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American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Securities Industry Developments — 2004/05

Strengthening Audit Integrity
Safeguarding Financial Reporting

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of broker-dealers in securities with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. Because securities broker-dealers often deal in commodity futures or function as commodity pool operators, this Audit Risk Alert expands the discussion of recent developments to include matters that may affect the audits of commodity entities as well.

This publication is an Other Auditing Publication as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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Securities Industry Developments—2004/05

How This Alert Helps You

This Audit Risk Alert helps you plan and perform the audits of your securities industry clients. The knowledge delivered by this Alert assists you in achieving a more robust understanding of your client's business and economic environment. This Alert is an important tool in helping you identify the significant risks that may result in the material misstatement of your client's financial statements. Moreover, this Alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

If you understand what is happening in the securities industry and can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry knowledge and understanding.

This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2004/05* (product no. 022335kk).

Economic and Industry Developments

See the AICPA general *Audit Risk Alert—2004/05* for a discussion of the United States economic and business environment.

Mixed Operating Results

The securities industry reported exceptional results in the first quarter of 2004. On February 11, 2004, the Dow Jones Industrial Average (DJIA) reached a two and one-half year high. Stock trading activity was strong throughout the quarter resulting in growth in trading commissions. The industry also registered gains in both bond and equity underwriting activity. As the bond trading environment remained strong due to low interest rates, securities firms continued reaping huge rewards from trading bonds for their proprietary accounts. According to the Securities Industry Association (SIA), the first-quarter performance of broker-dealers doing a public business in the United States was only surpassed by the second quarter of 2000, just after the securities industry and stock markets reached their record highs.

Second-quarter results were strong; however, they paled in comparison to the first-quarter performance. Many industry observers were not discouraged by these results, having anticipated that revenues and profitability would decline to more normal levels because, they argued, the industry could not be expected to sustain the exceptional growth rates of 2003 and the first quarter of 2004. Proprietary trading, especially debt trading, continued to generate substantial revenues for many broker-dealers, but the trading gains were significantly below the results reported in the preceding periods. In June the Federal Reserve finally started raising interest rates from a 45-year-low of 1 percent. Rising rates resulted in sharply lower bond issuance, causing a decrease in bond underwriting revenues, as well as a decrease in bond trading gains. Many securities firms also experienced a drop in sales commissions as trading volume declined.

The results of the third quarter were significantly lower than in the first half of the year. Continued low levels of stock-trading volume due to investors' concern about the upcoming presidential election, the economy and terrorism, resulted in a further decrease in commission and fee income. As the Federal Reserve proceeded to increase interest rates to 2 percent, fixed income trading profits also declined for many firms. Proprietary trading results were mixed in the third quarter with some firms posting trading gains while others showed record losses. Those results underscore that the trading with the firm's own capital is very risky because if the firm bets the wrong way, losses can be substantial. There are a number of audit-related issues that need to be considered in connection with proprietary trading. See the "Auditing Considerations Related to Proprietary Trading" section of the Alert for a detailed discussion of different types of proprietary trading and related auditing considerations.

The outlook for the fourth quarter is uncertain. On October 25, the DJIA slid to an eleven-month low of 9749.99. The National Association of Securities Dealers Automated Quotation (NASDAQ) composite index was down 4.5 percent for the year as of the end of October with the Standard & Poor's 500 stock index (S&P 500) down by 1.5 percent. The Federal Reserve is expected to continue lifting the interest rate with some expecting it to reach 2.5 percent by the middle of next year.

Variable Annuities

Security regulators have become increasingly concerned about tactics used by some broker-dealers to promote and sell variable annuity products. Variable annuities are complex products that have both securities and insurance features. They are considered to be long-term investment vehicles and are inappropriate for short-term investors because of their potentially high surrender fees for withdrawals within a specified time period after purchase and the tax implications because withdrawals by investors before they reach the age of 59½ are generally subject to a 10-percent tax penalty. With the increase in popularity of variable annuities, regulators started receiving complaints from individual investors about abusive sales practices by some broker-dealers.

The Securities and Exchange Commission (SEC) and National Association of Securities Dealers (NASD) conducted examinations of broker-dealers that sell variable insurance products and in June of 2004 issued *Joint SEC/NASD Staff Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products*, which summarizes sound and weak practices identified during examinations. The findings describe practices noted during the examinations, particularly in the areas of suitability, sales practices, conflicts of interest, supervision, disclosure, books and records, and training. This report can be viewed at http://www.sec.gov/news/studies/secnasdvip.pdf

Variable annuity sales have also been the subject of more than 80 NASD disciplinary actions in the past two years, as a result of which several broker dealers were permanently barred from the industry, while others paid hefty fines. These disciplinary actions involved a wide array of misconduct, including excessive switching which generated commissions and fees for broker-dealers while costing investors a lot of money in surrender fees; failure to disclose material facts such as various fees, risks and tax consequences; and misleading marketing.

Earlier, NASD tried to address this problem by issuing best practice guidelines in Notice to Members (NTM) 99-35, which covered disclosure, suitability, account opening, and sales practices for variable annuities. However, the best practice guidelines were not mandatory and, while some firms adopted them, others chose not to. These guidelines can be viewed at the NASD Web site at www.nasd.com.

As a result, in June of 2004 the NASD issued NTM 04-45 to propose a rule relating to transactions in deferred variable annuities. In general, the proposed rule is based on NTM 99-35 and includes suitability, disclosure, principal review, supervisory and training requirements tailored specifically to transactions in deferred variable annuities. You can access the proposed rule at www.nasd.com.

The regulatory actions discussed above may have significant adverse financial consequences for a broker-dealer as well as damage the firm's reputation and growth prospects. In the worst-case scenario, noncompliance with the regulations may even lead to the suspension or revocation of a broker-dealer's registration. As an auditor of a securities firm, you need to consider the impact of these proceedings on your client's financial statements. See the "Litigation, Claims, and Assessments" section of this Alert for a further discussion of this topic.

529 College Savings Plans

In 2004 regulators continued scrutinizing sales practices of broker-dealers in relation to 529 college savings plans (529 plans). Named after the section of the federal tax code that governs them, 529 plans are financial products designed to help families save for college by providing them with the opportunity to obtain tax-free growth and distribution of the money invested. 529

plans have become increasingly popular over the past couple of years. Industry statistics indicate that about $43 billion were invested in 529 plans at the end of the second quarter of this year and, according to some estimates, the number is expected to double by the end of 2006. Investors can purchase interests in 529 plans directly from the state that sponsors the plan or through an intermediary, such as brokerage firm, investment adviser, or bank. It is estimated approximately 75 percent of all 529 plans are sold through intermediaries.

In 2003, the NASD began investigating possible misconduct by brokers in sales of 529 plans. The probe that began with six securities firms was later expanded to include almost 20 firms. Regulators were concerned that risks and rewards of investing in the plans, as well as various costs and tax consequences of the plans, were not adequately disclosed to potential investors. Regulators were alarmed by their initial findings that more than 90 percent of the sales by some of the firms were to nonresidents of the states sponsoring the plans, despite the fact that half of the states offer a state tax deduction for contributions to home state plans. Although there may be cases in which out-of-state plans are more suitable for investors than their home state plans because of their lower fees or better performance record, each case needs to be analyzed on an individual basis to ensure that investors do not forgo state tax benefits without gaining anything in exchange. In its probe, the NASD is trying to determine whether broker-dealers disclosed that investors may be missing out on state tax benefits by purchasing out-of-state plans and whether the level of compensation received by broker-dealers for selling different 529 plans affected their recommendations.

In addition to being accorded different tax treatment from state to state, 529 plans are further complicated by the variation in fees the plans charge and the existence of different share classes within some plans. These factors and the lack of standardized disclosure requirements make it difficult to compare one plan to another. To address this and other issues related to 529 plans, the SEC chairman established the Chairman's Task Force on College Savings Plans. In September 2004, Congress held hearings on 529 plans.

As regulators and lawmakers evaluate their options, the NASD pledged to continue its investigations into the sales practices of broker-dealers relating to 529 plans and enforce rules with a full range of disciplinary options, including fines, restitution to customers, and the potential for suspension or expulsion from the industry.

As an auditor of a security firm, you should keep abreast of the regulatory and legislative developments in this area since they can have a serious impact on the operations of your client.

Developments in Fixed-Income Markets

Until recently, fixed-income markets used to be overshadowed by the stock market, which was viewed as the market to which corporations turned when they needed to raise capital and in which brokerage firms earned the major portion of their revenues. However, the substantial slowdown of the stock market and all-time low interest rates contributed to the growth of fixed-income markets as it became cheaper for companies to obtain financing by issuing bonds as opposed to equity. Also, individual investors started playing a much more prominent role in the bond market as they moved some of their savings from stocks to more stable bonds after becoming disillusioned by the performance of the stock market. According to a recent NASD study, smaller trades account for about 70 percent of the volume in investment-grade corporate bonds and 52 percent of volume in high-yield corporate bonds, markets which traditionally were dominated by institutional investors. With approximately $23 trillion outstanding, the bond market plays a major role in the United States economy and is considered to be one of the most obscure but fastest-growing markets.

Enhanced Transparency

The corporate bond market with approximately $4.3 trillion outstanding is larger than the U.S. Treasury market, estimated at $3.8 trillion; or the municipal bond market, estimated at $2 trillion. However, until recently, investors did not have ready access to transaction information in the corporate debt markets because most of the bonds were traded between securities firms over the counter as opposed to a centralized exchange which disseminates price information. In July of 2002, the NASD launched its Trade Reporting and Compliance Engine (TRACE) in an effort to improve the transparency of the bond market by providing investors with access to pricing information on a timely basis. As TRACE is being gradually phased in, the number of bonds on which it reports has been increasing while the transaction reporting time has been decreasing. Until September 30, 2004, TRACE publicly reported pricing and transactions on approximately 4,600 investment-grade and high-yield corporate bonds within 45 minutes of each trade. Starting October 1, 2004, TRACE's public reporting expanded to approximately 17,000 bonds, and reporting time was shortened to 30 minutes. By February 1, 2005, TRACE will publicly report transactions on all 23,000 corporate bonds, more than 99 percent of which will be reported within 30 minutes. On July 1, 2005, that reporting time will be shortened to just 15 minutes.

The Municipal Securities Rulemaking Board (MSRB), which regulates the municipal bond market, also undertook an initiative to improve real-time trade reporting. On August 31, 2004, the SEC approved an MSRB proposal to require reporting of transactions in municipal securities within 15 minutes of the time of trade execution instead of by midnight on trade date. The MSRB expects that a proposed facility for real-time collection and dissemination of transaction prices will become operational in January 2005, at which time MSRB will begin to disseminate transaction data electronically in real time.

The SEC chairman set up a Task Force on Bond Market Transparency, which is commissioned to consider issues relating to fixed-income market transparency, identify current problems, and generate potential solutions. The Task Force has presented its work plan to the chairman for consideration, in which it discusses possible ways to maximize the benefits of transparency in the bond markets and identifies the specific areas it believes the SEC should consider in order to determine whether or not additional action is needed.

