Presentation and disclosure*. Control activities designed to reasonably ensure that the accounting process for a transaction is completely performed and is in conformity with GAAP.
- *Timing (cutoff)*. Control activities that are designed to reasonably ensure that a transaction is accounted for in the proper time period.
- *Regulatory*. Control activities that are designed to reasonably ensure that a transaction complies with the applicable laws and regulations of the SEC and other regulatory bodies.

- *Safeguarding of assets.* Control activities that are designed to protect against unauthorized acquisition, use or disposal of assets, including customer-related assets.

## Understanding Control Activities<sup>7</sup>

**6.52** The auditor should obtain an understanding of those control activities relevant to the audit. As the auditor obtains an understanding of the other components, he or she is also likely to obtain knowledge about some control activities. For example, in obtaining an understanding of the documents, records, and processing steps in the financial reporting information system that pertain to cash, the auditor is likely to become aware of whether bank accounts are reconciled. The auditor should consider the knowledge about the presence or absence of control activities obtained from the understanding of the other components in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities. An audit does not require an understanding of all the control activities related to each account balance, class of transactions, and disclosure component in the financial statements or to every relevant assertion. Ordinarily, control activities that may be relevant to an audit include those relating to authorization, segregation of duties, safeguarding of assets, and asset accountability, including, for example, reconciliations of the general ledger to the detailed records. In accordance with paragraph .21 of AU-C section 315, the auditor should obtain an understanding of the process of reconciling detail to the general ledger for significant accounts. Also, control activities are relevant to the audit if the auditor is required to evaluate them as discussed in paragraphs .30–.31 of AU-C section 315.

**6.53** In obtaining an understanding of control activities, the auditor's primary consideration is whether and how a specific control activity, individually or in combination with others, prevents or detects and corrects, material misstatements in classes of transactions, account balances, or disclosures. Control activities relevant to the audit are those for which the auditor considers it necessary to obtain an understanding in order to assess risks of material misstatement at the assertion level and to design and perform further audit procedures responsive to the assessed risks. The auditor's emphasis is on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that material misstatements are more likely to occur. When multiple control activities achieve the same objective, it may be unnecessary to obtain an understanding of each of the control activities related to such objective.

**6.54** The auditor should obtain an understanding of how IT affects control activities that are relevant to planning the audit. Some broker-dealers and auditors may view the IT control activities in terms of application controls and general controls. Application controls apply to the processing of individual applications. Accordingly, application controls relate to the use of IT to initiate, authorize, record, process, and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed.

**6.55** Application controls may be performed by IT or individuals. When application controls are performed by people interacting with IT, they may be referred to as user controls. The effectiveness of user controls, such as reviews

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<sup>7</sup> See paragraph 6.11 for information regarding the auditor's responsibility for obtaining an understanding of internal controls of service organizations utilized by the entity.

of computer-produced exception reports or other information produced by IT, may depend on the accuracy of the information produced.

**6.56** General controls are policies and procedures that relate to many applications and support the effective functioning of application controls by helping ensure the continued proper operation of information systems. General controls commonly include controls over data center and network operations; system software acquisition and maintenance; access security; and application system acquisition, development, and maintenance.

**6.57** The use of IT affects the way that control activities are implemented. For example, when IT is used in an information system, segregation of duties often is achieved by implementing security controls.

## Monitoring

**6.58** *Monitoring* is a process that assesses the quality of an entity's internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions. The frequency with which controls are assessed depends on the significance of the risk being controlled and the importance of a particular control in reducing the risk. Higher priority risks generally will require more frequent assessment. Similarly, those controls most critical to reducing a given risk will tend to be assessed more often.

**6.59** Monitoring of controls is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are built into the normal recurring activities of a broker-dealer and include regular management and supervisory activities, comparisons, reconciliations, and other actions personnel take in performing their duties. Managers at divisional and corporate levels are in touch with operations and may question reports that differ significantly from their knowledge of operations. Usually, some combination of ongoing monitoring and separate evaluations will together ensure that internal control maintains its effectiveness over time.

**6.60** In many broker-dealers, internal auditors or personnel performing similar functions contribute to the monitoring of the broker-dealer's activities through separate evaluations. They regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the design and operation of internal control. They communicate information about strengths and weaknesses and recommendations for improving internal control.

**6.61** Monitoring activities may include using information from communications from external parties. Customers implicitly corroborate transaction data by paying their amount owed or complaining about their charges. In addition, regulators may communicate with the broker-dealer concerning matters that affect the functioning of internal control (for example, communications regarding examinations by self-regulatory organizations). Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

**6.62** In many entities, much of the information used in monitoring may be produced by the entity's information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption,

errors may exist in the information, potentially leading management to incorrect conclusions from their monitoring activities.

## Understanding Monitoring Activities

**6.63** The auditor should obtain an understanding of the major types of activities the broker-dealer uses to monitor internal control over financial reporting, including the source of the information related to those activities, and how those activities are used to initiate corrective action. Paragraphs .04–.08 of AU-C section 610, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*),<sup>8</sup> provide requirements and guidance related to obtaining an understanding in situations when the entity has an internal audit function.

## Broker-Dealer Control and Monitoring Activities

**6.64** Control and monitoring activities may be present in the functions of a broker-dealer. Management uses such activities to mitigate business risk. This guide discusses only those control and monitoring activities that are unique to broker-dealers. The absence of any of these specific control activities is not indicative of a deficiency in internal control; however, a deficiency in internal control may exist if the overall control objective is not met.

**6.65** The discussion of control and monitoring activities in this part of the chapter is primarily from management's perspective and is intended to provide the auditor with an overview of the types of desirable controls. Management of all broker-dealers have a responsibility to establish and maintain adequate internal control over financial reporting and to comply with specific rules addressing financial responsibility and recordkeeping.

**6.66** Security transactions may be processed, recorded, and monitored by different departments within the broker-dealer. Even though this discussion addresses specific broker-dealer control and monitoring activities, the presentation is general in nature and does not necessarily reflect the actual operations or departments of every broker-dealer. Control and monitoring activities performed by persons with appropriate segregation of duties provides the strongest control environment.

**6.67** In many small introducing broker-dealers, individuals play several roles, including having conflicting duties that would ideally be segregated. In these situations, the auditor might consider their ability to rely on controls and monitoring activities. Some mitigating factors to consider may include the types of functions outsourced to third parties (for example, securities clearance, customer statement generation, financial reporting, Financial and Operations Principal functions, and the like), the owners' participation as management in the daily activities of the broker-dealer, detailed review of financial performance compared to budget, detailed review of the general ledger by an individual independent of recording transactions, and having one individual responsible for recording transactions while another individual independently

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<sup>8</sup> Statement on Auditing Standards No. 122, *Statements on Auditing Standards: Clarification and Recodification* (AICPA, *Professional Standards*), redesignates AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*), as AU-C section 610, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*). The guidance in AU-C section 610 has not yet been clarified. When it is redrafted for clarity, the current guidance in AU-C section 610 (former AU section 322) will be superseded.

receives bank and clearing broker statements that they reconcile or compare to the general ledger.

## Sales and Compliance

**6.68** *New accounts.* Control and monitoring activities for opening and maintaining new accounts are essential for broker-dealers. The opening of new accounts is primarily the responsibility of customer service centers and branch offices. Control and monitoring activities are designed to ensure that recorded transactions are valid, complete, and properly authorized. Broker-dealers follow various procedures (some of which are required by regulatory authorities), such as the following:

- Have new accounts approved by appropriate personnel and ensure that the account file contains documentation concerning the essential facts pertaining to each customer. For instance, if the customer is a corporation, the file indicates that the person from whom the orders are accepted is duly authorized by the corporation to act on its behalf. Rules requiring such documentation, as well as related account supervision activities, are referred to as the “know-your-customer” rules. Special documentation may also be required for other accounts, such as for all customers who wish to trade options or customers who are nonresident aliens.
- Have customer files contain signed copies of IRS Form W-9 and, for non-U.S. citizens, IRS Form W-8.
- Have margin customers sign agreements, referred to as hypothecation agreements, that authorize the broker-dealer to use customers’ securities that are not fully paid for. Broker-dealers may finance unpaid balances by borrowing money from banks or other broker-dealers, and use customer securities as collateral to the extent permissible.
- Require all accounts be in the name of the customer, unless the broker-dealer has received a written statement signed by the customer attesting to his or her ownership of an account in any other name, symbol, or number.
- Mail letters to customers requesting confirmation after being notified of changes in addresses. Some broker-dealers mail confirmation requests to the customers’ last known and current addresses.
- Mail or electronically transmit, as appropriate, customer statements periodically (at least quarterly, or monthly if there is any activity) unless a customer has requested in writing—and a designated official has approved the request—that the statements not be mailed.
- Require written authorization from each customer for whom the broker-dealer carries a discretionary account, receiving the approval (from a designated person who does not exercise discretionary authority) for every trade in the discretionary account, and mail an advice to the discretionary account customer on the date each trade is executed.
- Identify the accounts of partners, officers, and employees and their known relatives so that transactions in such accounts can be reviewed by designated personnel.
- Obtain written approval from another broker-dealer for opening an account of an employee of that broker-dealer.

- Ensure policies and procedures exist and function to comply with the requirements of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA PATRIOT Act).
- Accurately capture all unique customer data attributes in the broker-dealer's client reference data master files, which will serve as the source for key downstream processing.

**6.69** *Order entry.* The primary objectives of the order department are to ensure that all authorized orders are directed to the proper marketplace, executed, and accurately recorded. The auditor may identify and test control and monitoring activities over customer orders to purchase and sell securities because of the volume of accounting information generated from customer order forms. Customer orders generate accounting entries that affect the following financial statement accounts:

- Receivables from, and payables to, customers
- Firm inventory
- Receivables from, and payables to, other broker-dealers and clearing organizations
- Commission income and expense
- Interest income and expense
- Cash

**6.70** Some of the control and monitoring activities typically associated with the order department include

- assigning a number to orders when placed and accounting for all order numbers.
- reviewing, by supervisory personnel, the open order file.
- comparing trade data recorded on the customer confirmation with the order form prepared by the order department and registered representative before mailing it to the customer.
- requiring that the execution price of an order be confirmed by the order department to the registered representative, and by the registered representative to the customer shortly after placing the order. Lack of confirmation of execution usually initiates inquiry by the registered representative or customer.
- including a check digit in the customer account number on order forms.
- segregating and not processing orders lacking required information, such as an invalid contra broker-dealer number.
- verifying completed order forms.
- not processing limit orders if the execution price is not within predetermined market limits.
- using order forms that provide for the entry of all relevant information about an order to be processed.
- time-stamping orders when they are placed, when they are transmitted to exchanges or trading rooms, and upon notice of execution. Disputes regarding prices can be resolved based on the time the order was placed and executed.

- requiring orders, other than those automatically executed, to be initiated by a registered representative, placed by the order desk, executed by a trader, and confirmed by a clerk.
- reviewing exception reports to resolve quantity and price differences.

**6.71** *Sales compliance.* The compliance department is responsible for ensuring that the broker-dealer's sales activities are conducted in accordance with applicable laws and regulations. Some of the control and monitoring activities typically associated with and in connection with regulatory rules requiring adequate supervision of the sales compliance function include the following:

- Monitoring and reviewing transactions in customer accounts for suitability, particularly with respect to discretionary accounts
- Documenting and investigating customer complaints
- Requiring sales representatives to be registered in accordance with applicable regulations
- Monitoring and reviewing transactions in employee accounts
- Requiring a cash transaction reporting form to be completed for all receipts of funds, in conformity with anti-money laundering rules and regulations, including the Bank Secrecy Act
- Reviewing proprietary transactions to identify transactions that may violate prohibitions on insider trading or represent manipulative and deceptive practices
- Monitoring and actively reviewing closed accounts or inactive accounts
- Generating and then reviewing exception reports that highlight unusual activity
- Reviewing sales and advertising literature to ensure compliance with federal and state securities laws, as well as various regulations of self-regulatory bodies
- Reviewing IPOs to customers to ensure that the securities offered are registered in accordance with the Securities Act of 1933 and in accordance with state Blue-Sky laws

## Clearance

**6.72** *Purchases and sales.* The purchase and sales (P&S) department processes customer and proprietary orders and is responsible for the following:

- Recording P&S transactions if that is not done automatically through the order entry process
- Preparing confirmations of securities transactions
- Comparing transactions with other broker-dealers and clearing organizations and computing commissions, taxes, and other fees

**6.73** Some of the control and monitoring activities typically associated with the P&S department include the following:

- Compare the total number of orders entered with the total number of orders on the trade date blotter, and reconcile any differences (for instance, canceled trades, limit orders not executed, and rejects).



- Compare all transactions cleared through clearing organizations with clearing organization contract sheets or electronically through IT interfaces (including electronic communications networks), and compare all broker-to-broker transactions with confirmations received from the contra broker-dealer.
- Recap daily the adjustments between trade date blotters (such as T/D+1, T/D+2, and T/D+3), and use them to reconcile those blotters.
- Trace all totals on the settlement blotters to the general ledger.
- Prohibit P&S personnel from obtaining access to customer accounts, stock records, margin records, the cashier's department, and the mailing department through systems or other processes.
- Compare order tickets on a test basis with entries on the trade date blotter, and recompute commissions, taxes, and other fees.
- Balance principal transactions with customers internally against the firm trading accounts with exceptions promptly entered into the suspense file and investigated.
- Balance presettlement customer and streetside transactions daily, to ensure that balance entries are posted to the general ledger and securities record.
- Periodically (preferably daily) review, age, and report to appropriate officials concerning open P&S suspense items because suspended trades represent potential fails, "don't knows," unknown inventory positions, or financing costs.
- Agree amounts and account distributions on the settlement blotter to general ledger entries.
- Summarize on exception reports and actively review "as of" transactions and "canceled and corrected" transactions.
- Mail trade confirmations to customers generally before settlement date and report any misstatements noted by customers.

## Securities Settlement

**6.74** *Receive and deliver.* All receipts and deliveries of securities and money are handled by the receive-and-deliver section of the cashier's department, this is either performed physically or by electronic book entry. Some of the control and monitoring activities typically associated with the receive-and-deliver function include the following:

- Monitoring real-time and overnight batch process matching with clearing organizations to identify any securities due for settlement that cannot be settled
- Ensuring end-of-day cash and securities movements agree to clearing organizations for continuous net settlement accounts
- Periodically reviewing operations suspense items to determine the propriety of receivables or payables carried in the account
- Receiving or delivering securities only if they are supported by written instructions prepared by another department or workstation
- Electronic imaging of securities received and delivered to resolve any differences between broker-dealers

- Examining for negotiability (that is, properly endorsed, signed, guaranteed, or otherwise papered) and for completeness (that is, coupons and warrants) securities received before they are placed in the active box or vault
- Recording the certificate numbers of securities received
- Authorizing certain designated employees to execute or guarantee assignments
- Maintaining control over the facsimile signature devices used
- Designating an employee who does not handle securities or cash to determine that payment is received when securities are delivered against payment
- Bonding all employees who handle securities and money
- Balancing daily movements of securities and assigning responsibility for the clearance of out-of-balance positions to specific individuals who have no other duties related to any other aspects of securities processing
- Investigating and resolving securities positions (and related ledger amounts) in suspense accounts on a timely basis
- Ensuring that due bills for dividends are identified and recorded with the receipt or delivery of securities
- Periodically comparing the details of fails to receive and fails to deliver with the stock record, in accordance with SEC Rule 17a-13, and agreeing the respective amounts receivable or payable to the related general ledger control accounts
- Maintaining aging schedules of fail-to-receive and fail-to-deliver transactions currently, following up on aged fail transactions, initiating buy-ins in accordance with various regulatory rules, and analyzing aged fails for regulatory purposes
- Periodically reviewing operations suspense items to determine the propriety of receivables or payables carried in the account
- Comparing suspense items with underlying trade tickets or other records and reviewing the propriety of the subsequent clearance of suspense items

**6.75** *Extension of credit.* The margin department, also called the credit department, monitors the extension of credit to customers. Some of the control and monitoring activities over transactions with customers that are typically associated with the margin department include the following:

- Establishing procedures to ensure compliance with the requirements of Federal Reserve Regulation T (Regulation T) of the Board of Governors of the Federal Reserve System, including cash, margin, and other accounts, as well as maintenance margin (Financial Industry Regulatory Authority Rule 4210) requirements.
- Implementing a system designed to prevent violations of Regulation T and similar regulations addressing the extension and maintenance of credit, including the prompt issuance of Regulation T calls and maintenance calls, and prompt follow-up action in the event that calls are not met.

- Implementing a system to have “house” margin requirements that are higher than those established by regulatory authorities if it is considered necessary for the protection of the broker-dealer.
- Performing credit investigations before transacting business with a customer and before establishing credit limits.
- Obtaining signed margin agreements before trading in a margin account can occur.
- Disbursing cash and delivering securities only upon written authorization of the appropriate personnel.
- Requiring the authorization of margin department personnel before paying funds or withdrawing securities from customers’ accounts.
- Prohibiting margin clerks from initiating entries to customer accounts and from having contact with customers’ securities, remittances, or disbursements.
- Assigning responsibility for monitoring customer accounts to specific employees who are rotated onto other duties periodically.
- Reviewing margin records periodically (by an employee who has no duties in connection with them) to determine that the minimum margin requirements of the firm are being maintained.
- Reviewing customer accounts on a regular basis to ensure sufficient margin exists to meet “house” and regulatory requirements. When accounts are determined to be undermargined, requesting additional collateral from the customer to properly secure the account.
- Promptly reporting to management on customers’ undermargined accounts and unsecured or partly secured accounts for purposes of evaluation concerning collectibility.
- Delegating duties appropriately and rotating the duties of personnel in key control areas.
- Accepting securities received from customers that are registered in a name other than the customer’s only if proof of ownership is provided.
- Permitting only designated employees to make entries to customer accounts and requiring that two employees approve changes to customer account files. Limit the types of transactions (such as cash receipts, cash disbursements, securities receipts and deliveries, or adjustments) that an employee can initiate.
- Establishing procedures to ensure compliance with the requirements of SEC Rules 400–406 and Commodity Futures Trading Commission Rules 41.42–41.49 governing customer margin for transactions in security futures.
- Reviewing securities underlying receivables and payables regularly concerning their valuation.

## Custody<sup>9</sup>

**6.76 Cashiering.** The cashiering department is responsible for the custody, safekeeping, and segregation of securities, either in the firm vault or at depositories. Some of the control and monitoring activities typically associated with the custody function include

- agreeing results of security counts, and verifications to the stock record with any differences noted, in accordance with Rule 17a-13, and following to a conclusion.
- agreeing daily, and reconciling at least monthly, the details of transactions for accounts carried by other broker-dealers (such as omnibus accounts) and resolving any differences.
- reconciling the securities held at depositories to the stock record daily.
- balancing on a daily basis customer accounts with the stock record and general ledger control accounts, as well as with margin department records.
- identifying and segregating worthless and restricted securities.
- confirming securities, counting securities, or both, once each calendar quarter and comparing the results to the books and records, as required under SEC Rule 17a-13. Rule 17a-13 requires that certain broker-dealers, at least once in each calendar quarter, physically examine and count all securities held and account for all other securities that are subject to the broker-dealer's control or direction and are not in its physical possession. The counting and verification of securities is required to be performed by or supervised by personnel that do not have daily responsibility for the securities.
- noting, in the records of the broker-dealer, customers' fully paid and excess margin securities as securities required to be in its physical possession or control in accordance with SEC Rule 15c3-3; maintaining records of customers' fully paid and excess margin securities not in the broker-dealer's possession or control, determining the location of such securities and initiating action to bring them into possession or control within the time frames set forth in the rule.
- maintaining securities that are on the premises in a fireproof vault.
- keeping securities that are not needed in daily operations at depositories.
- maintaining physical controls over securities on hand by restricting access to areas containing securities to authorized employees and by always keeping the cage and vault doors locked.
- using dual controls over access to securities.
- limiting the number of employees who have access to physical securities.
- periodically imaging electronically securities on hand for use in researching any misstatements.
- conducting surprise counts of securities on hand.

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<sup>9</sup> A broker-dealer that is also a registered investment adviser is subject to additional requirements related to custody. See the "Additional Requirements for Registered Investment Advisers" section in chapter 3 of this guide.

**6.77** *Securities transfer.* The transfer department is responsible for the transfer of ownership and the registration and reissuance of securities. The following are some of the control and monitoring activities typically associated with the transfer department:

- Recording in a memo field on the stock record transfer instructions
- Matching securities received back from the transfer agent against open transfer instructions
- Maintaining and reporting, for management and regulatory purposes, the aging of open transfer items
- Periodically confirming with the transfer agent aged open transfer items

## Dividends, Interest, and Reorganization

**6.78** *Dividends and interest.* The dividend department normally monitors dividends declared by business entities; monitors the collection (and payment, if the broker-dealer is short) of dividends; records interest and dividends on securities owned by the firm or its customers; and credits customer and firm accounts with their dividends and interest. The following are some of the control and monitoring activities typically associated with the processing of dividends and interest:

- Receiving information regarding dividend declarations, pending coupon payments, factor changes, and other corporate actions electronically from independent dividend-reporting services
- Manually reviewing input dividend information separately
- Obtaining information regarding bond interest coupon dates when new issues are recorded on the securities master file
- Automatically creating on the record date from an extract of the stock record (commonly referred to as a take-off sheet) a dividend file that identifies all long and short security positions in each issue for which a dividend has been declared
- Crediting, through an automated process on the payment date, all entries to customer, noncustomer, and processing accounts
- Recording in the suspense account and having the dividend department investigate differences between money received and the receivable amount or between money paid and the payable amount
- Following up with paying agents or depositories holding the firm's and its customers' securities in street name for payments
- Routinely aging receivables and payables and long and short stock dividends for exposure and for regulatory and escheatment purposes, and reporting them to management
- Agreeing customer elections as recorded in the dividend system or offline file to supporting documentation, for dividends that may be paid in either cash or shares at the discretion of the customer

**6.79** *Reorganizations.* The reorganization department is responsible for the processing of securities involving corporate reorganizations, consolidations, subscriptions, and exchanges. Some of the control and monitoring activities typically associated with reorganization departments include

- receiving information regarding pending reorganization transactions electronically from independent reporting services.
- manually reviewing input reorganization information separately.
- controlling physical movements of securities subject to pending reorganizations by processing them through the appropriate reorganization accounts.
- balancing all reorganization transactions on a security-by-security basis.
- periodically recording and confirming money receivable or securities at agents with any differences entered into a suspense account and investigated.
- agreeing customer elections as recorded in the reorganization system or offline file to supporting documentation for reorganizations in which a vote, election, or other matter is at the discretion of the customer

### To-Be-Announced Securities

**6.80** Broker-dealers often obtain and sell the rights to mortgage-backed securities that have not been issued yet. These to-be-announced (TBA) transactions are unique operationally because they have certain characteristics of both a security and a derivative. Some of the control and monitoring activities that are typically associated with such securities include

- establishing and monitoring a standardized strategy for allocating TBAs to specified pools.
- analyzing and monitoring securities received in incoming pools.
- properly recording unallocated TBAs as fails.
- ensuring that the allocation of TBAs to pools is efficient, adequately validated, and properly recorded.
- ensuring that complete and correct factor updates are received on a timely basis.
- obtaining principal and interest information (including factors) from external sources (especially for derivatives) and ensuring that the validated information is updated on the appropriate systems on a timely basis.

### Principal Transactions

**6.81** *Firm trading.* Many broker-dealers buy and sell securities and over-the-counter (OTC) derivatives in their capacity as dealers and as part of various positioning strategies that attempt to generate profits by anticipating future market movements. These dealer and positioning strategies are collectively referred to as firm trading. Given the volatility of the financial markets, proper control and monitoring activities over firm trading activities are critical. Some of the control and monitoring activities that are typically associated with firm trading generally include

- monitoring the internal testing and review of high-frequency trading algorithms prior to implementation.
- establishing and monitoring overall position limits, as well as separate limits for each trader and product.

- comparing trade tickets to the daily transaction information recorded on the firm's books and records.
- time stamping or electronic monitoring of trade tickets at the time a transaction is received and executed.
- reviewing cancel and correction trade ticket adjustments.
- sending trade confirmations to each counterparty.
- reviewing and verifying all confirmations received from counterparties.
- reviewing suppressed trades and aged trade confirmations.
- daily monitoring positions and trading gains and losses by each trader on a trade-date basis.
- daily independent calculation and reconciliation of trading desk records, which are maintained on a trade-date basis, to the accounting department records.
- periodic, independent review of fair value of firm trading positions (see paragraph 6.83 for further details).
- management review of reports of all aged positions.
- management review of reports of position concentrations.
- recording traders' phone conversations with counterparties.
- daily reviewing the automated comparison of settled positions on the firm inventory system versus positions on the stock record.
- daily balancing principal transactions conducted with the broker-dealer's customers.
- reviewing pending trades file.
- performing reconciliations between the front-end trading systems and the general ledger.

**6.82** *Underwriting.* A broker-dealer may act as a manager, comanager, or syndicate member in the underwriting of public or private offerings of securities. Many of the control and monitoring activities related to firm trading also serve as control and monitoring activities over underwriting activity. Some additional control and monitoring activities typically associated with the underwriting function include

- maintaining the subscription records for the underwriting, and receiving from members of the buying and selling groups reports of orders from their customers, so that the managing underwriter knows at all times the status of the offering.
- separately accounting for the revenue and expenses of the syndicate.
- aging and separately maintaining on a deal-by-deal basis amounts receivable or payable that are recorded on the broker-dealer's books pursuant to an underwriting.

**6.83** *Reporting fair value.* Management is responsible for having controls in place in order to adequately determine the fair value of securities held on a day-to-day basis and at the end of a reporting period. Some of the control and monitoring activities typically associated with calculating and reporting the fair value of financial instruments include

- employing personnel who are involved in the determination of fair value and are experienced with the products and pricing methodologies used.
- establishing or maintaining a pricing validation group that is independent from the front office, which reviews securities valuation by comparing pricing or other input data from multiple sources, reviews valuations based on established tolerances, analyzes day-to-day movements in valuation for unusual activity, evaluates stale data, and the like.
- establishing or maintaining a model validation group for securities held by broker-dealers that are complex or when there is limited market data available. The model validation group supervisor performs a review of significant inputs and other parameters, and is independent from the front office.
- ensuring policies and procedures are in place to review and approve new or changes to existing valuation models.
- periodically revalidating outputs of valuation models to ensure the models still function as intended.
- reporting results of independent pricing and model verifications to senior management and financial reporting departments for review.
- periodic reconciling of automated data feeds to source data.
- monitoring for credit events or other market trends that may indicate a change in previous fair value calculations.
- periodically analyze unrealized gains and losses for unusual activity.
- performing an independent analysis the classification of securities as level 1, 2, or 3 to verify liquidity of the marketplace and observability of pricing inputs.

## OTC Derivative Transactions<sup>10</sup>

**6.84** Many broker-dealers enter into derivative transactions in their capacity as dealers and as part of various strategies. Some of the control and monitoring activities that are typically associated with such transactions include

- providing training to staff with respect to systems used to process derivatives, as well as technical updates on the processing of, and accounting for, new products.
- hiring staff that is experienced with the various types of products processed and ensuring that such staff is supervised by experienced individuals.
- reviewing the systems used to process and account for derivative transactions in order to ensure that they are operating as intended.

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<sup>10</sup> Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires the SEC to work with other regulators, the Commodity Futures Trading Commission in particular, to write rules that result in a reorganization of the over-the-counter derivatives market. The rulemaking required to implement the Dodd-Frank Act provisions in this area is extensive, and work is continuing by regulators. See chapter 3 of this guide for more information.



- reviewing the system selected to process derivative transactions to ensure it is able to handle the current and projected volume of business.
- ensuring that systems or technical personnel are capable of supporting the current system and augmenting features of the system as needed.
- developing a contingency plan in the event the system breaks down.
- restricting access to the system by using codes and passwords.
- obtaining and maintaining signed contracts for each derivative transaction, as well as maintaining a list of outstanding unsigned contracts.
- reviewing master netting agreements and the presentation of netted transactions to ensure that they comply with requirements of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 210, *Balance Sheet*.<sup>11</sup>
- reviewing files periodically to validate that they include correspondence from counterparties regarding payment instructions, amounts to be paid or received, modifications to current contracts, and notifications of early terminations and final payments.
- separating the functions of inputting derivative transactions into the system and verifying the accuracy of the input.
- separating such functions as monitoring, calculating, and processing of payments and receipts.
- ensuring that the execution of derivative transactions and the monitoring of counterparty credit quality and counterparty exposure limits are performed by separate individuals.
- establishing and maintaining formal policies concerning hedging strategies.<sup>12</sup>
- restricting control and maintenance over legal documentation.
- performing reconciliations between cash disbursements and receipts, systems calculations, and correspondence from counterparties.
- performing the valuation of the derivatives portfolio frequently and obtaining from reliable sources consistently on each valuation date the market data used to value the portfolio (see paragraph 6.83 for further details). Limit access to models used to value positions and

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<sup>11</sup> Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) No. 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities*, issued in December 2011, is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. Early adoption is not permitted. ASU No. 2011-11 requires enhanced disclosures about financial instruments and derivative instruments that are either offset in accordance with FASB *Accounting Standards Codification* (ASC) 210-20-45 or FASB ASC 815-10-45, or subject to an enforceable master netting arrangement or similar agreement (irrespective of whether they are offset in accordance with the aforementioned FASB ASC sections).

The effective date of ASU No. 2013-01, *Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*, is the same as the effective date of ASU No. 2011-11. The amendments provide clarification of the scope of the disclosure requirements in ASU No. 2011-11. See chapter 4, “Financial Statement Presentation and Classification,” and chapter 7, “Accounting Standards,” of this guide for more information.

<sup>12</sup> Hedge accounting is permitted only if the requirements of FASB ASC 815, *Derivatives and Hedging*, are met.

review changes made to those models. The valuation process and the verification of this process is performed by individuals who are independent of the traders.

- analyzing the changes in the portfolio's valuation into the following separate components:
  - Market fluctuations.
  - Accretion.
  - Swap payments and receipts.
  - Maturations and terminations.
  - New transactions.
- reconciling traders' estimates of profit and loss to the portfolio valuation system.

## Commissions

**6.85** Many broker-dealers earn commissions and fees from executing and clearing client transactions on stock, options, and futures markets. Some of the control and monitoring activities that are typically associated with such transactions include

- sending statements to customers that provide account information (for example, statement period, account number, customer contact information, clearing firm and contact information, summary of the client holdings, recent market value of client holdings, income [gains and losses], fees charged, account activity [trading activity, movement of money or securities, and the beginning and ending balance for the statement period], margin, and other portfolio level detail), and reconciling or investigating any variances identified by the customer.
- maintaining and reviewing a customer complaint log.
- maintaining an approved commission rates table, including approvals for any subsequent changes made to such tables.
- reviewing commission rates in excess of commission rate tables.

## Collateralized Financings

**6.86** *Stock loan and stock borrow.* Stock loan and borrow transactions generally result from the need for one broker-dealer to borrow securities to make delivery to another broker-dealer or customer for a security that the broker-dealer does not have in its possession. At large broker-dealers, the stock loan department has responsibility for entering into and monitoring such transactions, as well as processing the "recall" of the securities as directed by the lender. Some of the control and monitoring activities typically associated with stock loan and stock borrow activity include

- reviewing counterparties for creditworthiness and obtaining master trade agreements and credit approval for counterparties before entering into a stock-loan or stock-borrow transaction.
- establishing approved transaction limits by counterparty.
- listing those securities in excess of SEC Rule 15c3-3 possession or control requirements as available to be loaned for any given day. Recalling those securities in deficits within the time frames required.

- obtaining physical possession or control of all collateral, and reconciling it to signed agreements.
- ensuring that borrowings are made in accordance with the requirements of Regulation T.
- subsequently measuring at fair value all collateral daily and, if a deficit (within established guidelines) exists, obtaining additional collateral from the counterparty.
- reconciling the stock-loan and stock-borrow subsidiary ledgers to the stock record (positions) and general ledger (contract amounts) daily. Out of balances are recorded as suspense items and researched immediately.
- confirming securities borrowed and lent periodically, on a basis that, at a minimum, complies with SEC Rule 17a-13 regarding the quarterly verification of securities.
- confirming key contract terms (for example, underlying security, quantity, price, and rate) for each stock loan or stock borrow transaction.
- listing transactions with unusually high or low rebate terms on an exception report for review by management.
- obtaining and reviewing the SOC 1 report of third party vendors that are involved in securities lending transactions and addressing all user control considerations and any control issues that are identified. (See the discussion beginning in paragraph 6.11 for information on the auditor's responsibility when the broker-dealer uses a service organization in its operations.)

**6.87** *Repos and reverse repos.* A *repurchase agreement* (repo) is the sale of securities along with an agreement to purchase the securities at a specified price at a later, specified date. Repo agreements are typically entered into to finance positions in government and government-agency securities. A *reverse repurchase agreement* (reverse repo) is the purchase of securities along with an agreement to sell the securities at a specified price at a later, specified date. Repos and reverse repos, similar to stock-loan and stock-borrow transactions, respectively, feature a provider of collateral and a lender of cash. Control and monitoring activities typically associated with repo and reverse repo agreements include

- reviewing counterparties for creditworthiness and obtaining master trade agreements and credit approval for counterparties before entering into a repo or reverse repo transaction.
- establishing position and credit limits by counterparty.
- reviewing presentation of offsetting transactions (netdown) to ensure that it complies with the requirements of FASB ASC 210-20-45.<sup>13</sup>
- obtaining collateral from the counterparty.
- subsequently measuring at fair value all collateral daily; if a deficit (within established guidelines) exists, additional collateral may be obtained from the counterparty.