Excessive Markups and Markdowns in Corporate High-Yield Bonds

The recent increase in transparency improved regulators' ability to maintain surveillance on the bond market for abusive trading practices. In 2004, regulators continued to investigate bond-trading activity and brought several enforcement actions against broker-dealers. In July, NASD ordered four major securities firms to pay $5 million each for rule violations relating to trading in corporate high-yield bonds. Those are the largest penalties to date related to bond market investigations. All four firms were cited for charging excessive markups or markdowns, inadequate recordkeeping, and supervision violations. According to NASD rules, when a customer buys a security from the dealer, the customer's total purchase price, and the markup included in the price, must be fair and reasonable. Similarly, when the customer sells a security to a dealer, the customer's total proceeds from the sale, which were reduced by the markdown, and the markdown, must be fair and reasonable. Under NASD guidelines, markups and markdowns generally should not exceed 5 percent and, for most debt transactions, that figure should be lower. Markups and markdowns are affected by factors such as liquidity, credit rating, and yield and can range from less than one-half of one percent for government debt, to higher amounts for high-yield bonds, depending on how much risk the broker-dealer assumes. As the transactions examined by NASD in this case were executed in pairs, with almost simultaneous sales and purchases of the same face amount of a specific bond, NASD found that the brokerage firms bore little or no risk and, therefore, were not justified in charging investors large markups and markdowns, which ranged from about 10 percent to almost 33 percent, far in excess of NASD established guidelines. This settlement covers trading activity that took place between 2000 and 2002. The NASD is currently focusing on data subsequent to 2002 looking for similar trading abuses.

In September 2003, the NASD filed a proposal with the SEC to add a new Interpretation to its rules to provide additional markup guidance for transactions in debt securities, except municipal securities. The current proposal would address how, for purposes of calculating a markup, the NASD members should determine a debt security's prevailing market price. The NASD proposal would provide a base standard that the prevailing market price for a debt security would be the dealer's contemporaneous cost. In June 2004, the NASD filed an amendment to this proposed rule change. The NASD's original proposal and the related amendment can be viewed at www.nasd.com under Rule Filings, File No. SR-NASD-2003-141.

Municipal Bond Price Violations

In June of 2004, NASD ordered eight firms to pay penalties totaling $610,000 in connection with certain municipal bond trades in which customers did not receive a fair price for their bonds, in violation of MSRB rules. NASD found that a number of customers of these firms received below-market prices when selling their municipal bonds to the eight firms, as evidenced by the fact that the bonds were subsequently resold by other dealers—often in same-day transactions—at markedly higher prices, in violation of MSRB Rules G-30 and G-17. Those rules require municipal bond dealers, regardless of the compensation received by the dealers, to deal fairly with their customers and to buy and sell bonds at fair prices. In these cases, NASD found that in subsequent trading of the customers' bonds, the prices paid were higher than the prices the customers had originally received, which indicated that the customers had not received fair prices for the bonds the customers sold. By relying solely on the prices provided by the broker's broker to determine the fair-market value (FMV) of the bonds, the customers' dealer breached their duty to ensure that their customers received a price for their bonds that was reasonably close to the FMV. NASD is currently investigating the conduct of the brokers' brokers involved in these transactions and their compliance with MSRB Rules. The rules require brokers' brokers to make a reasonable effort to obtain a price for a firm selling its customers' bonds that is fair and reasonable in relation to prevailing market conditions.

The MSRB issued Notice 2004-3, "Review of Dealer Pricing Responsibilities," to remind municipal security dealers that they must exercise diligence in establishing the market value of the security and the reasonableness of the compensation received on the transaction. The MSRB expressed concern with "transaction chains" in which a block of securities was bought from a retail investor, and then, after a series of interdealer trades, was sold to another retail customer at a substantially higher price, thus causing large intraday price differentials to be absorbed by retail customers. You can view this notice at http://www.msrb.org/msrb1/archive/2004/pricingnotice04final1.htm.

SEC Investigation of Auction Rate Bonds

Recently, the SEC opened an investigation of whether securities firms acted improperly in handling transactions in auction rate bonds. Auction rate bonds are long-term, variable-rate debt instruments whose interest rates are reset at predetermined short-term intervals through a Dutch auction process. Under this process, a broker-dealer acts as a middleman who receives investor orders and submits them to the auction agent, a third party that facilitates the auction process by determining the clearing rate and allocating the bonds. The clearing rate is the lowest bid rate at which all the bonds can be sold at par. Investors who bid a minimum rate above the clearing rate receive no bonds, while those whose minimum bid rates were at or below the clearing rate receive the clearing rate for the next period. Auction rate bonds are especially popular in the municipal bond market.

The SEC sent out letters to many broker-dealers which are active in debt underwriting, asking them to voluntarily investigate a number of their practices in connection with auction rate securities and to provide the SEC with written reports detailing potentially deceptive, dishonest, or unfair practices. Regulators are concerned that broker-dealers' involvement may have compromised the integrity of the auction process. When broker-dealers collect bids from investors prior to passing them along to auction agents, they get access to information, which allows them to calculate the winning bid. If broker-dealers pass that information to some investors or use it to set their own bids, then they interfere with the blind auction in which bidders are not supposed to know other bids until the auction is over.

Regulatory Initiatives to Improve Investor Education

As individual investors started to play a major role in the bond market, regulators became concerned that such investors may not fully understand the costs and risks associated with bond transactions. Following the launch of TRACE, NASD convened the Corporate Debt Market Panel, composed of market participants and academics, to ensure that it is proactively monitoring shifting market dynamics. The panel was charged with making recommendations regarding how best to ensure the integrity of the market and protect investors. In September 2004, the panel released its report in which it recommended, among other things, that broker-dealers ensure that they provide improved information for individual investors at the time of indicating interest in corporate bonds as well as immediately prior to buying or selling a bond. The panel's complete findings and recommendations are contained in the "Report of the Corporate Debt Market Panel," available at www.nasd.com—under Rules & Regulations—Reports and Studies.

In April 2004, NASD issued NTM 04-30 to remind firms that sell bonds and bond funds of their sales practice obligations in connection with such products. As the number of retail customers investing in bonds and bond funds grows, NASD became concerned that many investors may not fully appreciate the risks and costs associated with such products. According to the NTM, it is the responsibility of firms to take appropriate steps to ensure that their registered representatives understand and inform their customers about the risks as well as the rewards of the products they offer and recommend. This NTM may be viewed at www.nasd.com.

Auditing Considerations

Broker-dealers operate in a highly regulated industry that requires close attention to compliance matters. As regulators continue their investigations of trading abuses in the bond market and evaluate the need for new rules or other regulatory reforms, auditors of broker-dealers need to stay alert to further developments to determine that their clients are in compliance with the regulations. Also, remember that the fact that your broker-dealer client is being investigated by regulators may require disclosure.

The Commodities Industry

Consistent with prior year trends, global futures and options contract volume has continued to increase through 2003 and into 2004. At U.S. derivatives exchanges, futures and options on futures contract volume for the first eight months of 2004 reached 1.051 billion contracts, a 26.2-percent increase from the same period in 2003. This increase can be attributed primarily to increases in trading volume in interest rate (597.4 million; 31.8-percent increase), equity (225.5 million; 14.5-percent increase), and energy (84.9 million; 13.6-percent increase) products.

The U.S. futures industry, in addition to the increasing volume, has also experienced other significant changes through 2003 and into 2004. In July 2003, the Commodity Futures Trading Commission (CFTC) approved rule submissions by the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CBOT) establishing a common clearing link that allowed the CME clearinghouse to replace the CBOT's traditional clearing relationship with The Clearing Corporation (formerly the Board of Trade Clearing Corporation) for the clearing of CBOT-listed futures and option contracts. This clearing link was fully operational in January 2004. The CBOT reports that the common clearing link has provided benefits to the exchanges' common members in the form of reduced performance bond requirements and capital reductions.

Concurrently, the U.S. Futures Exchange, L.L.C. (USFE), an indirect subsidiary of Eurex, applied to the CFTC for designation as a contract market for the automated trading of futures and options on futures in the United States. In February 2004, the CFTC approved this application and USFE thereafter commenced trading, using The Clearing Corporation as an independent clearing organization for clearing services. The entry of USFE into the U.S. futures industry in 2004 has brought an increase in competition, as USFE immediately offered contracts that directly compete with contracts listed on the CBOT.

Regulatory Issues and Developments[1]

Chapter 5, "Auditing Considerations," of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* discusses auditing considerations for an audit of the financial statements of a broker-dealer. The Guide notes that the regulatory environment of a broker-dealer has a major effect on the audit of a broker-dealer because of the requirements that auditors report on the adequacy of the broker-dealer's internal control and on its compliance with the specific rules addressing financial responsibility and recordkeeping. Accordingly, certain tests of controls are performed even if the auditor would not otherwise choose to do so.

The audit and reporting requirements for securities broker-dealers are regulated by Rule 17a-5 under the Securities Exchange Act of 1934 (the Exchange Act). An alternative regulatory framework has been created for over-the-counter derivatives dealers that establishes a special class of broker-dealers who may choose to register with the SEC under a limited regulatory structure. Further, registered broker-dealers in U.S. government securities are regulated by Section 405.02 of the regulations pursuant to Section 15C of the Exchange Act.

1. Readers should be alert for updates, amendments, or other changes to the rules discussed in this section and for other recent developments related to regulatory activities. The brief summaries provided in this section of the Alert are for informational purposes only. Readers should refer to the full text of the regulations. The complete text of SEC rules, including rules adopted subsequent to the publication of this Alert, can be obtained from the SEC Web site at www.sec.gov; CFTC rules—at www.cftc.gov; NYSE rules—at www.nyse.com; NASD rules—at www.nasd.com; and NFA rules—www.nfa.futures.org. See the "Information Sources" table at the end of this Alert for a list of Internet resources.

Qualifications and reports of independent accountants of commodity entities are specified by Regulation 1.16 of the Commodity Exchange Act. Before undertaking the audit of a regulated entity, auditors should read the applicable rules and understand the prescribed scope of the audit and the related reporting requirements.

Certain regulatory activities and developments relevant to entities operating in the securities industry are presented in the sections below.

Registration With PCAOB—Extension of Order Regarding Broker-Dealer Financial Statement Requirements Under Section 17 of the Exchange Act

Although the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley or the Act) is directed at "issuers" (as defined by the Act) and their auditors, nonpublic broker-dealers also come under the scope of certain provisions of the Act. This is because Section 205(c)(2) of the Act amended Section 17 (15 U.S.C. 78q) of the Exchange Act to require *all* broker-dealers (both public and nonpublic) to be audited by a public accounting firm registered with the Public Company Accounting Oversight Board (PCAOB).

Section 17(e)(1)(A) of the Exchange Act requires that every registered broker-dealer annually file with the SEC a certified balance sheet and income statement, and Section 17(e)(1)(B) requires that the broker-dealer annually send to its customers its *certified balance sheet*. The Sarbanes-Oxley Act established the PCAOB and amended Section 17(e) to replace the words "an independent public accountant" with "a registered public accounting firm."

The Act establishes a deadline for registration with the PCAOB of auditors of financial statements of "issuers." The Act does not provide a deadline for registration of auditors of nonpublic broker-dealers. Application of registration requirements and procedures to auditors of nonpublic broker-dealers is still being considered.

On July 14, 2004, the SEC extended its Order, which provides that nonpublic broker-dealers may file with the SEC and may send to their customers documents and information required by Section 17(e) certified by an independent public accountant, instead of by a registered public accounting firm until January 1, 2006, unless rules are in place regarding the PCAOB registration of auditors of nonpublic broker-dealers that set an earlier date. The original Order was issued on August 4, 2003, and was set to expire on January 1, 2005.