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<sup>13</sup> See footnote 11.

- reconciling the repo and reverse repo subsidiary ledgers to the stock record (positions) and general ledger (contract amounts) daily. Out of balances are recorded as suspense items and researched immediately.
- periodically confirming transactions on a basis that, at a minimum, complies with SEC Rule 17a-13 regarding quarterly verification of securities.
- listing transactions with unusually high or low interest terms on an exception report for review by management.

**6.88** *Bank loan financing.* A broker-dealer may finance its proprietary or customer activity through collateralized bank loans. Such loans are generally negotiated separately with each bank. Some of the control and monitoring activities typically associated with bank loan financing include

- ensuring that customer, noncustomer, and firm bank loans are separately maintained and that procedures are in place to prevent commingling of collateral.
- maintaining separate accounts in the general ledger for each loan, with separate positions being maintained on the stock record for the securities collateralizing each loan.
- ensuring that securities used to collateralize bank loans for customers are not fully paid or excess-margin securities because such securities are required to be segregated pursuant to SEC Rule 15c3-3 possession or control requirements.
- periodically confirming bank loan collateral on a basis that, at a minimum, complies with SEC Rule 17a-13 regarding the quarterly verification of securities.

## Period End Financial Reporting

**6.89** In addition to periodic financial reporting on Financial and Operational Combined Uniform Single reporting, broker-dealers are required to prepare annual financial statements including all required disclosures. Management is responsible for preparing complete and accurate financial statements in accordance with authoritative accounting guidance. Control and monitoring activities typically associated with the period-end financial reporting process include

- period-end close procedures, including recurring adjustments and consolidation procedures, are established and approved by management and documented, which is reviewed and compared to the procedures performed and adjustments made at each period end.
- reconciling general ledger accounts to source systems and subledgers by personnel other than those making the entries; any variances from the expectation are identified, researched, and resolved if necessary.
- appropriate configuration of the general ledger system for posting and closing periods; period-end close is prevented if incomplete or erroneous transactions are detected.
- reconciling the subledger or stock record, or both, and key external parties, including banks and depositories.
- management's review of automated reconciliations performed by the system for completeness and accuracy.

- management’s review of periodic business analyses on performance and other metrics that are prepared using source system data; any unexpected findings are researched and responded to appropriately.
- management’s review and approval of manual journal entries, consolidation entries, and any entries that are recorded directly to the financial statements.

## Report on Internal Control Required by SEC Rule 17a-5(g)(1)<sup>14</sup>

**6.90** The auditor has specific requirements under SEC Rule 17a-5(g)(1) related to internal control. The auditor is required to make, and report on, a study of the practices and procedures followed by the broker-dealer, including consideration of control procedures for safeguarding securities. The practices and procedures should be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the audit would be disclosed. The specific areas to be covered as part of this study include the following:

- The accounting system
- The internal accounting control
- Procedures for safeguarding securities
- The practices and procedures followed by the broker-dealer with respect to the following:
  - The periodic computations of net capital under SEC Rule 17a-3(a)(11) and the reserve required by SEC Rule 15c3-3(e)
  - The quarterly securities count rule (SEC Rule 17a-13)
  - Regulation T requirements for prompt payment of securities
  - Obtaining and maintaining physical possession or control of securities as required by SEC Rule 15c3-3, including a determination about the adequacy of the procedures described in the records required to be maintained pursuant to SEC Rule 15c3-3(d)(4)

See chapter 3, “Regulatory Considerations,” of this guide for more information on this report and information on the guidance found in SEC Rule 17a-5(g)(3) relating to material inadequacy. See also appendix D, “Report on Internal Control Required by SEC Rule 17a-5(g)(1).”

## SEC Requirements for Management’s Report on Internal Control Over Financial Reporting for Issuers

**6.91** SEC Rule 13a-15(f) defines *internal control over financial reporting* as a process designed by, or under the supervision of, the (company’s) principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant’s board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes those policies and procedures that

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<sup>14</sup> See footnote 2.

- a. pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;
- b. provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and
- c. provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

**6.92** As directed by Section 404 of the Sarbanes-Oxley Act of 2002 (SOX), in 2003, the SEC adopted final rules requiring companies subject to the reporting requirements of the Securities Exchange Act of 1934 (the 1934 Act), other than registered investment companies, to include in their annual reports a report of management on the company's internal control over financial reporting. The SEC rules clarify that management's assessment and report is limited to internal control over financial reporting. Management is not required to consider other aspects of control, such as controls pertaining to operations or compliance with laws and regulations. The SEC's definition of *internal control* encompasses the COSO definition, but the SEC does not mandate that the entity use the COSO framework as its criteria for evaluating effectiveness; however, the company must disclose which framework it uses to evaluate internal controls. See the SEC website at [www.sec.gov/rules/final/33-8238.htm](http://www.sec.gov/rules/final/33-8238.htm) for the full text of the regulation.

**6.93** This requirement is applicable to issuer broker-dealers, whereas nonissuer broker-dealers are not required to include in their annual reports a management report on the company's internal control over financial reporting. However, for broker-dealers that are subsidiaries of public companies (issuers), auditors may perform additional procedures to be able to report on the consolidated entity's financial statements and internal control in accordance with the SEC requirements and PCAOB standards.

**6.94** A company that is an accelerated filer or a large accelerated filer, as defined in Rule 12b-2, is required to comply with the SEC rules regarding Section 404(b) of SOX that includes providing an auditor's attestation report on internal control over financial reporting in its annual report. Section 989G of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) contains a provision that permanently exempts nonaccelerated filers (those filers that do not meet the definition of an accelerated filer or a large accelerated filer) from complying with Section 404(b) of SOX. SEC Release 33-9142, *Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-accelerated Filers*, issued in 2010, contains conforming amendments to align its regulations to Section 989G of the Dodd-Frank Act, thereby permanently exempting nonaccelerated filers from the provisions of Section 404(b) of SOX.

## Annual Reporting Requirements for Issuers

**6.95** In accordance with SEC rules, item 9A, “Controls and Procedures,” of the company’s annual Form 10-K must include the following:

- a. *Management’s Annual Report on Internal Control Over Financial Reporting.* This report on the company’s internal control over financial reporting should contain
  - i. a statement of management’s responsibilities for establishing and maintaining adequate internal control over financial reporting.
  - ii. a statement identifying the framework used by management to evaluate the effectiveness of the company’s internal control over financial reporting.
  - iii. management’s assessment of the effectiveness of the company’s internal control over financial reporting as of the end of the most recent fiscal year, including a statement concerning whether internal control over financial reporting is effective. This discussion should include disclosure of any material weakness in the company’s internal control over financial reporting identified by management. Management is not permitted to conclude that the registrant’s internal control over financial reporting is effective if there are one or more material weaknesses in the company’s internal control over financial reporting.
  - iv. a statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management’s assessment of the registrant’s internal control over financial reporting.
- b. *Attestation Report of the Registered Public Accounting Firm.* This is the registered public accounting firm’s attestation report on management’s assessment of the company’s internal control over financial reporting.
- c. *Changes in Internal Control Over Financial Reporting.* This report should disclose any change in the company’s internal control over financial reporting that has materially affected or is reasonably likely to materially affect the company’s internal control over financial reporting.

## Quarterly Reporting Requirements for Issuers

**6.96** The SEC rules also require management to evaluate any change in the entity’s internal control that occurred during a fiscal quarter and that has materially affected, or is reasonably likely to materially affect, the entity’s internal control over financial reporting.

**6.97** Additionally, management is required to evaluate the effectiveness of the entity’s *disclosure controls and procedures* and *issue a report concerning their effectiveness on a quarterly basis*. With these rules, the SEC introduced a new term, *disclosure controls and procedures*, as defined in SEC Rule 13a-15(d), that is different from *internal controls over financial reporting* and much broader.

**6.98** As defined, *disclosure controls and procedures* encompass the controls over all material financial *and nonfinancial information* in the 1934 Act reports. This definition refers to information disclosed outside the financial statements. Information that would fall under this definition that may *not* be part of an entity's internal control over financial reporting might include, for example, disclosures related to the signing of a significant contract, changes in a strategic relationship, management compensation, or legal proceedings.

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## Chapter 7

# Accounting Standards

### ***Presentation of Pending Content in the Financial Accounting Standards Board Accounting Standards Codification***

Amendments to Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) (issued in the form of Accounting Standards Updates [ASUs]) are initially incorporated into FASB ASC in “Pending Content” boxes located below the paragraphs being amended with links to the transition information. The pending content boxes are meant to provide users with information about how the guidance in a paragraph will change as a result of the new guidance.

Pending content applies to different entities at different times due to varying fiscal year-ends and because certain guidance may be effective on different dates for public and nonpublic entities. As such, FASB maintains amended guidance in pending content boxes within FASB ASC until the “roll-off” date. Generally, the roll-off date is six months following the latest fiscal year end for which the original guidance being amended could still be applied.

### ***Presentation of Pending Content in AICPA Audit and Accounting Guides***

Amended FASB ASC guidance that is included in pending content boxes in FASB ASC on May 1, 2013, is referenced as “Pending Content” in this guide. “Pending Content” referenced or discussed within this guide’s chapter is fully effective as of the date of this guide and should be considered by readers for current reporting periods. “Pending Content” referenced or discussed within this guide’s shaded “Guidance Updates” boxes that follow or within appendix A, “Guidance Updates,” is not fully effective as of the date of this guide. Readers should be aware that “Pending Content” referenced in this guide will eventually be subjected to FASB’s roll-off process and will no longer be labeled as “Pending Content” in FASB ASC (as discussed in the previous paragraph).

**7.01** Accounting principles generally accepted in the United States of America (GAAP) apply to broker-dealers in the same manner as they apply to other industries; however, certain activities of broker-dealers’ operations are unique. It is the purpose of this chapter to identify and discuss the accounting treatment for certain of those unique activities that are engaged in by broker-dealers. New broker-dealer activities may develop that will require accounting guidance to reflect their economic substance. The accounting principles that apply to the specific activities addressed in this chapter can be applied to other activities that are similar to those discussed. Broker-dealers also prepare regulatory reports and supplemental information, in addition to financial statements. Accounting and reporting requirements under GAAP may differ from broker-dealer regulatory accounting and reporting requirements stipulated by the Securities and Exchange Commission (SEC) and other regulatory organizations. (See chapter 3, “Regulatory Considerations,” of this guide.) In addition, the financial reporting practices and recording of transactions discussed in this chapter may differ significantly from the tax basis of reporting.

## Accounting Model

**7.02** A broker-dealer accounts for inventory and derivative positions (such as futures, forwards, swaps, and options) at fair value. Most other assets, such as fixed assets, accounts receivable, securities borrowed, securities purchased under agreements to resell (known as resale or reverse repurchase agreements [reverse repos]), and exchange memberships owned, are reported at historical cost, at contract, or the fair value of collateral to be returned. The FASB ASC glossary defines *collateral* as personal or real property in which a security interest has been given. Obligations for short inventory positions are reported at fair value.

**7.03** Per FASB ASC 940-20-30-2, liabilities related to broker-dealer operations, such as fails to receive and securities sold under agreements to repurchase (known as repurchase agreements [repos]), are recorded at contract amounts or the fair value of collateral to be returned.

**7.04** Fair value is measured by management using the guidance provided in FASB ASC 820, *Fair Value Measurement*, and is usually determined for accounting purposes as of the end of the entity's business day in the principal location of the broker-dealer entity issuing financial statements.

**7.05** FASB ASC 820 defines *fair value* (see paragraph 7.07 for the definition), establishes a framework for measuring fair value, and requires certain disclosures about fair value measurement. The following paragraphs summarize FASB ASC 820 but are not intended as a substitute for reviewing FASB ASC 820 in its entirety.

**7.06** In May 2011, FASB issued ASU No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*.<sup>1</sup> The objective of this ASU was to improve the comparability of fair value measurements presented and disclosed in financial statements prepared in accordance with U.S. GAAP and International Financial Reporting Standards (IFRSs). The amendments include clarification of FASB's intent about the application of existing fair value measurement and disclosure requirements and those that change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. See chapter 4, "Financial Statement Presentation and Classification," of this guide for information related to disclosures required by FASB ASC 820 and the related effect of ASU No. 2011-04.

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<sup>1</sup> In February 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2013-03, *Financial Instruments (Topic 825): Clarifying the Scope and Applicability of a Particular Disclosure to Nonpublic Entities*. ASU No. 2013-03 was issued to clarify the scope and applicability of a particular disclosure to nonpublic entities that resulted from the issuance of ASU No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. Contrary to the stated intent of ASU No. 2011-04 to exempt all nonpublic entities for a particular disclosure, its amendments to FASB *Accounting Standards Codification* (ASC) 825, *Financial Instruments*, suggested that nonpublic entities that have total assets of \$100 million or more or that have one or more derivative instruments would not qualify for the intended exemption. The amendments in ASU No. 2013-03 clarify that the requirement to disclose "the level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2, or 3)" does not apply to nonpublic entities for items that are not measured at fair value in the statement of financial position but for which fair value is disclosed.

## Definition of Fair Value

**7.07** FASB ASC 820-10-20 defines *fair value* as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. “Pending Content” in FASB ASC 820-10-35-5 states that a fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place either in the principal market for the asset or liability or, in the absence of a principal market, in the most advantageous market for the asset or liability. “Pending Content” in the FASB ASC glossary defines the *principal market* as the market with the greatest volume and level of activity for the asset or liability. The reporting entity must have access to the principal (or most advantageous) market at the measurement date. Because different entities with different activities may have access to different markets, the principal or most advantageous market for the same asset or liability might be different for different entities (and business within those entities). The principal market (and, thus, market participants) should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities.

**7.08** “Pending Content” in FASB ASC 820-10-05-1B notes that fair value is a market-based measurement, not an entity-specific measurement. For some assets and liabilities, observable market transactions or market information might be available, but, for others, that information might not be available. However, the objective of a fair value measurement in both cases is the same, to estimate the price at which an orderly transaction to sell the asset or transfer the liability would take place between market participants at the measurement date under current market conditions (that is, an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability). Conceptually, entry prices and exit prices are different. However, “Pending Content” in FASB ASC 820-10-30-3 explains that, in many cases, at initial recognition, the transaction price will equal fair value (for example, when the transaction takes place in the market in which the asset would be sold).

**7.09** “Pending Content” in paragraphs 9B–9C of FASB ASC 820-10-35 provide that the price should not be adjusted for transaction costs. Transaction costs do not include transportation costs. If location is a characteristic of the asset (for example, for a commodity), the price should be adjusted for the costs, if any, that would be incurred to transport the asset from its current location to its principal (or most advantageous) market.

## Application of Fair Value Measurement to Liabilities and Instruments Classified in a Reporting Entity’s Shareholders’ Equity

**7.10** According to “Pending Content” in FASB ASC 820-10-35-16, a fair value measurement assumes that financial or nonfinancial liability or an instrument classified in a reporting entity’s shareholders’ equity is transferred to a market participant at the measurement date. The transfer of a liability or an instrument classified in a reporting entity’s shareholders’ equity assumes the following:

- A liability would remain outstanding and the market participant transferee would be required to fulfill the obligation. The liability would not be settled with the counterparty or otherwise extinguished on the measurement date.

- An instrument classified in a reporting entity's shareholders' equity would remain outstanding and the market participant transferee would take on the rights and responsibilities associated with the instrument. The instrument would not be canceled or otherwise extinguished at the measurement date.

**7.11** "Pending Content" in FASB ASC 820-10-35-16A states that even when there is no observable market to provide pricing information about the transfer of a liability or an instrument classified in a reporting entity's shareholders' equity (for example, because contractual or other legal restrictions prevent the transfer of such items), there might be an observable market for such items if they are held by other parties as assets (for example, a corporate bond or a call option on a reporting entity's shares). In all cases, a reporting entity should maximize the use of relevant observable inputs and minimize the use of unobservable inputs to meet the objective of a fair value measurement. See the "Pending Content" in paragraphs 16D–16L of FASB ASC 820-10-35 for additional guidance regarding measuring the fair value of liabilities and instruments classified in a reporting entity's shareholders' equity.

**7.12** "Pending Content" in paragraphs 17–18 of FASB ASC 820-10-35 provides that the fair value of a liability reflects the effect of nonperformance risk. Nonperformance risk includes, but may not be limited to, a reporting entity's own credit risk. Nonperformance risk is assumed to be the same before and after the transfer of the liability. When measuring the fair value of a liability, a reporting entity should take into account the effect of its credit risk (credit standing) and any other factors that might influence the likelihood that the obligation will or will not be fulfilled. See the "Pending Content" in paragraphs 17–18 of FASB ASC 820-10-35 for additional guidance.

## Valuation Techniques

**7.13** A reporting entity should use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs. Three widely used valuation techniques are the market approach, cost approach, and income approach. The main aspects of those approaches are summarized in the "Pending Content" in paragraphs 3A–3G of FASB ASC 820-10-55. An entity should use valuation techniques consistent with one or more of these approaches to measure fair value:

- The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets, liabilities, or a group of assets and liabilities, such as a business. Valuation techniques consistent with the market approach include matrix pricing and those that use market multiples derived from a set of comparables.
- The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost). From the perspective of a market participant seller, the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.
- The income approach converts future amounts (for example, cash flows or income and expenses) to a single current (that is, discounted)

amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts. Valuation techniques consistent with the income approach include present value techniques, option-pricing models, and the multiperiod excess earnings method. Paragraph 20 and the “Pending Content” in paragraphs 4–19 of FASB ASC 820-10-55 provide guidance for using present value techniques.

**7.14** “Pending Content” in FASB ASC 820-10-35-24B notes that, in some cases, a single valuation technique will be appropriate (for example, when valuing an asset or a liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate (for example, that might be the case when valuing a reporting unit). If multiple valuation techniques are used to measure fair value, the results (that is, respective indications of fair value) should be evaluated, considering the reasonableness of the range of values indicated by those results. “Pending Content” beginning in paragraph 35 of FASB ASC 820-10-55 provides two cases that illustrate the use of multiple valuation techniques. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

**7.15** “Pending Content” in paragraphs 25–26 of FASB ASC 820-10-35 explains that valuation techniques used to measure fair value should be applied consistently. However, a change in a valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. Revisions resulting from such a change in valuation technique or its application should be accounted for as a change in accounting estimate in accordance with the provisions of FASB ASC 250, *Accounting Changes and Error Corrections*.

## Inputs to Valuation Techniques

**7.16** “Pending Content” in FASB ASC 820-10-35-36 notes that valuation techniques used to measure fair value should maximize the use of relevant observable inputs and minimize the use of unobservable inputs. Markets in which inputs might be observable for some assets and liabilities (for example, financial instruments) include, for example, exchange markets, dealer markets, brokered markets, and principal-to-principal markets.

**7.17** A reporting entity should select inputs that are consistent with the characteristics of the asset or liability that market participants would take into account in a transaction for the asset or liability. In some cases, those characteristics result in the application of an adjustment, such as a premium or discount (for example, a control premium or noncontrolling interest discount). However, a fair value measurement should not incorporate a premium or discount that is inconsistent with the unit of account in the guidance that requires or permits the fair value measurement. Premiums or discounts that reflect size as a characteristic of the reporting entity’s holding (blockage factor) rather than as a characteristic of the asset or liability (for example, a control premium when measuring the fair value of a controlling interest) are not permitted in a fair value measurement. In all cases, if there is a quoted price in an active market (that is, a level 1 input) for an asset or a liability, a reporting entity should use that quoted price without adjustment when measuring fair value, except as specified in the “Pending Content” in FASB ASC 820-10-35-41C.

## Application to Financial Assets and Financial Liabilities With Offsetting Positions in Market Risks or Counterparty Credit Risk

**7.18** Generally, the unit of account for a financial instrument is the individual financial instrument. A reporting entity should apply adjustments that are consistent with that unit of account, which generally does not include adjustments due to the size of the reporting entity's position.

**7.19** "Pending Content" in FASB ASC 820-10-35-18D permits an exception when a reporting entity manages a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk. When the criteria in the "Pending Content" in FASB ASC 820-10-35-18E are met, the exception permits a reporting entity to measure the fair value of a group of financial assets and financial liabilities on the basis of the price that would be received to sell a net long position (that is, an asset) or to transfer a net short position (that is, a liability) in an orderly transaction between market participants at the measurement date under current market conditions. The "Pending Content" in FASB ASC 820-10-35-18G states that a reporting entity should make an accounting policy decision about whether to elect to use the exception in the "Pending Content" in FASB ASC 820-10-35-18D. If a reporting entity elects to use the exception, it should disclose that fact.

**7.20** When a reporting entity elects to use the exception in the "Pending Content" in FASB ASC 820-10-35-18D, the unit of account becomes the net open risk position. The reporting entity may apply adjustments, including adjustments due to the size of the net open risk position, consistent with market participant assumptions and in accordance with the unit of account. See paragraph 7.16 for more information about adjustments to inputs to fair value measurements.

### Inputs Based on Bid and Ask Prices

**7.21** "Pending Content" in FASB ASC 820-10-35-36C states that if an asset or a liability measured at fair value has a bid price and an ask price (for example, an input from a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances should be used to measure fair value, regardless of where the input is categorized within the fair value hierarchy (that is, level 1, 2, or 3). The use of bid prices for asset positions and ask prices for liability positions is permitted but not required. GAAP, as stated in "Pending Content" in FASB ASC 820-10-35-36D, does not preclude the use of midmarket pricing or other pricing conventions that are used by market participants as a practical expedient for fair value measurements within a bid-ask spread.

### Present Value Techniques

**7.22** Paragraph 20 and "Pending Content" in paragraphs 5–19 of FASB ASC 820-10-55 describe the use of present value techniques to measure fair value. Those paragraphs neither prescribe the use of a single specific present value technique nor limit the use of present value techniques to measure fair value to the techniques discussed therein. *Present value* (that is, an application of the income approach) is a tool used to link future amounts to a present amount using a discount rate. A fair value measurement of an asset or a liability using a present value technique captures all of the following elements from the perspective of market participants at the measurement date:

- An estimate of future cash flows for the asset or liability being measured.
- Expectations about possible variations in the amount and timing of the cash flows representing the uncertainty inherent in the cash flows.
- The time value of money, represented by the rate on risk-free monetary assets that have maturity dates or durations that coincide with the period covered by the cash flows and pose neither uncertainty in timing nor risk of default to the holder (that is, a risk-free interest rate). For present value computations denominated in nominal U.S. dollars, the yield curve for U.S. Treasury securities determines the appropriate risk-free interest rate.
- The price for bearing the uncertainty inherent in the cash flows (that is, a risk premium).
- Other factors that market participants would take into account in the circumstances.
- For a liability, the nonperformance risk relating to that liability, including the reporting entity's (obligor's) own credit risk.

**7.23** "Pending Content" in FASB ASC 820-10-55-6 provides the general principles that govern any present value technique, as follows:

- Cash flows and discount rates should reflect assumptions that market participants would use when pricing the asset or liability.
- Cash flows and discount rates should take into account only the factors attributable to the asset or liability being measured.
- To avoid double counting or omitting the effects of risk factors, discount rates should reflect assumptions that are consistent with those inherent in the cash flows. For example, a discount rate that reflects the uncertainty in expectations about future defaults is appropriate if using the contractual cash flows of a loan but is not appropriate if using a technique that already reflects assumptions about the uncertainty in future defaults.
- Assumptions about cash flows and discount rates should be internally consistent. For example, nominal cash flows (that include the effects of inflation) should be discounted at a rate that includes the effects of inflation.
- Discount rates should be consistent with the underlying economic factors of the currency in which the cash flows are denominated.

**7.24** "Pending Content" in FASB ASC 820-10-55-9 describes how present value techniques differ in how they adjust for risk and in the type of cash flows they use. For example, the discount rate adjustment technique uses a risk-adjusted discount rate and contractual, promised, or most likely cash flows. In contrast, method 1 of the expected present value technique uses risk-adjusted expected cash flows and a risk-free rate. Method 2 of the expected present value technique uses expected cash flows that are not risk adjusted and a discount rate adjusted to include the risk premium that market participants require. The traditional present value technique and two methods of expected present value techniques are discussed more fully in FASB ASC 820-10-55.

**7.25** This guide includes guidance about measuring assets and liabilities using traditional present value techniques. That guidance is not intended to

suggest that the income approach is the only one of the three approaches that is appropriate in the circumstances, nor is it intended to suggest that the traditional present value technique described in the guide is preferred over other present value techniques.

## The Fair Value Hierarchy

**7.26** As noted in “Pending Content” in FASB ASC 820-10-35-37, the fair value hierarchy categorizes into three levels the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The three levels are

- level 1 inputs (“Pending Content” in paragraphs 40–46 of FASB ASC 820-10-35). *Level 1 inputs* are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date. An *active market*, as defined in the FASB ASC glossary, is a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. FASB ASC 820-10-35-41 notes that a quoted price in an active market provides the most reliable evidence of fair value and should be used without adjustment to measure fair value whenever available, except as specified in “Pending Content” in FASB ASC 820-10-35-41C. If the reporting entity holds a position in a single asset or liability (including a position comprising a large number of identical assets or liabilities) and the asset or liability is traded in an active market, the fair value of the asset or liability should be measured within level 1 as the product of the quoted price for the individual asset or liability and the quantity held by the reporting entity. This is the case even if a market’s normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.
- level 2 inputs (“Pending Content” in paragraphs 47–51 of FASB ASC 820-10-35). *Level 2 inputs* are inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a level 2 input must be observable for substantially the full term of the asset or liability. “Pending Content” in FASB ASC 820-10-35-48 provides examples of inputs considered to be level 2 inputs. Adjustments to level 2 inputs will vary depending on factors (noted in “Pending Content” in FASB ASC 820-10-35-50) specific to the asset or liability. An adjustment to a level 2 input that is significant to the entire measurement might result in a fair value measurement categorized within level 3 of the fair value hierarchy if the adjustment uses significant unobservable inputs. See “Pending Content” in FASB ASC 820-10-55-21 for examples of level 2 inputs.
- level 3 inputs (“Pending Content” in paragraphs 52–55 of FASB ASC 820-10-35). *Level 3 inputs* are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same (that is, an exit price from the perspective of a market participant that holds the



asset or owes the liability). Therefore, unobservable inputs should reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. Assumptions about risk include the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and the risk inherent in inputs to the valuation technique. A measurement that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one when pricing the asset or liability. Unobservable inputs should be developed using the best information available in the circumstances, which might include the entity's own data. In developing unobservable inputs, a reporting entity may begin with its own data, but it should adjust those data if reasonably available information indicates that other market participants would use different data, or there is something particular to the reporting entity that is not available to other market participants. A reporting entity need not undertake exhaustive efforts to obtain information about market participant assumptions; however, information about market participant assumptions that is reasonably available should be taken into account. See "Pending Content" in FASB ASC 820-10-55-22 for examples of level 3 inputs.

**7.27** As explained in "Pending Content" in FASB ASC 820-10-35-37A, in some cases, the inputs used to measure the fair value of an asset or a liability might be categorized within different levels of the fair value hierarchy. In those cases, the fair value measurement is categorized in its entirety in the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement. Adjustments to arrive at measurements based on fair value, such as costs to sell when measuring fair value less costs to sell, should not be taken into account when determining the level of the fair value hierarchy within which a fair value measurement is categorized.

**7.28** As discussed in "Pending Content" in FASB ASC 820-10-35-38, the availability of relevant inputs and their relative subjectivity might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques used to measure fair value. For example, a fair value measurement developed using a present value technique might be categorized within level 2 or level 3, depending on the inputs that are significant to the entire measurement and the level of the fair value hierarchy within which those inputs are categorized.

**7.29** A fair value measurement is for a particular asset or liability; therefore, when measuring fair value, a reporting entity should take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. Such characteristics include the condition and location of the asset or restriction, if any, on the sale or use of the asset. As stated by "Pending Content" in FASB ASC 820-10-35-2C, the effect on the measurement arising from a particular characteristic will differ depending on how that characteristic would be taken into account by market participants. Example 6 in "Pending Content" in paragraphs 51–55 of FASB ASC 820-10-55 explains that when the restriction is a characteristic of the asset and, therefore, would transfer to a market participant, the fair value of the asset would be adjusted to reflect the effect of the restriction.

## Fair Value Measurements of Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)

**7.30** Paragraphs 60 and 62 and “Pending Content” in paragraphs 59 and 61 (paragraphs 59–62) of FASB ASC 820-10-35 contain guidance that permits the use of a practical expedient, with appropriate disclosures, when measuring the fair value of an alternative investment that does not have a readily determinable fair value. According to “Pending Content” in FASB ASC 820-10-15-4, this guidance applies only to an investment that meets both of the following criteria as of the reporting entity’s measurement date:

- a. The investment does not have a readily determinable fair value.<sup>2</sup>
- b. The investment is in an entity that has all the attributes specified in “Pending Content” in FASB ASC 946-10-15-2 (investment activity, unit ownership, pooling of funds, and reporting entity) or, if one or more of the attributes specified in “Pending Content” in FASB ASC 946-10-15-2 are not present, is in an entity for which it is industry practice to issue financial statements using guidance that is consistent with the measurement principles in FASB ASC 946, *Financial Services—Investment Companies*.

Examples of investments to which this guidance applies may include hedge funds, private equity funds, real estate funds, venture capital funds, offshore fund vehicles, and funds of funds.

**7.31** FASB ASC 820-10-35-60 explains that if the net asset value per share of the investment obtained from the investee is not as of the reporting entity’s measurement date or is not calculated in a manner consistent with the measurement principles of FASB ASC 946, the reporting entity should consider whether an adjustment to the most recent net asset value per share is necessary.

**7.32** “Pending Content” in FASB ASC 820-10-35-54B states that categorization within the fair value hierarchy of a fair value measurement of an investment that is within the scope and measured at net asset value per share requires judgment. This guidance provides considerations for determining the level within the fair value hierarchy that a fair value measurement of an investment at net asset value per share (or its equivalent) should be categorized.

**7.33** “Pending Content” in FASB ASC 820-10-35-61 states that the reporting entity should decide on an investment-by-investment basis whether to apply the practical expedient and should apply that practical expedient consistently to the fair value measurement of the reporting entity’s entire position in a particular investment, unless it is probable at the measurement date that

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<sup>2</sup> FASB ASC 820-10-15-5 notes that the FASB ASC glossary definition of *readily determinable fair value* indicates that an equity security would have a readily determinable fair value if any one of three conditions is met. One of those conditions is that sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the Securities and Exchange Commission (SEC) or in the over-the-counter (OTC) market, provided that those prices or quotations for the OTC market are publicly reported by the National Association of Securities Dealers Automated Quotations systems (or NASDAQ) or by Pink Sheets LLC (now known as OTC Pink). The definition notes that restricted stock meets that definition if the restriction expires within one year. If an investment otherwise would have a readily determinable fair value, except that the investment has a restriction expiring in more than one year, the reporting entity should not apply paragraphs 60 and 62, the “Pending Content” in paragraphs 59 and 61 (paragraphs 59–62) of FASB ASC 820-10-35, and the “Pending Content” in FASB ASC 820-10-50-6A to the investment.

the reporting entity will sell a portion of an investment at an amount different from net asset value per share (or its equivalent), as described in FASB ASC 820-10-35-62. In those situations, the reporting entity should account for the portion of the investment that is being sold in accordance with FASB ASC 820-10 and should not apply the practical expedient discussed in “Pending Content” in FASB ASC 820-10-35-59.

## Fair Value Determination When the Volume or Level of Activity Has Significantly Decreased

**7.34** “Pending Content” in paragraphs 54C–54H of FASB ASC 820-10-35 clarify the application of FASB ASC 820 in determining fair value when the volume or level of activity for an asset or a liability has significantly decreased. Guidance is also included in identifying transactions that are not orderly. In addition, “Pending Content” in paragraphs 90–98 of FASB ASC 820-10-55 includes illustrations on the application of this guidance.

**7.35** “Pending Content” in FASB ASC 820-10-35-54C lists a number of factors that should be evaluated to determine whether there has been a significant decrease in the volume or level of activity for the asset or liability (or similar assets or liabilities) when compared with normal market activity. If the reporting entity concludes that there has been a significant decrease in the volume or level of activity for the asset or liability in relation to normal market conditions, further analysis of the transactions or quoted prices is needed to determine whether an adjustment to the transactions or quoted prices is necessary. In certain circumstances such adjustments may be significant to the fair value measurement in its entirety. Note that a decrease in the volume or level of activity on its own does not necessarily indicate that a transaction price or quoted price does not represent fair value or that a transaction in that market is not orderly.

**7.36** FASB ASC 820 does not prescribe a methodology for making significant adjustments to transactions or quoted prices. Regardless of the valuation technique used, a reporting entity should include appropriate risk adjustments, including a risk premium reflecting the amount that market participants would demand as compensation for the uncertainty inherent in the cash flows of an asset or a liability. “Pending Content” in FASB ASC 820-10-35-54F notes that if there has been a significant decrease in the volume or level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. When weighting indications of fair value resulting from the use of multiple valuation techniques, a reporting entity should consider the reasonableness of the range of fair value measurements. The objective is to determine the point within the range that is most representative of fair value under current market conditions.

**7.37** Even when there has been a significant decrease in the volume or level of activity for the asset or liability, the objective of a fair value measurement remains the same. *Fair value* is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date under current market conditions. “Pending Content” in FASB ASC 820-10-35-54H states that estimating the price at which market participants would be willing to enter into a transaction at the measurement date under current market conditions if there has been a significant decrease in the volume or level of activity for the asset or liability depends on the facts and circumstances at the measurement date and requires judgment. A reporting entity’s intention to hold the asset or to settle or

otherwise fulfill the liability is not relevant when measuring fair value because fair value is a market-based measurement, not an entity-specific measurement.

**7.38** According to “Pending Content” in FASB ASC 820-10-35-54I, a reporting entity should evaluate the circumstances to determine whether, on the weight of the evidence available, the transaction is orderly. The determination of whether a transaction is orderly (or is not orderly) is more difficult if there has been a significant decrease in the volume or level of activity for the asset or liability in relation to normal market activity for the asset or liability. In such circumstances, it is not appropriate to conclude that all transactions in that market are not orderly (that is, forced liquidations or distress sales). Circumstances that may indicate that a transaction is not orderly and guidance that should be considered in the determination are found in “Pending Content” in FASB ASC 820-10-35-54I. “Pending Content” in FASB ASC 820-10-35-54J notes the factors a reporting entity should consider when measuring fair value or estimating market risk premiums. An entity does not need to undertake exhaustive efforts to determine whether a transaction is orderly, but it should not ignore information that is reasonably available. When a reporting entity is a party to a transaction, it is presumed to have sufficient information to conclude whether a transaction is orderly.

## Fair Value Option

**7.39** FASB ASC 825, *Financial Instruments*, creates a fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measure for many financial instruments and certain other items, with changes in fair value recognized in the statement of activities as those changes occur. An election is made on an instrument-by-instrument basis (with certain exceptions) on its election date. Generally this is when an instrument is initially recognized in the financial statements. See FASB ASC 825-10-25-4 for information on election dates for specific eligible items that are other than when the instrument is initially recognized in the financial statements. The fair value option need not be applied to all identical items, except as required by FASB ASC 825-10-25-7. FASB ASC 825-10-15-4 notes that recognized financial assets and financial liabilities are eligible except those specifically listed. (See paragraph 7.40 for those items excluded from the election.) In addition to the eligible financial instruments, certain other items are eligible for the election such as firm commitments for financial instruments and certain nonfinancial contracts. FASB ASC 825-10-35-4 explains that an entity should report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date.

**7.40** FASB ASC 825-10-15-5 lists those instruments that are not eligible for the fair value option. Specifically excluded from eligibility is an investment in a subsidiary that the entity is required to consolidate; an interest in a variable interest entity (VIE) that the entity is required to consolidate; employer’s and plan’s obligations for pension benefits; other postretirement benefits (including health care and life insurance benefits); postemployment benefits and deferred compensation arrangements (or assets representing overfunded positions in those plans); financial assets and liabilities recognized under leases (this does not apply to a guarantee of a third-party lease obligation or a contingent obligation arising from a cancelled lease); deposit liabilities of depository institutions; and financial instruments that are, in whole or part, classified by the issuer as a component of shareholders’ equity (including temporary equity).

**7.41** FASB ASC 825-10-45 and 825-10-50 also include presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. Paragraphs 1–2 of FASB ASC 825-10-45 state that entities should report assets and liabilities that are measured using the fair value option in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute. To accomplish that, an entity should either (a) present the aggregate carrying amount for both fair value and non-fair-value items on a single line, with the fair value amount parenthetically disclosed or (b) present separate lines for the fair value carrying amounts and the non-fair-value carrying amounts. As discussed in FASB ASC 825-10-25-3, upfront costs and fees, such as debt issue costs, may not be deferred for items for which the fair value option has been elected.

## Additional Fair Value Considerations

### Financial Instruments Listed on a Recognized Exchange

**7.42** Ordinarily, management values a financial instrument traded on a recognized exchange (NASDAQ, for example) based on quotations of completed transactions. This is consistent with the guidance in FASB ASC 820. A financial instrument traded on a recognized exchange on the valuation date is usually valued at the last quoted sales price. Such prices are published daily. In the case of a financial instrument listed on more than one recognized exchange, the financial instrument is valued at the last quoted sales price on the exchange on which the financial instrument is principally traded. A financial instrument traded primarily on foreign exchanges is valued at the U.S. dollar equivalent, generally at the closing sales price on the principal exchange where it is traded.

**7.43** “Pending Content” in paragraphs 5–6A of FASB ASC 820-10-35 states that in the absence of a principal market, the most advantageous market is used. In either case, the principal (or most advantageous) market should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities. If there is a principal market for the asset or liability, the fair value measurement should represent the price in that market (whether that price is directly observable or estimated using another valuation technique), even if the price in a different market is potentially more advantageous at the measurement date.

**7.44** The FASB ASC glossary defines *level 1 inputs* as quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. “Pending Content” in FASB ASC 820-10-35-41 states that a quoted price in an active market provides the most reliable evidence of fair value and should be used without adjustment to measure fair value whenever available, except as specified in “Pending Content” in FASB ASC 820-10-35-41C. In the event that a market price is not representative of fair value due to significant events that occur after the close of the market but before the measurement date, the entity should establish and consistently apply a policy for identifying those events that might affect fair value measurement.

**7.45** Broker-dealers generally value their portfolios at the time of the close of trading on the principal exchange on which the financial instruments are traded. Related financial instruments may be traded in tandem (for example, as part of an arbitrage-trading strategy whose profitability is determined by the

relative value of the financial instruments). It is appropriate to review the prices occurring on different exchanges or in different markets for all the individual financial instruments in the trading strategy at a given time in order to assign the proper value to all securities encompassed in that financial strategy.

**7.46** According to “Pending Content” in FASB ASC 820-10-35-24, a reporting entity should use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs. See also paragraph 7.13.

### **Financial Instruments Not Listed on a Recognized Exchange but Having a Readily Available Market Price**

**7.47** Nonexchange-traded financial instruments are often traded in over-the-counter (OTC) markets by dealers or other intermediaries from whom market prices are obtainable. Quotations are available from various sources for many financial instruments traded regularly in the OTC market. Those sources include the financial press, various quotation and financial reporting services, and individual market makers.

**7.48** Financial instruments not listed on a recognized exchange are more likely to be valued using level 2 or level 3 inputs (as opposed to level 1 inputs). If there is a limited amount of trading activity for a financial instrument (that is, if the instrument is thinly traded), the reliability of the market quotation and other market information (for example, volume data) should be evaluated by management. In instances when the fair value, as determined by management, is higher than or lower than the market quotation for a similar, but not identical, financial instrument, the financial instruments should be valued at such fair value. See paragraph 7.26 for more information on the three levels of inputs to valuation techniques.

**7.49** “Pending Content” in paragraphs 50–51 of FASB ASC 820-10-35 explains that adjustments to level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition or location of the asset or liability, the extent to which the inputs relate to items that are comparable to the asset or liability (including those factors discussed in “Pending Content” in FASB ASC 820-10-35-16D), and the volume or level of activity in the markets within which the inputs are observed. A significant adjustment to a level 2 fair value measurement might result in a fair value measurement categorized within level 3 of the fair value hierarchy if the adjustment uses significant unobservable inputs.

### **Financial Instruments Not Having a Readily Available Market Price**

**7.50** A broker-dealer may have to determine the fair values of financial instruments for which there are no readily available price quotations or for which readily available price quotations are unreliable. These price quotations may be deemed unreliable because of a variety of reasons. For example, the financial instruments may have restrictions associated with them (such as not being registered), or the entity may have been forced to sell due to financial difficulties. In such cases, it may be appropriate for these financial instruments to be valued at fair value using level 3 inputs, as found in FASB ASC 820. See also the discussion beginning in paragraph 7.34.

**7.51** As noted in “Pending Content” in the FASB ASC glossary, *level 3 inputs* are unobservable inputs for the asset or liability. According to “Pending Content” in FASB ASC 820-10-35-53, unobservable inputs are used to measure fair value to the extent that relevant observable inputs are not available. Unobservable inputs should reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. See also the discussion in paragraph 7.26.

**7.52** Management of the reporting entity should take into consideration all indications of value that are reasonably available in determining the fair value assigned to a particular financial instrument. The information considered and the basis for the decision should be documented. This guide does not purport to delineate all factors that may be considered.

**7.53** As noted in FASB ASC 940-820-30-1, the following is a list of certain factors that have been taken into consideration by broker-dealers as part of the determination of fair value:<sup>3</sup>

- Financial standing of the issuer
- Business and financial plan of the issuer
- Cost at date of purchase
- The liquidity of the market (see paragraph 7.16 for considerations regarding this factor)
- Contractual restrictions on salability
- Pending public offering with respect to the financial instrument
- Pending reorganization activity affecting the financial instrument (such as merger proposals, tender offers, debt restructurings, and conversions)
- Reported prices and the extent of public trading in similar financial instruments of the issuer or comparable entities
- Ability of the issuer to obtain needed financing
- Changes in the economic conditions affecting the issuer
- A recent purchase or sale of a security of the entity
- Pricing by other dealers in similar securities

**7.54** Management may use a variety of methods to assist in determining the valuation of a financial instrument. These methods include analogy to reliable quotations of similar financial instruments, pricing models, matrix pricing, and other formula-based pricing methods. These methodologies incorporate factors for which published market data may be available. For instance, the mathematical technique known as matrix pricing may be used to determine the values based on market data available with respect to the issue and similar issues without exclusive reliance on issuer-specific quoted market prices. “Pending Content” in FASB ASC 820-10-35-41C notes that matrix pricing is an alternative pricing method that renders the fair value measurement a lower-level measurement.

**7.55** Pricing methods may also be based on a multiple of earnings or a discount (or, less frequently, a premium) from market of a similar, freely traded

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<sup>3</sup> The SEC’s *Codification of Financial Reporting Policies* provides guidance on the factors to be considered and the methods used to value securities for which market quotations are not readily available. FASB ASC 820-10-35 also provides guidance on the valuation of financial instruments for which market quotations are not readily available.

security; on a yield to maturity with respect to debt issues; or on a combination of these and other methods. In addition, with respect to derivative products, other factors (such as volatility, anticipated future interest rates, and term to maturity) should be considered. If such methods are used, management should continuously review the appropriateness of such methods to satisfy themselves that the resulting valuations are fair and in compliance with FASB ASC 820.

## Trade-Date Versus Settlement-Date Accounting

**7.56** Broker-dealers execute a wide variety of transactions in financial instruments for their own accounts (proprietary transactions, also referred to as principal transactions) or on behalf of customers (agency transactions). The transactions usually involve at least two important dates:

**trade date.** The date on which an agreement (an executory contract) is entered into, setting forth the important aspects of the transaction (such as a description of the instruments, quantity, price, delivery terms, and so forth).

**settlement date.** The date on which the financial instrument is required to be delivered to the purchaser and consideration paid. Depending on the particular transaction, the settlement date could be as early as the same day as the trade date or as far away as months (and sometimes more than one year) after the trade date.

**7.57** The settlement date is generally established by convention or regulations of the market in which the transaction is executed (for instance, regular-way trades executed on the floor of a stock exchange); for certain types of transactions, the settlement date is based on the terms agreed to by the parties (for instance, forward transactions).

**7.58** Although the terms for each type of transaction may differ in many respects, they tend to have the following two major aspects in common:

- a. On the trade date, the purchaser assumes the risks and rewards of further changes in the value of the underlying financial instrument.
- b. On the settlement date, the seller is required to deliver and the purchaser is required to pay for, the financial instrument.

## Proprietary and Principal Transactions

**7.59** As explained in FASB ASC 940-320-25-1, the statement of financial condition should reflect all regular-way trades on an accrual or a trade-date basis. Risk, benefits, and economic potentials are created and conveyed at the trade date (that is, the inception of the contract), which is when the major terms have been agreed to by the parties. In order to properly reflect the economic effects of purchase and sale transactions for financial instruments (that is, to reflect the assumption of the risks and rewards resulting from changes in the value of financial instruments), broker-dealers should account for the changes in value relating to all proprietary and principal transactions on a trade-date basis.

**7.60** For example, as stated in FASB ASC 940-320-25-2, if the broker-dealer purchased financial instruments for its own account on the date of the statement of financial condition, the transaction should be reflected in the broker-dealer's inventory with a corresponding credit to net receivable or



payable for unsettled regular-way trades. Per the FASB ASC glossary, regular-way trades include the following: (a) all transactions in exchange-traded financial instruments that are expected to settle within the standard settlement cycle of that exchange (for example, three days for U.S. securities exchanges) and (b) all transactions in cash-market-traded financial instruments that are expected to settle within the time frame prevalent or traditional for each specific instrument (for example, for U.S. government securities, one or two days).

**7.61** For physical commodities (such as lumber, crude oil, and precious metals), the prevalent trade practice for recording such transactions should be followed, which is typically when title passes.

**7.62** As noted in FASB ASC 940-320-05-4, the risk of nonperformance of regular-way settling trades is minimal, given the following: (a) they are fully collateralized on the trade date; (b) the period of time between trade date and settlement date is reasonably short; and (c) most equity, U.S. government, and mortgage-backed agency securities are affirmed by both parties to the trade and settle net through a clearing entity. Accordingly, FASB ASC 940-20-45-3 states that payables and receivables arising from these unsettled regular-way transactions may be recorded net in an account titled “Net Receivable (or Payable) for Unsettled Regular-Way Trades.”

**7.63** Contracts that are defined as derivative instruments according to FASB ASC 815, *Derivatives and Hedging*, should be measured at fair value, in accordance with FASB ASC 820, and recognized in the statement of financial condition as either assets or liabilities, depending on the rights or obligations under the contracts. The fair values of these contracts or of accrued receivables or payables arising from the contracts may be offset only if the provisions of FASB ASC 210-20<sup>4</sup> are met.

**7.64** Certain other contracts are also recognized in the financial statements of broker-dealers on a trade-date basis. The fair values of unsettled delayed-delivery and to-be-announced securities trades should be based on prices for forward-settling trades. For example, a foreign-exchange forward contract may call for a party to deliver two million U.S. dollars in exchange for two million British pounds sterling at a specified future date. Under current reporting practice, the party would not record a receivable for the British pounds sterling or a payable for the U.S. dollars. Rather, a net amount reflecting the fair value of the position would be reported in the statement of financial condition.

**7.65** Per FASB ASC 940-320-25-2, if the exchange does not occur on the contracted settlement date (referred to as a fail to receive or fail to deliver), these transactions should be recognized on the statement of financial condition

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<sup>4</sup> ASU No. 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities*, issued in December 2011, is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. Early adoption is not permitted. ASU No. 2011-11 requires enhanced disclosures about financial instruments and derivative instruments that are either offset in accordance with FASB ASC 210-20-45 or FASB ASC 815-10-45, or subject to an enforceable master netting arrangement or similar agreement (irrespective of whether they are offset in accordance with the aforementioned FASB ASC sections).

The effective date of ASU No. 2013-01, *Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*, is the same as the effective date of ASU No. 2011-11. The amendments provide clarification of the scope of the disclosure requirements in ASU No. 2011. See chapter 4, “Financial Statement Presentation and Classification,” of this guide for more information.

as fails to deliver or fails to receive. See chapter 2, “Broker-Dealer Functions, Books, and Records,” for more information on fails to receive and fails to deliver.

**7.66** The receivables and payables resulting from these failed transactions may be netted for financial statement reporting purposes to the extent the provisions of FASB ASC 210-20<sup>5</sup> are met.

## Agency Transactions

**7.67** FASB ASC 940-20-25-1 explains that transactions executed by broker-dealers as agents for customers are not reflected in the statement of financial condition of the broker-dealer unless the transaction fails to settle on the contracted settlement date. Because the broker-dealer typically delivers cash or financial instruments on behalf of the customer, if the customer fails on the settlement date, the broker-dealer is required to record the transaction (for example, as a fail to receive from customer, payable to customer, or stock borrowed or loaned on behalf of customer).

**7.68** In accordance with FASB ASC 940-20-25-2, for securities purchased, commissions should be recorded as a receivable from customers; for securities sold, commissions should be recorded as reductions in the payable to customers. The commission income and related expenses are accrued by the broker-dealer on the trade date because substantially all the efforts in generating the commissions have been completed.

**7.69** Unlike a principal transaction in which the broker-dealer is the counterparty to the transaction with the customer and, thus, would have the securities transactions flow through its inventory because it is acting in a dealer capacity, in an agency transaction, the broker-dealer is simply a middleman between two counterparties, and thus, the securities transaction does not flow through its inventory because it is acting in a broker capacity.

## Statement of Financial Condition Considerations

### Due From, and Due to, Other Broker-Dealers and Clearing Entities

**7.70** Amounts due from, and due to, other broker-dealers and clearing entities may arise from the following:

- Net receivables or payables arising from unsettled regular-way transactions
- Securities borrowed and loaned
- Failed settlement transactions
- Clearing entity balances
- Commissions
- Deposits

**7.71** Balances arising from the foregoing, with the exception of the net payable or receivable arising from unsettled transactions, are reported gross on the statement of financial condition, unless the provisions of FASB ASC 210-20 are met. For example, a broker-dealer may report on a net basis payables and receivables associated with clearing through a clearing entity that provides for and guarantees net settlement balances because the criteria of FASB ASC

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<sup>5</sup> See footnote 4.

210-20<sup>6</sup> are met. FASB ASC 210-20-45-9 discusses the nature of support required for an assertion in financial statements that a right of setoff is enforceable at law.

## Transfers of Financial Assets

**7.72** As noted in FASB ASC 860-10-05-4, transfers of financial assets often occur in which the transferor has some continuing involvement either with the assets transferred or the transferee. This situation raises issues about the circumstances under which a transfer should be considered a sale of financial assets rather than a secured borrowing and how transferees and transferors should account for such transactions. FASB ASC 860, *Transfers and Servicing*, establishes accounting and reporting standards for transfers and servicing of financial assets, including sales of financial assets, secured borrowings and collateral, and servicing assets and liabilities.

**7.73** Broker-dealers enter into a variety of transactions that may be required to be accounted for either as sales of securities or secured borrowings,<sup>7</sup> depending on the terms of the particular transaction. These include securities borrowing and lending transactions, repo and reverse repo agreements, and dollar repurchase agreements (dollar rolls).

**7.74** Repo and reverse repo agreements are structured such that they are documented legally as sales or purchases of securities with forward purchase or sales contracts. In a repo agreement, a security is sold with an agreement to repurchase the security from the buyer; in a reverse repo agreement, a security is purchased with an agreement to resell the security to the seller-lender at a stated price plus interest at a specific date or in specified circumstances.<sup>8</sup> In general, most repo and reverse repo agreements are accounted for as financings, disregarding the legal form of the agreement. However, some repos and reverse repos are accounted for as sales (for example, a term repo).

**7.75** The FASB ASC glossary defines *dollar roll repurchase agreements* (dollar rolls) as agreements to sell and repurchase similar but not identical securities. The securities sold and repurchased are usually of the same issuer. Dollar rolls differ from regular repurchase agreements in that the securities sold and repurchased have all of the following characteristics:

- a. They are represented by different certificates.
- b. They are collateralized by different but similar mortgage pools (for example, conforming single-family residential mortgages).
- c. They generally have different principal amounts.

Fixed coupon and yield maintenance dollar agreements comprise the most common agreement variations. In a fixed coupon agreement, the seller and buyer agree that delivery will be made with securities having the same stated interest rate as the interest rate stated on the securities sold. In a yield maintenance agreement, the parties agree that delivery will be made with securities that will provide the seller a yield that is specified in the agreement.

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<sup>6</sup> See footnote 4.

<sup>7</sup> *Secured borrowings*, as that term is used in FASB ASC 860, *Transfers and Servicing*, are also sometimes referred to as collateralized financings.

<sup>8</sup> In certain industries, the terminology is reversed.

## ***Sale Treatment of Transferred Assets***<sup>9</sup>

**7.76** FASB ASC 860-10-40 sets forth the conditions required to be met in order to treat the transfer of financial assets as a sale. There are a number of factors to consider when determining when and how to account for transfers of financial assets. One factor is whether the transferee would be consolidated by the transferor. Another key factor in determining if the transaction is a sale (and, therefore, derecognized from the statement of financial position) is determining whether the transferor has surrendered control over the transferred financial assets.<sup>10</sup>

**7.77** As noted in FASB ASC 860-10-40-5, a transfer of an entire financial asset, a group of entire financial assets, or a participating interest<sup>11</sup> in an entire financial asset in which the transferor surrenders control over those financial assets should be accounted for as a sale if and only if all of the following conditions are met:

- a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (see paragraphs 7–14 of FASB ASC 860-10-40).
- b. Each transferee (or each third-party beneficial interest)<sup>12</sup> has the right to pledge or exchange the assets (or beneficial interests) it received, and no transferor-imposed condition constrains the transferee (or third-party holder of the beneficial interest) from taking advantage of its right to pledge or exchange and, through that constraint, provides more than a trivial benefit to the transferor (see paragraphs 15–21 of FASB ASC 860-10-40).
- c. The transferor (or its consolidated affiliates included in the financial statements being presented or its agents) does not maintain effective control over the transferred assets or third-party beneficial interests related to those transferred assets. Effective control includes, but is not limited to
  - i. an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (see paragraphs 23 and 25 and “Pending Content” in paragraphs 24 and 26–27 of FASB ASC 860-10-40);
  - ii. an agreement, other than through a cleanup call, that provides the transferor both the unilateral ability to cause the holder to

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<sup>9</sup> Refer to FASB ASC 860 for complete information.

<sup>10</sup> In April 2011, FASB issued ASU No. 2011-03, *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements*. The amendments in this ASU remove one specific criterion and related implementation guidance from the assessment of effective control as it relates to repurchase and other agreements that both entitle and obligate the transferor to repurchase or redeem financial assets before their maturity. Specifically, when assessing effective control for these type of agreements, the amendments remove from the assessment (a) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (b) the requirement to demonstrate that the transferor possesses adequate collateral to fund substantially all the cost of purchasing replacement financial assets. Other criteria applicable to the assessment of effective control are not changed by this ASU.

<sup>11</sup> *Participating interest* is defined in FASB ASC 860-10-40-6A.

<sup>12</sup> Third-party beneficial interest is applicable if the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities, and that entity is constrained from pledging or exchanging the assets it receives.

return specific assets and a more than trivial benefit attributable to that ability (see paragraphs 28–39 of FASB ASC 860-10-40); or

- iii. an agreement that permits the transferee to require the transferor to repurchase the transferred financial assets at a price that is so favorable to the transferee that it is probable the transferee will require the transferor to repurchase them (see FASB 860-10-55-42D).

FASB ASC 860-20 provides derecognition guidance related to transfers of financial assets that meet the criteria for a sale. Auditing procedures related to transfers of financial assets that are accounted for under FASB ASC 860 are discussed in Interpretation No. 1, “The Use of Legal Interpretations as Audit Evidence to Support Management’s Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraphs 7–14 of Financial Accounting Standards Board *Accounting Standards Codification* 860-10-40,” of AU-C section 620, *Using the Work of an Auditor’s Specialist* (AICPA, *Professional Standards*, AU-C sec. 9620 par. .01–.21).

## Secured Borrowings

**7.78** Securities lending transactions are documented as loans of securities in which the borrower of securities generally is required to provide collateral, commonly cash but sometimes other securities or standby letters of credit, to the lender of securities. The collateral provided will have a value slightly higher than that of the securities borrowed. If the collateral is cash, the lender of securities typically earns a return by investing that cash at rates higher than the rate paid or rebated to the borrower. If the collateral is other than cash, the lender of securities typically receives a fee.

**7.79** FASB ASC 860-30 provides guidance related to transfers of financial assets<sup>13</sup> that are accounted for as secured borrowings with a transfer of collateral. This guidance applies to many types of transactions in which cash is obtained in exchange for financial assets with an obligation for an opposite exchange later and to transactions that possess these characteristics. Types of transactions that may be affected include repurchase agreements, dollar rolls, and securities lending transactions. FASB ASC 860-30-25-2 notes that the transferor and transferee should account for a transfer as a secured borrowing with a pledge of collateral in either of the following circumstances:

- If a transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset does not meet the conditions for a sale in FASB ASC 860-10-40-5
- If a transfer of a portion of an entire financial asset does not meet the definition of a *participating interest*

In either of these circumstances, the transferor should continue to report the transferred financial asset in its statement of financial position with no change in the asset’s measurement (basis of accounting).

**7.80** FASB ASC 860-30-25-5 states that the accounting for noncash collateral by the obligor (or debtor) and the secured party depends on whether the secured party has the right to sell or repledge the collateral and whether the

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<sup>13</sup> Some of the items subject to this guidance are financial instruments. For guidance on matters related broadly to all financial instruments, including the fair value option, see FASB ASC 825.

debtor has defaulted. As noted in FASB ASC 860-30-25-4, cash collateral sometimes used, for example, in securities lending transactions should be derecognized by the payer (obligor) and recognized by the recipient (secured party), not as collateral but, rather, as proceeds of either a sale or borrowing. FASB ASC 860-30 provides additional guidance on accounting for collateral.

**7.81** As discussed in FASB ASC 860-30-25-7, many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred financial assets from the transferee maintains the transferor's effective control over those assets under FASB ASC 860-10-40-5(c)(1), if all the conditions in "Pending Content" in FASB ASC 860-10-40-24<sup>14</sup> are met. Those transactions should be accounted for as secured borrowings in which either cash or securities that the holder is permitted by contract or custom to sell or repledge received as collateral is considered the amount borrowed, the securities loaned are considered pledged as collateral against the cash borrowed and reclassified as set forth in FASB ASC 860-30-25-5(a), and any rebate paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed.

**7.82** FASB ASC 860-30-25-8 states that the transferor of securities being loaned accounts for cash received in the same way whether the transfer is accounted for as a sale or secured borrowing. Cash collateral or securities received as collateral that a securities lender is permitted to sell or repledge are the proceeds of a borrowing secured by them. The cash received should be recognized as the transferor's asset—as should investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash. If securities that may be sold or repledged are received, the transferor of the securities being loaned accounts for those securities in the same way as it would account for cash received.

**7.83** Paragraph 51 and "Pending Content" in paragraph 53 of FASB ASC 860-10-55 state the following with respect to repurchase agreements:

**55-51** Repurchase agreements that do not meet all the conditions in paragraph 860-10-40-5 shall be treated as secured borrowings. Under many agreements to repurchase transferred financial assets before their maturity, the transferor maintains effective control over those financial assets.

**55-53** Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need not be the same as the securities sold, qualify as borrowings if they are substantially the same (see the "Pending Content" in paragraph 860-10-40-24[a]) securities as those concurrently transferred. Therefore, those transactions shall be accounted for as secured borrowings by both parties to the transfer provided all other criteria for effective control has been met.

**7.84** Balances arising from securities lending transactions that are accounted for as secured borrowings are reported gross on the statement of financial condition. Securities-borrowed and securities-loaned transactions do not typically have explicit settlement dates, which is an indication that the reporting party does not intend to setoff. Therefore, those type transactions do not meet the conditions for a right of setoff found in FASB ASC 210-20-45-1.

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<sup>14</sup> See paragraph 7.77.

Balances arising from repo transactions treated as secured borrowings should be reported gross in the statement of financial condition, unless all the provisions of FASB ASC 210-20-45-11 are met. FASB ASC 210-20-45-11 may be applied only to repo and reverse repo transactions.

## Exchange Memberships Owned or Contributed

**7.85** As discussed in FASB ASC 940-340-25-1, the accounting for exchange memberships depends on the rights they convey and the reasons they are held as assets, as follows:

- a. *Ownership interest in the exchange.* An exchange membership should be accounted for as an ownership interest in the exchange if the exchange membership represents (i) both an ownership interest and the right to conduct business on the exchange, which are owned by a broker-dealer and held for operating purposes, or (ii) an ownership interest, which must be held by a broker-dealer to conduct business on the exchange. In accordance with FASB ASC 940-340-30-1 and 940-340-35-1, an ownership interest in the exchange should be accounted for initially and subsequently at cost or a lesser amount if there is an other-than-temporary impairment in value.
- b. *Intangible asset.* An exchange membership should be accounted for as an intangible asset in accordance with FASB ASC 350-10 if it represents only the right to conduct business on an exchange. Such memberships may have finite or indefinite lives based on the terms of the arrangement and the estimated life of the membership.
- c. *Contributed interest.* A membership may be considered to be an asset of the broker-dealer if its use has been contributed to the broker-dealer under a formal or informal subordination agreement. An exchange membership contributed for the use of the broker-dealer and subordinated to claims of general creditors should be accounted for as a contributed interest and a liability subordinated to claims of general creditors. In accordance with FASB ASC 940-340-30-2 and 940-340-35-2, this type of exchange membership should be recorded initially and subsequently at fair value with an equal and offsetting amount recorded for the subordinated liability.

## Suspense Accounts

**7.86** FASB ASC 940-20-05-8 notes that because of the number of transactions that take place when trades are cleared for the broker-dealer or its customers, unreconciled differences and trading errors occur. A broker-dealer often has several suspense accounts to facilitate the identification and resolution of differences. Per FASB ASC 940-20-25-6, unreconciled differences are recorded at the amount of the transaction with an appropriate valuation account until a determination of the cause of the differences is made and the differences are resolved. Trading errors are recorded in the broker-dealer's error suspense account until they are resolved. FASB ASC 940-20-35-2 further states that the underlying securities are subsequently measured at fair value, and the gain or loss is recognized in income.

## Conditional Transactions

**7.87** FASB ASC 940-20-25-7 notes that certain transactions (for example, those for when-issued securities) are, by their nature, conditional (that is, their completion is dependent on the occurrence of a future event or events). For those conditional transactions in which completion is assured beyond a reasonable doubt, the recognition of the transactions and related profit and loss should be the same as for unconditional transactions. For those conditional transactions in which completion is not assured beyond a reasonable doubt, only fair value losses should be recognized, whereas fair value gains should be deferred. As noted in FASB ASC 940-20-35-1, fair value gains that have been deferred under FASB 940-20-25-7 should be recognized when the uncertainty is eliminated. For the scope application of FASB ASC 815 to contracts for the purchase or sale of when-issued securities or other securities that do not yet exist, see FASB ASC 815-10-15-17. (See also the “Derivatives” section of this chapter for a discussion of FASB ASC 815.)

## Leveraged Buyouts and Bridge Loans

**7.88** As noted in FASB ASC 940-325-05-1, a broker-dealer may make investments in the form of equity or provide financing to another entity in connection with financial-restructuring transactions. These investments may take many forms, including a direct investment or an investment in an entity (sometimes referred to as a bridge entity) that is established for the purpose of accumulating funds from several sources sufficient to make the investment. FASB ASC 940-325-30-1 and 940-325-35-1 state that investments in the form of equity or financing provided to another entity in connection with financial-restructuring transactions should be initially and subsequently measured at fair value. As stated in FASB ASC 940-810-45-1, a majority-owned entity that is not in the scope of the “Variable Interest Entity” subsection of FASB ASC 810-10-15 and in which a parent has a controlling financial interest, should not be consolidated if the parent is a broker dealer, and control is likely to be temporary.

## Asset Securitizations

**7.89** The complexity of securitized products has increased significantly because of the nature of underlying collateral, the complexity of the structure (for example, residual tranches and interest- and principal-only strips), and the depth of markets. Such factors have affected the accounting and valuation of those products. Broker-dealers may acquire, either through market purchases or the underwriting process, securities arising from asset securitizations. Those securities should be valued at fair value in accordance with the guidelines discussed previously.

**7.90** FASB ASC 860-50-30-1 states that an entity should initially measure all separately recognized servicing assets and servicing liabilities at fair value. FASB ASC 860-50-35-1 permits, but does not require, the subsequent measurement of separately recognized servicing assets and servicing liabilities at fair value.

**7.91** An entity that uses derivative instruments to mitigate the risks inherent in servicing assets and servicing liabilities is required to account for those derivative instruments at fair value. An entity can elect subsequent fair value measurement to account for its separately recognized servicing assets and servicing liabilities. By electing that option, an entity may simplify its



accounting because that option permits income statement recognition of the potential offsetting changes in fair value of those servicing assets and servicing liabilities and derivative instruments in the same accounting period.

**7.92** In addition, certain securities that arise from asset securitizations may raise issues about whether the underlying legal entity should be consolidated by the broker-dealer. FASB ASC 860 provides guidance on the securitization of financial assets held by broker-dealers and for other transfers of financial assets involving special purpose entities. In a typical asset securitization transaction, a company transfers assets to a special-purpose vehicle (SPV) or VIE in exchange for cash or securities issued by the SPV or the VIE. Securitization vehicles need to be evaluated under FASB ASC 810, *Consolidation*, to determine if the broker-dealer is the primary beneficiary of the VIE and, therefore, should consolidate the VIE or if the broker-dealer holds a significant variable interest in the VIE and should make the appropriate disclosures.

## Variable Interest Entities

**7.93** FASB ASC 810 addresses consolidation by business entities of VIEs with certain characteristics. A *VIE*, as defined by the FASB ASC glossary, is a legal entity subject to consolidation according to the provisions of the “Variable Interest Entity” subsections of FASB ASC 810-10. FASB ASC 810 addresses certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FASB ASC 810-10-50 includes disclosure requirements.

## Derivatives

**7.94** FASB ASC 815 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities.

**7.95** FASB ASC 815-10-15-83 states that a *derivative instrument* is a financial instrument or other contract with all three of the following characteristics:

- a. It has (i) one or more underlyings and (ii) one or more notional amounts<sup>15</sup> or payment provisions or both. Those terms determine the amount of the settlement(s), and, in some cases, whether a settlement is required.
- b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- c. Its terms implicitly or explicitly require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

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<sup>15</sup> *Notional amount* is the number of units specified in the contract (for example, shares, bushels, or other unit). Sometimes other names are used for the term notional. For example, the notional amount is called a “face amount” in some contracts.

As noted in FASB ASC 815-10-15-71, notwithstanding the previously mentioned characteristics, loan commitments that relate to the origination of mortgage loans that will be held for sale, should be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender). FASB ASC 815-10-15-69 provides a scope exception for the accounting for certain loan commitments.