See Release No. 34-50020 at http://www.sec.gov/rules/other/34-50020.htm for more information.

SEC Independence Rules and Contingent Fees

The audit and reporting requirements for securities broker-dealers are regulated by Rule 17a-5 under the Exchange Act. SEC Rule 17a-5 requires that the provisions set forth in SEC Rule 2-01(b) and (c) of Regulation S-X be adhered to when determining whether the accountant is deemed to be independent. Therefore, auditors of broker-dealers have to follow SEC independence rules.

In 2003, the SEC provided responses to frequently asked questions regarding the application of its rules on auditor independence in which it also indicated that the scope of services provisions of Sarbanes-Oxley extend to auditors of privately held broker-dealers. Accordingly, auditors of privately held broker-dealers are restricted from performing those services specifically excluded by Sarbanes-Oxley and are expected to comply with all other SEC independence rules, including those that prohibit bookkeeping and the preparation of financial statements for privately held broker-dealers. However, as indicated by the response to question 35, the auditor rotation rules do not apply to auditors of private broker-dealers. SEC answers to frequently asked questions regarding the independence rules can be found at www.sec.gov/info/accountants/ocafaqaudind080703.htm.

In May of 2004, the SEC expressed its views on contingent fee arrangements and their effect on auditor independence. Differences have been noted between the AICPA and SEC rules pertaining to the exclusion of contingent fees in tax matters that are "determined based on the results of judicial proceedings or the findings of governmental agencies." Although both the AICPA and SEC rules provide an exception for such fees, AICPA Interpretation No. 302-1, *Contingent Fees in Tax Matters*, under Rule of Conduct 302, *Contingent Fees* (AICPA, *Professional Standards*, vol. 2, ET sec. 302.01), defines what is meant by "determined based on the findings of governmental agencies" and does not consider a fee to be contingent if "the member can demonstrate a reasonable expectation, at the time of a fee arrangement of substantive consideration by an agency with respect to the members' client."

The SEC's position, as stated in Financial Reporting Release No. 56, is that the exception would only apply "when the fee is determined not by the parties but by courts or government agencies acting in the public interest." This Interpretation precludes auditors of public companies from entering into certain tax arrangements that comply with AICPA Interpretation No. 302-1.

Another notable difference between the AICPA and SEC contingent fee rules pertains to value-added fees (i.e., when a client, at its complete discretion, determines at the end of an engagement that the accountant provided services that had greater value than the amount due under the contract). The SEC emphasizes that although value-added fees are not within the scope of the prohibition, the SEC staff will closely look to determine whether a fee labeled a "value-added" fee is in fact a contingent fee. AICPA Interpretation No. 302-1 does not specifically address value-added fees.

In light of these recent developments, the AICPA is currently reviewing the existing rules under Interpretation No. 302-1. In the interim, the Center for Public Company Audit Firms of the AICPA advises firms that in good faith applied the AICPA's contingent fee rules with respect to SEC audit clients to engagements initiated prior to May 21, 2004 (the date of the letter that clarified the SEC's position) to perform the following:

- Review all practice areas, not limited to tax practice, to identify all findings-based and value-added fee arrangements with SEC audit clients that were entered into on or after February 5, 2001, the effective date of revisions to the SEC's independence rules.

- Discuss all identified engagements entered into since February 5, 2001, and paid by May 21, 2004, with the audit committees of SEC audit clients. The discussion should enable registrants to comply with their requirements to engage independent accountants and comply with their proxy disclosure requirements.

- In connection with the aforementioned discussion, because the May 21, 2004, letter is intended to "remove any ambiguity," such fee arrangements that were in compliance with the AICPA contingent fee rules should be discussed with the relevant audit committees to ascertain whether the audit committee would agree that the accountant's analysis and conclusion regarding independence for the relevant period prior to May 21, 2004, was appropriate.

- For such fee arrangements that are still incomplete or unpaid as of May 21, 2004, firms should settle or convert those engagements to acceptable fee arrangements as soon as practicable in order to comply with the staff's interpretation as set forth in the May 21, 2004, letter. If such engagements cannot be settled or converted promptly, firms may alternatively resign the audit engagement.

- Proxy fee disclosures should include any payments for such fee arrangements irrespective of the year(s) in which services were provided. Footnote disclosure that the fee related to services that were rendered in a prior year would be acceptable where appropriate.

- Direct any questions regarding the application of the contingent fee rules to the SEC Office of the Chief Accountant.

As auditors of broker-dealers (both public and nonpublic) are expected to comply with SEC independence rules, they should evaluate their fee arrangements to ensure that they are not considered contingent fees and do not impair auditor independence. Please refer to the SEC letter at http://www.sec.gov/info/accountants/staffletters/webb052104.htm for more information.

Broker-Dealer Expense-Sharing Agreements

Many broker-dealers enter into expense-sharing arrangements with third parties, including a parent or affiliate, under which a broker-dealer pays service fees to the parent or affiliate for providing it with office space, facilities, equipment, as well as certain administrative functions. The NASD and the New York Stock Exchange (NYSE) (collectively referred to as self-regulatory organizations or SROs) were concerned that some broker-dealers were using these expense-sharing agreements as a basis for not recording the costs they incurred on their books and records. In that instance, the books and records of a broker-dealer may not accurately reflect its performance and financial condition, artificially inflating its profitability, causing it to appear to be in capital compliance when it is not, and possibly disguising fraudulent activity.

In July 2003, the SEC Division of Market Regulation sent a letter to the NASD and the NYSE concerning the application of the financial responsibility rules[2] when a third party, which may include a parent, holding company, or affiliate of a broker-dealer, agrees to assume responsibility for payment of the broker-dealer's expenses.

Under the financial responsibility rules, broker-dealers are required to prepare certain financial statements in accordance with generally accepted accounting principles (GAAP). A broker-dealer is also required to make and keep current certain books and records relating to its business, including records reflecting all assets and liabilities, income and expense and capital accounts. A broker-dealer must also retain copies of all written agreements entered into by the broker-dealer relating to its business.

2. Exchange Act Rules 15c3-1, 17a-3, 17a-4, and 17a-5.

The SEC Division of Market Regulation provided the following guidance:

1. Pursuant to Exchange Act Rule 17a-3(a)(1) and (a)(2), a broker-dealer must make a record reflecting each expense incurred relating to its business and any corresponding liability, regardless of whether the liability is joint or several with any person and regardless of whether a third party has agreed to assume the expense or liability. A broker-dealer must make a record of each expense incurred relating to its business, including the value of any goods or services used in its business, when a third party has furnished the goods or services or has paid or has agreed to pay the expense or liability, whether or not the recording of the expense is required by GAAP and whether or not any liability relating to the expense is considered a liability of the broker-dealer for net capital purposes. One proper method is to record the expense in an amount that is determined according to an allocation made by the third party on a reasonable basis.

2. If the broker-dealer does not record certain expenses on the reports it is required to file with the SEC or with its designated examining authority (DEA) under the financial responsibility rules, the broker-dealer may satisfy the Securities Exchange Act Rule 17a-3(a)(1) and (a)(2) requirement to make a record of those expenses by making a separate schedule of the expenses.

3. If a third party agrees or has agreed to assume responsibility for an expense relating to the business of the broker-dealer, and the expense is not recorded on the reports the broker-dealer is required to file with the SEC or with its DEA under the financial responsibility rules, any corresponding liability will be considered a liability of the broker-dealer for net capital purposes unless:

   - If the expense results in payment owed to a vendor or other party, the vendor or other party has agreed in writing that the broker-dealer is not directly or indirectly liable to the vendor or other party for the expense.[3]

- The third party has agreed in writing that the broker-dealer is not directly or indirectly liable to the third party for the expense.
- There is no other indication that the broker-dealer is directly or indirectly liable to any person for the expense.
- The liability is not a liability of the broker-dealer under GAAP.
- The broker-dealer can demonstrate that the third party has adequate resources independent of the broker-dealer to pay the liability or expense.

4. Any withdrawal of equity capital, as defined in paragraph (e)(4)(ii) of Securities Exchange Act Rule 15c3-1, from a broker-dealer by a third party, other than a withdrawal described in paragraph (e)(4)(iii) of Exchange Act Rule 15c3-1, within three months before or within one year after the broker-dealer incurs an expense which the third party has paid or agreed to pay, will be presumed for net capital purposes to have been made to repay the third party for the expense of the broker-dealer, unless the broker-dealer's books and records reflect a liability to the third party relating to the expense.

5. For purposes of determining net capital, if the broker-dealer records a capital contribution from a third party that has assumed responsibility for paying an expense of the broker-dealer, and the expense is not recorded on the reports the broker-dealer is required to file with the SEC or with its DEA under the financial responsibility rules, the broker-dealer must be able to demonstrate that the recording of a contribution to capital is appropriate. Among other things, the broker-dealer must be able to demonstrate that the third party has paid the expense or has adequate resources independent of the

3. This requirement does not apply to a fixed-term arrangement with a lessor that was in place before the issuance of this guidance.

broker-dealer to pay the expense and that the broker-dealer has no obligation, direct or indirect, to a vendor or other party to pay the expense. For net capital purposes, any equity capital withdrawn by the third party, other than a withdrawal described in paragraph (e)(4)(iii) of Securities Exchange Act Rule 15c3-1, within three months before or one year after the broker-dealer incurs the expense, will be deemed to have been a repayment of the expense to the third party. For net capital purposes, if a contribution to capital is made to a broker-dealer with an understanding that the contribution can be withdrawn at the option of the contributor, the contribution may not be included in the firm's net capital computation and must be re-characterized as a liability. Any withdrawal of capital as to that contributor within a period of one year, other than a withdrawal described in paragraph (e)(4)(iii) of Exchange Act Rule 15c3-1, shall be presumed to have been contemplated at the time of the contribution.

6. If a third party agrees or has agreed to assume responsibility for an expense of the broker-dealer, the broker-dealer must make, keep current, and preserve the following records pursuant to Exchange Act Rules 17a-3 and 17a-4:
   - If a vendor or other party has agreed that the broker-dealer is not liable directly or indirectly to the vendor or other party for an expense, a written agreement between the broker-dealer and the vendor or other party that clearly states that the broker-dealer has no liability, direct or indirect, to the vendor or other party
   - A record of each expense assumed by the third party

7. A broker-dealer must make, keep current, and preserve a written expense-sharing agreement[4] between the broker-dealer and a third party that has paid or agreed to pay an expense of the broker-dealer. The agreement must set out clearly which party is obligated to pay each expense,

4. Expense-sharing agreements include franchising or other agreements relating to the costs of doing business of the broker-dealer.

whether the broker-dealer has any obligation, direct or indirect, to reimburse or otherwise compensate any party for paying the expense, and, when the broker-dealer records the expense in an amount that is determined according to an allocation made by the third party, the method of allocation.

8. Each broker-dealer and broker-dealer applicant must be able to demonstrate to the appropriate authorities that it is in compliance with the financial responsibility rules in connection with any expense-sharing agreement it has entered into, and, therefore, may be required to provide these authorities with access to books and records, including those of unregistered entities, relating to the expenses covered by the agreement.

9. A broker-dealer must notify its DEA if it enters into, or has entered into, an expense-sharing agreement and the broker-dealer does not record each of the expenses it incurs relating to its business on the reports it is required to file with the SEC or with its DEA under the financial responsibility rules. The notification must include the date of the agreement and the names of the parties to the agreement. The broker-dealer must provide a copy of the agreement to its DEA upon request.