**7.96** When recognizing certain loan commitments, SEC Staff Accounting Bulletin (SAB) No. 109 amends and replaces Section DD of Topic 5. This SAB provides interpretive guidance and emphasizes certain disclosure requirements that may be relevant in the context of mortgage banking activities.

**7.97** Broker-dealers enter into derivative transactions to deal, to take proprietary positions, to effect economic hedges of instruments in other trading portfolios, to execute arbitrage strategies, or to hedge long-term debt or long-dated resale and repurchase transactions.

**7.98** FASB ASC 815-10-05-4 requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial condition and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (a) a hedge of the exposure to changes in the fair value of a recognized asset or liability or of an unrecognized firm commitment that is attributable to a particular risk (referred to as a fair value hedge); (b) a hedge of the exposure to variability in the cash flows of a recognized asset or liability or of a forecasted transaction, that is attributable to a particular risk (referred to as a cash flow hedge); or (c) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a forecasted transaction.

**7.99** As noted in FASB ASC 815-10-35-2, the accounting for changes in the fair value of a derivative instrument (that is, gains and losses) depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. The gain or loss on a derivative instrument not designated as a hedging instrument should be recognized currently in earnings, except as noted in FASB ASC 815-10-35-3. See FASB ASC 815-20 for guidance on the accounting for the gain or loss on a derivative instrument that is designated as a hedging instrument.

**7.100** Derivatives entered into by dealers in connection with their dealing activities should be carried at fair value with resultant gains and losses reported currently in income. Quoted market prices provide the most reliable fair value for derivatives traded on a recognized exchange. Fair value for derivatives not traded on a recognized exchange is generally considered to be the value that could be realized through termination or assignment of the derivative. Common valuation methodologies for an interest rate swap incorporate a comparison of the yield of the swap with the current treasury security yield curve and swap to treasury spread quotations or the current swap yield curve. The swap yield curve is derived from quoted swap rates. Dealer bid and offer quotes are generally available for basic interest rate swaps involving counterparties whose securities are investment grade. (The Group of Thirty Report<sup>16</sup> contains several recommendations regarding dealer pricing, including that derivatives portfolios be valued based on midmarket levels less specific

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<sup>16</sup> Established in 1978, The Group of Thirty is a private, nonprofit, international body composed of senior representatives from private and public sectors and academia. It aims to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and policymakers.

adjustments.) Factors that could influence the valuation of an individual derivative include the counterparty's credit standing and the complexity of the derivative. If those factors differ from those basic factors underlying the quote, an adjustment to the quoted price should be considered.

**7.101** In determining a derivative's value, consideration should be given to recognizing and providing for credit and liquidity risk and the operational and administrative costs associated with the management of derivative portfolios. The methods for determining the amount of credit risk and operational costs may differ among dealers.

**7.102** FASB ASC 815-15-25-4 explains that an entity that initially recognizes a hybrid financial instrument that would otherwise be required to be separated into a host contract and derivative instrument may irrevocably elect to initially and subsequently measure that hybrid financial instrument in its entirety at fair value (with changes in fair value recognized in earnings). The financial instrument should be evaluated to determine that it has an embedded derivative requiring bifurcation before the instrument can become a candidate for the fair value election. FASB ASC 815-15-25-5 states that the recognized hybrid financial instrument could be an asset or a liability and it could be acquired or issued by the entity. Also, the fair value election may be made on an instrument-by-instrument basis at the inception of the hybrid instrument (or upon a remeasurement event) and should be supported by concurrent documentation or a preexisting documented policy for automatic election. For more information see the guidance in FASB ASC 815-15.

**7.103** FASB ASC 815-10-50 provides guidance regarding the disclosures required in the notes to financial statements as related to derivatives. Note that in some cases, the disclosures required for derivatives relate to disclosures that appear on the face of the financial statements. See chapter 4 for information on disclosures related to derivative instruments.

## Soft-Dollar Arrangements

**7.104** According to the FASB ASC glossary, *soft-dollar arrangements* are arrangements in which a broker-dealer provides research to a customer in return for trade order flow (a certain volume of trades) from that customer. As noted in FASB ASC 940-20-05-4, these arrangements generate commission income for the broker-dealer. Many of these agreements are oral, and the value of the research to be provided is typically based on a percentage of commission income. Soft-dollar customers are typically institutional investors or money managers. Soft-dollar research may be generated either internally by the broker-dealer or purchased by the broker-dealer from a third party.

**7.105** Since the 1970s, when soft-dollars were first used, some broker-dealers and money managers have used soft-dollars to cover transactions or expenses not associated with research. These types of transactions are governed by Section 28(e) of the Securities Exchange Act of 1934, which allows the paying of a brokerage commission if the manager determines in good faith that the commission is reasonable in relation to the value of the brokerage and research services provided.

**7.106** In 2006, the SEC published final interpretative guidance (Release No. 34-54165, *Commission Guidance Regarding Client Commission Practices Under Section 28[e] of the Securities Exchange Act of 1934*) regarding the "soft-dollar" safe harbor of Section 28(e) of the Securities Exchange Act of 1934.

The release more clearly defines the boundaries of permissible “research” and “brokerage” products under the safe harbor.

**7.107** FASB ASC 940-20-25-3 explains that at the date of the statement of financial condition, the broker-dealer should analyze both the commission income generated from soft-dollar customers and the research provided to the soft-dollar customers to determine whether a liability should be accrued for research due to customers based on the commission income generated or whether any soft-dollar expenses have been prepaid and need to be deferred.

**7.108** The realizability of any prepaid expenses should be evaluated as of the financial statement date.

## Mandatorily Redeemable Instruments<sup>17</sup>

**7.109** A *mandatorily redeemable instrument* is a financial instrument issued in the form of shares<sup>18</sup> that embody an unconditional obligation requiring the issuer<sup>19</sup> to redeem the instrument by transferring its assets at specified or determinable date(s) or upon an event that is certain to occur. FASB ASC 480, *Distinguishing Liabilities from Equity*, establishes standards for how an issuer classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. FASB ASC 480-10-25 requires that an issuer classify a financial instrument within its scope as a liability (or an asset in some circumstances) because that financial instrument embodies an obligation of the issuer.

**7.110** Such obligation as mentioned in the previous paragraph may arise from the terms of an operating, a partnership, or an incorporation agreement or the operation of state law.

**7.111** Under FASB ASC 480-10, broker-dealers that have issued shares that must be sold back to the company upon the holder’s death or termination of employment should record those shares as liabilities, rather than equity because the shares are mandatorily redeemable upon an event certain to occur. As a result, some broker-dealers may report minimal or no equity in their GAAP financial statements. From a regulatory standpoint, application of FASB ASC 480 can cause a broker-dealer to fall below its minimum net capital requirements under SEC Rule 15c3-l(a) or cause its subordinated debt to debt-equity total to increase above the 70 percent limit set forth in Rule 15c3-l(d). Broker-dealers may have amended, partnership, operating (such as limited liability company), shareholder, or other agreements to avoid the potential adverse impacts of FASB ASC 480 on net capital.

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<sup>17</sup> The effective date for the classification, measurement, and disclosure provisions of FASB ASC 480, *Distinguishing Liabilities from Equity*, is deferred indefinitely for certain mandatorily redeemable financial instruments of certain nonpublic entities and certain mandatorily redeemable noncontrolling interests, as discussed in FASB ASC 480-10-65-1. Mandatorily redeemable financial instruments issued by SEC registrants are not eligible for the effective date deferral. Because registered broker-dealers are required to submit financial statements to the SEC, they are within the scope of SEC registrant in this guidance and, therefore, are subject to the guidance in FASB ASC 480-10.

<sup>18</sup> For the purpose of this guidance, shares include various forms of ownership that may or may not take the legal form of securities (for example, partnership interests).

<sup>19</sup> An *issuer*, for the purpose of this guidance, is the entity that issued the financial instrument.

## Statement of Income or Loss Considerations

### Underwriting Revenues and Expenses

**7.112** As noted in FASB ASC 940-20-05-10, there are several different ways in which a broker-dealer may participate in the underwriting of a new issue of securities. The broker-dealer may be the managing or lead underwriter, a member of the syndicate, or a member of the selling group. Such participation may be on one of the following bases:

- Firm commitment
- Standby
- Best efforts
- All or none

**7.113** FASB ASC 940-340-05-1(b) notes that in connection with its participation in an underwriting of securities, a broker-dealer may receive various types of revenues, as well as incur various related expenses. Such revenues include management fees (in the case of the lead or comanaging underwriter), underwriting fees (in the case of the lead underwriter and other members of the syndicate), and selling concession fees (in the case of all selling group members). The related expenses include, but are not limited to, marketing and advertising fees, legal fees, stabilization costs, and the other costs associated with setting up the syndicate group. These expenses are accumulated by the lead underwriter and allocated to the other members of the syndicate on a pro rata basis.

**7.114** As discussed in FASB ASC 940-605-25-2, the fee revenue relating to the underwriting commitment should be recorded when all significant items relating to the underwriting cycle have been completed and the amount of the underwriting revenue has been determined. This will generally be at the point at which all of the following have occurred (which may or may not be prior to the settlement date of the issue):

- The issuer's registration statement has become effective with the SEC, or other offering documents are finalized (as opposed to the closing or settlement date).
- The broker-dealer has made a firm commitment for the purchase of the shares or debt from the issuer.
- The broker-dealer has been informed of the exact number of shares or the principal amount of debt that it has been allotted (if it is not the lead underwriter of an undivided offering).

**7.115** FASB ASC 940-340-25-3 and 940-340-35-3 state that when the related underwriting expenses described previously are incurred prior to the actual issuance of the securities, such expenses are deferred and recognized at the time the related revenues are recorded. In the event that the transaction is not completed and the securities are not issued, the entities that have agreed to participate in the costs associated with the underwriting write those costs off to expense.

**7.116** According to FASB ASC 940-20-35-3, with respect to the underwriting of issues that trade prior to the settlement date, the broker-dealer should subsequently measure at fair value any shares that it is firmly committed to purchase but that have not yet been subscribed to by customers.

## Mutual Fund Distribution Costs

**7.117** FASB ASC 940-20-05-5 notes that broker-dealers may contract with one or more mutual funds to act as the registered distributor of the mutual fund's shares, assisting the fund in selling and distributing its shares. If a broker-dealer undertakes the responsibility for selling and distributing fund shares, it will incur different types of costs, the most common of which are commissions paid to those of its representatives who arrange fund sales. To compensate a broker-dealer for those selling efforts, mutual funds may establish some form of a fund-charge and shareholder-commission structure that provides fees to the broker-dealer either at the time of sale or over a specified period of time. Two common forms of compensation are the following:

- A front-end commission paid to the broker-dealer by the fund shareholder at the time of sale.
- A 12b-1 distribution fee that is paid by the fund over a period of time based on a percentage of the fund's daily net asset levels, together with a deferred sales charge that is a commission paid to the broker-dealer by the shareholder at the time the shareholder exits the fund. Deferred sales charges are often charged to the shareholder in decreasing amounts over time.

**7.118** In accordance with FASB ASC 940-605-25-3, a front-end commission should be recorded in full by the broker-dealer at the time it is earned (the trade date). FASB ASC 940-605-25-4 further notes that with respect to 12b-1 fees and deferred sales charges, the broker-dealer generally defers its incremental direct costs associated with the selling of the fund shares (such as sales representatives' commissions and direct marketing costs) and amortizes these costs over the period in which the fees from the fund or fund shareholders are expected to be received. Indirect costs associated with selling the fund shares are expensed as incurred.

**7.119** Fees from the funds or fund shareholders are recognized when received (see FASB ASC 946-605-25-8).

## Half-Turn Convention

**7.120** According to FASB ASC 940-605-30-1, commissions on certain contracts, such as commodity futures and options, may be billed to customers on a round-turn basis. The FASB ASC glossary defines *round turn* as a purchase and subsequent sale or a sale and subsequent purchase of a commodity futures contract. As explained in FASB ASC 940-605-30-2, even though the round-turn commissions may be reflected in the customer's account upon entering into the transaction or on the date of the round turn, this commission income should be recognized in the statement of income on a half-turn basis. Per the FASB ASC glossary, *half turn* is a transaction involving the purchase or sale as either an opening or a closing transaction of a commodity futures contract.

## Interest, Dividends, and Rebates

**7.121** The income statement classification of interest, dividends, and rebate income and expense varies, because certain transactions are entered into as financings and others are entered into as part of trading strategies.

**7.122** FASB ASC 940-405-45-1 states that stock-loan and repo transactions may be entered into for the purpose of financing positions (such as in lieu

of a bank loan). If such transactions are accounted for as financing transactions (see the “Secured Borrowings” section of this chapter), the rebate or interest expense should be reflected in the income statement as an expense separate and apart from any trading gains or losses.

**7.123** However, FASB ASC 940-320-05-3 notes that broker-dealers frequently enter into matched-stock borrow and loan transactions as a finder or conduit, or enter into repo and reverse repo agreements as part of a matched-book trading strategy. Further, complex trading strategies often involve numerous long and short positions in different products so that those positions reflect a trading position that is different from its individual components (for example, box spreads, conversions, and reversals). FASB ASC 940-320-45-6 further states that for those activities, the resulting income and expense may be reflected net in the income statement, with disclosure of the gross components either on the face of the income statement or in the notes to the financial statements.

### **Costs Associated With Exit or Disposal Activities**

**7.124** FASB ASC 420, *Exit or Disposal Cost Obligations*, provides guidance on accounting and reporting for costs associated with exit or disposal activities, such as during a restructuring. Examples of costs include, but are not limited to, costs to consolidate or close facilities and relocate employees and costs to terminate a contract that is not a capital lease. Appropriate disclosure of any exit or disposal activity should be in the notes to the financial statements and the financial effects should be disclosed in the financial statements, as required by FASB ASC 420-10-50.

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## Appendix A

### *Guidance Updates*

This appendix contains additional information on applicable guidance updates presented throughout the chapters of this guide, specifically guidance issued through the as of date of this guide that is not yet effective but will be for the next edition of this guide, and incorporated therein. Readers should consider this information for the reporting period to which it applies.

#### **A.01**

*Note:* Based on the criteria previously described, all applicable guidance has been incorporated into the text of the guide. As such, this appendix has intentionally been left blank.

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## Appendix B

# Mapping and Summarization of Changes— Clarified Auditing Standards

This appendix maps the extant<sup>1</sup> AU sections to the clarified AU-C sections. As a result of the Auditing Standards Board's (ASB's) Clarity Project, all extant AU sections have been modified. In some cases, individual AU sections have been revised into individual clarified standards. In other cases, some AU sections have been grouped together and revised as one or more clarified standards. In addition, the ASB revised the AU section number order established by Statement on Auditing Standards No. 1, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, AU sec. 110), to follow the same number order used in International Standards on Auditing (ISAs) for all clarified AU sections for which there are comparable ISAs. The clarified standards are effective for audits of financial statements for periods ending on or after December 15, 2012.

Although the Clarity Project was not intended to create additional requirements, some revisions have resulted in changes that may require auditors to make adjustments in their practices. To assist auditors in the transition process, these changes have been organized into the following four types:

- Substantive changes
- Primarily clarifying changes
- Primarily formatting changes
- Standards not yet issued in the Clarity Project

This appendix identifies those AU-C sections associated with these four types of changes.

### Substantive Changes

Substantive changes are considered likely to affect the firms' audit methodology and engagements because they contain *substantive* or *other changes*, defined as having one or both of the following characteristics:

- A change or changes to an audit methodology that may require effort to implement
- A number of small changes that, although not individually significant, may affect audit engagements

### Primarily Clarifying Changes

Primarily clarifying changes are intended to explicitly state what may have been implicit in the extant standards, which, over time, resulted in diversity in practice.

(continued)

<sup>1</sup> The term *extant* is used throughout this appendix in reference to the standards that are superseded by the clarified standards.

### Primarily Formatting Changes

Primarily formatting changes from the extant standards do not contain changes that expand the extant sections in any significant way and may not require adjustments to current practice.

### Standards Not Yet Issued in the Clarity Project

Standards not yet issued in the Clarity Project contain the remaining sections that are in exposure or have not yet been reworked.

The preface of this guide and the Financial Reporting Center at [www.aicpa.org/frc](http://www.aicpa.org/frc) provide more information about the Clarity Project. You can also visit [www.aicpa.org/sasclarity.aspx](http://www.aicpa.org/sasclarity.aspx).

#### Extant AU Sections Mapped to the Clarified AU-C Sections

Extant AU Section		AU Section Super-seded	New AU-C Section		Type of Change
110	Responsibilities and Functions of the Independent Auditor	All	200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards [1]	Primarily formatting changes
120	Defining Professional Requirements in Statements on Auditing Standards	All			
150	Generally Accepted Auditing Standards	All			
161	The Relationship of Generally Accepted Auditing Standards to Quality Control Standards	All	220	Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards	Primarily clarifying changes

**Extant AU Sections Mapped to the  
Clarified AU-C Sections—continued**

Extant AU Section		AU Section Super-seded	New AU-C Section		Type of Change
201	Nature of the General Standards	All	200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards [1]	Primarily formatting changes
210	Training and Proficiency of the Independent Auditor	All			
220	Independence	All			
230	Due Professional Care in the Performance of Work	All			
311	Planning and Supervision	All except paragraphs .08–.10	300	Planning an Audit	Primarily formatting changes
		Paragraphs .08–.10	210	Terms of Engagement	Primarily clarifying changes
312	Audit Risk and Materiality in Conducting an Audit	All	320	Materiality in Planning and Performing an Audit	Primarily formatting changes
			450	Evaluation of Misstatements Identified During the Audit	Primarily formatting changes
314	Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement	All	315	Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement	Primarily formatting changes
315	Communications Between Predecessor and Successor Auditors	All except paragraphs .03–.10 and .14	510	Opening Balances—Initial Audit Engagements, Including Reaudit Engagements	Primarily clarifying changes

(continued)

**Extant AU Sections Mapped to the  
Clarified AU-C Sections—continued**

Extant AU Section		AU Section Superseded	New AU-C Section		Type of Change
		Paragraphs .03–.10 and .14	210	Terms of Engagement	Primarily clarifying changes
316	Consideration of Fraud in a Financial Statement Audit	All	240	Consideration of Fraud in a Financial Statement Audit	Primarily formatting changes
317	Illegal Acts by Clients	All	250	Consideration of Laws and Regulations in an Audit of Financial Statements	Substantive changes
318	Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained	All	330	Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained	Primarily formatting changes
322	The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements	All	Planned to be issued as AU-C section 610	The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements	Standards not yet issued in the Clarity Project
324	Service Organizations	All	402	Audit Considerations Relating to an Entity Using a Service Organization	Primarily clarifying changes
325	Communicating Internal Control Related Matters Identified in an Audit	All	265	Communicating Internal Control Related Matters Identified in an Audit	Substantive changes
326	Audit Evidence	All	500	Audit Evidence	Primarily formatting changes

**Extant AU Sections Mapped to the  
Clarified AU-C Sections—continued**

Extant AU Section		AU Section Superseded	New AU-C Section		Type of Change
328	Auditing Fair Value Measurements and Disclosures	All	540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures [2]	Primarily formatting changes
329	Analytical Procedures	All	520	Analytical Procedures	Primarily formatting changes
330	The Confirmation Process	All	505	External Confirmations	Primarily clarifying changes
331	Inventories	All	501	Audit Evidence—Specific Considerations for Selected Items [3]	Primarily clarifying changes
332	Auditing Derivative Instruments, Hedging Activities, and Investments in Securities	All	501	Audit Evidence—Specific Considerations for Selected Items [3]	Primarily clarifying changes
333	Management Representations	All	580	Written Representations	Primarily formatting changes
334	Related Parties	All	550	Related Parties	Substantive changes
336	Using the Work of a Specialist	All	620	Using the Work of an Auditor's Specialist	Primarily Clarifying Changes
337	Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments	All	501	Audit Evidence—Specific Considerations for Selected Items [3]	Primarily clarifying changes

(continued)

**Extant AU Sections Mapped to the  
Clarified AU-C Sections—continued**

Extant AU Section		AU Section Superseded	New AU-C Section		Type of Change
339	Audit Documentation	All	230	Audit Documentation	Primarily formatting changes
341	The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern	All	570	The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern	Primarily formatting changes
342	Auditing Accounting Estimates	All	540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures [2]	Primarily formatting changes
350	Audit Sampling	All	530	Audit Sampling	Primarily formatting changes
380	The Auditor's Communication With Those Charged With Governance	All	260	The Auditor's Communication With Those Charged With Governance	Primarily formatting changes
390	Consideration of Omitted Procedures After the Report Date	All	585	Consideration of Omitted Procedures After the Report Release Date	Primarily formatting changes
410	Adherence to Generally Accepted Accounting Principles	All	700	Forming an Opinion and Reporting on Financial Statements [4]	Substantive changes
420	Consistency of Application of Generally Accepted Accounting Principles	All	708	Consistency of Financial Statements	Primarily clarifying changes



**Extant AU Sections Mapped to the  
Clarified AU-C Sections—continued**

Extant AU Section		AU Section Super-seded	New AU-C Section		Type of Change
431	Adequacy of Disclosure in Financial Statements	All	705	Modifications to the Opinion in the Independent Auditor's Report [5]	Primarily formatting changes
504	Association With Financial Statements	All	N/A	Withdrawn	
508	Reports on Audited Financial Statements	Paragraphs .01–.11, .14–.15, .19–.32, .35–.52, .58–.70, and .74–.76	700	Forming an Opinion and Reporting on Financial Statements [4]	Substantive changes
			705	Modifications to the Opinion in the Independent Auditor's Report [5]	Primarily formatting changes
			706	Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report [6]	Substantive changes
		Paragraphs .12–.13	600	Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)	Substantive changes
		Paragraphs .16–.18 and .53–.57	708	Consistency of Financial Statements	Primarily clarifying changes

(continued)

**Extant AU Sections Mapped to the  
Clarified AU-C Sections—continued**

Extant AU Section		AU Section Superseded	New AU-C Section		Type of Change
		Paragraphs .33–.34	805	Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement	Primarily clarifying changes
		Paragraphs .71–.73	560	Subsequent Events and Subsequently Discovered Facts [7]	Primarily formatting changes
530	Dating of the Independent Auditor's Report	Paragraphs .01–.02	700	Forming an Opinion and Reporting on Financial Statements [4]	Substantive changes
		Paragraphs .03–.08	560	Subsequent Events and Subsequently Discovered Facts [7]	Primarily formatting changes
532	Restricting the Use of an Auditor's Report	All	905	Alert That Restricts the Use of the Auditor's Written Communication	Primarily clarifying changes
534	Reporting on Financial Statements Prepared for Use in Other Countries	All	910	Financial Statements Prepared in Accordance With a Financial Reporting Framework Generally Accepted in Another Country	Primarily clarifying changes

**Extant AU Sections Mapped to the  
Clarified AU-C Sections—continued**

Extant AU Section		AU Section Super-seded	New AU-C Section		Type of Change
543	Part of Audit Performed by Other Independent Auditors	All	600	Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)	Substantive changes
544	Lack of Conformity With Generally Accepted Accounting Principles	All	800	Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks [8]	Primarily clarifying changes
550	Other Information in Documents Containing Audited Financial Statements	All	720	Other Information in Documents Containing Audited Financial Statements	Primarily formatting changes
551	Supplementary Information in Relation to the Financial Statements as a Whole	All	725	Supplementary Information in Relation to the Financial Statements as a Whole	Primarily formatting changes
552	Reporting on Condensed Financial Statements and Selected Financial Data	All	810	Engagements to Report on Summary Financial Statements	Primarily clarifying changes
558	Required Supplementary Information	All	730	Required Supplementary Information	Primarily formatting changes

(continued)

**Extant AU Sections Mapped to the  
Clarified AU-C Sections—continued**

Extant AU Section		AU Section Super-seded	New AU-C Section		Type of Change
560	Subsequent Events	All	560	Subsequent Events and Subsequently Discovered Facts [7]	Primarily formatting changes
561	Subsequent Discovery of Facts Existing at the Date of the Auditor's Report	All			
623	Special Reports	Paragraphs .19–.21	806	Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements	Primarily formatting changes
		Paragraphs .01–.10 and .22–.34	800	Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks [8]	Primarily clarifying changes
		Paragraphs .11–.18	805	Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement	Primarily clarifying changes

**Extant AU Sections Mapped to the  
Clarified AU-C Sections—continued**

Extant AU Section		AU Section Superseded	New AU-C Section		Type of Change
625	Reports on the Application of Accounting Principles	All	915	Reports on Application of Requirements of an Applicable Financial Reporting Framework	Primarily formatting changes
634	Letters for Underwriters and Certain Other Requesting Parties	All	920	Letters for Underwriters and Certain Other Requesting Parties	Primarily formatting changes
711	Filings Under Federal Securities Statutes	All	925	Filings With the U.S. Securities and Exchange Commission Under the Securities Act of 1933	Primarily formatting changes
722	Interim Financial Information	All	930	Interim Financial Information	Primarily formatting changes
801	Compliance Audits	All	935	Compliance Audits	Primarily formatting changes
901	Public Warehouses—Controls and Auditing Procedures for Goods Held	All	501	Audit Evidence—Specific Considerations for Selected Items [3]	Primarily clarifying changes
<b>Legend:</b>					
[n] Bracketed number indicates a clarity standard that supersedes more than one extant AU section.					

The AICPA developed an Audit Risk Alert to assist auditors and members in practice prepare for the transition to the clarified standards. It is organized to give you the background information on the development of the clarified standards and to identify the new requirements and changes from the extant standards. Check out the Audit Risk Alert *Understanding the Clarified Auditing Standards* (product no. ARACLA12P), which is available in the AICPA store on [www.cpa2biz.com](http://www.cpa2biz.com).

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## Appendix C

# Auditor's Standard Reports

Illustration 1 — Unmodified Opinion on Financial Statements of Nonissuers

Illustration 2 — Unmodified Opinion on Financial Statements With an Other-Matter Paragraph for Supplementary Information of Nonissuers (Unmodified Opinion on the Supplementary Information)

Illustration 3 — A Separate Report on Supplementary Information When the Auditor Is Issuing an Unmodified Opinion on the Financial Statements With an Unmodified Opinion on the Supplementary Information of Nonissuers

## Illustration 1 — Unmodified Opinion on Financial Statements of Nonissuers<sup>1</sup>

The following is an illustration of an auditor's report that expresses an unmodified opinion on the financial statements.

### Independent Auditor's Report

Board of Directors  
Standard Stockbrokerage Co., Inc.:

We have audited the accompanying [*consolidated*] financial statements of Standards Stockbrokerage Co., Inc., [*and Subsidiaries*] (the Company), which comprise the [*consolidated*] statement of financial condition as of December 31, 20X1, and the related [*consolidated*] statements of income, changes in stockholders' equity, changes in liabilities subordinated to claims of general creditors, and cash flows for the year then ended that are filed pursuant to Rule 17a-5 under the Securities Exchange Act of 1934, and the related notes to the [*consolidated*] financial statements.

### **Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these [*consolidated*] financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of [*consolidated*] financial statements that are free from material misstatement, whether due to fraud or error.

### **Auditor's Responsibility**

Our responsibility is to express an opinion on these [*consolidated*] financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the [*consolidated*] financial statements are free from material misstatement.

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<sup>1</sup> For audits of issuer broker-dealers, which are conducted in accordance with Public Company Accounting Oversight Board (PCAOB) standards, the auditor should refer to AU section 508, *Reports on Audited Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), for reporting requirements.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the [consolidated] financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the [consolidated] financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the [consolidated] financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we express no such opinion.<sup>2</sup> An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the [consolidated] financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.<sup>3</sup>

### **Opinion**

In our opinion, the [consolidated] financial statements referred to above present fairly, in all material respects, the financial position of Standard Stockbrokerage Co., Inc. [and Subsidiaries] as of December 31, 20X1, and the results of its [their] operations and its [their] cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Accounting Firm  
New York, New York<sup>4</sup>  
February 15, 20X3<sup>5</sup>

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<sup>2</sup> In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements (for example, when the audit is conducted in accordance with PCAOB standards), the auditor should modify this paragraph, as required in paragraph .32 of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*). In this situation, the following paragraph should be used:

*An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the [consolidated] financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the [consolidated] financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the [consolidated] financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the [consolidated] financial statements.*

<sup>3</sup> See paragraphs 3.138–.144 of this guide for information on obtaining confidential treatment of the financial statements from the SEC and the Commodity Futures Trading Commission.

<sup>4</sup> Technical Questions and Answers section 9100.07, "Naming the City and State Where the Auditor Practices" (AICPA, *Technical Practice Aids*), states that the city and state where the auditor practices is not required to be placed under the auditor's signature; they may be named in the firm's letterhead on which the report is issued. If multiple locations are presented in the letterhead, it should be clear which location is the issuing location.

<sup>5</sup> Paragraph .41 of AU-C section 700 states that the auditor's report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that (a) the audit documentation has been reviewed; (b) all the statements that the financial statements comprise, including the related notes, have been prepared; and (c) management has asserted that they have taken responsibility for those financial statements.



## Illustration 2 — Unmodified Opinion on Financial Statements With an Other-Matter Paragraph for Supplementary Information<sup>1</sup> of Nonissuers<sup>2</sup> (Unmodified Opinion on the Supplementary Information)

The following is an illustration of an auditor's report that expresses an unmodified opinion on the financial statements and the supplementary schedules required by the Securities and Exchange Commission.

### Independent Auditor's Report

Board of Directors  
Standard Stockbrokerage Co., Inc.:

We have audited the accompanying [*consolidated*] financial statements of Standards Stockbrokerage Co., Inc., [*and Subsidiaries*] (the Company), which comprise the [*consolidated*] statement of financial condition as of December 31, 20X1, and the related [*consolidated*] statements of income, changes in stockholders' equity, changes in liabilities subordinated to claims of general creditors, and cash flows for the year then ended that are filed pursuant to Rule 17a-5 under the Securities Exchange Act of 1934, and the related notes to the [*consolidated*] financial statements.

### **Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these [*consolidated*] financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of [*consolidated*] financial statements that are free from material misstatement, whether due to fraud or error.

### **Auditor's Responsibility**

Our responsibility is to express an opinion on these [*consolidated*] financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the [*consolidated*] financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the [*consolidated*] financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the [*consolidated*] financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the [*consolidated*] financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.

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<sup>1</sup> See AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), for additional guidance on reporting on supplementary information.

<sup>2</sup> For audits of issuer broker-dealers, which are conducted in accordance with Public Company Accounting Oversight Board (PCAOB) standards, the auditor should refer to AU section 508, *Reports on Audited Financial Statements* (AICPA, *PCAOB Standards and Related Rules, Interim Standards*), for reporting requirements.

Accordingly, we express no such opinion.<sup>3</sup> An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the [consolidated] financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.<sup>4</sup>

### **Opinion**

In our opinion, the [consolidated] financial statements referred to above present fairly, in all material respects, the financial position of Standard Stockbrokerage Co., Inc. [and Subsidiaries] as of December 31, 20X1, and the results of its [their] operations and its [their] cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

### **Other Matter**

Our audit was conducted for the purpose of forming an opinion on the [consolidated] financial statements as a whole. The supplementary information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the [consolidated] 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 [consolidated] financial statements. The information in Schedules I, II, III, and IV has been subjected to the auditing procedures applied in the audit of the [consolidated] financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the [consolidated] financial statements or to the [consolidated] financial statements themselves, and other additional procedures in accordance with auditing

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<sup>3</sup> In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements (for example, when the audit is conducted in accordance with PCAOB standards), the auditor should modify this paragraph, as required in paragraph .32 of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*). In this situation, the following paragraph should be used:

*An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the [consolidated] financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the [consolidated] financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the [consolidated] financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the [consolidated] financial statements.*

<sup>4</sup> See paragraphs 3.138–.144 of this guide for information on obtaining confidential treatment of the financial statements from the SEC and the Commodity Futures Trading Commission.

standards generally accepted in the United States of America. In our opinion, the information in Schedules I, II, III, and IV is fairly stated in all material respects in relation to the [*consolidated*] financial statements as a whole.<sup>5</sup>

Accounting Firm  
New York, New York<sup>6</sup>  
February 15, 20X3<sup>7</sup>

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<sup>5</sup> If the auditor issues a qualified opinion on the financial statements, and the qualification has an effect on the supplementary information, a statement that, in the auditor's opinion, except for the effects on the supplementary information of (refer to the paragraph in the auditor's report explaining the qualification), such information is fairly stated, in all material respects, in relation to the financial statements as a whole.

If the auditor's report on the audited financial statements contains an adverse opinion or a disclaimer of opinion and the auditor has been engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to such financial statements as a whole, the auditor is precluded from expressing an opinion on the supplementary information. When permitted by law or regulation, the auditor may withdraw from the engagement to report on the supplementary information. If the auditor does not withdraw, the auditor's report on the supplementary information should state that because of the significance of the matter disclosed in the auditor's report, it is inappropriate to, and the auditor does not, express an opinion on the supplementary information.

See AU-C section 725 for additional guidance.

<sup>6</sup> Technical Questions and Answers section 9100.07, "Naming the City and State Where the Auditor Practices" (AICPA, *Technical Practice Aids*), states that the city and state where the auditor practices is not required to be placed under the auditor's signature; they may be named in the firm's letterhead on which the report is issued. If multiple locations are presented in the letterhead, it should be clear which location is the issuing location.