The SEC Division of Market Regulation Letter can be found on the Web at http://www.sec.gov/divisions/marketreg/mr-noaction/macchiaroli071103.pdf. The letter's requirements became effective when it was issued; however, NASD NTM 03-63 and NYSE Information Memo 03-49 extended the compliance period for their members to December 1, 2003. NASD NTM 03-63, issued in October 2003, also provides further guidance on the issues addressed in the letter.

As an auditor of a broker-dealer that has entered into expense-sharing arrangements with a third party you need to ensure that your client properly accounts for expenses and liabilities subject to those agreements as well as that the agreements meet the requirements of the SEC letter.

Collection Practices Under Section 31 of the Exchange Act

In June 2004, the SEC established new procedures that govern the calculation, payment, and collection of fees and assessments on securities transactions owed by national securities exchanges and national securities associations (collectively, SROs) to the SEC pursuant to Section 31 of the Exchange Act. Under these new procedures, each SRO must provide the SEC with data on its securities transactions. The SEC will for the first time exclusively calculate the amount of fees and assessments due based on the volume of these transactions and bill the SRO that amount. This rule became effective on August 6, 2004, with some exceptions. See Release No. 34-49928 at http://www.sec.gov/rules/final/34-49928.htm for compliance date and other information.

Labeling of Fees

In its rule adoption, it was pointed out that Section 31 of the Exchange Act places obligations only on SROs and the SEC. SROs must pay certain fees and assessments to the SEC. The SEC is required by Section 31 to collect such fees and assessments. Section 31, however, does not address the manner or extent to which SROs may seek to recover the costs of their Section 31 obligations from their members. Nor does Section 31 address the manner or extent to which members of SROs may seek to pass any such charges on to their customers. In practice, the SROs obtain the funds for these fees and assessments by assessing charges on their members, and the members in turn pass these charges to their customers. It is customary for a customer who sells a security to see an "SEC Fee" on his or her trade confirmation.

The SEC is concerned about the manner in which SROs label the fees that they pass to their members and the manner in which members label the fees passed to their customers. These are not "Section 31 Fees" or "SEC Fees." Section 31 places no obligation on members of SROs or their customers, and it is misleading to suggest that a customer or an SRO member incurs an obligation to the SEC under Section 31. Accordingly, the SEC believes that SROs and their members should take prompt action to correct any such misperceptions.

Accumulated Overages at Broker-Dealer Firms

Currently, amounts remitted to the SEC by SROs are calculated either by SROs or their members. According to the SIA, there has been a concern for many years about the amounts collected under SRO rules when broker-dealers pass the fees onto their customers. Since broker-dealers have no alternative but to assess the fee on each separate sale transaction, i.e., on a per-transaction basis, broker-dealers do not collect amounts identical to that of the SRO's liability to the SEC which is based on the aggregate dollar amount of securities sale transactions. Furthermore, broker-dealers typically round up the amount of the customer's charges to the next whole cent. As a result, many broker-dealer firms accumulated considerable overages for the fees assessed by their SROs for Section 31 purposes. The new SEC guidance on Section 31 transaction fees does not address the issue of overcollection and broker-dealers will need to work with their SROs to determine how to handle those overages.

Related SRO Guidance

NASD. As a result of the SEC's adoption of new procedures for calculation, payment, and collection of Section 31 fees, in August 2004, the NASD issued NTM 04-63, which contains important information on the new SEC procedures relating to Section 31 fees and NASD fees collected from members in accordance with Section 3 of Schedule A to the NASD By-Laws. Among other things, the NTM discusses the following issues:

- *Overages.* According to the NTM, NASD understands that reconciling the amounts billed by NASD and the amounts collected by member firms has been difficult from a member firm perspective, resulting in overages at some broker-dealer firms, in part due to the practice of routinely rounding up to the next cent. Accordingly, to more accurately reconcile the amount that NASD bills its members and the amount collected by members from their customers, members should no longer solely round up when there is a remainder after truncating the resulting amount. Rather, if there is any remainder, members should alternate between rounding up and rounding down to the next cent.

- Away From the Market Sales.5 NASD previously had not included away from the market sales in its calculation of the transaction fees owed to the SEC under Section 31 based upon SEC guidance that such transactions were not subject to Section 31 fees. In the Adopting Release, however, the SEC stated that it now believes that such transactions are subject to Section 31 fees where consideration is given for the securities. Therefore, NASD will begin seeking trade information on away from the market sales from its members through self-reporting so that it can satisfy its reporting obligation under the new SEC procedures.
- Timing of Reporting and Payments. Given NASD's obligation to process the trade data in a shorter timeframe, NASD also will now require that trade data and applicable payments be received by NASD by the seventh calendar day of each month subsequent to the trade period covered on the report. Currently, members have until the tenth calendar day of each month to submit the trade data and payments to NASD.

For more information please refer to NTM 04-63 at www.nasd.com.

NYSE. On August 5, 2004, the NYSE issued Information Memo No. 04-42, "Rule 440 H ('Transaction Fees')—Repository and Remittance Requirements," to clarify several issues relating to members' and member organizations' responsibilities, procedures, method of calculation (including rounding), prepa-

5. Sales in which the buyer and seller have agreed to trade at a price substantially unrelated to the current market for the security and where these sales were not required to be reported pursuant to NASD rules.

ration of Form 120-A, and submission of transaction fees to the NYSE pursuant to Rule 440H. Among other things, Information Memo No. 04-42 instructs its members and member organizations to disregard the advice provided in the "Calculation of Fees—Rounding Up" section of Information Memo No. 01-51, dated December 28, 2001, which required each member or member organization to use a "rounding up" formula to calculate the fee relative to each transaction. For more information please refer to Information Memo No. 04-42 at *Published Memo Number 04-42*.

Breakpoint Refund Liability

Last year, broker-dealers selling mutual funds with front-end loads were ordered by the NASD to provide refunds to customers who did not receive breakpoint discounts. Mutual funds sold through broker-dealers may include a sales charge (also called a *load*), which compensates the broker-dealer selling the fund's shares. Mutual funds with front-end sales loads often offer investors the opportunity for a reduction in sales loads as the dollar value of the shares purchased by an investor or a member of his or her family increases. The levels at which the front-end sales charge is reduced are determined by the mutual funds and are generally termed *breakpoints*. Although breakpoint discounts are offered by mutual funds, much of the responsibility for calculating the proper discounts falls on brokerage firms that sell the funds.

In its NTM 03-47, "Refunds to Customers Who Did Not Receive Appropriate Breakpoint Discounts in Connection with the Purchase of Class A Shares of Front-End Load Mutual Funds and the Capital Treatment of Refund Liability," the NASD provided guidelines for firms to follow when calculating refunds to customers and accounting for their anticipated refund liabilities. The NASD stressed that firms needed to consider the requirements of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, when accounting for their refund liability. FASB Concept No. 6 specifically recognizes that the amount of a liability does not need to be certain before it is recorded. Accordingly, approximations and estimates may be used to record a liability. Thus, firms had to determine their probable liability based upon currently available information in accordance with FASB Concept No. 6 and GAAP. The NASD also issued a notice to members as to the amount of refund they should be providing to customers, and brokers were either to record this amount or statistically justify another amount.

Now many broker-dealers believe, based on their experience to date, that they were overly conservative in estimating the total amount of such claims. Accordingly, some believe that it is appropriate, based on their experience to date, to reverse fully or reduce those reserves.

NASD on its Web site stated (under *Ask NASD* a "Frequently Asked Questions" discussion, which can be viewed at http://nasd.broaddaylight.com/nasd/FAQ_56_6133.shtm) that firms need to reflect the balance of the breakpoint refund liability and fund such balances until they believe that all customers who did not receive applicable breakpoint discounts have been compensated, or until the time limit for customers to present claims has expired in accordance with applicable law.

NASD is considering issuing a Notice to Members to address concerns of its members about breakpoint refund liabilities. NASD believes that the current absence of customers' claims does not support removal of the liability. Prior to reducing or removing its current liability, a firm will need to explain to NASD staff the basis for concluding that its initial estimate was substantially in excess of its actual obligations and provide detailed documentary support as to how the original amounts were unjustified.

As an auditor of a securities firm that had to set up a breakpoint refund liability, you need to stay alert to further regulatory developments and ensure that the balance maintained in that account is adequate.

Anti-Money Laundering Developments

Over the past three years, the Department of the Treasury, along with other regulatory organizations, has issued a number of rules to implement key provisions of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the Patriot Act). It is critical for securities firms to comply with anti-money laundering regulations, as noncompliance may lead to serious negative consequences, including tarnished reputations, legal and regulatory problems, and, in some cases, civil or criminal actions.

Money launderers tend to use the business entity more as a conduit than as a means of directly expropriating assets. For this reason, money laundering is far less likely to affect financial statements than are other types of fraud, such as misappropriation, and, consequently, is unlikely to be detected in a financial statement audit. In addition, other forms of fraudulent activity usually result in the loss or disappearance of assets or revenue, whereas money laundering involves the manipulation of large quantities of illicit proceeds to distance them from their source quickly and in as undetectable a manner as possible. However, money laundering activities may have indirect effects on an entity's financial statements.

Money laundering is considered to be an illegal act and independent auditors have a responsibility under Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), to be aware of the possibility that illegal acts may have occurred, indirectly affecting amounts recorded in an entity's financial statements. AICPA Practice Alert 2004-1, *Illegal Acts*, issued in October 2004, provides additional guidance for the auditors on non-issuers with respect to illegal acts. In addition, if specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect (for example, the entity's contingent liability resulting from illegal acts committed as part of the money-laundering process) on the entity's financial statements, the auditor should apply auditing procedures specifically designed to ascertain whether an illegal act has occurred.

Auditors should also note that laundered funds and their proceeds could be subject to asset seizure and forfeiture (claims) by law enforcement agencies, which could result in material contingent liabilities during the prosecution and adjudication of cases.

The following sections discuss recent anti-money laundering developments as well as issues of continuing importance.

Customer Identification Programs—SEC No-Action Letter

On April 29, 2003, Treasury and the SEC jointly issued a final rule to implement Section 326 of the Patriot Act. The final rule requires that broker-dealers establish, document, and maintain a written customer identification program (CIP). This program must be appropriate for the firm's size and business, be part of the firm's anti-money-laundering (AML) compliance program, and, at a minimum, must contain the following four elements: (1) establishing identity verification procedures; (2) maintaining records related to CIP; (3) determining whether a customer appears on any designated list of terrorists or terrorist organizations; and (4) providing customers with notice that information is being obtained to verify their identities.

Paragraph (b)(6) of the CIP Rule permits broker-dealers to rely on certain other financial institutions to undertake the required elements with respect to shared customers. The rule permits such reliance if, among other things, the other financial institution is subject to an AML Rule and regulated by a Federal functional regulator.

The interrelationship between broker-dealers and advisers is the type of situation intended to be covered by the reliance provisions. Because these advisers are registered with the SEC, they meet the requirement that the relied-on financial institution be regulated by a Federal functional regulator. However, they are not currently subject to an AML Rule and, consequently, do not meet this condition of paragraph (b)(6) of the CIP Rule. On April 28, 2003, the Financial Crimes Enforcement Network (FinCEN), Department of the Treasury, proposed an AML Rule for registered investment advisers. Final rules have not been adopted.

On February 12, 2004, the SEC Division of Market Regulation issued a No-Action Letter in which it indicated that it will not recommend enforcement action to the SEC under Rule 17a-8 if a broker-dealer relies on an investment adviser, prior to such adviser becoming subject to an AML Rule, provided all the other requirements and conditions in paragraph (b)(6) of the CIP Rule are met, namely that (1) such reliance is reasonable under the circumstances; (2) the investment adviser is regulated by a Federal functional regulator; and (3) the investment adviser enters into a contract requiring it to certify annually to the broker-dealer that it has implemented an AML program, and that it will perform (or its agent will perform) specified requirements of the broker-dealer's customer identification program. This No-Action Letter will be withdrawn without further action on the earlier of: (1) the date upon which an AML Rule for advisers becomes effective, or (2) February 12, 2005.

The complete letter can be viewed at http://www.sec.gov/divisions/marketreg/mr-noaction/sia021204.htm.

Anti-Money Laundering Programs—Independent Review Requirement

Section 352 of the Patriot Act requires each financial institution, as defined in the Bank Secrecy Act (BSA), to establish an AML program, which, at a minimum, must contain the following components: (1) development of internal policies, procedures, and controls; (2) designation of a compliance officer; (3) an ongoing employee training program; and (4) an independent audit function to test programs. In April 2002, the SEC approved NASD Rule 3011 and NYSE Rule 445, which require each member firm and member organization to have AML compliance programs in place by April 24, 2002. Among other things, these rules require that firms independently test their AML programs. In NTM 02-21, NASD stated that the independent tests should occur on an annual basis. Many small firms are concerned about the independent testing requirement and its impact on their auditors' independence. In October 2003, Lori Richards, Director of the SEC Office of Compliance Inspections and Examinations, stated that "small 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 the firm's AML system. However, some firms may find it more cost effective to use a qualified outside party. Training internal staff and establishing procedures to ensure their independence also costs money. Some small firms have coordinated with other small firms to hire an outside auditor at a reduced group rate."

NASD offers on its Web site (http://www.nasdr.com/money.asp) an AML compliance program template for small firms to assist them in fulfilling their responsibilities to establish an AML program. The template contains instructions, relevant rules and Web sites, and other resources that are useful for developing an AML plan for a small firm.

Proprietary Accounts of Introducing Brokers

The discussion below contains guidance that was originally issued several years ago. It is included in this Alert to emphasize the continuing importance of the requirements related to proprietary accounts of introducing brokers (PAIB accounts).

NYSE Interpretation Memo 98-10 extends the requirement to perform a Customer Reserve Computation with respect to PAIB accounts carried by their clearing brokers in order for the introducing broker to receive allowable asset treatment under Rule 15c3-1 for proprietary assets held at their clearing broker. The introducing broker and its 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.

At the November 10, 2000, meeting of the AICPA Stockbrokerage and Investment Banking Regulatory Liaison Task Force, representatives from the SEC and the NYSE expressed their expectation that the footnotes to the financial statements of clearing brokers will include a disclosure relating to the calculation of PAIB reserves, and that the disclosure should state whether or not a deposit is required and, if so, the amount of the required deposit and the amount that is actually on deposit.

Supervision Programs for Broker-Dealers and Affiliates

In April 2004, the SEC adopted rule amendments and new rules under the Exchange Act that establish two separate voluntary regulatory programs for the SEC to supervise broker-dealers and their affiliates on a consolidated basis. These rules respond to international developments relating to firms that do business in the European Union (EU). These firms may need to demonstrate that they have consolidated supervision at the holding company level that is "equivalent" to EU consolidated supervision. The SEC believes that its supervision contemplated by these rules will meet this standard. As a result, these rules should minimize duplicative regulatory burdens on firms that are active in the EU, as well as in other jurisdictions that may have similar laws.

One program, "Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities," establishes an alternative method to compute certain net capital charges for broker-dealers that are part of a holding company that manages risks on a group-wide basis and whose holding company consents to group-wide SEC supervision. This alternative method is available to broker-dealers that maintain tentative net capital of at least \$1 billion and net capital of at least \$500 million. Big Wall Street firms with international presence are expected to benefit from this program, which, according to some estimates, will allow the largest firms to reduce the amount of capital they must set aside by half or even more. The broker-dealer's ultimate holding company and its affiliates, if subject to SEC supervision, is referred to as a consolidated supervised entity (CSE).

This alternative method permits a broker-dealer to use mathematical models to calculate net capital requirements for market and derivatives-related credit risk. The CSE is required to comply with rules regarding its group-wide internal risk management control system and has to periodically provide the SEC with consolidated computations of allowable capital and risk allowances (or other capital assessment) prepared in a form that is consistent with the Basel Standards. The SEC supervision of the CSE includes recordkeeping, reporting, and examination requirements. An ultimate holding company that has a principal regulator generally is not subject either to SEC examination or those rules requiring internal risk management controls outside of the broker-dealer and is subject to reduced reporting, recordkeeping, and notification requirements.

The other program, "Supervised Investment Bank Holding Companies," implements Section 17(i) of the Exchange Act, which created a new structure for consolidated supervision of holding companies of broker-dealers, or investment bank holding companies (IBHCs), and their affiliates. This alternative is available to smaller firms holding tentative net capital of $100 million or more. Pursuant to the Exchange Act, an IBHC that meets certain specified criteria may voluntarily register with the SEC as a supervised investment bank holding company (SIBHC) and be subject to supervision on a group-wide basis. These companies will continue to calculate net capital requirements using traditional methods. Pursuant to the new rules, registration as an SIBHC is limited to IBHCs that are not affiliated with certain types of banks and that have a substantial presence in the securities markets. The rules provide an IBHC with an application process to become supervised by the SEC as an SIBHC, and establish regulatory requirements for those SIBHCs.

SEC supervision of an SIBHC includes recordkeeping, reporting, and examination requirements. Further, the SIBHC is also required to comply with rules regarding its group-wide internal risk management control system and has to periodically provide the SEC with consolidated computations of allowable capital and risk allowances (or other capital assessment) consistent with the Basel Standards.

Both programs also include technical and conforming amendments to the risk assessment rules (Securities Exchange Act Rules

17h-1T and 17h-2T). In addition, the SIBHC rule also amends the audit requirements for over-the-counter derivative dealers to permit them to file, as part of their annual audits, a supplemental report regarding the firm's internal risk management control systems based on agreed-upon procedures rather than auditing standards.

These rules became effective on August 20, 2004. See SEC Release Nos. 34-49830 at http://www.sec.gov/rules/final/34-49830.htm and 34-49831 at http://www.sec.gov/rules/final/34-49831.htm for more information.

Regulation National Market System

In February 2004, the SEC published for public comment Regulation National Market System (NMS), which contains four interrelated proposals designed to modernize the regulatory structure of the U.S. equity markets. The topics addressed by proposed Regulation NMS are (1) trade-throughs, (2) intermarket access, (3) subpenny pricing, and (4) market data.

Trade-Throughs

Regulation NMS would establish a uniform trade-through rule for all market centers that would affirm the fundamental principle of price priority, while also addressing problems posed by the inherent difference in the nature of prices displayed by automated markets, which are immediately accessible, compared to prices displayed by manual markets, which are not.

Specifically, the proposal would require SROs, as well as any market center that executes orders, to establish procedures to prevent the execution of an order for national market system stocks at a price that is inferior to the best bid or offer displayed by another market center at the time of execution. At the same time, the proposal would include two exceptions to the general trade-through rule.

1. A market center would be allowed to execute an order that trades through a better-priced bid or offer on another market center if the person entering the order makes an

informed decision to affirmatively opt out of the trade-through protections. Informed consent would need to be given on an order-by-order basis. This exception is designed to provide greater flexibility to informed traders while preserving the average customer's expectation of having his or her orders executed at the best price.

2. An automated market, one that provides for an immediate automated response to incoming orders for the full size of its best displayed bid or offer, without restriction, would be able to trade through a better displayed bid or offer on a nonautomated market up to a de minimis amount of one to five cents, depending on the stock's price. This exception reflects the comparative difficulty of accessing market quotes of nonautomated markets.

Overall, the proposal is designed to be a practical response to developments in the marketplace that still preserves the important customer protection and market integrity goals of best execution and the protection of limit orders. The proposed trade-through rule would not change a broker-dealer's existing duty to obtain best execution for customer orders.

Intermarket Access

Regulation NMS addresses the need for non-discriminatory access, quote standardization, locked and crossed markets, and sub-penny pricing, as described in the following sections.

Non-Discriminatory Access. Regulation NMS would establish a uniform market access rule that would help assure non-discriminatory access to the best prices displayed by market centers, but without mandating inflexible, "hard" linkages such as the Intermarket Trading System (ITS). The proposal would prohibit a market center from imposing unfairly discriminatory terms that prevent or inhibit any person from accessing its quotations indirectly through a member, customer, or subscriber.

Quote Standardization. Regulation NMS also would establish an access fee standard. This standard is intended to harmonize quotations and facilitate the ready comparison of quotes across the national market system. The proposal would establish a *de minimis* fee standard for all market centers and broker-dealers that display attributable quotes through SROs. Specifically, access fees would be capped at $0.001 per share, and the aggregation of this fee would be limited to no more than $0.002 per share in any transaction.

Locked and Crossed Markets. The proposed rule would require each SRO to establish and enforce rules requiring its members to avoid—and prohibiting them from engaging in a pattern or practice of—locking or crossing the markets.

Sub-Penny Pricing

Regulation NMS would ban sub-penny quoting in most stocks. Specifically, it would prohibit market participants from accepting, ranking, or displaying orders, quotes, or indications of interest in a pricing increment finer than a penny in national market system stocks, other than those with a share price below $1.00.

Market Data

Regulation NMS would amend the existing arrangements for disseminating market data in order to better reward SROs for their contributions to public price discovery, as well as implement most of the recommendations of the SEC's Advisory Committee on Market Information. Under existing rules and joint industry plans, the trades and best quotes in thousands of listed and NASDAQ stocks are made available on a real-time and consolidated basis. The proposal would:

- Replace the current plan formulas for allocating revenues derived from market data fees to the SROs, which are based solely on the number of trades or share volume reported by an SRO.
- Broaden participation in plan governance by creating advisory committees composed of non-SRO representatives.
- Authorize market centers to distribute their own additional data, such as limit order books, separate from other

markets, as well as establish uniform standards for the terms of such distribution.

Please see Release No. 34-49325 at http://www.sec.gov/rules/proposed/34-49325.htm for more information.

Ban on Directed Brokerage

In 2004, regulators continued addressing conflicts of interest in mutual funds focusing among other things on the business arrangements between brokerage firms and fund companies under which brokers agree to promote the fund company's products in exchange for the fund company directing its trading activity to the brokerage firm.

SEC Rule

Last year, the SEC conducted a review of current brokerage practices and found that the use of brokerage commissions to facilitate the sale of fund shares is widespread among funds that rely on broker-dealers to sell fund shares. In some cases, transactions are directed to selling brokers. In other cases, in which the selling broker lacks capacity to execute fund securities transactions, fund advisers will cause the fund to enter into "step out" and other types of arrangements under which a portion of the commission is directed to the selling brokers. Fund advisers and selling brokers keep track of the value of directed brokerage, and if an insufficient amount of brokerage is directed to a selling broker, the broker may require compensation from the adviser. If the compensation that a selling broker receives for distributing shares of a fund (or a fund complex) falls below agreed-upon levels, the selling broker may reduce its selling efforts for the funds.