<sup>7</sup> The date of the other-matter paragraph should not be earlier than the date on which the auditor completed the procedures required by paragraph .07 of AU-C section 725 in order to opine on the supplementary information. Therefore, the date of the auditor's report on supplementary information may be the same date as that of the financial statement report, or a later date (in no case would it be earlier). The auditor may dual date the report. See also footnote 5 in illustration 1.

### Illustration 3 — A Separate Report on Supplementary Information When the Auditor Is Issuing an Unmodified Opinion on Financial Statements With an Unmodified Opinion on the Supplementary Information of Nonissuers<sup>1</sup>

The following is an illustration of a separate auditor's report that expresses an unmodified opinion on the supplementary schedules required by the Securities and Exchange Commission.

#### **Independent Auditor's Report on Supplementary Information Required by Rule 17a-5 Under the Securities Exchange Act of 1934**

Board of Directors

Standard Stockbrokerage Co., Inc.:

We have audited the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] as of and for the year ended December 31, 20X1, and have issued our report thereon dated February 15, 20X3, which contained an unmodified opinion on those [*consolidated*] financial statements. Our audit was performed for the purpose of forming an opinion on the [*consolidated*] financial statements as a whole. The supplementary information contained in Schedules I, II, III, and IV, required by Rule 17a-5 under the Securities Exchange Act of 1934, is presented for purposes of additional analysis and is not a required part of the [*consolidated*] financial statements. 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 [*consolidated*] financial statements. The information in Schedules I, II, III, and IV has been subjected to the auditing procedures applied in the audit of the [*consolidated*] financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the [*consolidated*] financial statements or to the [*consolidated*] 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

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<sup>1</sup> For audits of issuer broker-dealers, which are conducted in accordance with Public Company Accounting Oversight Board standards, the auditor should refer to AU section 508, *Reports on Audited Financial Statements* (AICPA, *PCAOB Standards and Related Rules, Interim Standards*), for reporting requirements.

in Schedules I, II, III, and IV is fairly stated in all material respects in relation to the [consolidated] financial statements as a whole.<sup>2</sup>

Accounting Firm  
New York, New York<sup>3</sup>  
February 15, 20X3<sup>4</sup>

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<sup>2</sup> If the auditor issues a qualified opinion on the financial statements, and the qualification has an effect on the supplementary information, a statement that, in the auditor's opinion, except for the effects on the supplementary information of (*refer to the paragraph in the auditor's report explaining the qualification*), such information is fairly stated, in all material respects, in relation to the financial statements as a whole.

If the auditor's report on the audited financial statements contains an adverse opinion or a disclaimer of opinion and the auditor has been engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to such financial statements as a whole, the auditor is precluded from expressing an opinion on the supplementary information. When permitted by law or regulation, the auditor may withdraw from the engagement to report on the supplementary information. If the auditor does not withdraw, the auditor's report on the supplementary information should state that because of the significance of the matter disclosed in the auditor's report, it is inappropriate to, and the auditor does not, express an opinion on the supplementary information.

See AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), for additional guidance.

<sup>3</sup> Technical Questions and Answers section 9100.07, "Naming the City and State Where the Auditor Practices" (AICPA, *Technical Practice Aids*), states that the city and state where the auditor practices is not required to be placed under the auditor's signature; they may be named in the firm's letterhead on which the report is issued. If multiple locations are presented in the letterhead, it should be clear which location is the issuing location.

<sup>4</sup> The date of this report should not be earlier than the date on which the auditor completed the procedures required by paragraph .07 of AU-C section 725 in order to opine on such information. Therefore, the date of the auditor's report on supplementary information may be the same date as that of the financial statement report or a later date (in no case would it be earlier).



## Appendix D

### **Report on Internal Control Required by SEC Rule 17a-5(g)(1)<sup>1</sup>**

The following is an illustration of the independent auditor's report on internal control required by Securities and Exchange Commission Rule 17a-5(g)(1).

Board of Directors  
Standard Stockbrokerage Co., Inc.:

In planning and performing our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company), as of and for the year ended December 31, 20X1, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the [*consolidated*] financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Also, as required by Rule 17a-5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study of the practices and procedures followed by the Company, including consideration of control activities for safeguarding securities. This study included tests of compliance with such practices and procedures that we considered relevant to the objectives stated in Rule 17a-5(g), in the following:

1. Making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under Rule 17a-3(a)(11) and the reserve required by Rule 15c3-3(e)
2. Making the quarterly securities examinations, counts, verifications, and comparisons, and the recordation of differences required by Rule 17a-13
3. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System
4. Obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls, and of the practices and procedures referred to in the preceding paragraph, and to assess whether those practices and procedures can be expected to achieve

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<sup>1</sup> For audits conducted in accordance with Public Company Accounting Oversight Board standards refer to footnote 1 in appendix C, "Auditor's Standard Reports."

the SEC's previously mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in internal control and the practices and procedures referred to above, error or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the company's financial statements will not be prevented, or detected and corrected, on a timely basis.

Our consideration of internal control was for the limited purpose described in the first and second paragraphs and would not necessarily identify all deficiencies in internal control that might be material weaknesses. We did not identify any deficiencies in internal control and control activities for safeguarding securities that we consider to be material weaknesses, as defined previously.<sup>2</sup>

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are

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<sup>2</sup> Exhibit B, "Illustrative No Material Weakness Communication," of AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*), notes that a no material weakness communication may be modified if significant deficiencies are identified. This paragraph may be modified by inserting, "However, we identified certain deficiencies in internal control that we consider to be significant deficiencies, and communicated them in writing to management and those charged with governance on [date]." Paragraph .16 of AU-C section 265 states that the auditor should not issue a written communication stating that no significant deficiencies were identified during the audit because of the potential to be misunderstood or misused.

If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of this paragraph of the report should be modified as follows:

However, we identified the following deficiencies in [internal control or control activities for safeguarding securities] that we consider to be material weaknesses, as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures performed in our audit of the [consolidated] financial statements of Standard Stockbrokerage Co., Inc. [and Subsidiaries] as of and for the year ended December 31, 20X2, and this report does not affect our report thereon dated February 15, 20Y1. [A description of the material weaknesses that have come to the auditor's attention and corrective action.]



considered by the SEC to be adequate for its purposes in accordance with the Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures, as described in the second paragraph of this report, were adequate at December 31, 20X1, to meet the SEC's objectives.<sup>3</sup>

This report is intended solely for the information and use of the Board of Directors, management, the SEC, [*Designated self-regulatory organization*], and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 in their regulation of registered brokers and dealers, and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm  
New York, New York  
February 15, 20X2

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<sup>3</sup> Whenever inadequacies are described, the last sentence of this paragraph should be modified as per footnote 2. The report should also describe material inadequacies that the auditor becomes aware of that existed during the period but were corrected prior to the end of the period, unless management already has reported them to the Securities and Exchange Commission.



## Appendix E

### **Report on Internal Control Required by SEC Rule 17a-5(g)(1) for a Broker-Dealer Claiming an Exemption From SEC Rule 15c3-3<sup>1,2</sup>**

The following is an illustration of an independent auditor's report on internal control of a broker-dealer claiming an exemption from Securities and Exchange Commission Rule 15c3-3.

Board of Directors  
Standard Stockbrokerage Co., Inc.:

In planning and performing our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company), as of and for the year ended December 31, 20X1, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the [*consolidated*] financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Also, as required by Rule 17a-5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study of the practices and procedures followed by the Company including consideration of control activities for safeguarding securities. This study included tests of such practices and procedures that we considered relevant to the objectives stated in Rule 17a-5(g) in making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under Rule 17a-3(a)(11) and for determining compliance with the exemptive provisions of Rule 15c3-3. Because the Company does not carry securities accounts for customers or perform custodial functions relating to customer securities, we did not review the practices and procedures followed by the Company in any of the following:

1. Making quarterly securities examinations, counts, verifications, and comparisons and recordation of differences required by Rule 17a-13
2. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility,

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<sup>1</sup> For audits conducted in accordance with Public Company Accounting Oversight Board standards, refer to footnote 1 in appendix C, "Auditor's Standard Reports."

<sup>2</sup> There are different types of exemptions under Securities and Exchange Commission Rules 15c3-3-k(1), k(2)(i), and k(2)(ii). Other formats of this letter may be required depending on the type of the exemption claimed.

estimates and judgments by management are required to assess the expected benefits and related costs of controls and of the practices and procedures referred to in the preceding paragraph and to assess whether those practices and procedures can be expected to achieve the SEC's previously mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in internal control and the practices and procedures referred to above, error or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the company's financial statements will not be prevented, or detected and corrected, on a timely basis.

Our consideration of internal control was for the limited purpose described in the first and second paragraphs and would not necessarily identify all deficiencies in internal control that might be material weaknesses. We did not identify any deficiencies in internal control and control activities for safeguarding securities that we consider to be material weaknesses, as defined previously.<sup>3</sup>

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the SEC to be adequate for its purposes in accordance with the Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures, as described in the second paragraph of this report, were adequate at December 31, 20X1, to meet the SEC's objectives.<sup>4</sup>

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<sup>3</sup> See footnote 2 in appendix D, "Report on Internal Control Required by SEC Rule 17a-5(g)(1)."

<sup>4</sup> See footnote 3 in appendix D.

This report is intended solely for the information and use of the Board of Directors, management, the SEC, [*Designated self-regulatory organization*], and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 in their regulation of registered brokers and dealers, and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm  
New York, New York  
February 15, 20X2

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## Appendix F

### ***Letter to the Securities and Exchange Commission When the Broker-Dealer Has Not Made the Required Notification***

The following report is appropriate if the broker-dealer has not made the required notification of material inadequacy or if the auditor does not agree with the statements therein. Modification of this letter may be required based on the facts and circumstances of the particular situation.

Securities and Exchange Commission  
Washington D.C., and [*Appropriate regional office*]  
Designated Examining Authority

Dear Sirs:

Our most recent audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company), was as of December 31, 20X0, and for the year then ended, which we reported on under date of February 15, 20X1. We have not audited any financial statements of the Company as of any date or for any period subsequent to December 31, 20X0. Although we are presently performing certain procedures as part of our audit of the [*consolidated*] financial statements of the Company as of December 31, 20X1, and for the year then ending, these procedures do not constitute all the procedures necessary in an audit conducted in accordance with auditing standards generally accepted in the United States of America or all the procedures necessary to (1) consider the Company's internal control as required by generally accepted auditing standards or (2) study the Company's practices and procedures relevant to the objectives stated in Rule 17a-5(g) of the Securities and Exchange Commission as required by Rule 17a-5.

The management of the Company is responsible for establishing and maintaining internal control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls. The objectives of internal control are to provide management with reasonable but not absolute assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and are recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles.

Because of inherent limitations in internal control, error or fraud may occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the effectiveness of the design and operation of controls may deteriorate.

The purpose of performing certain procedures prior to the date of the financial statements is to facilitate the expression of an opinion on the Company's financial statements. It must be understood that the procedures performed would not necessarily identify all material

weaknesses in internal control and control activities for safeguarding securities.

However, pursuant to the requirements of Rule 17a-5(h)(2), we are to call to the attention of the chief financial officer any weaknesses that we believe to be material and that were disclosed during the course of interim work. We have made such notification to the chief financial officer of Standard Stockbrokerage Co., Inc., and we believe the following additional information is required pursuant to the requirements of the rule.

*[List and describe all instances where the independent auditor did not agree with the notification of the broker or dealer or where the required notification was not made.]*

Accounting Firm  
New York, New York  
December 10, 20X1

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## Appendix G

### **Report on Internal Control Required by CFTC Regulation 1.16 and SEC Rule 17a-5(g)(1)<sup>1</sup>**

The following is an illustration of the independent auditor's report on internal control required by Commodity Futures Trading Commission Regulation 1.16 and Securities and Exchange Commission Rule 17a-5(g)(1).

Board of Directors  
Standard Stockbrokerage Co., Inc.:

In planning and performing our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company) as of and for the year ended December 31, 20X1, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the [*consolidated*] financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Also, as required by Rule 17a-5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study of the practices and procedures followed by the Company, including consideration of control activities for safeguarding securities. This study included tests of compliance with such practices and procedures that we considered relevant to the objectives stated in Rule 17a-5(g), in the following:

1. Making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under Rule 17a-3(a)(11) and the reserve required by Rule 15c3-3(e)
2. Making the quarterly securities examinations, counts, verifications, and comparisons, and the recordation of differences required by Rule 17a-13
3. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System
4. Obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3

In addition, as required by Regulation 1.16 of the Commodity Futures Trading Commission (CFTC), we have made a study of the practices and procedures followed by the Company including consideration of control activities for safeguarding customer and firm assets. This study included tests of such practices and procedures

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<sup>1</sup> For audits conducted in accordance with Public Company Accounting Oversight Board standards, refer to footnote 1 in appendix C, "Auditor's Standard Reports."

that we considered relevant to the objectives stated in Regulation 1.16, in making the following:

1. The periodic computations of minimum financial requirements pursuant to Regulation 1.17
2. The daily computations of the segregation requirements of Section 4d(a)(2) of the Commodity Exchange Act and the regulations thereunder, and the segregation of funds based on such computations
3. The daily computations of the foreign futures and foreign options secured amount requirements pursuant to Regulation 30.7 of the CFTC

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraphs. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls and of the practices and procedures referred to in the preceding paragraphs and to assess whether those practices and procedures can be expected to achieve the SEC's and the CFTC's previously mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) and Regulation 1.16(d)(2) list additional objectives of the practices and procedures listed in the preceding paragraphs.

Because of inherent limitations in internal control and the practices and procedures referred to above, error or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the company's financial statements will not be prevented, or detected and corrected, on a timely basis.

Our consideration of internal control was for the limited purpose described in the first, second and third paragraphs and would not necessarily identify all deficiencies in internal control that might be material weaknesses. We did not identify any deficiencies in internal control and control activities for safeguarding securities and certain

regulated commodity customer and firm assets that we consider to be material weaknesses, as defined previously.<sup>2</sup>

We understand that practices and procedures that accomplish the objectives referred to in the second and third paragraphs of this report are considered by the SEC and CFTC to be adequate for their purposes in accordance with the Securities Exchange Act of 1934, the Commodity Exchange Act, and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures, as described in the second and third paragraphs of this report, were adequate at December 31, 20X1, to meet the SEC's and CFTC's objectives.<sup>3</sup>

This report is intended solely for the information and use of the Board of Directors, management, the SEC, the CFTC, [*Designated Self-Regulatory Organization*] and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 or Regulation 1.16 of the CFTC or both in their regulation of registered broker-dealers and futures commission merchants, and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm  
New York, New York  
February 15, 20X2

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<sup>2</sup> See footnote 2 in appendix D, "Report on Internal Control Required by Securities and Exchange Commission Rule 17a-5(g)(1)."

<sup>3</sup> Whenever inadequacies are described, the last sentence of this paragraph should be modified as per footnote 2 in appendix D. The report should also describe material inadequacies that the auditor becomes aware of that existed during the period but were corrected prior to the end of the period, unless management already has reported them to the Securities and Exchange Commission and the Commodity Futures Trading Commission.



## Appendix H

# ***Independent Accountants' Report on Applying Agreed-Upon Procedures Related to an Entity's SIPC Assessment Reconciliation***<sup>1</sup>

The following is an illustration of the independent accountant's report related to the entity's Securities Investor Protection Corporation (SIPC) assessment reconciliation as required under Securities and Exchange Commission Rule 17a-5(e)(4).

To the Board of Directors of Standard Stockbrokerage Co., Inc.  
[Address]  
[City, State]

In accordance with Rule 17a-5(e)(4) under the Securities Exchange Act of 1934, we have performed the procedures enumerated below with respect to the accompanying Schedule of Assessment and Payments [General Assessment Reconciliation (Form SIPC-7)] to the Securities Investor Protection Corporation (SIPC) for the year ended December 31, 20X2, which were agreed to by Standard Stockbrokerage Co., Inc. and the Securities and Exchange Commission, Financial Industry Regulatory Authority, Inc., SIPC, and [other designated examining authority or *specified parties of report*], solely to assist you and the other specified parties in evaluating Standard Stockbrokerage Co., Inc.'s compliance with the applicable instructions of the General Assessment Reconciliation (Form SIPC-7). Standard Stockbrokerage Co., Inc.'s management is responsible for the Standard Stockbrokerage Co., Inc.'s compliance with those requirements. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose. The procedures we performed and our findings are as follows:

1. Compared the listed assessment payments in Form SIPC-7 with respective cash disbursement records entries [*Insert description of disbursement records*] noting no differences;<sup>2</sup>
2. Compared the amounts reported on the audited Form X-17A-5 for the year ended December 31, 20X2, as applicable, with the

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<sup>1</sup> Securities and Exchange Commission Rule 17a-5(e)(4) states that a broker or dealer should file a supplemental report that covers the Securities Investor Protection Corporation (SIPC) annual general assessment reconciliation or exclusion from SIPC membership. At the issue date of this guide, an illustration of the report that covers an entity's exclusion from SIPC membership was being developed. When the illustrative report is available, it will be posted on the AICPA website at the Stockbrokerage and Investment Banking expert panel section.

<sup>2</sup> To the extent any differences are noted in any of the procedures, such differences will be disclosed as a finding.

amounts reported in Form SIPC-7 for the year ended December 31, 20X2, noting no differences;

3. Compared any adjustments reported in Form SIPC-7 with supporting schedules and working papers [*Insert description of supporting schedules and working papers*] noting no differences;
4. Proved the arithmetical accuracy of the calculations reflected in Form SIPC-7 and in the related schedules and working papers [*Insert description of supporting schedules and working papers*] supporting the adjustments noting no differences; and
5. Compared the amount of any overpayment applied to the current assessment with the Form SIPC-7 on which it was originally computed noting no differences [*if applicable*].

We were not engaged to, and did not conduct an examination, the objective of which would be the expression of an opinion on compliance. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the specified parties listed above and is not intended to be and should not be used by anyone other than these specified parties.

February 15, 20X3

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## Appendix I

### Representation Letter<sup>1</sup>

[Date of Auditor's Report]

To [Independent Auditor]

This representation letter is provided in connection with your audit of the [consolidated] financial statements of Standard Stockbrokerage Co., Inc. [and Subsidiaries] (the Company), which comprise the [consolidated] statement of financial condition as of December 31, 20X1,<sup>2</sup> and the related [consolidated] statements of income, changes in stockholders' equity, changes in liabilities subordinated to claims of general creditors, and cash flows for the year then ended, and the related notes to the [consolidated] financial statements, for the purpose of expressing an opinion on whether the [consolidated] financial statements are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States (U.S. GAAP). We also recognize that we are responsible for establishing and maintaining effective internal control.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

Except when otherwise stated below, immaterial matters less than \$[insert amount] collectively are not considered to be exceptions that require disclosure for the purpose of the following representations. This amount is not necessarily indicative of amounts that would require adjustment to or disclosure in the [consolidated] financial statements.

We confirm the following [ , to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves] [as of (date of auditor's report),]:

[Consolidated] Financial Statements

1. We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated [insert date], for the preparation and fair presentation of the [consolidated] financial statements in accordance with U.S. GAAP.

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<sup>1</sup> See paragraph 5.22 in chapter 5, "Auditing Considerations," for information relating to a letter sent by the Securities and Exchange Commission (SEC) to the AICPA Stockbrokerage and Investment Banking Expert Panel. The letter notes that in order to obtain reasonable assurance to support the reporting of material inadequacies to the SEC, the auditor should follow the requirements contained in existing professional standards, including the AICPA's Statements on Standards for Attestation Engagements. As a result, an auditor may consider obtaining representations found in paragraph .68 of AT section 601, *Compliance Attestation* (AICPA, *Professional Standards*), in addition to representations obtained as part of the financial statement audit.

<sup>2</sup> Note that AU-C section 580, *Written Representations* (AICPA, *Professional Standards*), requires the auditor to obtain written representations from management and, when appropriate, those charged with governance for all financial statements and periods covered by the auditor's report.

2. We acknowledge our responsibility for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of [*consolidated*] financial statements that are free from material misstatement, whether due to fraud or error.
3. We acknowledge our responsibility for the design, implementation, and maintenance of internal control to prevent and detect fraud.
4. Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable.
5. Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of U.S. GAAP.
6. All events subsequent to the date of the [*consolidated*] financial statements and for which U.S. GAAP requires adjustment or disclosure have been adjusted or disclosed.
7. The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the [*consolidated*] financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter.<sup>3</sup>
8. The effects of all known actual or possible litigation and claims have been accounted for and disclosed in accordance with U.S. GAAP.

[*Any other matters that the auditor may consider appropriate*]<sup>4</sup>

#### *Information Provided*

9. We have provided you with
  - a. access to all information, of which we are aware that is relevant to the preparation and fair presentation of the [*consolidated*] financial statements such as records, documentation and other matters;
  - b. additional information that you have requested from us for the purpose of the audit; and
  - c. unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.
10. All transactions have been recorded in the accounting records and are reflected in the [*consolidated*] financial statements.

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<sup>3</sup> If management believes that certain of the identified items are not misstatements, management's belief may be acknowledged by adding to the representation, for example, "We do not agree that items XX and XX constitute misstatements because [*description of reasons here*]." Also, a summary of the uncorrected misstatements should be included in, or attached to, the representation letter.

<sup>4</sup> According to paragraph .A21 of AU-C section 580, the auditor may consider it necessary to request management to provide written representations about specific assertions in the financial statements; in particular, to support an understanding that the auditor has obtained from other audit evidence of management's judgment or intent regarding, or the completeness of, a specific assertion. For example, if the intent of management is important to the valuation basis for investments, it may not be possible to obtain sufficient appropriate audit evidence without a written representation from management about its intentions. Although such written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own for that assertion.



11. We have disclosed to you the results of our assessment of the risk that the *[consolidated]* financial statements may be materially misstated as a result of fraud.
12. We have *[no knowledge of any]* *[disclosed to you all information that we are aware of regarding]* fraud or suspected fraud that affects the Company and involves
  - a. management;
  - b. employees who have significant roles in internal control; or
  - c. others when the fraud could have a material effect on the *[consolidated]* financial statements.
13. We have *[no knowledge of any]* *[disclosed to you all information that we are aware of regarding]* allegations of fraud, or suspected fraud, affecting the Company's *[consolidated]* financial statements communicated by employees, former employees, analysts, regulators, short sellers, or others.
14. We have disclosed to you all known instances of noncompliance or suspected noncompliance with laws and regulations whose effects should be considered when preparing the *[consolidated]* financial statements.
15. We *[have disclosed to you all known actual or possible]* *[are not aware of any pending or threatened]* litigation and claims whose effects should be considered when preparing the *[consolidated]* financial statements *[and we have not consulted legal counsel concerning litigation or claims]*.
16. We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware.
17. The following have been properly recorded or disclosed in the *[consolidated]* financial statements:
  - a. Arrangements with financial institutions involving compensating balance arrangements involving restrictions on cash balances and lines of credit, or similar arrangements.
  - b. The following information about financial instruments with off-balance-sheet risk and financial instruments *[including receivables]* with concentrations of credit risk:
    - i. The extent, nature, and terms of financial instruments with off-balance-sheet risk.
    - ii. The amount of credit risk of financial instruments with off-balance-sheet risk and information about the collateral supporting such financial instruments.
    - iii. Significant concentrations of credit risk arising from all financial instruments and information about the collateral supporting such financial instruments.
  - c. Agreements to repurchase assets previously sold or resell assets previously purchased.

18. There are no
  - a. violations or possible violations of laws or regulations whose effects should be considered for disclosure in the [consolidated] financial statements or as a basis for recording a loss contingency.
  - b. unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with FASB ASC 450, *Contingencies*.<sup>5</sup>
  - c. other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB ASC 450.
19. The Company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral, except as disclosed in the [consolidated] financial statements.
20. The Company has complied with all aspects of contractual agreements that would have a material effect on the [consolidated] financial statements in the event of noncompliance.
21. Customers' debit balances, brokers' debit balances, and other accounts receivable are valid receivables. In our opinion, an adequate reserve has been established to cover any losses that may be incurred upon collection.
22. Provision has been made for any material loss to be sustained in the fulfillment of or from the inability to fulfill any purchase or sales commitments.
23. There are no securities or investments not readily marketable owned by the Company or borrowed under subordination agreements except as disclosed in the [consolidated] financial statements or notes thereto or as follows.

It is understood that the term *securities and investments not readily marketable* includes but is not limited to the following:

- a. Securities for which there is no market on a securities exchange or independent publicly quoted market.
- b. Securities that cannot be publicly offered or sold unless registration has been effected under the Securities Act of 1933 (or the conditions of an exemption such as Regulation A under Section 3(B) of such act have been complied with), that is, restricted stock.

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<sup>5</sup> Paragraph .15 of AU-C section 580 notes that the auditor should request management to provide written representations that all known actual or possible litigation and claims whose effects should be considered by management when preparing the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable reporting framework. As noted in paragraph .A45 of AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), when management has not consulted legal counsel, the auditor should obtain a representation as required by AU-C section 580. When legal counsel has not been consulted, a representation might be worded as follows:

We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the [consolidated] financial statements in accordance with Financial Accounting Standards Board *Accounting Standards Codification* 450, *Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments.

- c. Securities and investments that cannot be offered or sold because of other arrangements, restrictions, or conditions applicable to the securities and investments or to the Company (that is, control stock).
24. The methods and significant assumptions used to determine fair values of financial instruments, including derivative product transactions, are as follows: *[Describe methods and significant assumptions used to determine fair value appropriate for financial statement measurement and disclosure purposes.]*
25. In addition, the Company at December 31, 20X1, had
  - a. recorded all securities exchange memberships on the books.
  - b. properly recorded all participation in joint accounts carried by others.
  - c. no material unrecorded assets or contingent assets, such as claims relating to buy-ins, unfulfilled contracts, and so forth, whose value depends on the fulfillment of conditions regarded as uncertain.
  - d. no open contractual commitments other than those appearing on the memo books and records; for example, when-distributed and delayed delivery contracts, underwritings and when-issued contracts, endorsements of puts and calls, and commitments in foreign currencies and spot (cash) commodity contracts.
  - e. established a reserve for dividends and transfer items and security differences that is adequate to cover any anticipated losses in connection with the short securities that may have to be covered or claims arising from the liquidation of long securities.
  - f. no borrowings or claims unconditionally subordinated to all claims or general creditors pursuant to a written agreement except as disclosed in the *[consolidated]* financial statements or notes thereto.
26. All liabilities subordinated to the claims of general creditors are covered by satisfactory subordination agreements under 17 CFR 240.15c3-1 (The Net Capital Rule) and approved by *[Examining authority]*.
27. In accordance with FASB ASC 820, *Fair Value Measurement*, the Company has categorized its financial instruments, based on the priority of inputs to the valuation technique, into a three-level fair value hierarchy. The fair value gives the highest priority to quoted prices in active markets for identical assets or liabilities (level 1) and the lowest priority to unobservable inputs (level 3). If the inputs used to measure the financial instruments fall within different levels of the hierarchy, the categorization is based on the lowest level input that is significant to the fair value measurement of the instrument.
28. The Company has assessed the impact of FASB ASC 740, *Income Taxes*, and has determined that no material liability is required to be recorded.

29. Risks associated with concentrations, based on information known to management, that meet all of the following criteria have been disclosed in the [consolidated] financial statements:
- a. The concentration exists at the date of the [consolidated] financial statements.
  - b. The concentration makes the enterprise vulnerable to the risk of a near-term severe impact.
  - c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.
30. There are no capital withdrawals anticipated within the next six months other than as disclosed in the [consolidated] financial statements or notes thereto except as follows [list any such items].
31. We are responsible for establishing and maintaining adequate internal control for safeguarding customer and the Company's securities and for the practices and procedures relevant to the objectives stated in Securities and Exchange Commission Rule 17a-5(g), including the following:
- a. Making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under Rule 17a-3(a)(11), the reserve required by Rule 15c3-3(e), and the reserve required for the Company's proprietary accounts of introducing broker-dealers (PAIB calculation).
  - b. Making the quarterly securities examinations, counts, verifications, and comparisons, and the recordation of differences required by Rule 17a-13.
  - c. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System.
  - d. Obtaining and maintaining physical possession or control of all fully paid and excess-margin securities of customers as required by Rule 15c3-3.

*[For a broker-dealer not subject to Rule 15c3-3, replace the representation above with the following:*

32. We are responsible for establishing and maintaining adequate internal control for safeguarding customer and the Company's securities and for the practices and procedures relevant to the objectives stated in Rule 17a-5(g), including making the periodic computations of aggregated indebtedness (or aggregate debits) and net capital under Rule 17a-3(a)(11) and for maintaining compliance with the exemptive provisions of Rule 15c3-3. Because the Company does not carry securities accounts for customers or perform custodial functions relating to customer securities, we do not maintain practices and procedures related to the following:
- a. Making quarterly securities examinations, counts, verifications, and comparisons, and recordation of differences required by Rule 17a-13.

- b. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System.]

We believe that our practices and procedures as described above were adequate at [balance sheet date] to meet the SEC's objectives.

There have been no significant changes in internal control since [latest balance sheet date].

- 33. There are no significant deficiencies or material weaknesses or material inadequacies at December 31, 20X1, or during the period January 1, 20X1, to the date of the auditor's report, in internal control over financial reporting and control activities for safeguarding securities, and the practices and procedures followed in
  - a. making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital as defined in accordance with the Net Capital Rule and the customer reserve computations required by 17 CFR 240.15c3-3(e) (The Customer Protection Rule).
  - b. making the quarterly securities examinations, counts, verifications and comparisons, and the recordation of differences required by 17 CFR 240.17a-13.
  - c. complying with the requirement for prompt payment for securities under Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System.
  - d. obtaining and maintaining physical possession or control of all fully paid and excess-margin securities of customers as required by the Customer Protection Rule.
  - e. making periodic computations of the minimum financial requirements pursuant to Regulation 1.17 of the Commodity Exchange Act.
  - f. making daily computations of the segregation requirements of Section 4d(2) (and Regulation 30) of the Commodity Exchange Act and the regulations thereunder, and the segregation of funds based upon such computations.
- 34. Net capital computations, prepared by the Company during the period from January 1, 20X1, through the date of the auditor's report, indicated that the Company was in compliance with the requirements of the Net Capital Rule (and applicable exchange requirements) at all times during the period. Customer reserve computations pursuant to the Customer Protection Rule during the period did not reveal any deposit requirements that were not made on a timely basis. [For a broker-dealer not subject to the requirements of Rule 15c3-3, replace the previous sentence with the following: The Company is not subject to and did not prepare a calculation for the reserve requirements of Rule 15c3-3 in accordance with applicable regulation.]
- 35. There was no computation of segregation requirements under the Commodity Exchange Act that indicated an insufficiency in segregation during the period from January 1, 20X1, through the date of the auditor's report.

36. The Company has appropriately reconciled its books and records (for example, general ledger accounts) underlying the [consolidated] financial statements to their related supporting information (for example, sub ledger or third-party data). All related reconciling items considered to be material were identified and included on the reconciliations and were appropriately adjusted in the [consolidated] financial statements. There were no material unreconciled differences or general ledger suspense account items that should have been adjusted or reclassified to another account. *[All consolidating entries have been properly recorded.]* All intracompany and *[intercompany]* accounts have been eliminated or appropriately measured and considered for disclosure in the [consolidated] financial statements.
37. Foreign and domestic operating subsidiaries of the Company which are subject to local securities and capital adequacy requirements were in compliance with such regulations and requirements at December 31, 20X1, and for the year then ended.
38. All borrowings and financial obligations of the Company of which we are aware are included in the [consolidated] financial statements at December 31, 20X1, as appropriate. We have fully disclosed to you all borrowing arrangements of which we are aware.
39. There are no outstanding past due PCAOB accounting support fees.
40. The Company's expense sharing agreement with *[Subsidiaries]* has been determined to be on a reasonable basis which is considered a proper method pursuant to Exchange Act Rule 17a-3(a)(1) and (a)(2).<sup>6</sup>
41. As it related to supplementary information included in the [consolidated] financial statements,
- a. the Company acknowledges and understands its responsibility for the presentation of the supplementary information in accordance with Rule 17a-5 of the Securities Exchange Act of 1934.
  - b. the supplementary information, including its form and content, is fairly presented in accordance with Rule 17a-5 of the Securities Exchange Act of 1934.
  - c. the methods of measurement or presentation have not changed from those used in the prior period *[or if the methods of measurement or presentation have changed, the reasons for such changes]*.
  - d. there were no significant assumptions or interpretations underlying the *[measurement or]* presentation of the supplementary information  
  
*[in the case where there are significant assumptions or interpretations replace this bullet with "significant assumptions or interpretations underlying the [measurement or] presentation*

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<sup>6</sup> This representation may need to be modified based on the entity issuing the financial statements associated with the representation letter, for example, if the subsidiary is the issuing entity, the representation should state:

*The Company's expense sharing agreement with [The Holding Company] ("Parent") has been determined to be on a reasonable basis which is considered a proper method pursuant to Exchange Act Rule 17a-3(a)(1) and (a)(2).*

of the supplementary information are [*describe significant assumptions or interpretations*]. We are responsible for the significant assumptions or interpretations underlying the [*measurement or*] presentation of the supplementary information. We believe the significant assumptions or interpretations used are reasonable.”]

- e. the Company will make the audited financial statements readily available to the intended users of the schedule no later than the issuance date by the entity of the supplementary information and the auditor’s report thereon [*include when the supplementary information is not presented with the audited financial statements*].

[*Any other matters that the auditor may consider appropriate*]<sup>7</sup>

To the best of our knowledge and belief, no events have occurred subsequent to the statement of financial condition date and through the date of this letter that would require adjustment to or disclosure in the aforementioned [*consolidated*] financial statements.

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[*Name of Chief Executive Officer and Title*]

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[*Name of Chief Financial Officer and Title*]

For publicly held broker dealers that include certifications of the CEO and CFO when filing with the Securities and Exchange Commission, the individuals certifying in those capacities should also sign the representation letter in order to directly confirm and document the communications to auditors described in their certifications (see paragraphs 5.124–.125). Other officers who provide material representations during the audit should also be considered for inclusion as signers.

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<sup>7</sup> See footnote 4.





## Appendix J

### Agreed-Upon Procedures

[Date]

To the Board of Directors  
Standard Stockbrokerage Co., Inc.:

We have performed the procedures enumerated below, which were agreed to by the Standard Stockbrokerage Co., Inc. (the Company) and [Name of government sponsored entity] (the Agency), solely to assist the specified parties in evaluating the Company's compliance with Section(s) of the Agency's Selling Group Agreement dated [Date] (the Agreement), entitled [Title], and Section(s) entitled [Title] of the Guidelines to the Agreement (collectively, the Agreements and Procedures), during the period [Define period] (the Period). Management is responsible for the Company's compliance with those requirements. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report was requested or for any other purpose.

The procedures we have performed are as follows.

1. Read the Agreement(s) and Procedure(s) provided to us by the Company.
2. Obtained written representation from management of the Company stating that: (1) the Company complied with the provisions of the Agreement(s) and Procedure(s) for the Period; (2) all records maintained pursuant to the Agreement(s) are retained in accordance with the record-keeping provisions of the Agreement(s) and Procedure(s); (3) all required offering documentation had been sent to investors during the Period in accordance with the Agreement(s); and (4) for any affiliates, domestic or foreign, through which primary [Agency] securities were distributed to customers, the compliance standards maintained were also met by the affiliates; additionally, any affiliates not meeting such standards were excluded from participating in primary distribution of [Agency] securities.
3. Read the Company's trading and selling policies and procedures related to the Agreements noted above as furnished to us by the Company. *[If policies and procedures are not documented in writing, the accountant should so indicate.]*
4. Based on our reading of the above-mentioned trading and selling policies and procedures, noted that the traders and salespeople (including salespeople in domestic and foreign affiliates which operate as broker-dealers for Agency primary issuance) involved in the offering and sale of Agency Securities are required to read and be familiar with the Agreement(s) and the Company's written procedures covering the offering and sale of Agency Securities.

5. Inquired of the designated individuals within the Company responsible for monitoring compliance with the Agreement(s) and Procedure(s) as to whether there are any written reports prepared during the Period relative to the Company's compliance with the Agreement and the Guidelines for the Agreement(s) and Procedure(s).
6. Obtained and read the report(s) noted in step 5 above (if applicable) and have confirmed that the reports did not contain any findings that would be deemed to be in noncompliance with the Agreement(s) and Procedure(s).
7. Obtained from the Company a list of all issues and the total allotment for which the Company has acted as a selling group member during the Period (see appendix K, "Agency Issues Participation Listing"). The Company has represented to us that such list is complete and accurate. The listings were compared to the detail supplied by the Agency. Please note that certain agencies, for example, the Federal National Mortgage Association (FNMA or Fannie Mae) may provide the independent auditor with this list. When provided, this list should be utilized in performing all related procedures.
8. Requested and obtained the Distribution Reports, Securities Industry and Financial Markets Association (SIFMA) Prepricing Reports or substantially similar reports that include all the information that is contained in a SIFMA Prepricing Report (Prepricing Reports), trade tickets, and general ledger account detail from Company personnel for a sample of issues [*state number of issues*] referred to in step 7 above. Please note the following:
  - a. All other relevant trading account records will be requested and report names and terminology may vary.
  - b. The Company should confer with each Agency to determine the appropriate number of issues for selection purposes.
  - c. Certain agencies will provide the independent auditor with copies of Distribution Reports (for example, Fannie Mae). In these instances, the reports and the complete list of issues (described in step 7 above) received from the Agency should be used to perform this step.
9. Performed the following procedures with respect to the Distribution Reports for issues selected in step 8.
  - a. Read the Distribution Reports and noted signatures; Company representatives indicated that individuals who signed the Distribution Reports were authorized persons pursuant to Section [*Number*] of the Agreement.
  - b. Compared and agreed the number of transactions, amount, and classification [*for example, municipal organization, corporation, or brokers*] of all sales to customers, before when-issued trading, and total allotment from the Distribution Reports to the Prepricing Reports.
  - c. Recomputed the mathematical accuracy of all totals on the Distribution Reports.
10. Performed the following procedures with respect to the Prepricing Reports for issues as obtained in step 8.

- a. Selected haphazardly [*Number*] orders for each sample issue selected in step 8.
  - b. For all orders selected in step a above, verified information accuracy by utilizing internal records or sent confirmation requests to confirm the amount, price, type of order, type of customer, trade date and other specified conditions of the order (for example, limit order). All orders selected must be validated via the described procedures or alternative procedures. Less than 100 percent compliance should be noted as an exception. [*Please note that the number and minimum confirm response rate should be determined by the Company in conjunction with the Agency. Confirmation results should be summarized and the nature of exceptions, if any, should be described either in the body of the report or in a separate attachment.*] See appendix L, “Confirmation Statistics,” for a summary of confirmations.
  - c. For all orders selected in step 10a above, compared and agreed individual orders and amounts to the related trade tickets and general ledger account detail.
  - d. Read each Prepricing Report for the applicable issues identified in step 8 above, noting that total allotment and order conditionality were noted on such report.
  - e. For all orders selected in step 10a above, read the trade tickets, noting that the sales prices were at face value or at prices offered to the public as published by the Agency.
  - f. For [*Number*] transactions haphazardly selected from the Prepricing Reports obtained in step 8 above, we obtained from representatives of the Company the names of the sales person(s) (institutional or retail) who were involved in the transactions, and obtained documentation as provided by the Company indicating that such individuals have received training, as defined in the Agreement(s). Such documentation consists of [*Describe*].
11. [*For purchases and sales from or to other members of the Agency Bond Selling Group (Reallowance Orders), if any, prior to the time that the securities are free to trade on the offering date, the Company is required to receive express authorization or specific permission from the Agency for such purchases and sales from the Agency for Reallowance Orders for such issue. Please note that authorization is not required for all reallowance orders. Certain reallowance orders are permitted under the Agreement. The Company should read the Agreement and contact the Agency for purposes of identifying such orders.*] Attached is a list in appendix M, “List of Reallowance Orders,” of all reallowance orders for which authorization is required as represented to us by the Company.
  12. [*For all orders for the account of an affiliate of the Company or for another nonaffiliated dealer who is not a member of the Agency Selling Group that are purchasing the securities, the Company must specifically advise the Agency of such orders.*] Compared the principal amount and trade date for such purchases as provided to us by

representatives of the Company from the trade tickets to the corresponding data reflected in the notification to the Agency as provided by the Company, and found them to be in agreement.

13. For all participating programs, reviewed the Company's policies and procedures relative to the process of identifying, initiating, tracking, recording and sending of the required offering documentation. For the items selected above, ensured the customers received offering documentation (as an alternative procedure, customer confirmations can be sent). *[Any exceptions should be provided in an attachment.]*

We were not engaged to, and did not conduct an examination, the objective of which would be the expression of an opinion on compliance. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of Standard Stockbrokerage Co., Inc. and *[Name of specified government sponsored entity using the report]* and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm  
New York, New York  
May 15, 20XX

**Note:** The agreed-upon procedures report suggests certain procedures that the independent auditor should perform. Please note the Company may request its independent auditor to perform other procedures. Such additional procedures should be performed to satisfy other specific requirements of certain government agencies and the Company should consult with the agencies in determining such procedures.

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**Appendix K**

**Agency Issues Participation Listing**

**Standard Stockbrokerage Co., Inc.  
 Agency Issues Participation Listing<sup>1</sup>  
 For the Period \_\_ to \_\_**

<i>CUSIP Number</i>	<i>Total Allotment</i>	<i>Reported Sales Per Prepricing Report<sup>2</sup></i>	<i>Actual Sales Per Distribution Report<sup>2</sup></i>	<i>Offering Documentation Delivered to Customers<sup>3</sup> Yes/No</i>

\_\_\_\_\_

<sup>1</sup> Certain agencies may incorporate the contents of this appendix into the agreed-upon procedures report.

<sup>2</sup> Information should be provided for issues selected for testing.

<sup>3</sup> If offering documentation is not delivered, please indicate specific reasons.



## Appendix L

**Confirmation Statistics**

Standard Stockbrokerage Co., Inc.

Confirmation Statistics<sup>1</sup>[March 15, 20XX] Offering

<b>Confirmations—Orders<sup>2</sup></b>		
Total number of orders	<u>[#]</u>	<u>[\$[Amount]]</u>
Orders confirmed	<u>[#]</u>	<u>[\$[Amount]]</u>
Confirmations returned without exception	<u>[#]</u>	<u>[\$[Amount]]</u>
Confirmations returned with exception	<u>[#]</u>	<u>[\$[Amount]]</u>
Confirmation exceptions cleared	<u>[#]</u>	<u>[\$[Amount]]</u>
Alternative procedures performed	<u>[#]</u>	<u>[\$[Amount]]</u>
Coverage <sup>3</sup> (based on number of confirmations mailed)	<u>[%]</u>	

[April 30, 20XX] Offering

<b>Confirmations—Orders<sup>2</sup></b>		
Total number of orders	<u>[#]</u>	<u>[\$[Amount]]</u>
Orders confirmed	<u>[#]</u>	<u>[\$[Amount]]</u>
Confirmations returned without exception	<u>[#]</u>	<u>[\$[Amount]]</u>
Confirmations returned with exception	<u>[#]</u>	<u>[\$[Amount]]</u>
Confirmation exceptions cleared	<u>[#]</u>	<u>[\$[Amount]]</u>
Alternative procedures performed	<u>[#]</u>	<u>[\$[Amount]]</u>
Coverage (based on number of confirmations mailed)	<u>[%]</u>	

<sup>1</sup> Certain agencies may incorporate the contents of this appendix into the agreed-upon procedures report.

<sup>2</sup> Orders include filled, partially filled, not filled or canceled orders.

<sup>3</sup> If the minimum response rate is not obtained as determined in step 10a of the report, two follow-up requests, either written or oral, should be performed. Further, if the minimum response rate is not obtained through follow-up requests, alternative procedures should be performed and described in the body of the report or in a separate attachment.





**Appendix M**

**List of Reallowance Orders**

Standard Stockbrokerage Co., Inc.

List of Reallowance Orders<sup>1</sup>

[March 15, 20XX] Offering

<i>Date</i>	<i>Description of Security</i>	<i>Quantity Re-allowed</i>	<i>Purchase Amount</i>	<i>Sell Amount</i>
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[April 30, 20XX] Offering

<i>Date</i>	<i>Description of Security</i>	<i>Quantity Re-allowed</i>	<i>Purchase Amount</i>	<i>Sell Amount</i>
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<sup>1</sup> Certain agencies may incorporate the contents of this appendix into the agreed-upon procedures report.



## Appendix N

### *Information Sources*

For further information on matters addressed in this guide, including the full text of standards and regulations, readers are encouraged to contact the various organizations listed in the table that follows. Many nongovernment and some government publications and services involve a charge or membership requirement.

## Information Sources

Organization	General Information	Fax	Website Address/Electronic Bulletin Board
<b>American Institute of Certified Public Accountants</b>	<i>Order Department</i> 220 Leigh Farm Rd. Durham, NC 27707-8110 (888) 777-7077 If outside of the U.S., call 919.402.4500	24 Hour Fax Hotline 800.362.5066	www.aicpa.org
<b>Financial Accounting Standards Board</b>	<i>Order Department</i> 401 Merritt 7, P.O. Box 5116 Norwalk, CT 06856-5116 800.748.0659		www.fasb.org
<b>U.S. Securities and Exchange Commission</b>	100 F Street, NE Washington, DC 20549 <i>Information Line</i> 888.SEC.6585		www.sec.gov
<b>Public Company Accounting Oversight Board</b>	1666 K Street, NW Washington, DC 20006-2803 202.207.9100	202.862.8430	http://pcaobus.org

**Information Sources—continued**

<b>Organization</b>	<b>General Information</b>	<b>Fax</b>	<b>Website Address/Electronic Bulletin Board</b>
<b>Securities Industry and Financial Markets Association</b>	120 Broadway, 35th FL New York, NY 10271 212.313.1200	212.313.1301	www.sifma.org
<b>NYSE Euronext</b>	11 Wall Street New York, NY 10005 212.656.3000	212.656.5549	www.nyse.com
<b>Financial Industry Regulatory Authority (FINRA)</b>	1735 K Street Washington, DC 20006 301.590.6500		www.finra.org
<b>Commodity Futures Trading Commission</b>	Three Lafayette Center 1155 21st Street, NW Washington, DC 20581 General number 202.418.5000	202.418.5521	www.cftc.gov
<b>Futures Industry Association</b>	2001 Pennsylvania Avenue, NW Suite 600 Washington, DC 20006-1823 202.466.5460	202.296.3184	www.futuresindustry.org

(continued)

## Information Sources—continued

Organization	General Information	Fax	Website Address/Electronic Bulletin Board
<b>National Futures Association</b>	300 S. Riverside Plaza #1800 Chicago, IL 60606-6615 Main number 312.781.1300  <i>Information Center</i> 312.781.1410 or 800.621.3570	312.781.1467	www.nfa.futures.org

## Appendix O

# *International Financial Reporting Standards*

## Introduction

The following information provides a brief overview of the ongoing globalization of accounting standards, International Financial Reporting Standards (IFRSs) as a body of accounting literature, the status of convergence with IFRSs in the United States, and the related issues that accounting professionals need to consider today.

## Globalization of Accounting Standards

As the business world becomes more globally connected, regulators, investors, audit firms, and public and private companies of all sizes are expressing an increased interest in having common accounting standards among participants in capital markets and trading partners around the world. Proponents of convergence with, or adoption of, IFRSs for financial reporting in the United States believe that one set of financial reporting standards would improve the quality and comparability of investor information and promote fair, orderly, and efficient markets.

Many critics, however, believe that accounting principles generally accepted in the United States of America (U.S. GAAP) are the superior standards and question whether the use of IFRSs will result in more useful financial statements in the long term and whether the cost of implementing IFRSs will outweigh the benefits. Implementing IFRSs will require a staggering effort by management, auditors, and financial statement users, not to mention educators.

The increasing pressure to globalize accounting standards, both in the United States and around the world, means that now is the time to become knowledgeable about these changes. The discussion that follows explains the underpinnings of the international support for a common set of high quality global standards and many of the challenges and potential opportunities associated with such a fundamental shift in financial accounting and reporting.

The international standard setting process began several decades ago as an effort by industrialized nations to create standards that could be used by developing and smaller nations. However, as cross-border transactions and globalization increased, other nations began to take interest, and the global reach of IFRSs expanded. More than 100 nations and reporting jurisdictions permit or require IFRSs for domestic listed companies and most have fully conformed to IFRSs as promulgated by the International Accounting Standards Board (IASB) and include a statement acknowledging such conformity in audit reports. Several countries, including Argentina and Canada, adopted IFRSs on January 1, 2011, and many other countries have plans to converge (or eliminate significant differences between) their national standards and IFRSs in the future.

For many years, the United States has been a strong leader in international efforts to develop globally accepted standards. Among other actions in support of IFRSs, the U.S. Securities and Exchange Commission (SEC) removed the requirement for foreign private issuers registered in the United States to reconcile their financial reports with U.S. GAAP if their accounts complied with

IFRSs as issued by the IASB. In addition, the SEC continues to analyze and evaluate appropriate steps toward, and challenges related to, incorporating IFRSs into the U.S. financial reporting system, as subsequently described.

In addition to the support received from certain U.S. based entities, financial and economic leaders from various organizations have announced their support for global accounting standards. Most notably, in 2009, the Group of Twenty Finance Ministers and Central Bank Governors (G20), a group from 20 of the world's industrialized and developing economies (with the 20th member being the European Union, collectively), called for standard setters to redouble their efforts to complete convergence in global accounting standards.

Acceptance of a single set of high quality accounting standards may present many significant opportunities, including the improvement in financial reporting to global investors, the facilitation of cross-border investments, and the integration of capital markets. Further, U.S. entities with international operations could realize significant cost savings from the use of a single set of financial reporting standards. For example, U.S. issuers raising capital outside the United States are required to comply with the domestic reporting standards of the foreign country and U.S. GAAP. As a result, additional costs arise from the duplication and translation of financial reporting information.

Many multinational companies support the use of common accounting standards to increase comparability of financial results among reporting entities from different countries. They believe common standards will help investors better understand the entities' business activities and financial position. Large public companies with subsidiaries in multiple jurisdictions would be able to use one accounting language company-wide and present their financial statements in the same language as their competitors. In addition, some believe that in a truly global economy, financial professionals, including CPAs, will be more mobile, and companies will more easily be able to respond to the human capital needs of their subsidiaries around the world.

Although certain cost reductions are expected, the initial cost of convergence with IFRSs is expected to be one of the largest obstacles for many entities, including accounting firms and educational institutions. Substantial internal costs for U.S. corporations in the areas of employee training, IT conversions, and general ledger software have been predicted. In addition, the time and effort required from various external functions, including the education of auditors, investors, lenders, and other financial statement users, will be significant factors for consideration.

Although the likelihood of acceptance of IFRSs may lack clarity for the time being, U.S. companies should consider preparing for the costly transition to new or converged standards, which likely will include higher costs in the areas of training and software compliance.

## Who is the IASB?

The IASB is the independent standard setting body of the IFRS Foundation, formerly, the International Accounting Standards Committee Foundation. As a private sector organization, the IFRS Foundation has no authority to impose funding regimes on countries. However, a levy system and national contributions through regulatory and standard-setting authorities or stock exchanges have been introduced in a number of countries to fund the organization. Although the AICPA was a founding member of the International Accounting Standards Committee, the IASB's predecessor organization, it is not affiliated with the IASB.



The IASB, founded on April 1, 2001, in London, England, is responsible for developing IFRSs and promoting the use and application of these standards. In pursuit of this objective, the IASB cooperates with national accounting standard setters to achieve convergence in accounting standards around the world.

The structure includes the following primary groups: (a) the IFRS Foundation, an independent organization having two main bodies: the IFRS Foundation trustees and the IASB; (b) the IFRS Advisory Council; and (c) the IFRS Interpretations Committee, formerly the International Financial Reporting Interpretations Committee (IFRIC). The trustees appoint the IASB members, exercise oversight, and raise the funds needed, but the IASB itself has responsibility for establishing IFRSs.

The IFRS Foundation is linked to a monitoring board of public authorities, including committees of the International Organization of Securities Commissions, the European Commission, and the SEC. The monitoring board's main responsibilities are to ensure that the trustees continue to discharge their duties as defined by the IFRS Foundation Constitution, as well as approving the appointment or reappointment of trustees. In addition, through the monitoring board, capital markets authorities that allow or require the use of IFRSs in their jurisdictions will be able to more effectively carry out their mandates regarding investor protection, market integrity, and capital formation.

The IASB board members are selected chiefly upon their professional competence and practical experience. The trustees are required to select members so that the IASB will comprise the best available combination of technical expertise and international business and market experience and to ensure that the IASB is not dominated by any particular geographical interest or constituency. The IASB has members from several different countries, including the United States. The members are responsible for the development and publication of IFRSs, including *International Financial Reporting Standard for Small- and Medium-sized Entities (IFRS for SMEs)*, and for approving the interpretations of IFRSs as developed by the IFRS Interpretations Committee.

The IFRS Interpretations Committee, founded in March 2002, is the successor of the previous interpretations committee, the Standing Interpretations Committee (SIC), and is the interpretative body of the IASB. The role of the IFRS Interpretations Committee is to provide timely guidance on newly identified financial reporting issues not specifically addressed in IFRSs or issues in which interpretations are not sufficient.

IFRSs are developed through a formal system of due process and broad international consultation, similar to the development of U.S. GAAP.

Readers are encouraged to become involved in the standard-setting process by responding to open calls from the standard setting organizations.

## What Are IFRSs?

The term *IFRSs* has both a narrow and broad meaning. Narrowly, IFRSs refers to the numbered series of pronouncements issued by the IASB, collectively called *standards*. More broadly, however, IFRSs refer to the entire body of authoritative IASB literature, including the following:

1. Standards, whether labeled IFRSs or International Accounting Standards (IASs)<sup>1</sup>

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<sup>1</sup> See [www.ifrs.org](http://www.ifrs.org) for a current listing of International Financial Reporting Standards (IFRSs) and International Accounting Standards (IASs).

2. Interpretations, whether labeled IFRIC (the former name of the interpretive body) or SIC (the predecessor to IFRIC)<sup>2</sup>

The preface to the IFRS 2012 *Bound Volume* states that IFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-oriented entities, including commercial, industrial, and financial entities, regardless of legal form or organization. IFRSs are not designed to apply to not-for-profit entities or those in the public sector,<sup>3</sup> but these entities may find IFRSs appropriate in accounting for their activities.

The IASB's *Conceptual Framework for Financial Reporting* (conceptual framework) establishes the concepts that underlie the preparation and presentation of financial statements for external users. The IASB is guided by the conceptual framework in the development of future standards and in its review of existing standards. The conceptual framework is not an IFRS, and when there is a conflict between the conceptual framework and any IFRS, the standard will prevail. The conceptual framework is an overall statement of guidance for those interpreting financial statements, whereas IFRSs are issue and subject specific.

When an IFRS specifically applies to a transaction, other event, or condition, the accounting policy or policies applied to that item shall be determined by applying the IFRS and considering any relevant implementation guidance issued by the IASB for the IFRS.

Further, if an IFRS does not address a specific transaction, event, or condition explicitly, IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, states that management should use its judgment in developing and applying an accounting policy that results in information that is relevant and reliable. With respect to the reliability of financial statements, IAS 8 states that the financial statements (a) represent faithfully the financial position, financial performance, and cash flows of the entity; (b) reflect the economic substance of transactions, other events, and conditions; (c) are neutral; (d) are prudent; and (e) are complete in all material respects. When making this type of judgment, management should refer to, and consider the applicability of, the following in descending order:

1. The requirements and guidance in IFRSs dealing with similar and related issues
2. The definitions, recognition criteria, and measurement concepts for assets, liabilities, income, and expenses in the conceptual framework

Management may also consider the most recent pronouncements of other standard setting bodies that use a similar conceptual framework (for example, U.S. GAAP), other accounting literature, and accepted industry practices to the extent that these do not conflict with IFRSs.

## IFRS for SMEs

*IFRS for SMEs* is a modification and simplification of full IFRSs aimed at meeting the needs of private company financial reporting users and easing the financial reporting burden on private companies through a cost-benefit approach. *IFRS for SMEs* is a self-contained, global accounting and financial reporting standard applicable to the general purpose financial statements of

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<sup>2</sup> See [www.ifrs.org](http://www.ifrs.org) for a current listing of International Financial Reporting Interpretations Committee and Standing Interpretations Committee interpretations.

<sup>3</sup> Generally speaking, *public* means government-owned entities, and *private* means nongovernment-owned entities.

entities that, in many countries, are known as small- and medium-sized entities (SMEs). Full IFRSs and *IFRS for SMEs* are promulgated by the IASB.

*SMEs* are entities that publish general purpose financial statements for external users and do not have public accountability. An entity has public accountability under the IASB's definition if it files its financial statements with a securities commission or other regulatory organization or it holds assets in a fiduciary capacity (for example, banks, insurance companies, brokers and dealers in securities, pension funds, and mutual funds). It is not the IASB's intention to exclude entities that hold assets in a fiduciary capacity for reasons incidental to their primary business (for example, travel agents, schools, and utilities) from utilizing *IFRS for SMEs*.

The needs of users of SME financial statements often are different from the needs of users of public company financial statements and other entities that likely would use full IFRSs. Whereas full IFRSs were designed specifically to meet the needs of equity investors in the public capital markets, *IFRS for SMEs* was developed with the needs of a wide range of users in mind. Users of the financial statements of SMEs may be more focused on shorter-term cash flows, liquidity, balance sheet strength, interest coverage, and solvency issues. Full IFRSs may impose a burden on SME preparers in that full IFRSs contain topics and detailed implementation guidance that generally are not relevant to SMEs. This burden has been growing as IFRSs have become more detailed. As such, a significant need existed for an accounting and financial reporting standard for SMEs that would meet the needs of their financial statement users while balancing the costs and benefits from a preparer perspective.

Practically speaking, *IFRS for SMEs* is viewed as an accounting framework for entities that do not have the capacity or resources to use full IFRSs. In the United States, the term SME would encompass many private companies.

In May 2008, the AICPA Governing Council voted to recognize the IASB as an accounting body for purposes of establishing international financial accounting and reporting principles and amended appendix A, "Council Resolution Designating Bodies to Promulgate Technical Standards," of Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, ET sec. 202 par. .01), and Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, ET sec. 203 par. .01). This amendment gives AICPA members the option to use IFRSs as an alternative to U.S. GAAP. Accordingly, IFRSs are not considered to be an other comprehensive basis of accounting. Rather, they are a source of generally accepted accounting principles.

As such, a key professional barrier to using IFRSs and, therefore, *IFRS for SMEs*, has been removed. Any remaining barriers may come in the form of unwillingness by a private company's financial statement users to accept financial statements prepared under *IFRS for SMEs* and a private company's expenditure of money, time, and effort to convert to *IFRS for SMEs*.<sup>4</sup>

The AICPA has developed a resource that compares *IFRS for SMEs* with corresponding requirements of U.S. GAAP. This resource is available in a Wiki format, which allows AICPA members and others to contribute to its development. To learn more about the resource, view available sections, and contribute to its content, visit the Wiki at <http://wiki.ifrs.com/>.

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<sup>4</sup> CPAs are encouraged to consult their state boards of accountancy to determine the status of reporting on financial statements prepared in accordance with *International Financial Reporting Standard for Small- and Medium-sized Entities* within their individual state.

## The Financial Accounting Standards Board and IASB Convergence Efforts<sup>5</sup>

To address significant differences between IFRSs and U.S. GAAP, the Financial Accounting Standards Board (FASB) and the IASB agreed to a “Memorandum of Understanding” (MoU), which was originally issued in 2006 and subsequently updated. Readers are encouraged to monitor the FASB and IASB websites for additional developments regarding the convergence efforts, such as discussion papers, exposure drafts, and requests for comments.

### Comparison of U.S. GAAP and IFRSs

One of the major differences between U.S. GAAP and IFRSs lies in the conceptual approach: U.S. GAAP is based on principles, with heavy use of rules to illustrate the principles; however, IFRSs are principles based, without heavy use of rules.

In general, a principles-based set of accounting standards, such as IFRSs, is broad in scope. The standards are concise, written in plain language, and provide for limited exceptions and bright lines. Principles-based standards typically require a higher level of professional judgment, which may facilitate an enhanced focus on the economic purpose of a company’s transactions and how the transactions are reflected in its financial reporting.

A noticeable result of these differences is that IFRSs provide much less overall detail. In developing an IFRS, the IASB expects preparers to rely on core principles and limited application guidance with fewer prescriptive rules. In contrast, FASB often leans more toward providing extensive prescriptive guidance and detailed rules. The guidance provided in IFRSs regarding revenue recognition, for example, is significantly less extensive than U.S. GAAP. IFRSs also contain relatively little industry-specific guidance.

An inherent issue in a principles-based system is the potential for different interpretations of similar transactions across jurisdictions and entities, which may affect the relative comparability of financial reporting.

Because of long-standing convergence projects between the IASB and FASB, the extent of the specific differences between IFRSs and U.S. GAAP is decreasing. Yet, significant differences remain, which could result in significantly different reported results, depending on a company’s industry and individual facts and circumstances. For example, some differences include the following:

- IFRSs do not permit last in, first out (LIFO) inventory accounting.
- IFRSs allow for the revaluation of assets in certain circumstances.
- IFRSs use a single-step method for impairment write-downs rather than the two-step method used in U.S. GAAP, making write-downs more likely.
- IFRSs have a different probability threshold and measurement objective for contingencies.
- IFRSs generally do not allow net presentation for derivatives.

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<sup>5</sup> Because the convergence projects discussed are active and subject to change, updates will be posted periodically to [www.journalofaccountancy.com](http://www.journalofaccountancy.com). Readers also are encouraged to monitor the progress of these projects at the respective boards’ websites: [www.ifrs.org](http://www.ifrs.org) and [www.fasb.org](http://www.fasb.org).

U.S. GAAP also addresses some specific transactions not currently addressed in IFRSs, such as accounting for reorganizations, including quasi reorganizations; troubled debt restructuring; spin-offs; and reverse spin-offs. In addition, U.S. GAAP is designed to apply to all nongovernmental entities, including not-for-profit entities, and includes specific guidance for not-for-profit entities, development stage entities, limited liability entities, and personal financial statements.

The difference in the amount of industry-specific guidance also illustrates the different approaches. Currently, IFRSs include only several standards (for example, IAS 41, *Agriculture*)<sup>6</sup> that might be regarded as primarily industry-specific guidance. However, the scope of these standards includes all entities to which the scope of IFRSs applies. In contrast, U.S. GAAP has considerable guidance for entities within specific industries. For example, on liability recognition and measurement alone, U.S. GAAP contains specific guidance for entities in the following industries, which is not found in IFRSs:

- Health care
- Contractors and construction
- Contractors and the federal government
- Entertainment, with separate guidance for casinos, films, and music
- Financial services, with separate guidance for brokers and dealers and depository and lending, insurance, and investment companies

For nonmonetary transactions, U.S. GAAP provides specific guidance for the airline, software, and entertainment industries.

## SEC Work Plan

The SEC continues to affirm its support for a single set of high-quality, globally accepted accounting standards; however, no decision has been made on whether or not to adopt IFRSs. In May 2011, the SEC staff produced a work plan outlining how such a possible transition might happen.

In November 2011, the SEC released a staff paper that summarizes the current status of convergence projects, which are grouped by both short-term and long-term, as well as by level of priority (greater priority versus lower priority). Currently, the three projects that are of greater priority are financial instruments, revenue recognition, and leases.

In July 2012, the SEC published its final staff report on the Work Plan, which focuses on the arguments for and against various forms of adoption of global accounting standards. When assessing the implications of incorporating IFRSs in the U.S. financial reporting system, the SEC concluded that while international standards have improved in comprehensiveness, there are still some gaps, especially in the areas of insurance, extractive industries, and rate-regulated industries. The report also states that the costs of full IFRS adoption remain to be among the most significant costs required from an accounting perspective, and that companies questioned whether the benefits would justify such a full-scale transition. Although the report does not contain information

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<sup>6</sup> In addition to IAS 41, *Agriculture*, the other IFRSs that address issues specific to certain industries are IFRS 4, *Insurance Contracts*, and IFRS 6, *Exploration for and Evaluation of Mineral Resources*.

leading to any decision the SEC has made regarding incorporation of IFRSs, the staff expects that the SEC and others in the United States will remain involved with the development and application of IFRSs.

Refer to [www.sec.gov](http://www.sec.gov) for the full version of the staff paper.

## AICPA

In response to an SEC staff paper issued in May 2011, the AICPA issued a comment letter in August 2011 stating AICPA's agreement with the SEC that FASB should continue to have an active role in the international financial reporting arena to ensure that U.S. interests are suitably addressed in the development of IFRSs. Results from an IFRS Readiness Survey conducted by the AICPA in September 2011 show that a majority of CPAs support optional adoption of IFRSs. This would allow publicly traded U.S. companies to use IFRS while the SEC decides whether to incorporate the standards into U.S. reporting requirements. In response to the SEC's final staff report on the Work Plan, the AICPA applauds the SEC's efforts in performing a detailed review of IFRSs and stresses the importance of high-quality, transparent, and comparable financial information for the world's capital markets to make sound investment decisions.

## Additional Resources

<i>Website</i>	<i>URL</i>
AICPA	<a href="http://www.aicpa.org">www.aicpa.org</a>
AICPA International Financial Reporting Standards Resources	<a href="http://www.ifrs.com">www.ifrs.com</a>
International Accounting Standards Board and IFRS Foundation	<a href="http://www.ifrs.org">www.ifrs.org</a>
Comparison Wiki of <i>International Financial Reporting Standard for Small- and Medium-sized Entities</i> and U.S. generally accepted accounting principles	<a href="http://wiki.ifrs.com">http://wiki.ifrs.com</a>
Financial Accounting Standards Board	<a href="http://www.fasb.org">www.fasb.org</a>

## Appendix P

### ***Schedule of Changes Made to the Text From the Previous Edition***

**As of July 1, 2013**

This schedule of changes identifies areas in the text and footnotes of this guide that have changed since the previous edition. Entries in the table of this appendix reflect current numbering, lettering (including that in appendix names), and character designations that resulted from the renumbering or reordering that occurred in the updating of this guide.

<b><i>Reference</i></b>	<b><i>Change</i></b>
Preface	Updated.
Paragraphs 1.01–.03	Revised for clarification.
Former footnote 2 to heading before paragraph 1.04	Added to chapter text.
Footnote 2 in paragraph 1.04; paragraph 1.05	Added for clarification.
Paragraph 1.06	Revised for clarification.
Footnote 4 in paragraph 1.29	Added for clarification.
Paragraph 1.38; footnotes 5–6 in paragraph 1.47; paragraph 1.48; footnote 7 in paragraph 1.48	Revised for clarification.
Former footnote 7 in paragraph 1.50	Added to chapter text.
Paragraph 1.71	Revised for issuance of FASB ASU No. 2012-04.
Footnote 8 in paragraph 1.82	Revised for clarification.
Footnote 9 in paragraph 1.85	Added for clarification.
Paragraphs 1.96 and 1.101	Revised for clarification.
Footnote 11 in paragraph 1.102	Added for issuance of proposed rule as found in SEC Release No. 33-9354.
Paragraph 1.107	Revised for issuance of ASU No. 2012-04.
Paragraphs 1.115, 1.123, 2.01–.02, 2.07, 2.11, 2.13, and 2.28	Revised for clarification.