After reviewing the current directed brokerage practices in September 2004, the SEC adopted amendments to the rule under the Investment Company Act of 1940 that governs the use of assets of open-end management investment companies (termed *funds*) to distribute their shares.

Rule 12b-1(h)(1) prohibits funds from compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions to that broker. The prohibition applies both to directing transactions to selling brokers, and to indirectly compensating selling brokers by participation in step-out and similar arrangements in which the selling broker receives a portion of the commission. The SEC adopted these prohibitions because the practice of trading brokerage for sales of fund shares may harm investors in mutual funds by: (1) adversely affecting decisions on how and where to effect portfolio securities transactions, or how frequently to trade portfolio securities; (2) allowing fund advisers and brokers to circumvent the NASD rules on excessive sales charges; (3) diminishing the transparency of fund distribution costs; and (4) creating conflicts of interest between broker-dealers and their customers.

Nevertheless, the SEC recognizes that many funds are likely to find that, for some portfolio transactions, the broker-dealer who can provide best execution also distributes the fund's shares. The prohibitions adopted by the SEC are not intended to compromise best execution. Nevertheless, the fact that a selling broker provides best execution would not cure a violation of the prohibition on funds or their advisers directly or indirectly compensating the broker for promoting fund shares with payments from portfolio transactions. Rule 12b-1(h)(2) permits a fund to use its selling broker to execute transactions in portfolio securities only if the fund or its adviser has implemented policies and procedures designed to ensure that its selection of selling brokers for portfolio securities transactions is not influenced by considerations about the sale of fund shares.

The effective date of the amendments is October 14, 2004, and the date by which funds must comply with the new requirements is December 13, 2004. For more information, please refer to the rule entitled "Prohibition on the Use of Brokerage Commissions to Finance Distribution," Release No. IC-26591, on the SEC Web site at http://www.sec.gov/rules/final/ic-26591.htm.

NASD Proposed Rule

The NASD also has proposed a corresponding change to its rules. Under the proposed rule change, the NASD would eliminate the provision of the Anti-Reciprocal Rule that allows NASD members to sell shares of funds that follow a disclosed policy of considering the sale of fund shares in the selection of executing brokers. See "Proposed Amendment to Rule Relating to Execution of Investment Company Portfolio Transactions," NASD Rule Filing 2004-027 at http://www.sec.gov/rules/sro/nasd/34-50611.pdf.

Rules Proposed by the SEC on Sales-Related Disclosures

Many in the financial sector believe that banning directed brokerage will result in an increase in revenue-sharing arrangements, in which an investment adviser or other offeror agrees to pay a broker-dealer cash compensation or reimburse expenses for distribution of the investment company's shares. In return, mutual funds often receive a place on a list of funds that a broker-dealer most commonly offers, referred to as *shelf space*. However, regulators believe that properly disclosed revenue sharing payments present more manageable conflicts for funds and broker-dealers than directed brokerage.

To address the disclosures of revenue sharing arrangements as well as other conflicts of interest, in February 2004, the SEC proposed two rules in the release entitled "Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendment to the Registration Form for Mutual Funds." These rules would require broker-dealers to provide their customers with specific information, at the point of sale and in transaction confirmations, regarding the costs and conflicts of interest that arise from the distribution of fund shares. Among other things, broker-dealers would be required to disclose their compensation for selling mutual funds, and to disclose information about revenue-sharing arrangements that create conflicts of interest for them. Moreover, the proposed rules would require broker-dealers to inform customers about whether their salespersons or other associated persons receive extra compensation for selling certain fund shares or fund share classes. In addition to mutual funds, the proposed rules would also require broker-dealers to disclose the costs and conflicts of interest that arise from the distribution of unit investment trust (UIT) interests (including insurance company separate accounts that offer variable annuity contracts and variable life insurance policies), and municipal fund securities used for education savings (commonly called 529 plans). Because the SEC prohibited the payment of brokerage commissions to finance fund share distribution, funds will no longer be able to pay for share distribution with brokerage commissions. Thus, the SEC will consider the effect of this prohibition when evaluating any further action with regard to disclosures of brokerage commissions associated with portfolio securities transactions. These proposed rules may be viewed at the SEC Web site at http://www.sec.gov/rules/proposed/33-8358.htm.

Application of the Investment Advisers Act to Certain Broker-Dealers

On November 4, 1999, the SEC proposed a rule to address the application of the Investment Advisers Act of 1940 (the Advisers Act) to brokers offering full service brokerage service, including advice, for a fee based on the amount of assets in customers' accounts, instead of traditional commissions, mark-ups and mark-downs. Brokers who charge their customers asset-based fees may be subject to regulation under the Advisers Act, as well as the Exchange Act. The proposed rule would keep broker-dealers from being subject to the Advisers Act when they offer these programs. However, the SEC never formally adopted the proposal, but permitted brokers to operate as if it were law. In July of 2004, the Financial Planning Association (FPA) sued the SEC for violating administrative procedures by allowing the rule to go into effect without formally voting on it. Financial planners believe that broker-dealers that provide financial advice should be considered fiduciaries and held to the same strict standards as financial planners. As a result, in August 2004, the SEC reopened the proposed rule for public comment.

The proposed rule makes the nature of the services provided, rather than the form of compensation, the primary factor in determining whether the Advisers Act applies. Under the proposed rule, if the broker does not have discretionary authority to trade securities in an account, the Advisers Act generally would not apply to that account. If the broker does have discretionary authority and charges an asset-based fee, the account would be subject to the Advisers Act.

The comment period closed on September 22, 2004 and the SEC intends to reach a final decision on the proposal by December 31, 2004. For more information please refer to the SEC Web site at http://www.sec.gov/rules/proposed/34-50213.htm (August 18, 2004) and http://www.sec.gov/rules/proposed/34-42099.htm (November 4, 1999).

SEC Regulations

Certain SEC regulations are discussed in the "Economic and Industry Developments" section of this Alert in detail due to the significance of their impact on broker-dealers. In addition to reading about the regulatory matters presented below, see the AICPA general *Audit Risk Alert — 2004/05* and the AICPA *Independence and Ethics Alert — 2004/05* for a discussion of some of the most important SEC regulations that have been issued recently that affect many industries, including the securities industry. Also, auditors should visit the SEC Web site at www.sec.gov to inform themselves about recent SEC rulemaking activities.

The following is a summary of some of the rules that the SEC issued since the writing of last year's Audit Risk Alert. For convenience, the rules were grouped into the following three categories: Rulemaking Related to Electronic Filing, Amendments to the Securities Exchange Act of 1934, and Other Rulemaking.

Rulemaking Related to Electronic Filing

- *Adoption of Updated EDGAR Filer Manual.* In August 2004, the SEC adopted revisions to the Electronic Data Gathering, Analysis, and Retrieval System (EDGAR) Filer Manual to reflect updates to the EDGAR system. The revisions are being made primarily to support the redesign of Form 8-K. Effective date: August 23, 2004. See Release No. 33-8454 for more information.

- *Mandated Electronic Filing for Form ID.* In April 2004, the SEC adopted rule and form amendments to mandate the electronic filing of Form ID on a new on-line system. Form ID is the application for access codes to file on EDGAR. Effective date: April 26, 2004. See Release No. 33-8410 for more information.

- *Adoption of Updated EDGAR Filer Manual.* In March 2004, the SEC adopted revisions to the EDGAR Filer Manual to reflect updates to the EDGAR system. The revisions were made primarily to support the mandatory electronic filing of Form ID. Effective date: April 26, 2004. See Release No. 33-8409 for more information.

Amendments to the Securities Exchange Act of 1934

- *Proposed Rule Changes of Self-Regulatory Organizations.* In October 2004, the SEC adopted rule amendments that require SROs to file proposed rule changes electronically with the SEC, rather than in paper form. In addition, the SEC requires SROs to post all proposed rule changes, as well as current and complete sets of their rules, on their Web sites. The SEC also requires all participants in National Market System Plans (NMS Plans) to arrange for posting on a designated Web site a current and complete version of the NMS Plan. Finally, the SEC made certain technical amendments to the requirements for SRO rule changes. Together, the amendments are designed to modernize the SRO rule filing process by making it more efficient and cost effective. Effective date: November 8, 2004, except for certain sections which will become effective on May 9, 2005. See Release No. 34-50486 for more information.

- *Rule 15c3-3 Reserve Requirements for Margin Related to Security Futures Products*. In August 2004, the SEC adopted amendments to the formula for determination of customer reserve requirements of broker-dealers under the Exchange Act to address issues related to customer margin for security futures products. The amendments permit a broker-dealer to include margin related to security futures products written, purchased, or sold in customer securities accounts required and on deposit with a registered clearing agency or a derivatives clearing organization as a debit item in calculating its customer reserve requirement under specified conditions. The amendments are intended to help ensure that a broker-dealer is not required to fund its customer reserve requirements with proprietary assets. In addition, the SEC adopted a rule amendment delegating authority to the Director of the Division of Market Regulation to provide relief, under certain circumstances, from the conditions under which margin related to customer security futures products margin may be included as a debit item. Effective date: thirty days after publication in the Federal Register. See Release No. 34-50295 for more information.

- *Short Sales.* In July 2004, the SEC adopted new Regulation SHO, under the Exchange Act, which defines ownership of securities, specifies the aggregation of long and short positions, and requires broker-dealers to mark sales in all equity securities "long," "short," or "short exempt." Regulation SHO also includes a temporary rule that establishes procedures for the SEC to suspend temporarily the operation of the current "tick" test and any short sale price test of any exchange or national securities association, for specified securities. Regulation SHO also requires short sellers in all equity securities to locate securities to borrow before selling, and also imposes additional delivery requirements on broker-dealers for securities in which a substantial number of failures to deliver have occurred. The SEC also adopted amendments that remove the shelf offering exception, and issued interpretive guidance addressing sham transactions designed to evade Regulation M. Effective date: September 7, 2004 with some exceptions. See Release No. 34-50103 for the compliance date and other information.

- *Collection Practices Under Section 31 of the Exchange Act.* See the discussion of this rule in the "Collection Practices under Section 31 of the Exchange Act" section.

- *Supervised Investment Bank Holding Companies*. See the discussion of this rule in the "Supervision Programs for Broker-Dealers and Affiliates" section.

- *Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities*. See the discussion of this rule in the "Supervision Programs for Broker-Dealers and Affiliates" section.

- *Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date.* In March 2004, the SEC expanded the number of events that are reportable on Form 8-K under the Exchange Act. These amendments added eight new items to the form, including the creation of a material direct financial obligation or material obligation under an off-balance sheet arrangement, material costs associated with exit or disposal activities, and material impairments (e.g., securities impairments and goodwill). Judgment will be required as to what constitutes a material obligation, arrangement, or impairment. The amendments also shorten the Form 8-K filing deadline for most items to four business days after the occurrence of an event triggering the disclosure requirements of the form. Finally, the SEC adopted a limited safe harbor from liability for failure to file certain of the required Form 8-K reports. Disclosures are expanded for departures of directors or principal officers, election of directors, or appointment of principal officers and amendments to the registrant's articles of incorporation or bylaws and change in fiscal year. The release transfers two disclosure items related to unregistered sales of equity securities by a company and material modifications to the rights of holders of a company's securities from Form 10-K/10-Q to Form 8-K. Effective date: August 23, 2004. See Release Nos. 33-8400 and 34-49424 for more information. On August 4, the SEC made technical corrections to rules adopted in Release No. 33-8400. See Release No. 33-8400A for more information.