*(continued)*

<i>Reference</i>	<i>Change</i>
Former footnote 3 in paragraph 2.36 and former footnote 4 in paragraph 2.37	Added to chapter text.
Footnote 3 in paragraph 2.43	Added for issuance of ASU No. 2012-04.
Former footnote 5 in paragraph 2.49	Added to chapter text.
Paragraphs 2.88, 2.93, and 2.95	Revised for clarification.
Former footnote 7 in paragraph 2.99	Added to chapter text.
Footnote 4 to heading before paragraph 2.99	Revised for clarification.
Former footnote 8 in paragraph 2.102	Added to chapter text.
Paragraphs 2.106, 2.122, 2.133, 2.138, and 2.145	Revised for clarification.
Former footnote 9 to heading before paragraph 2.147	Added to chapter text.
Footnote 5 in paragraph 2.147	Added for clarification.
Former footnote 10 in paragraph 2.147	Deleted.
Former footnote 11 in paragraph 2.149	Added to chapter text.
Footnote 6 to heading before paragraph 2.156	Added for issuance of proposed ASU <i>Transfers and Servicing (Topic 860): Effective Control for Transfers with Forward Agreements to Repurchase Assets and Accounting for Repurchase Financings</i> .
Paragraphs 2.160 and 2.173	Revised for clarification.
Former footnote 1 in paragraph 3.02	Added to chapter text.
Footnote 1 in paragraph 3.02	Revised for clarification.
Former footnote 3 in paragraph 3.03 and former footnotes 5 and 8–9 in paragraph 3.06	Added to chapter text.
Paragraph 3.06	Revised for clarification and for issuance of SEC Rule 15c3-1(e), SEC Rule 17Ad-17, SEC Rule 17Ad-22, and Regulation S–ID.



<i>Reference</i>	<i>Change</i>
Former footnotes 13–15 in paragraph 3.08	Added to chapter text.
Paragraph 3.09	Revised for clarification.
Former footnote 16 in paragraph 3.12	Added to chapter text.
Footnote 8 in paragraph 3.18	Added for issuance of ASU No. 2012-04.
Former footnotes 17–18 in paragraph 3.26 and former footnote 19 in paragraph 3.30	Added to chapter text.
Paragraphs 3.31 and 3.37	Revised for clarification.
Former footnote 21 in paragraph 3.38	Added to chapter text.
Paragraphs 3.40 and 3.42	Revised for clarification.
Former footnotes 23–24 in paragraph 3.42	Added to chapter text.
Footnote 11 in paragraph 3.42	Added for issuance of SEC Release Nos. 34-68071, 34-68660, and 34-69491.
Paragraphs 3.43–.44; footnote 13 in paragraph 3.50	Revised for clarification.
Former footnote 28 in paragraph 3.53	Added to chapter text.
Paragraph 3.58	Revised for clarification.
Paragraphs 3.59–.63	Added for issuance of SEC Rule 15c3-1(e).
Paragraph 3.67	Revised for clarification.
Former footnote 30 in paragraph 3.76	Added to chapter text.
Heading before paragraph 3.78	Revised for clarification.
Paragraphs 3.82–.87	Added for issuance of SEC Rule 17Ad-17.
Paragraphs 3.88–.89	Added for issuance of SEC Rule 17Ad-22.
Paragraph 3.90	Added for issuance of SEC Rule 17-248 Subpart C.
Former footnote 31 in paragraph 3.91 and former footnote 33 in paragraph 3.94	Added to chapter text.
Paragraphs 3.95 and 3.97–.99	Revised for clarification.

(continued)

<i>Reference</i>	<i>Change</i>
Former footnote 35 in paragraph 3.102; former footnote 36 in paragraph 3.103; former footnote 37 in paragraph 3.104; and former footnote 39 in paragraph 3.110	Added to chapter text.
Paragraphs 3.115 and 3.117	Revised for clarification.
Former footnote 42 in paragraph 3.117 and former footnote 43 to heading before paragraph 3.118	Added to chapter text.
Former footnote 46 in paragraph 3.134	Deleted.
Former footnote 47 in paragraph 3.138 and former footnote 48 in paragraph 3.139	Added to chapter text.
Paragraph 3.150	Revised for clarification.
Paragraph 3.157	Revised for clarification and for annual SIPC Board of Directors meeting.
Former footnote 51 in paragraph 3.159; former footnote 53 in paragraph 3.162; former footnote 55 in paragraph 3.163; former footnote 57 in paragraph 3.168; former footnote 58 in paragraph 3.169; and former footnote 59 in paragraph 3.171	Added to chapter text.
Paragraph 3.171	Revised for clarification.
Former footnote 60 in paragraph 3.173 and former footnote 62 in paragraph 3.175	Added to chapter text.
Footnote 33 in paragraph 3.177	Revised for amendments to CFTC Regulations 1.31 and 1.35.
Footnote 34 in paragraph 3.177	Revised for issuance of CFTC Regulations 23.500–.505.
Paragraph 3.179	Revised for passage of time.
Paragraph 3.182	Revised for issuance of CFTC Regulation 3.3.
Footnote 36 in paragraph 3.182	Added for issuance of CFTC Letter No. 13-03.

<i>Reference</i>	<i>Change</i>
Paragraph A-8 of appendix A of chapter 3	Revised for issuance of proposed rule as found in CFTC Release No. 77 FR 74284.
Paragraph A-10 of appendix A of chapter 3	Added for issuance of proposed rule as found in SEC Release Nos. 34-68071 and 34-68660.
Paragraph A-11 of appendix A of chapter 3	Added for issuance of proposed rule as found in SEC Release No. 33-9354.
Note before paragraph 4.01	Added for clarification of the presentation of "Pending Content" in FASB ASC and AICPA Audit and Accounting Guides.
Footnote 2 in paragraph 4.02; paragraphs 4.11–.12 and 4.14	Revised for clarification.
Former footnote 4 to heading before paragraph 4.18; former footnote 5 in paragraph 4.20; former footnote 6 in paragraph 4.22; and former footnote 7 in paragraph 4.24	Added to chapter text.
Paragraphs 4.22, 4.24, and 4.28	Revised for clarification.
Footnote 5 in paragraph 4.28	Added for issuance of ASU No. 2012-02.
Paragraph 4.41	Revised for issuance of ASU Nos. 2011-11 and 2013-01.
Note before paragraph 4.44	Deleted due to passage of time; added to chapter text.
Former footnote 9 in paragraph 4.45 and former footnote 10 in paragraph 4.46	Added to chapter text.
Paragraph 4.46	Revised for issuance of ASU No. 2011-03.
Paragraph 4.50	Revised for issuance of ASU No. 2012-04.
Paragraphs 4.58 and 4.69; heading before paragraph 4.70; paragraphs 4.70 and 4.79–.80	Revised for clarification.
Paragraph 4.81	Revised for clarification; revised for issuance of ASU No. 2012-04.
Former footnote 11 in paragraph 4.86	Added to chapter text.
Footnote 6 in paragraph 4.89	Added for issuance of ASU No. 2012-02.

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<i>Reference</i>	<i>Change</i>
Former footnote 12 to heading before paragraph 4.93	Added to chapter text.
Paragraphs 4.96–.97	Revised for clarification.
Paragraph 4.98	Revised for issuance of ASU No. 2012-04.
Paragraphs 4.99–.102	Added for clarification.
Former footnote 13 in paragraph 4.105	Added to chapter text.
Paragraphs 4.106–.112	Added for issuance of ASU Nos. 2011-11 and 2013-01.
Note before paragraph 4.113	Deleted due to passage of time; added to chapter text.
Footnote 7 to heading before paragraph 4.113	Revised due to passage of time; revised for clarification.
Exhibit 4-4	Revised for clarification.
Footnote 10 in exhibit 4-4	Added for issuance of ASU No. 2013-02.
Footnote 11 in exhibit 4-6	Added for issuance of ASU Nos. 2011-05 and 2011-12.
Exhibit 4-8	Revised for issuance of ASU Nos. 2011-04 and 2012-04; also revised for clarification.
Footnote 18 in exhibit 4-8	Added.
Footnote 25 in exhibit 4-8	Revised for issuance of ASU No. 2013-03.
Former footnote 27 in exhibit 4-8	Deleted.
Former footnote 36 in exhibit 4-8	Deleted.
Schedules I, II, and IV in chapter 4	Revised for issuance of ASU No. 2012-04.
Footnote 3 to heading before paragraph 5.01	Added for issuance of proposed rule as found in SEC Release No. 34-64676.
Paragraph 5.02	Revised for clarification.
Footnote 4 in paragraph 5.02 and footnote 5 in paragraph 5.03	Added for clarification.
Former footnote 3 in paragraph 5.05	Added to chapter text.
Paragraphs 5.05 and 5.07	Revised for clarification.
Former footnote 5 in paragraph 5.07	Added to chapter text.

<i>Reference</i>	<i>Change</i>
Footnote 7 in paragraph 5.07	Added for clarification.
Former footnote 7 in paragraph 5.09 and former footnote 8 in paragraph 5.11	Added to chapter text.
Footnote 10 to heading before paragraph 5.15 and paragraphs 5.15-.19	Revised for clarification.
Former footnote 13 in paragraph 5.20	Added to chapter text.
Paragraph 5.22; heading before paragraph 5.24; and paragraph 5.25	Revised for clarification.
Former footnote 14 in paragraph 5.33	Added to chapter text.
Paragraph 5.35	Revised for clarification.
Former footnote 17 in paragraph 5.45 and former footnote 18 in paragraph 5.46	Added to chapter text.
Paragraphs 5.46-.47, 5.49; heading before paragraph 5.53; paragraphs 5.72 and 5.87	Revised for clarification.
Paragraph 5.90	Added for issuance of SEC Rule 17Ad-22.
Paragraph 5.93	Revised for issuance of ASU No. 2012-04; also revised for clarification.
Footnote 16 to heading before paragraph 5.94	Revised for clarification.
Footnote 17 to heading before paragraph 5.104	Added for clarification.
Footnote 18 to heading before paragraph 5.107	Added for issuance of PCAOB Staff Audit Practice Alert No. 10.
Former footnote 21 to heading before paragraph 5.108	Deleted.
Paragraphs 5.110 and 5.112	Revised for clarification.

*(continued)*

<i>Reference</i>	<i>Change</i>
Former footnote 22 to heading before paragraph 5.114 and former footnote 23 to heading before paragraph 5.122	Added to chapter text.
Footnote 19 in paragraph 5.124	Added for clarification.
Paragraphs 5.140, 5.146, and 5.151	Revised for clarification.
Paragraph 5.154	Revised for issuance of PCAOB Auditing Standard No. 16.
Former footnote 24 to heading before paragraph 5.161	Deleted.
Paragraph 5.161	Revised for clarification.
Footnote 20 in paragraph 5.161	Added for clarification.
Paragraphs 5.162, 5.164, 5.169, and 5.171–.172	Revised for clarification.
Former footnote 25 in paragraph 5.172	Added to chapter text.
Paragraphs 5.175, 5.179, and 5.183	Revised for clarification.
Paragraphs 5.184 and 5.190	Revised for issuance of ASU No. 2012-04.
Paragraphs 5.191–.194 and 5.204	Revised for clarification.
Paragraphs 5.209–.210 and 5.214	Added for clarification.
Appendix A to chapter 5	Revised for issuance of ASU No. 2012-04; also revised for clarification.
Footnote 1 in appendix A to chapter 5	Revised for passage of time.
Footnote 2 in appendix A to chapter 5	Added for issuance of ASU No. 2012-04; also added for clarification.
Appendix B to chapter 5	Revised for clarification.
Paragraph 6.01	Revised for issuance of PCAOB Auditing Standard No. 16; also revised for clarification.
Former footnote 4 in paragraph 6.01	Added to chapter text.
Paragraphs 6.02 and 6.04	Revised for clarification.

<i>Reference</i>	<i>Change</i>
Footnote 4 in paragraph 6.04	Added for clarification.
Footnote 5 in paragraph 6.05	Added for issuance of COSO's 2013 <i>Internal Control-Integrated Framework</i> .
Paragraphs 6.07, 6.12, 6.16, and 6.19	Revised for clarification.
Former footnote 5 in paragraph 6.26 and former footnote 6 in paragraph 6.29	Added to chapter text.
Paragraphs 6.29 and 6.33	Revised for clarification.
Paragraph 6.35	Revised for issuance of ASU No. 2012-04.
Paragraphs 6.44 and 6.52	Revised for clarification.
Footnote 8 in paragraph 6.63 and paragraph 6.67	Added for clarification.
Paragraphs 6.68, 6.71, 6.73-.76 and 6.78-.81 and heading before paragraph 6.80	Revised for clarification.
Paragraph 6.83	Added for clarification.
Paragraph 6.84	Revised for clarification.
Footnote 11 in paragraph 6.84	Added for issuance of ASU Nos. 2011-11 and 2013-01.
Paragraph 6.85	Added for clarification.
Former footnote 12 in paragraph 6.86	Added to chapter text.
Paragraphs 6.86-.87	Revised for clarification and for issuance of ASU No. 2012-04.
Footnote 13 in paragraph 6.87	Added for issuance of ASU Nos. 2011-11 and 2013-01.
Paragraph 6.88	Revised for clarification.
Paragraph 6.89 and footnote 14 to heading before paragraph 6.90	Added for clarification.
Heading before paragraph 6.91	Revised for clarification.
Paragraph 6.91	Added for clarification.
Paragraph 6.92	Revised for clarification.
Former footnote 14 in paragraph 6.92	Added to chapter text.
Paragraph 6.93	Revised for clarification.

(continued)

<i>Reference</i>	<i>Change</i>
Former footnote 16 in paragraph 6.94	Deleted.
Paragraphs 6.94–.95 and 6.97–.98	Revised for clarification.
Note before paragraph 7.01	Added for clarification of the presentation of “Pending Content” in FASB ASC and AICPA Audit and Accounting Guides.
Former footnote 1 in paragraph 7.02 and former footnote 2 in paragraph 7.04	Added to chapter text.
Paragraph 7.05	Revised for clarification.
Footnote 1 in paragraph 7.06	Added for issuance of ASU No. 2013-03.
Paragraphs 7.07–.24	Revised for clarification.
Former paragraph 7.25	Deleted.
Paragraphs 7.26–.30 and 7.32–.33	Revised for clarification.
Former footnote 4 in paragraph 7.33	Deleted.
Paragraphs 7.34–.38 and 7.41	Revised for clarification.
Former footnote 5 in paragraph 7.42	Added to chapter text.
Paragraphs 7.43–.46, 7.48–.51, and 7.53	Revised for clarification.
Former footnote 7 in paragraph 7.53 and former footnote 7 in paragraph 7.54	Added to chapter text.
Footnote 4 in paragraph 7.63	Added for issuance of ASU Nos. 2011-11 and 2013-01.
Paragraph 7.65	Revised for clarification.
Footnote 5 in paragraph 7.66	Added for issuance of ASU Nos. 2011-11 and 2013-01.
Note before paragraph 7.70	Deleted due to passage of time; added to chapter text.
Paragraph 7.75	Revised for clarification.
Footnote 9 to heading before paragraph 7.76	Added for clarification.
Former footnote 11 in paragraph 7.76	Added to chapter text.
Paragraphs 7.77, 7.81, and 7.83	Revised for clarification.



<i>Reference</i>	<i>Change</i>
Paragraphs 7.86–.87	Revised for issuance of ASU No. 2012-04.
Footnote 16 in paragraph 7.100	Added for clarification.
Former footnote 18 in paragraph 7.103 and former footnote 19 in paragraph 7.105	Added to chapter text.
Paragraph 7.116	Revised for issuance of ASU No. 2012-04.
Paragraph 7.122	Revised for clarification.
Appendix A; appendix C; appendixes H–J; and appendixes N–P	Updated.
Glossary	Updated.
Index of Pronouncements and Other Technical Guidance	Added.
Subject Index	Updated.

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## Glossary

The following terms can be found in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary:

**box spread.** A combination of long calls and short puts (identical with respect to the underlying security issue, number of shares, exercise price, and expiration date) coupled with long puts and short calls (identical with respect to the underlying security issue, number of shares, exercise price, and expiration date). In boxing (coupling), the long calls and short puts with the long puts and short calls, the underlying security issue, the number of shares, and the expiration date remain identical. However, the exercise price of each combination is at a different amount.

**fail to deliver.** Securities that the selling broker-dealer has not delivered to the purchasing broker-dealer at the settlement date.

**fail to receive.** Securities that the purchasing broker-dealer has not received from the selling broker-dealer at the settlement date.

**fair value.** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**FHLMC.** Abbreviation for Federal Home Loan Mortgage Corporation. Often referred to as Freddie Mac, FHLMC is a private corporation authorized by Congress to assist in the development and maintenance of a secondary market in conventional residential mortgages. FHLMC purchases mortgage loans and sells mortgages principally through mortgage participation certificates representing an undivided interest in a group of conventional mortgages. FHLMC guarantees the timely payment of interest and the collection of principal on the participation certificates.

**floor broker.** A member of a securities exchange who executes transactions on the floor of an exchange for the account of that member's own entity or for the account of other member entities. Broker-dealers often engage floor brokers, who are responsible for executing securities transactions on the exchanges for the account of the broker-dealer. Floor brokers employed by the entity may execute trades on behalf of other broker-dealers, for which the entity is paid a brokerage fee. The purchase and sale department of the broker-dealer maintains the records of floor brokerage fees that are due to other broker-dealers who execute orders on the entity's behalf and brokerage fees due from other broker-dealers.

**FNMA.** Abbreviation for Federal National Mortgage Association. Often referred to as Fannie Mae, FNMA is an investor-owned corporation established by Congress to support the secondary mortgage loan market by purchasing mortgage loans when other investor funds are limited and selling mortgage loans when other investor funds are available.

**GNMA.** Abbreviation for Government National Mortgage Association, often referred to as Ginnie Mae. GNMA is a U.S. governmental agency that guarantees certain types of mortgage-backed securities and provides funds for and administers certain types of low-income housing assistance programs.

**half turn.** A transaction involving the purchase or sale as either an opening or closing transaction of a commodity futures contract (see **round turn**).

- proprietary transactions.** Transactions in financial instruments that broker-dealers execute for their own account.
- regular-way trades.** Include both of the following: (a) all transactions in exchange-traded financial instruments that are expected to settle within the standard settlement cycle of that exchange (for example, three days for U.S. securities exchanges); and (b) all transactions in cash-market-traded financial instruments that are expected to settle within the time frame prevalent or traditional for each specific instrument (for example, for U.S. government securities, one or two days).
- repurchase agreement (repo agreement).** The sale of a security, usually a U.S. government obligation or corporate debt instrument, at a specified price with a simultaneous agreement to repurchase the security, usually at a fixed or determinable price on a specified future date. An agreed-upon interest rate is accrued by the seller-repurchaser over the life of the contract. For financial reporting purposes, the security is treated as part of the broker-dealer's trading and investment inventory, with the amount of the repurchase agreement reflected as a liability.
- reverse repurchase agreement (reverse repo or resale agreement).** An agreement whereby the purchaser of securities agrees to resell the securities within a specified time at a fixed or determinable price (see **repurchase agreement**).
- round turn.** A purchase and a subsequent sale, or a sale and a subsequent purchase, of a commodity futures contract.
- soft-dollar arrangements.** Arrangements in which a broker-dealer provides research to a customer in return for trade order flow (a certain volume of trades) from that customer.
- The following is a list of additional terms that have been used in this guide:
- account executive.** See **registered representative**.
- active box.** A position on the stock record (street side) indicating securities under the control of the broker-dealer that are normally available for the broker-dealer's general use.
- adequately collateralized.** Indebtedness for which the difference between the amount of the indebtedness and the fair value of the collateral is sufficient to make the loan acceptable as a fully secured loan to banks that regularly make comparable loans to broker-dealers in the community.
- ADR.** Abbreviation for American Depository Receipt, a certificate issued by a U.S. bank that serves as evidence of ownership of original foreign shares. These certificates are transferable and can be traded. The original foreign stock certificates are deposited with a foreign branch or foreign correspondent bank of the issuing U.S. bank.
- agency transactions.** Transactions in financial instruments that broker-dealers execute on behalf of customers to earn commission income.
- aggregate indebtedness.** The total of certain liabilities of a broker-dealer that are set forth in SEC Rule 15c3-1. The rule states that a broker-dealer shall not permit its aggregate indebtedness to exceed a specified percentage of its net capital as defined in the rule.
- allied member.** Any general partner, qualified voting stockholder, or officer of a FINRA (former NYSE) member firm, who is deemed to be a control person of a member organization and who is not himself or herself a member of a stock exchange.

- AMEX.** Popular name for the American Stock Exchange. AMEX was acquired by NYSE Euronext in 2008. In 2009, NYSE Amex was formed for trading small and mid-cap growth companies.
- arbitrage.** The act of buying a security in one market and simultaneously selling it in another in order to profit from price discrepancies. Also, buying a security subject to exchange, conversion, or reorganization and selling the security or securities to be received upon completion of the exchange, conversion, or reorganization.
- ask.** The lowest price a seller is willing to accept for a security at a particular time, also known as *offer* by exchanges.
- asset-backed commercial paper (ABCP).** Short-term promissory notes issued in bearer form by large corporations with similar features to the standard commercial paper, with the exception that the note is secured against specific assets, usually short-term trade receivables from a company (or companies). ABCP may also have liquidity support from a sponsoring bank to allow timely repayment at maturity (see **commercial paper**).
- auction rate securities.** Long-term debt securities with legal maturities typically of at least 20 years, with interest rates that are reset periodically (typically every week or month, but in some cases every 49, 60, or 90 days) in blind auctions held by investment banks. Most auction rate securities are guaranteed by a third party, typically known as a *bond insurer*, and the bond insurer's rating typically affects the rating of the bond.
- back office.** The operations area of a brokerage office, containing the book-keeping, margin, purchase and sales, cashier's, and dividend departments. The back office function generally supports trading thorough trade reconciliations, confirmations, settlement, and recordkeeping.
- bad delivery.** A delivery of securities that does not fulfill the requirements for delivery, including the standards required to transfer title to the buyer.
- balance order.** The net balance instructions, issued by a clearing organization, to receive or deliver securities based on a netting of all trades in a given security settling on the date of netting. The instructions give all the information needed by the member firm to clear its transactions on a given settlement date.
- basis point.** A measurement of changes in price or yields for fixed-income securities. One basis point equals 0.01 percent, or 10 cents per \$1,000 per annum.
- best efforts.** Refers to an agreement by an underwriter to buy from the issuing corporation only those securities it is able to sell to the public.
- bid.** The price a buyer is willing to pay for a security at a particular time.
- Big Board.** Popular name for the New York Stock Exchange.
- block trading.** The acquisition or disposition of large quantities (10,000 shares or more) or blocks of stock by a broker-dealer in order to facilitate the execution of buy and sell orders of customers, usually institutions. Often, a broker-dealer absorbs a portion of the order for its own account and risk.
- blotter.** A record of original entry. A book or individual unit used as a record of original entry to record transactions as they occur. It covers purchases, sales, cash receipts and disbursements, and securities received and delivered.

- blue list.** Daily publication, either or both print and electronic, listing primarily municipal bonds offered for sale.
- book entry system.** A system in which securities are not represented by physical certificates, but are maintained in computerized records at the custodian (such as the Depository Trust Company) in the name of registered owners.
- books closed.** The cutoff time that determines the stockholders of record for a prescribed period. Any entries affecting the registration or ownership of securities for dividend disbursements or proxy purposes must be made before this time.
- borrowed.** The act of borrowing a security for delivery. The equivalent value in money is usually deposited with the lender.
- box.** A term used for a “short” position in the stock record representing securities under the control of or in the possession of the broker-dealer. It indicates a place where securities are kept, such as a vault, file cabinet, and so forth. A box is also identified as a safekeeping box, segregation box, name-of box, active box, and so forth.
- box count.** An actual count of securities either in connection with an audit or with periodic checking.
- break.** The term applied to that position in the stock record to designate an out-of-balance position between the stock record long and short positions.
- broker loans.** Money borrowed by broker-dealers from banks. Typically loans are collateralized by DTC eligible stocks with a fair value of more than five dollars, subject to concentration limitations.
- broker’s transfer account.** An account kept by the transfer clerk of a broker-dealer giving details of securities transferred for the account of other broker-dealers. The need for the account arises when delivery is made by transfer as directed (TAD) instead of by delivery of the actual certificates.
- bulk segregation.** Securities (usually constituting excess collateral in margin accounts) that are filed in alphabetical order in special boxes in the vault but that are not specifically identified by owner. The securities are usually in the name of the broker-dealer, who maintains collateral records that indicate the owners.
- buy in.** The procedure followed by a broker-dealer desiring to settle a buy contract that is past due. The broker-dealer may file a notice termed a buy in with a stock exchange or the National Association of Security Dealers (NASD), as appropriate. A copy of the notice is also served on the broker-dealer from whom the securities were to be received. If the securities are not delivered, the stock or bond may be bought in for cash for the account of the broker-dealer from whom the securities are to be received. The difference in price between the buy in and the contract price is adjusted by check from one broker-dealer to another.
- buying power.** The equity remaining in a margin account after providing for the margining of existing securities in the account in accordance with federal and house margin requirements.
- cage.** The term given to the area of the broker or dealer’s office where the cashier, stock clerks, loan clerks, transfer clerks, blotter clerks, and others have, as a part of their duties, responsibility for receiving and delivering securities.

- call (margin).** A request, usually in writing, for a margin customer to put up additional collateral (cash or securities).
- call loan.** A loan that has no definite maturity or rate of interest. The loan may be either called by the lender or paid off by the borrower at any time.
- call option.** A contract that entitles the holder to buy (call), entirely at his or her option, a specified number of underlying units of a particular security at a specified price at any time until the stated expiration date of the contract. (This is an American-style option; a European-style option is exercisable only at a specific date.) Such an option (which is always for a transferable, round-lot amount) is bought with the expectation that the price will rise above the contract price. If the price rises as anticipated, the purchaser will exercise the option; if it does not, he or she will let the option expire and will lose only the cost of the option. There is both a listed and over-the-counter market in options. (During the existence of an OTC option, the exercise price and number of underlying units are adjusted on the expiration date for cash dividends, rights, and stock dividends or splits.)
- carry.** The cost of financing (borrowing to buy) a position in financial instruments. Positive carry is a condition that arises if the cost of financing (the short-term rate of interest) is less than the current return of the instrument. Negative carry is a condition that arises if the cost of financing is above the current return of the instrument.
- cash account.** The account of a customer of a broker-dealer who purchases and sells securities strictly on a cash basis. No credit margin is allowed.
- cash sale.** A sale with the same trade and settlement dates. The selling broker-dealer must be able to make delivery of the security sold on the trade date. The customer who is selling usually receives a discounted price on the sale for this special service.
- cash transaction.** A transaction that is expected to clear within the time prescribed by Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System.
- cashier's department.** A division of the operations department of a broker-dealer that handles the securities and money that are received or delivered by the broker-dealer (see **cage**).
- CBOE.** Abbreviation for Chicago Board Options Exchange, a national securities exchange based in Chicago that provides a continuous market for trading in put and call options. Various other exchanges (such as NYSE Arca Options and Philadelphia [now NASDAQ OMX PHLX]) also provide such markets.
- CFTC.** Abbreviation for Commodity Futures Trading Commission, an agency established by Congress to regulate U.S. commodity futures markets and futures commission merchants. Among other things, this agency establishes rules governing the minimum financial, reporting, and audit requirements of its members. Its function is similar to that performed by the SEC in regulating broker-dealers in securities and various securities markets.
- churning.** The process of excessive purchases and sales in customers' accounts for the purpose of generating commissions.
- circuit breaker.** A system of trading halts and price limits on equities, options, and futures markets designed to provide a cooling-off period during large, intraday market declines. The breakers are triggered when a market has fallen by a specific amount within a specified period.

- cleanup call.** A provision of an asset-backed security that permits the issuer to call it at par when the collateral has been paid down to a specified level.
- clearance.** The act of clearing securities transactions between buyers and sellers; receipt or delivery of securities against payment.
- clearing broker.** Usually, a broker-dealer who clears the transactions of another broker-dealer (see **correspondent**).
- clearinghouse.** The central location for matching and settling commodity transactions, collecting and maintaining margin, regulating delivery, and reporting trade information of members. The clearinghouse is responsible to all members for the fulfillment of the contracts and maintains sufficient funds by calling for margin deposits from members.
- clearing member.** A broker-dealer entitled to use the services of the clearing organization.
- clearing number.** A number assigned to a member by a clearing organization in order to identify that clearing member.
- clearing organization.** The central location for matching the security transactions of members (see **clearinghouse**).
- commercial paper (CP).** Short-term promissory notes issued in bearer form by large corporations, with maturities ranging from overnight to 270 days. However, most paper issued matures in less than 40 days. Standard CP is unsecured and subject to counterparty risk (see **asset-backed commercial paper**).
- commodity holdout.** Commodity transactions on the broker or dealer's records that are not reported on the clearinghouse sheets.
- commodity spreading.** Implies open purchase (long) and sale (short) contracts in the same commodity or in different commodities.
- comparison.** A formal notice that details the terms of the contract between broker-dealers that are parties to nonexchange trades. If the details of the trade are correct, the comparison is stamped (acknowledged) and returned; if they are incorrect, the broker-dealer indicates the differences and returns the comparison (see **DK**).
- compliance department.** The department of a broker-dealer that enforces adherence to policies established by the broker-dealer, plus all rules and regulations promulgated by the various regulatory agencies.
- confirmation.** A notice that sets forth the terms of a contract between a broker-dealer and its customer for the purchase or sale of securities. Details shown on a confirmation are the trade date, settlement date, number of shares or par value of bonds, security description, contract price, commission, account number and type of account, and customer's name and address, as well as any other information required.
- contract difference.** The difference between the contract and the fair values of commodities.
- contract sheet.** A listing of compared and un-compared transactions sent to each member firm by a stock-clearing corporation.
- control stock.** Securities of an issuer that are owned by an affiliate of that issuer. An affiliate of that issuer is a person who, directly or indirectly through one or more intermediaries, controls or is controlled by or is under common control with the issuer. Control is likely to be found if the person is a director, officer, or owner of a relatively large number of the issuing



company's voting securities. However, the notion of control is a factual matter that is determined on a case-by-case basis.

- correspondent.** One of the parties to an agreement between two broker-dealers who perform services for each other, such as the execution and the clearance of trades or the maintenance of customer accounts.
- cover value.** The amount necessary to buy-in a short security position at the fair value.
- CRD.** Abbreviation for Centralized Registration Depository; a computerized filing and data processing system, operated by FINRA, that maintains registration information regarding broker-dealers and their registered personnel.
- credit department.** See **margin department**.
- CUSIP number.** A means of uniformly describing and identifying all stocks and registered bonds in numeric form developed by the Committee on Uniform Security Identification Procedures.
- DAP.** Abbreviation for delivery against payment; a type of settlement in which the security is paid for when the selling broker-dealer delivers it to the purchaser or their agent. Also referred to as COD (cash on delivery), POD (payment on delivery), and DVP (delivery versus payment).
- day loan.** A loan made for only one day, generally on an unsecured basis, for the convenience of the broker-dealer.
- day traders.** Speculators or exchange members on the trading floor who take positions in securities or commodities for a very short period of time and generally liquidate them prior to the close of the same trading day.
- definitive certificates.** Actual and permanent certificates of bonds or stock given in exchange for temporary receipts. These temporary receipts are usually issued at the time of a new offering, before the engraved certificates are available.
- delayed delivery.** A transaction involving deferral of the settlement date (which is normally three business days for securities and one business day for options) to some point further in the future as agreed on by both buyer and seller (see **seller's option**).
- derivative.** A financial instrument, traded on or off an exchange, the price of which is directly dependent upon (that is, derived from) the value of one or more underlying securities, equity indices, debt instruments, commodities, other derivative instruments, or any agreed upon pricing index or arrangement (for example, the movement over time of the Consumer Price Index or freight rates). Derivatives involve the trading of rights or obligations based on the underlying product but do not directly transfer property.
- directed sale.** Sale by the manager of a syndicate to a customer, usually an institution, of a syndicate member.
- discretionary account.** An account over which a broker-dealer or some other person has been given authority by the customer to make decisions (including the kind of securities to buy or sell, as well as the date and prices to be paid or received) concerning purchases and sales of securities. The discretion may be complete or limited.
- distribution.** The sale of a large block of securities to the investing public.
- divided liability.** Liability in a syndicate or underwriting that is fixed or definite in the amount of shares or principal value for each participant (see **undivided liability**).

**dividend department.** A division of the operations department that is charged with the collection of dividends and the crediting of these dividends to the accounts of customers.

**DK.** Abbreviation for “don’t know;” an expression used by a broker-dealer to indicate that a transaction another broker-dealer is attempting to confirm or compare is unknown or is questioned (meaning that it is a questioned trade or a QT). When mutual understanding is reached, the transaction is properly compared or canceled.

**DTC.** Abbreviation for Depository Trust Company, a depository for eligible securities that facilitates clearance between member organizations and banks without the necessity of receiving or delivering actual certificates. DTC is a subsidiary of DTCC.

**DTCC.** The Depository Trust & Clearing Corporation, a holding company for DTC and NSCC.

**due bill.** A document, used to adjust security transactions, passed between broker-dealers stating that dividends, rights to subscribe, stock dividends, and so forth, are the property of the holder of the due bill.