- *Delegation of Authority to the Director of the Division of Market Regulation.* In February 2004, the SEC amended its Rules of Practice to delegate its authority to the Director of the Division of Market Regulation to grant or deny exemptions from the rule filing requirements of Section 19(b) of the Exchange Act pursuant to Section 36 of the Exchange Act, in cases of an SRO incorporating by reference the rules of another SRO. See Release No. 34-49259 for more information.

- *Recordkeeping Requirements for Registered Transfer Agents.* In December 2003, the SEC amended its rule concerning recordkeeping requirements for registered transfer agents. The amendments make clear that registered transfer agents may use electronic, microfilm, and microfiche media as a substitute for hard copy records, including cancelled stock certificates, for purposes of complying with the SEC's transfer agent recordkeeping rules and that a third party on behalf of a registered transfer agent may place into escrow the required software information. Effective date: January 28, 2004. See Release No. 34-48949 for more information.

- *Processing Requirements for Cancelled Security Certificates.* In December 2003, the SEC revised its rules governing cancelled securities certificates to improve the processing of securities certificates by transfer agents. The SEC adopted a new rule under the Exchange Act that requires every transfer agent to establish and implement written procedures for the cancellation, storage, transportation, destruction, or other disposition of securities certificates. This rule requires transfer agents to mark each cancelled securities certificate with the word *cancelled*; maintain a secure storage area for cancelled certificates; maintain a retrievable database of all of its cancelled, destroyed, or otherwise disposed of certificates; and have specific procedures for the destruction of cancelled certificates. Additionally, the SEC amended its lost and stolen securities rule and its transfer agent safekeeping rule to make it clear that these rules apply to unissued and cancelled certificates. Effective date: January 24, 2004. See Release No. 34-48931 for more information.

- *Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors.* In November 2003, the SEC adopted new disclosure requirements and amendments to existing disclosure requirements to enhance the transparency of the operations of boards of directors. Specifically, the SEC adopted enhancements to existing disclosure requirements regarding the operations of board nominating committees and a new disclosure requirement concerning the means, if any, by which security holders may communicate with directors. Effective date: January 1, 2004. See Release No. 33-8340 for more information.

- *Purchases of Certain Equity Securities by the Issuer and Others.* In November 2003, the SEC adopted amendments to Rule 10b-18 under the Exchange Act, which provides issuers with a "safe harbor" from liability for manipulation when they repurchase their common stock in the market in accordance with the rule's manner, timing, price, and volume conditions. The amendments are intended to simplify and update the safe harbor provisions in light of market developments since the rule's adoption. To enhance the transparency of issuer repurchases, the SEC also adopted amendments to a number of regulations and forms to require disclosure of all issuer repurchases (open market and private transactions), regardless of whether the repurchases are effected in accordance with the safe harbor rule. Effective date: December 17, 2003 with certain exceptions. See Release No. 33-8335 for more information.

Other Rulemaking

- *Prohibition on the Use of Brokerage Commissions to Finance Distribution.* See the discussion of this rule in the "Ban on Directed Brokerage" section.

- *Covered Securities Pursuant to Section 18 of the Securities Act of 1933.* In July 2004, the SEC adopted an amendment to a rule under Section 18 of the Securities Act of 1933 (the Securities Act) to designate options listed on the International Securities Exchange, Inc. (ISE) as covered securities. Covered securities under Section 18 of the Securities Act are exempt from state law registration requirements. Effective date: August 19, 2004. See Release No. 33-8442 for more information.

Other Recent SEC Developments

The following is a brief discussion of some other SEC developments that might be of interest to broker-dealers and their auditors.

SEC Staff Legal Bulletin[6]

SLB No. 17, Remote Office Supervision. In March 2004, the Division of Market Regulation of the SEC released Staff Legal Bulletin (SLB) No. 17, *Remote Office* Supervision, to remind broker-dealers of their responsibilities in supervising remote offices. Although the bulletin is not a rule, regulation or statement of the SEC, the bulletin describes certain supervisory tools that are characteristic of good supervisory procedures. The staff has reached these conclusions based on staff examinations and recent SEC enforcement cases.

Among the staff recommendations are the following:

- Use unannounced onsite inspections.
- Use centralized, offsite technology to monitor the trading and handling of funds, and the use of personal computers.
- Have an explicit delineation of the supervisory hierarchy, including the designation of a direct supervisor for each representative.

6. Staff Legal Bulletins summarize the SEC staff's views regarding various aspects of the federal securities laws and SEC regulations. They represent interpretations and policies followed by the Divisions of Corporation Finance, Market Regulation, or Investment Management on any given matter. Because they represent the views of the staff, staff legal bulletins are not legally binding.

- Carefully review NASD Forms U-4 and U-5 when hiring representatives.
- Closely monitor outside business activities.
- Monitor and verify customer address changes.
- Establish direct customer correspondence to a central firm location.

SEC Concept Releases[7]

Enhancing Commission Filings Through the Use of Tagged Data. In September 2004, the SEC issued a concept release seeking comments on the use of tagged data in certain filings pursuant to the Exchange Act and Investment Company Act of 1940. Data tagging provides a method for searching, retrieving, and analyzing information through automated means. As part of the SEC's initiative to improve the filing, information collection and disclosure process, the SEC is seeking to determine the impact and usefulness of tagged data generally, and more specifically the adequacy and efficacy of eXtensible Business Reporting Language (XBRL) as a format for reporting financial information. The comment period ended November 15, 2004. There have been no further developments with respect to this topic since the closure of the comment period.

Securities Transactions Settlement. On March 11, 2004, the SEC issued this concept release seeking comment on methods to improve the safety and operational efficiency of the U.S. clearance and settlement system and to help the U.S. securities industry achieve straight-through processing. First, the SEC requested comment on whether the SEC should adopt a new rule or the self-regulatory organizations should be required to amend their existing rules to require the completion of the confirmation and affirmation process on trade date (T+0) when a broker-dealer provides delivery-versus-payment or receive-versus-payment privileges to a customer. Second, the SEC requested comment on the

7. The SEC occasionally publishes "concept" releases to solicit the public's views on securities issues so that it can better evaluate the need for future rulemaking.

benefits and costs associated with implementing a settlement cycle for most broker-dealer transactions that is shorter than three days (T+3). Third, the SEC requested comment on reducing the use of physical securities. The comment period ended June 16, 2004. There have been no further developments with respect to this topic since the closure of the comment period.

Competitive Developments in the Options Markets. On February 3, 2004, the SEC issued the concept release which discusses changes in the options markets that have occurred since the start of widespread multiple trading of options that have had the greatest impact on competition. It also seeks comment on whether the SEC should take any action to improve the efficiency of the options markets and mitigate the conflicts of interest that may be impeding price competition in those markets. The comment period ended April 9, 2004. There have been no further developments with respect to this topic since the closure of the comment period.

SEC Interpretive Releases[8]

Commission Guidance Regarding the Public Company Accounting Oversight Board's Auditing and Related Professional Practice Standard No. 1. On May 14, 2004, the SEC approved PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board,* (AICPA, *Professional Standards*, vol. 1, PC sec. 130), and also issued an interpretive release to help with its implementation. The SEC's interpretive release is designed to assist the PCAOB, registrants, auditors, and investors by, among other things, addressing certain transitional implementation issues and clarifying the impact of Auditing Standard No. 1 on existing references in the SEC rules and regulations to generally accepted auditing standards (GAAS). The release specifies that effective May 24, 2004, references in SEC rules and staff guidance and in the

8 The SEC from time to time will provide guidance relating to topics of general interest to the business and investment communities by issuing an "interpretive release," in which it publishes its views on the subject matter and interprets the federal securities laws and its own regulations. The SEC Interpretive Releases are available on the SEC Web site at www.sec.gov.

federal securities laws to GAAS or to specific standards under GAAS, as they relate to issuers, should be understood to mean the standards of the PCAOB, plus any applicable rules of the SEC. The guidance in this release is applicable only to auditors' engagements that are governed by PCAOB rules. Effective date of interpretation: May 14, 2004. See Release No. 33-8422 for more information.

Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations. In December 2003, the SEC published interpretive guidance regarding the disclosure commonly known as Management's Discussion and Analysis of Financial Condition and Results of Operations, or MD&A, which is required by Item 303 of Regulation S-K, Items 303(b) and (c) of Regulation S-B, Item 5 of Form 20-F and Paragraph 11 of General Instruction B of Form 40-F. This guidance is intended to elicit more meaningful disclosure in MD&A in a number of areas, including the overall presentation and focus of MD&A, with general emphasis on the discussion and analysis of known trends, demands, commitments, events and uncertainties, and specific guidance on disclosures about liquidity, capital resources, and critical accounting estimates. Effective date of interpretation: December 29, 2003. See Release No. 33-8350 for more information.

Commission Guidance on Rule 3b-3 and Married Put Transactions. In November 2003, the SEC published interpretive guidance on calculating a "net long" position under the Exchange Act when using married put transactions as a part of certain trading strategies. A seller of securities is required to aggregate all of its positions in that security to determine the seller's net long position. Determining security ownership is an essential component to aggregating security positions under the Exchange Act. The guidance clarifies the determination of security ownership when married put transactions are used. Effective date of interpretation: November 21, 2003. See Release No. 34-48795 for more information.

SEC Policy Statements[9]

Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities. On May 19, 2004, the Office of the Comptroller of the Currency, Treasury (OCC), Office of Thrift Supervision, Treasury (OTS); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); and SEC (collectively, the Agencies) requested public comment on a proposed interagency statement concerning the complex structured finance activities of financial institutions (national and state banks; bank holding companies; federal and state savings associations; savings and loan holding companies; and SEC-registered broker-dealers and investment advisors) supervised by the Agencies. As recent events have highlighted, a financial institution may assume substantial reputational and legal risk if the institution enters into a complex structured finance transaction with a customer and the customer uses the transaction to circumvent regulatory or financial reporting requirements, evade tax liabilities, or further other illegal or improper behavior. The proposed interagency statement (the Statement) describes the types of internal controls and risk management procedures that the Agencies believe are particularly effective in assisting financial institutions to identify and address the reputational, legal, and other risks associated with complex structured finance transactions. The Statement, among other things, provides that financial institutions should have effective policies and procedures in place to identify those complex structured finance transactions that may involve heightened reputational and legal risk, to ensure that these transactions receive enhanced scrutiny by the institution, and to ensure that the institution does not participate in illegal or inappropriate transactions. The comment period ended July 19, 2004.

[9] From time to time, the SEC issues a “policy statement” to clarify its position on a particular matter.

SEC Special Studies[10]

Report on Transactions in Municipal Securities. Issued on July 1, 2004, the report examines various characteristics of the more than 7 million transactions in municipal securities, aggregating \$2.6 trillion, that took place between November 1, 1999, and October 31, 2000, and of the \$2 trillion of municipal securities that were outstanding during that period. The report provides summary information on spreads, trading volume and turnover, and the variation in prices received (or paid) by customers purchasing the same municipal security on the same day. The report also examines transaction activity classified by various characteristics of the bond, including interest rate type (fixed, variable or zero), issuance amount, insured status, rating, and maturity and includes information on other topics that may be of use in analyzing and understanding municipal securities markets.

Joint SEC/NASD Staff Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products. Please refer to the "Variable Annuities" section of this Alert for a brief discussion of this report.