**DVP.** Abbreviation for delivery versus payment; a type of settlement in which the security is paid for when the selling broker-dealer delivers the security to the purchaser or their agent.

**ECN.** Electronic Communication Network, an alternative trading system that facilitates trading of financial products outside of stock exchanges by directly connecting equity traders, agency brokers, market makers, and investors. ECNs must register with the SEC as a broker-dealer or an exchange and are subject to Regulation ATS.

**equity.** The net worth in an account carried by a broker-dealer, computed by subtracting the total of the short security values and the debit balance from the total of the long security values and the credit balance. If the result is a net credit, the account is said to liquidate to an equity.

**equity securities.** Term applied to common and preferred stocks.

**equity statements (runs).** Statements showing details of an account with security valuations.

**exchange tickets.** The tickets in a clearing corporation format, prepared by a broker-dealer for each transaction made on an exchange. These tickets list all pertinent details of the trade and are sent, along with a daily summary listing, to the clearing corporation for comparison and confirmation.

**ex-clearinghouse.** Transactions that are not settled through the clearing-house.

**ex-dividend.** Synonym for without dividend. The buyer of a stock selling ex-dividend does not receive the recently declared dividend. Open buy and sell stop orders and sell stop limit orders in a stock on the ex-dividend date are ordinarily reduced by the value of the particular dividend. In the case of open stop limit orders to sell, both the stop price and the limit price are reduced. Every dividend is payable on a fixed date to all shareholders recorded on the books of the disbursing company as of a previous date of record. For example, a dividend may be declared as payable to holders of record on the books of the disbursing company on a given Friday. Because three business days are allowed for delivering the security via regular-way delivery in transactions on a stock exchange, the exchange would declare the stock ex-dividend as of the opening of the market on the preceding

Wednesday. This means that anyone buying the stock on and after Wednesday would not be entitled to the dividend.

- execution report.** A confirmation notice of the completion of a trade that is sent from the floor of an exchange (for listed securities) or trading desk (for over-the-counter securities) back to the point of origin of the order.
- exempt securities.** Securities exempted from registration under the Securities Exchange Act of 1934, rather than by action of the SEC. Such securities include U.S. government and agency securities, and municipal bonds.
- ex-rights.** Same principle as ex-dividend. The buyer of stock selling ex-rights is not entitled to the rights distribution.
- extension.** Permission to extend credit beyond the time prescribed by Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System.
- ex-warrants.** On occasion, stocks or bonds have warrants attached entitling the holder to subscribe to additional shares within specified periods of time and at specified prices. If these warrants are detached, the security is traded ex-warrants—or without warrants.
- fails.** Uncompleted securities transactions between two broker-dealers (see **fail-to-deliver** and **fail-to-receive** in the FASB ASC section of the glossary).
- fair value.** As used in connection with margin trading, generally the closing price of a security as of the preceding business day.
- financial consultant.** See **registered representative**.
- FINRA.** Financial Industry Regulatory Authority, formed by the combination of the regulatory function of the NASD and the NYSE.
- fire wall.** (Also referred to as *systems security*.) An intangible barrier between the trading side of a broker-dealer and the corporate finance and research side that prevents broker-dealers from taking advantage of the corporate finance department's inside information.
- firm account.** An account consisting of securities in which the broker-dealer has taken a position for investment purposes, is making a market (principal wholesaler), or has an interest with another party (joint account).
- firm commitment.** The agreement of an underwriter to buy the entire issue of a security from the issuing corporation at a specified price.
- firm price.** The price at which a security can be bought or sold in the over-the-counter market for such period of time as the seller may specify.
- flat.** A method of trading in certain kinds of bonds. Usually used in trading income bonds that do not pay interest unless it has been earned and declared payable, or in bonds on which the issuer has defaulted in the payment of interest. When bonds are traded "flat," the seller is not entitled to the interest that has accumulated since the date of the last interest payment. The seller of a bond that is traded flat must deliver the bond with all unpaid coupons attached or a due bill authorizing the buyer to collect any payments of interest that may be made by the issuer in the future.
- flat statement.** A statement with no money or security balance.
- floating rate notes (FRN).** Notes issued by banks and corporations, typically with maturities of one year or more, that pay a regular coupon with the promise of return of the face value at maturity. The coupon rate is generally pegged to a benchmark rate such as the LIBOR or Euribor. Notes without

maturities are known as perpetual FRNs whereby investors can only regain capital by selling the instrument in the secondary market.

**floor.** Popular name for the area where securities are bought or sold at an exchange.

**floor brokerage.** The commission charged by one broker-dealer to another for executions of transactions at exchanges.

**floor clerk.** An employee of a broker-dealer who maintains a liaison between the order room and the floor broker.

**floor report.** A report of an executed trade given to the floor clerk by the floor broker and containing the number of shares, the price, and the identity of the other broker on the trade.

**FOCUS report.** Acronym for Financial and Operational Combined Uniform Single report. The uniform regulatory report (Form X-17A-5) filed periodically by all broker-dealers pursuant to Rule 17a-5 of the SEC.

**forward market.** Reference made to nonexchange trading of commodities and securities for settlement at a future date. Contracts of this nature are designed by both the buyer and seller about the delivery time, the amount, and so on.

**free securities.** Securities that are fully paid for.

**free shipment.** Shipments of securities, usually to out-of-town broker-dealers, without a draft attached, in order to avoid payment of collection charges.

**fully disclosed basis.** Situation in which a nonclearing broker introduces a customer to a clearing broker and the customer's name and statement are carried by, and disclosed to, that clearing broker.

**fully paid accounts.** Customer accounts in which the contract price to purchase securities has been paid. These securities should be locked up in the segregation or safekeeping box.

**fungibility.** Similar securities that are interchangeable, such as GNMA securities transactions that are interchangeable about interest rate and pool and are traded and settled at an equivalent yield basis.

**futures contract.** An exchange-traded contract for the purchase or sale of commodities at some time in the future.

**give-up.** Type of order that is given by a customer to a member firm on whose books the customer does not have an account.

**good delivery.** Certain basic qualifications that must be met before a security sold may be delivered. The security must be in proper form to comply with the contract of sale and to transfer title by delivery to the purchaser.

**good-faith deposit.** Deposit to guarantee performance, usually with respect to new issues of securities.

**group account.** A syndicate or joint account.

**GTC.** Abbreviation for good 'til canceled. Also called an open order. If this term appears on an order to buy or sell a security, it means that the order is to remain in effect until it is either executed or canceled.

**haircut.** Deductions from the net capital of certain specified percentages of the fair value of securities and commodity futures contracts that are long and short in the capital and proprietary accounts of a broker-dealer and in the accounts of partners. These deductions are solely for the purpose of computing net capital and are not entered on the books.

- holder of record.** The party listed as the owner on the transfer records of a corporation.
- holder's file.** A subsidiary file (punched cards, discs, or tapes) in account sequence showing securities owned or carried in such accounts.
- house account.** An account used by a broker-dealer to maintain a trading or investment position in a security for itself or its officers or partners. Also, a name given to a customer's account to which no registered representative has been assigned.
- house rules.** Rules promulgated by the broker-dealer. Usually refers to the maintenance margin required by the broker-dealer over and above the requirements of regulatory bodies.
- hypothecation agreement.** An agreement signed by a customer that permits his or her broker to use securities in the customer's margin account as collateral for loans made to the broker.
- in-house.** Within the broker or dealer's firm.
- initial margin.** The amount of money or its equivalent, specified by the Board of Governors of the Federal Reserve System, that a customer must deposit with his or her broker when the customer buys a security on margin.
- interest trades.** These transactions, as defined, involve (1) a purchase of GNMA securities for current settlement; (2) a delayed settlement sale of these securities or the possession of a long standby; and (3) a financing of the long GNMA position by a sale under an agreement to repurchase on or before the future delivery date.
- international arbitrage.** Same as arbitrage, except the markets are in different countries.
- investment banker.** One who underwrites securities on an initial or secondary basis. This type of underwriting often involves private placements for which the investment banker may act as both a broker and a dealer.
- joint account.** An account in which two or more persons have an interest.
- legal list.** A list of securities in which insurance companies, banks, and fiduciaries are permitted by law to invest.
- legal transfer.** A stock certificate having an assignment executed by an executor, administrator, trustee, guardian, and so forth, and requiring certain legal documents indicating the authority of the party signing the securities.
- letter of credit.** An unqualified commitment issued by banks or trust companies to pay a specified sum of money immediately upon demand at any time prior to the expiration of the letter of credit. Most commonly used by broker-dealers to satisfy margin requirements at the Options Clearing Corporation or commodity-clearing organizations or in stock-borrowed transactions.
- limit order.** Also called a limited order or limited price order, an order to buy or sell a security at a price specified by the customer or at a better price, if such a price can be obtained.
- liquidity rebate.** ECN's credit fee structure that pays a rebate or charges a fee based on whether the trade adds or removes liquidity. Under this credit structure, the ECN makes a profit from the difference between what they rebate and charge for the trade. This differs from the classic exchange-like fee structure that charges an exchange fee to all market participants regardless of whether they add or remove liquidity.

**listed security.** A security that is traded on an exchange.

**loan consent.** An agreement signed by a customer that permits the broker-dealer to lend securities owned by the customer to other broker-dealers.

**loaned.** The act of lending a security, usually for delivery against a short sale. The equivalent value in money is usually deposited by the borrower. This term is the opposite of *borrowed*.

**Loanet.** A privately owned and operated online real-time accounting service used by brokers and institutions in support of their domestic and international securities borrowing and lending activities. The system, part of SunGard Data Systems, Inc., provides interfaces to the Depository Trust Company for both receipt and delivery of securities, including fair values of the securities, and to clients' internal recordkeeping systems or outside accounting services. In addition, Loanet also provides daily contract comparison for all subscribers engaged in the borrowing and lending of securities and portfolio availability of most major lending institutions.

**loan value.** The value at which a security is accepted for margin. This value is usually less than, or at a discount from, the fair value.

**lock-up.** The act of placing securities in safekeeping or segregation.

**long.** Denotes ownership, or the right to possession, of securities.

**long and short record.** See **stock record**.

**long securities differences.** The excess of securities positions accounted for over the broker-dealer's long positions on the stock record. When recorded in a difference account, the excess would be recorded long on the stock record (see **short securities differences**).

**maintenance margin.** The amount of equity required to be maintained in a margin account in accordance with exchange regulations or house rules.

**margin.** The equity in an account. The requirements for the amount of margin vary between initial margin and maintenance margin and also according to the type of collateral used in computing the equity.

**margin call.** A request for additional margin.

**margin department.** A division of the operations department. Its functions include keeping an up-to-date record of each customer's purchases and sales of securities, carefully monitoring extensions of credit to customers, and the segregation of fully paid for or excess-margin securities.

**margin transaction.** A transaction in which the broker-dealer advances credit to the customer for a portion of the purchase price.

**market maker.** A broker-dealer that stands ready to buy or sell a particular security in the over-the-counter market at prices the broker-dealer has quoted. Also, an options trader on the floor of a registered exchange who stands ready to buy or sell a particular option.

**market price.** Usually means the last reported price at which a security has been sold.

**mark up.** The difference between what a broker-dealer has paid for a security and the price at which it offers the security to another person.

**master file.** A file that contains the official account numbers and descriptions of securities and customers' names and addresses.

**material associated person (MAP).** The determination of whether an affiliated person of a broker or dealer is a material associated person involves

consideration of all aspects of the activities of, and the relationship between, both entities, including the factors enumerated in SEC Rule 17h-1T.

- matrix pricing.** A mathematical technique used to value normal institutional-size trading units of debt securities without relying exclusively on quoted prices of the specific security. Factors such as the issue's coupon or stated interest rate, maturity, and rating and quoted prices of similar issues are considered in developing the issue's current market yield.
- maximum loan value.** The percentage of the purchase price of a security that a broker-dealer may lend to a customer who is buying a security on margin.
- member corporation.** A broker-dealer that is organized as a corporation and that has at least one director-holder of voting stock who is a member of an organized stock exchange.
- member firm.** A broker-dealer that is organized as a partnership and that has at least one general partner who is a member of an organized stock exchange.
- mixed account.** An account containing both long and short securities.
- money market deposit account.** Not to be confused with a money market mutual fund, this account is a type of savings account offered by banks and credit unions under Regulation D. A money market deposit account generally requires a higher minimum balance and a limited number of transactions and pays a higher interest rate. Assets in this account are Federal Deposit Insurance Corporation (FDIC) insured. The interest rate is either negotiated or determined by the bank and is based on a benchmark rate. These accounts are not subject to regulatory haircuts.
- money market mutual fund.** A type of mutual fund subject to the SEC Rule 2a-7, with an objective to preserve capital and maintain liquidity. Assets in this account are not FDIC insured. Although possible, investments in money market mutual funds have a low likelihood of loss of capital. The haircut on this type of investment is 2 percent (see SEC Rule 15c3-1).
- Municipal Securities Rulemaking Board (MSRB).** Agency established by Congress to establish rules for broker-dealers effecting transactions in obligations of, or guaranteed by, state or local governments or any agency or instrumentality thereof.
- name-of securities.** Securities registered in the name of customers of the broker-dealer (see **safekeeping**).
- NASD.** Abbreviation for National Association of Securities Dealers, Inc., formerly an association of broker-dealers doing business in the over-the-counter market. Prior to its incorporation into FINRA, the association supervised and regulated the trading conduct and sales practices of its members. See **FINRA**.
- NASDAQ.** Abbreviation for the NASDAQ Stock Market, an electronic stock market (formerly known as the National Association of Securities Dealers Automated Quotation System).
- net capital.** Net worth of a broker-dealer, less certain items such as exchange memberships, the carrying value of securities that are not readily marketable, haircuts on marketable securities in proprietary accounts, furniture and equipment, and other illiquid assets, as defined in the net capital rules.
- new issue.** A security that is sold by an issuing corporation for the first time. It may be referred to as an initial public offering or IPO.

**no-action letter.** A letter issued to a broker-dealer by the SEC staff of the Securities and Exchange Commission (SEC) in response to a request filed by the broker-dealer describing a proposed business activity that may or may not conform to SEC rules and regulations. In a no-action letter, the SEC staff indicates that, based on the facts presented by the broker-dealer, the SEC staff will recommend no action be taken against the broker-dealer for engaging in the proposed activity. A no-action letter does not have the force of law; however, it represents an interpretation of the SEC staff that may be applied in a situation where the broker-dealer is engaging in an activity not addressed by existing SEC rules and regulations.

**NSCC.** Abbreviation for National Securities Clearing Corporation, a subsidiary of DTCC, that provides trade processing, clearance, delivery, and settlement services to its members. It deals with brokers, dealers, and banks in the United States and Canada.

**NYSE.** Abbreviation for New York Stock Exchange, a not-for-profit corporation that is the largest securities exchange in the United States, and now a part of NYSE Euronext. It furnishes facilities for its members, allied members, member firms, and member corporations to aid them in conducting securities business.

**odd lot.** A quantity of securities that is less than the trading unit or round lot, usually a quantity less than an even 100 shares.

**off-board.** Used to describe transactions in listed securities that are not executed on a stock exchange.

**offer.** The lowest price at which a seller is willing to sell a security.

**omnibus account.** An open account carried and cleared by another broker-dealer and containing accounts of undisclosed customers on a commingled basis that are carried individually on the books of the broker-dealer introducing the trades.

**operations department.** The name associated with the overall clerical functions of a broker-dealer. Sometimes referred to as the back office.

**option conversion accounts.** Accounts consisting of long option and short option positions and a related underlying securities position.

**optional commitment.** A call exercisable at a future date. A long optional commitment is an option to purchase GNMA securities; a short optional commitment is an option to sell.

**optional commitment fee.** The amount received or paid for the sale or purchase of an optional commitment.

**optional dividend.** A dividend that is payable in either stock or cash at the option of the holder of record.

**order department.** A division of the operations department that receives customers' orders and transmits them either to the floor of a stock exchange or to the trading department for execution. The order department also receives notices of executed trades and transmits such notices to the purchases and sales department and to the registered representatives.

**order room.** Another name for the order department.

**OTC.** Abbreviation for over-the-counter. A securities trading market made up of broker-dealers that may or may not be members of a securities exchange. Thousands of companies either have insufficient shares outstanding, stockholders, or earnings to warrant application for or maintaining a listing on a stock exchange, or choose not to be listed on a stock exchange for other



business or economic reasons. Securities of these and other companies are traded in the OTC market between broker-dealers that act as either principals (dealers) or agents (brokers) for customers. The OTC market is the principal market for U.S. government and corporate bonds and municipal securities. In the United States, over-the-counter trading in securities is carried out by market makers using interdealer quotation services such as OTC Pink (operated by OTC Markets Group) and OTC Bulletin Board (operated by FINRA).

- overdelivery.** Delivering a greater amount of securities than called for, the surplus amount being returned by transferring it to the name of the delivering broker-dealer. An overdelivery can also occur if excess securities are delivered in error.
- over the window.** The direct delivery of securities between two brokerage concerns, rather than by use of the clearinghouse facilities. Delivery is made by hand to the receive window of the broker and is said to be “over the window.”
- pair off.** This can occur if two broker-dealers owe each other the same number of shares of the same security. Instead of actually receiving the security and delivering it back again, they will “pair off” the transaction by giving or receiving a check for the difference in price or exchanging checks for the full amount of each side of the transaction.
- papers.** A term sometimes given to put and call options.
- payable date.** The date on which a dividend is payable to holders of record as of some previous date.
- pink sheets.** Pink sheets got their name because they were formerly a listing of over-the-counter securities published on pink paper by the National Quotation Bureau (now Pink OTC Markets). Yellow sheets are to bonds what pink sheets are to corporate equity securities traded in the OTC market (see **OTC**).
- point.** If used in connection with the purchase or sale of stocks, point means a rise or decline of \$1 per share. If used in connection with the purchase or sale of bonds, it means a rise or decline of \$10 per \$1,000 principal amount.
- point balance.** A daily summary by commodity for exchange-traded futures and options on futures contracts that contains all open long and short positions and the original transaction price valued at the closing settlement prices. Separate summaries are prepared for customer transactions and proprietary and noncustomer transactions.
- position.** This term is used in referring to the securities “long” or “short” in an account or in the stock record.
- post.** A designated place on an exchange floor where specific securities must be traded.
- private placement.** The direct sale of a block of securities, either a new issue or a secondary issue, to a single investor or a group of investors. This is usually accomplished through an investment banker.
- proxy department.** A division of the operations department that helps corporations communicate with their stockholders in cases in which stock certificates are in street name.
- purchase and sales department.** A division of the operations department that is concerned with the preparation of customers’ confirmations of

security transactions and the comparison of such transactions with other brokerage concerns.

**put option.** A contract that entitles the holder to sell (put), entirely at his or her option, a specified number of underlying units of a particular security at a specified price anytime until the stated expiration date of the contract. (This is an American-style option; a European-style option is exercisable only at a specific date.) Such an option, which is always for a round-lot amount and which is transferable, is bought with the expectation of a price decline below the contract price. If the price decline occurs, the purchaser will exercise or sell the option. If the decline does not occur, he or she will let the option expire and will lose only the cost of the option. There are both listed and OTC markets in options. During the existence of an OTC option, the exercise price and number of underlying units are adjusted on the ex-date for cash dividends, rights, and stock dividends or splits.

**puts and calls.** Options to sell (put) or buy (call) securities within a specified period of time at specified prices (see **put option; call option; straddle**).

**quote.** The price of a security. It may be the price of the last sale made on an exchange or the current bid and ask price.

**receive-and-deliver department.** A division of the operations department responsible for the physical receipt and delivery of incoming and outgoing securities. Often, it is also responsible for the daily balancing of cash entries made by the various operations department divisions.

**record date.** The date on which the stockholder's name must be registered on the books of a company in order to receive a declared dividend or among other things to vote on company affairs.

**registered owner.** The owner of a security, whose name is recorded on the face of the certificate and on the books of the issuing corporation or its agent.

**registered representative.** Salesperson (often referred to as an account executive) of the broker-dealer. Salespeople are registered with the CRD (see **CRD**).

**registered trader.** Individuals or entities who have obtained approval to trade for their own account on the floor of a national securities exchange. Such individuals or entities have certain obligations with regard to the stabilization of the market in securities for which they are registered. They also have less stringent financial responsibilities and reporting requirements than do full-service broker-dealers.

**registrar.** Usually a trust company or bank charged with the responsibility of preventing the issuance of more stock than that authorized by the issuing company.

**regular way delivery.** Unless otherwise specified, the delivery of securities (other than those of the U.S. government) to the buying broker-dealer by the selling broker-dealer, with payments received on the third business day after the transaction. The regular-way delivery day for government bonds is the business day following the transaction.

**Regulation G.** The Federal Reserve Board regulation governing the amount of credit that persons other than banks or broker-dealers may extend to investors who borrow money to buy securities on margin.

**Regulation T.** The Federal Reserve Board regulation governing the amount of credit that broker-dealers may extend to customers who buy securities.

- Regulation U.** The Federal Reserve Board regulation governing the amount of credit that banks may extend to customers, including broker-dealers, who borrow money to buy securities on margin.
- Regulation X.** The Federal Reserve Board regulation specifying conditions with which a U.S. borrower, and foreign persons controlled by or acting on behalf of or in conjunction with a U.S. borrower, must comply when obtaining credit outside the United States for the purpose of purchasing or carrying U.S. securities or when obtaining credit within the United States to purchase or carry any securities.
- reorganization department.** A division of the operations department that processes securities involving corporate reorganizations, mergers, consolidations, subscriptions, and the exchange of convertible securities into common stocks.
- restricted account.** This means that a broker may not buy securities for a particular customer for a specified period of time unless the customer has deposited enough money in his or her account to pay for the securities before the customer's orders are executed.
- reverse split.** Opposite of stock split.
- rights.** The privilege offered by a corporation to its stockholders to subscribe to certain securities, usually at a advantageous price.
- round lot.** A unit of trading or a multiple thereof. On the NYSE, the unit of trading is generally 100 shares in stocks and \$1,000 par value in bonds.
- RVP.** Abbreviation for receive versus payment.
- safekeeping.** A position on the stock record (street side) indicating securities that have been fully paid for by customers and that are being held by the broker-dealer under custody arrangements. These securities are generally registered in the name of the customer.
- safekeeping box.** Location in which customers' fully paid-for securities are kept.
- SCA.** Abbreviation for subsequent coupons attached.
- scrip.** A certificate issued to stockholders of a corporation that may be exchanged for fractional shares of stock or the equivalent in cash by a fixed date. Scrip is usually issued in connection with a stock dividend or a stock split.
- seat.** Popular name for a membership on a stock exchange.
- SEC.** Abbreviation for Securities and Exchange Commission. An agency established by the U.S. Congress to administer federal securities laws.
- secondary distribution.** The sale of a large block of listed securities (other than an initial issue of a corporation) outside of the exchange on which they are listed. It is usually the holdings of a large individual stockholder or an estate that are being liquidated.
- securities borrowed.** See **borrowed**.
- securities loaned.** See **loaned**.
- securities not readily marketable.** This term refers to (1) securities, except exempted securities, for which there is no market on a securities exchange or no independent publicly quoted market; (2) securities that cannot be publicly offered or sold unless registration has been effected under the Securities Act of 1933 (or the conditions of an exemption, such as Regulation A under Section 3(b) of this act, have been complied with); or (3)

securities that cannot be offered or sold because of other arrangements, restrictions, or conditions applicable to the securities or the broker-dealer.

**segregation.** A position on the stock record (street side) indicating customers' fully paid-for or excess-margin securities that are subject to the customers' instructions and that have been set aside. These securities are generally in the name of the broker-dealer (see **bulk segregation**).

**segregation box.** Location in which segregated securities are kept.

**sell out.** Action taken by a broker-dealer to liquidate an account or transaction for failure to maintain proper margin or make timely payment.

**seller's option.** Transaction that, by agreement, is to be settled at a date later than the usual regular-way transaction.

**selling against the box.** This is similar to a short sale except that the seller already owns the stock being sold but keeps possession of it and so has to borrow the equivalent stock with which to make delivery to the purchaser.

**selling concession.** A discount in the public offering price offered by the issuer to members of its underwriting group.

**selling group.** A group of broker-dealers that has formed a joint account for the sale of securities, usually in connection with an underwriting.

**service bureau.** A data processing center that processes the transactions of broker-dealers. These centers are located away from the broker-dealer's office.

**settlement date.** The date on which a securities transaction is to be settled by the delivery or receipt of securities and the receipt or payment of cash.

**settlement price.** The price at which a security or commodity is to be settled. Used primarily in connection with clearing organization operations.

**short.** A stock record position (street side) that represents location (such as box, transfer, and so forth) or due from (such as failed to receive or owed to the brokerage concern by a customer.)

**short against the box.** See **selling against the box**.

**short covering.** The purchase of securities so that stock previously borrowed to make delivery on a short sale may be returned.

**short sale.** A sale of securities that requires borrowing equivalent securities to make delivery to the purchaser.

**short securities differences.** The excess of securities positions for which the broker-dealer is accountable on its stock record (longs) over those whose locations have been accounted for (shorts) after a securities verification. When recorded in a difference account, the excess would be recorded short on the stock record. See **long securities differences**.

**SIAC.** Abbreviation for Securities Industry Automation Corporation. Formerly owned and operated by AMEX and NYSE, this organization has been absorbed into the operations of NYSE Euronext.

**signature guarantee.** In order that a registered security may be a good delivery on the exchange or a good transfer, the signature of the registered owner must be properly guaranteed. The guarantee of a stock exchange member or a bank is usually considered sufficient guarantee.

**single stock future.** A contract for the sale or future delivery of a single security.

- SIPC.** Abbreviation for Securities Investor Protection Corporation, a corporation established for the purpose of protecting customers of broker-dealers in financial difficulty.
- specialist.** A broker who is a member of an exchange and who operates on the floor of the exchange to execute transactions and to maintain an orderly market in certain specified securities.
- special offering.** The sale of a large block of securities on the floor of a stock exchange. The sale is made in accordance with special procedures worked out by officials of the exchange.
- split.** The action of increasing the number of outstanding shares of stock of a company in order to decrease the market price and afford a greater distribution of the shares. For example, two shares for each share held will have the effect of reducing the price of the shares by approximately one-half.
- spot (commodity).** (1) The actual commodity as distinguished from a futures contract. (2) An outgrowth of the phrase “on the spot,” it usually refers to a cash market price for stocks of the physical commodity that are available for immediate delivery. (3) This term is also used when referring to the futures contract of the current month, in which case trading is still “futures” trading but delivery is possible at any time.
- spread.** A combination of a put and call option at different prices—one below and the other above the current market price. Also refers to the difference between the bid and asked prices of a security.
- SRO.** Abbreviation for self-regulatory organization. An SRO, of which a broker-dealer is a member, assumes responsibility for monitoring the broker-dealer’s compliance with minimum financial and related reporting requirements.
- standby.** A put exercisable at a future date. A long standby is an option to sell GNMA securities; a short standby is a commitment to buy.
- standby fee.** A negotiated amount received or paid for the sale or purchase of a standby.
- stock dividend.** A dividend payable in the stock of the issuing corporation.
- stock power.** A legal document used in lieu of the assignment section of a stock certificate.
- stock record (or position record).** The record of individual securities on which both the long and short positions are shown. For each security, the total of the long positions and the total of the short positions should be in balance.
- stock record department.** A division of the operations department that keeps up-to-date records of all securities positions, and is usually responsible for reconciling out-of-balance conditions.
- stock split.** See **split**.
- stockholder of record.** A stockholder whose name is registered on the books of the issuing corporation.
- stop order.** Also called a stop loss order, this is an order used by a customer to protect a paper profit in a security or to keep down a possible loss in a security. The stop order becomes a market order if the price of the security reaches or sells through the price specified by the customer.

- straddle.** A combination of one put and one call, identical with respect to the security issue, number of shares, exercise price, and expiration date.
- street.** A shortened term for Wall Street that refers to brokers, dealers, and other financial business concerns.
- street item.** A transaction or account between broker-dealers (for example, fail-to-receive, fail-to-deliver, stock loaned, and stock borrowed).
- street name.** Securities held in the name of a broker-dealer or a nominee instead of in customers' names are said to be carried in street name.
- striking price.** The price at which GNMA securities can be purchased or sold upon the exercise of a standby or optional commitment. The price at which an option (put or call) can be exercised (sometimes called the exercise price).
- subscription.** The offer to purchase a certain offering, such as a certain number of shares of the stipulated stock or principal amount of bonds, for a stipulated amount of money. The offer is not binding unless accepted by the proper authorized representatives of the issuing corporation.
- subsequently measured at fair value.** Term used to describe the process of valuing security positions for purposes of determining profit or loss on security positions in proprietary trading and investment accounts. The term also is applied to open contracts between broker-dealers and clearing corporations for determining the adjustments to be made for funds owed or receivable as a result of adjusting those contracts to fair values.
- substitution.** The act of withdrawing securities from a bank loan and substituting other securities of approximately equal value.
- suspense account.** An account used to record securities or monies that cannot be immediately identified and cleared (for example, reclamations, DK items, and bad deliveries).
- syndicate.** A group of broker-dealers that underwrites and distributes new issues of securities or large blocks of an outstanding issue.
- TAD.** An acronym for transfer as directed.
- takeoff.** Sometimes referred to as a daily activity list, this is a daily record showing the net changes in each security. A separate record is prepared for each security, and the information is used to post (update) the stock record. Also, a record of the long and short positions in a security on the record date, used by the dividend department to make the appropriate dividend entries.
- tax stamp.** A rubber-stamp facsimile (in some instances, a documentary stamp) affixed to a certificate to indicate that all applicable transfer taxes for the item have been paid.
- TBA.** Abbreviation for to be announced future government sponsored enterprises' pools that are bought and sold for future settlement. TBA refers to the announcement of the specific pools to be delivered or received.
- ticker.** An instrument that prints the price at which a security has been traded on an exchange after the trade has been executed.
- time loan.** A loan having a definite date of maturity and a specified rate of interest for the entire period.
- trade.** A term that indicates the consummation of a securities transaction, either a purchase or a sale.
- trade date.** The date on which a securities transaction is actually executed.

- trader.** An employee of a broker-dealer who executes orders in the OTC market for customers. Also, a person who buys or sells securities for his or her own or his or her company's account for short-term profit.
- trading post.** Another name for post.
- trading unit.** The unit by which the security is traded on an exchange, usually 100 shares of stock or \$1,000 principal amount of bonds (see **round lot**).
- transfer.** Usually refers to the act of changing the ownership of registered securities on the books of the issuing corporation.
- transfer agent.** A transfer agent keeps a record of the name and address of each registered shareholder and the number of shares each owns. The agent sees that certificates presented to his or her office for transfer are properly canceled and that new certificates are issued in the name of the transferee.
- transfer department.** A division of the operations department that matches, processes, and controls securities being transferred.
- two-dollar broker.** A name given to a member of an exchange who executes orders for other brokers on that exchange.
- underwriting.** The act of distributing a new issue of securities or a large block of issued securities, that is, a secondary offering.
- undivided liability.** An arrangement whereby each member of an underwriting syndicate is liable for his or her proportionate share of unsold securities in the underwriting account regardless of the number of securities the member has previously sold.
- undue concentration.** The additional haircut from net capital (see SEC Rule 15c3-1) on the fair value of certain proprietary security positions of a single class or series of the same issuer that exceeds 10 percent of a broker or dealer's net capital before haircuts.
- unlisted security.** A security that is not listed on an exchange.
- up-front fee.** The amount of cash paid to a delayed-settlement to-be-announced securities or GNMA purchaser that is offset by an increase in the sales price.
- value date.** See **settlement date**.
- valued stock record.** The stock record at the examination date, with each security position other than those in segregation and safekeeping assigned a price. Remaining quantities within the position are valued at the assigned price.
- variable rate demand obligations.** Short-term obligations that are characterized by a "put" or demand feature that gives the bondholder the ability to "put" the bonds back to the issuer. If the "put" bonds cannot be remarketed to another investor, a liquidity facility issued by a financial institution, such as a standby bond purchase agreement, letter of credit, or line of credit, typically provides the issuer's funding to cover the put.
- variation margin.** A term, used in commodity operations, that refers to the last-day point fluctuation (the difference between the prior day's settling price and the last day's settling price) on net positions long and short.
- warrants.** Rights to purchase additional securities. Usually affixed to the certificate at the time securities are originally issued. Also, a document evidencing rights, for instance, a warrant for 125 rights.

- when-distributed.** Refers to the distribution of new securities. Transactions are sometimes entered into on a when-distributed basis before the distribution takes place.
- when-issued.** A short form of *when, as, and if issued*. The term indicates a conditional transaction in a security authorized for issuance but not yet actually issued. All when-issued transactions are on an "if" basis, to be settled if and when the actual security is issued.
- window.** A term applied to a place in the office of a broker-dealer where securities are actually received or delivered.
- window ticket.** A term applied to a document given to the broker-dealer by a transfer agent as a receipt. Also applies to a transfer document originating with the brokerage concern (broker-originated window ticket).
- wire house.** A brokerage concern that has a network of communications (telephone or teletype) that links the main office to branch offices and to offices of correspondent brokerage concerns.
- wire room.** See **order department; order room.**
- yield.** The return on investment that an investor will receive from dividends or interest. The return is expressed as a percentage of the current market price of the security or, if the investor already owns the security, of the price he or she paid. The return on stocks is computed by dividing the total dividends paid in the past calendar year by the price of the stock. The return on bonds is computed by dividing the interest by the price of the bid and is computed as yield to maturity or as yield to earliest call.
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