SEC Speeches

The Vital Role of Effective Comprehensive Compliance Controls at Broker-Dealers. On February 4, 2004, Mary Ann Gadziala, Associate Director in the Office of Compliance Inspections and Examinations at the SEC, emphasized the importance of the development and implementation of effective comprehensive compliance programs for broker-dealers at the Bond Market Association's Ninth Annual Legal and Compliance Conference.

The speaker discussed the SEC's comprehensive compliance examination and indicated that it covers five key areas:

- Compliance culture, including Board and senior management involvement in compliance
- Structure, functions, and coverage of the compliance program

[10] The SEC or SEC staff often undertake special projects to study and report on current trends and issues facing the securities industry.

- Written supervisory procedures and supervision
- Employee hiring, registration, training; and personal trading
- Firm oversight of compliance risks

Effective Branch Office Supervision Fosters Investor Protection. On July 13, 2004, Mary Ann Gadziala gave the keynote address at the NASD Branch Office Supervision Conference. In her speech, she stated that creating, implementing, and maintaining an effective branch supervision program is a crucial aspect of a firm's compliance program.

A branch supervision program needs to include the following:

- Well-written and comprehensive policies and procedures, tailored to the firm's business, that are effectively implemented.
- The program should be under constant review and updated and improved as appropriate.
- The program should also consider and incorporate best practices.

Firms should also have:

- Qualified staff and adequate resources dedicated to compliance and supervision
- Appropriate systems and controls to monitor compliance and confirm that any responsibility to supervise is being diligently exercised
- Ability to detect concerns and weaknesses and address problems promptly

Some of the key areas that should be covered by branch office supervision are:

- Safeguarding customer funds and securities
- Maintaining books and records
- Communications with customers

- Supervision of customer accounts
- Transmittal of customer funds
- Validation of customer account information

Ms. Gadziala also highlighted certain aspects of a recently issued SLB No. 17, which discusses supervisory tools that, based on SEC examinations and enforcement actions, are characteristic of good supervisory procedures.

Ms. Gadziala also emphasized that regulators cannot conduct on-site exams of every branch office on a regular basis. It is the firm's responsibility to do this for all of its offices. Unless each firm conducts effective supervision and routine oversight at all offices of the firm, small problems could go undetected and escalate into big problems for the firm.

Commodity Futures Trading Commission Regulations

The following is a summary of some of the rulemaking of the CFTC in late 2003 and during 2004 and other current issues that may be of interest to the accounting industry with respect to financial reporting for futures commission merchants. The complete text of these rules, along with other CFTC final rules, including rules adopted and changes made subsequent to the publication of this Audit Risk Alert, can be downloaded from the CFTC's Web site at www.cftc.gov.

Amendments to financial and related reporting requirements for futures commission merchants and introducing brokers. The CFTC regulations required futures commission merchants (FCMs) to maintain minimum adjusted net capital in an amount equal to the greatest of: (1) $250,000; (2) 4 percent of the customer funds required to be held in segregated and secured accounts by the FCM in accordance with the Commodity Exchange Act and CFTC regulations; (3) the amount of adjusted net capital required by a registered futures association of which the FCM is a member; or, (4) for those FCMs that are also registered as securities brokers or dealers with the SEC, the amount of net capital specified by SEC regulations. In 2004, the

CFTC adopted final margin-based, or risk-based, minimum adjusted net capital requirements for FCMs. See Federal Register 49784 (August 12, 2004), which replaced item (2) above with a risk-based requirement. The CFTC also adopted amendments to reporting requirements applicable to FCMs and introducing brokers (IBs). The following list summarizes rule amendments that implement the new risk-based capital requirements for FCMs, and that revise notice requirements regarding the FCM's or IB's books and records and accounting systems.

- Rule 1.17(a) was amended to replace that part of the minimum adjusted net capital requirement that had been based on customer funds with a computation based on the maintenance margin levels of the positions carried by the FCM for its customers (8 percent) and noncustomers (4 percent). *Noncustomers* are defined to generally include the accounts of certain employees of the FCM and the FCM's affiliates. This amendment mirrors risk-based capital rules that were previously adopted by a derivatives clearing organization, two exchanges, and a registered futures association, namely, the National Futures Association.

- The following three rules were amended to reflect conforming changes for percentage limits related to the risk-based capital computation: Rule 1.12(b), which establishes "early warning" capital levels for FCMs; Rule 1.17(e), which imposes limitations on withdrawals of a firm's equity capital, and Rule 1.17(h), which sets forth the minimum and nonexclusive requirements for a firm's "satisfactory subordination agreements." Prior to their amendment, each of these rules included capital computations that were based on specified percentages of customer funds held in segregated and secured accounts. The new computations in these rules are based on specified percentages of the FCM's margin-based minimum adjusted net capital requirement, although the minimum dollar amount of "early warning" capital level remains the same at $375,000. FCMs that entered into satisfactory subordination agreements prior to the effective date of these amended rules

(September 30, 2004) are not required to revise the documents to reflect the amendments made to Rule 1.17(h), until such documents are otherwise amended or renewed.

- Rules 1.10(b) and (c) were also amended to require that introducing brokers file reports, including annual audited financial statements and schedules, solely with the NFA.
- Rules 1.12(c) and 1.12(d) were amended to shorten to 48 hours from 5 business days the time period in which an FCM or IB must provide a report of the actions it has taken, or is taking, to correct (i) a failure to maintain its books and records currently or (ii) a material inadequacy in its accounting systems. In addition, an FCM or IB must provide notice to the CFTC within 48 hours (formerly three business days) when it discovers a material inadequacy in its accounting systems. The revised time periods are the same as those applicable to securities brokers and dealers under similar SEC rules.

Investment of Customer Funds. During 2004, the CFTC amended Rule 1.25 governing the permissible investments of customers funds held by futures commission merchants (FCMs) and derivatives clearing organizations (DCOs) in two respects. See Federal Register 6140 (February 10, 2004). First, the CFTC adopted a new paragraph (a)(2)(ii) to permit FCMs and DCOs to enter into repurchase agreements using customer-deposited securities, subject to certain safeguards. The new requirements supersede CFTC Letter 84-24, which previously governed repurchase agreements using customer-deposited U.S. Treasury Bills. Second, the CFTC amended its portfolio time-to-maturity requirements under Rule 1.25(b)(5), adding paragraph (ii) to permit certain instruments to be treated as if they had a time-to-maturity of one day. This amendment was adopted to encourage and to accommodate the development of innovative collateral management programs at DCOs. The CFTC is considering additional amendments to the customer investment provisions of Rule 1.25, but no amendments were proposed as of the publication of this Alert.

1-FR Instructions Manual. In connection with the CFTC's adoption of the amendments to its minimum net capital and related financial reporting requirements set forth in Rule 1.17 and Rule 1.12 in 2004, the CFTC also revised its Form 1-FR-FCM effective September 30, 2004, to implement the change in the minimum capital calculation for futures commission merchants, and released an updated Instruction Manual to the Form 1-FR-FCM. In addition to the changes made with respect to the minimum capital calculation under Rule 1.17 and the notice requirements of Rule 1.12, the updated Instruction Manual now incorporates prior-year rule changes with respect to permissible investments of segregated funds under Rule 1.25 and the denomination of segregated funds in foreign currencies under Rule 1.49. The new Instructions Manual also provides additional clarification on FCM financial reporting topics that have been the source of implementation questions or that have arisen with respect to rule amendments adopted by the CFTC, some of which are highlighted below.

- *Consolidated Financial Report—Adjustments to eliminate benefits of consolidation.* The requirements for accounting consolidation of subsidiaries and affiliates are contained in CFTC Rule 1.17, but with respect to the recognition of a net capital benefit from such consolidation, any benefit that qualifies for recognition shall not be counted toward a registered FCM's fulfillment of its minimum required capital, but shall only be counted as an increase in the consolidated excess net capital. Also, a consolidated financial report should always clearly identify and exclude from consolidated net capital the value of any third-party or minority equity interests or ownership in a subsidiary that is not wholly owned.

- *Securities Purchased Under Resale Agreements* and Page 7-4, Line 13 Charges against repurchase and reverse repurchase transactions. In applying any reductions to the charge allowed under SEC Rule 240.15c3-1(c)(2)(iv)(F), FCMs should not reduce deficits in reverse repurchase agreements made with house or noncustomer funds with excess collateral under any repurchase agreements or reverse repurchase agreement with the same counterparty but made as permitted investments from segregated customer funds pursuant to Rule 1.25.

- *Investments in Subsidiaries.* The CFTC's Division of Clearing and Intermediary Oversight has interpreted that under specified conditions, an FCM with a wholly owned subsidiary which is also a registered FCM may file an unconsolidated financial report that includes its interest in the subsidiary as a one-line asset. The consolidation must result in a flow-through net capital benefit to the parent, and the parent may then reflect its net investment in the subsidiary, less the flow through net capital benefit, as a noncurrent asset, and separately report the flow through benefit as a current asset on Line 16 of the Balance Sheet of Form 1-FR-FCM. If more than one FCM subsidiary is reported through one-line consolidation, the parent must provide a supplemental schedule reconciling the balance to the investment in each subsidiary. The parent FCM must also provide supplemental schedules detailing the calculation of the flow through capital benefit reported and reconciling the adjusted net capital of the subsidiary FCM to the amount of the flow-through capital benefit claimed. One-line consolidation in lieu of full consolidation of all accounts will not be accepted for year-end audited financial statements.

- ***Customer Cross-Margin Accounts.*** An FCM must prepare daily a separate segregation statement for accounts carried for customers who are cross-margining their commodity futures/options and securities options positions. The FCM should prepare one cross-margin segregation statement for all of its cross-margin customers. In completing its Form 1-FR-FCM, an FCM should combine balances in cross-margin and non-cross-margin accounts in one Statement of Segregation Requirements and Funds in Segregation for Customers Trading on U.S. Commodity

Exchanges. An FCM is required to maintain sufficient funds in segregated cross-margin deposit accounts for its cross-margin customers at all times. Excess segregated cross-margin funds cannot be used to offset a deficiency in funds segregated for non-cross-margin customers. Likewise, excess funds in segregation for non-cross-margin customers cannot be used to offset a deficiency in funds segregated for cross-margin customers.

Minimum Net Capital for Forex Dealers Based on Off Exchange Forex Transactions With Retail Customers. In December 2003, the National Futures Association (NFA) adopted a rule requiring Forex Dealer Members to maintain adjusted net capital equal to or in excess of the greatest of (1) $250,000; (2) 1 percent of the total net aggregate notional value of all open foreign currency futures and options transactions in customer and noncustomer (but not proprietary) accounts that are between the Forex Dealer Member and a person that is not an eligible contract participant as defined in Section 1a(12) of the Commodity Exchange Act and that are not executed on a contract market, a derivatives transaction execution facility, a national securities exchange registered pursuant to Section 6(a) of the Exchange Act, or a foreign board of trade; or (3) any other amount required under NFA's financial requirements.

In addition, in December 2003 and effective June 2004, the NFA adopted another rule requiring Forex Dealer Members that do not hold twice the amount of required capital under the minimum capital rule to collect minimum security deposits from their retail off-exchange customers based on the notional value of their transactions.

Commodity Futures Trading Commission Annual "Dear CPO" Letter

On January 22, 2004, CFTC staff issued its annual letter to commodity pool operators (CPOs) outlining key reporting issues and common reporting deficiencies found in annual financial reports for commodity pools. The letter emphasized the CFTC staff's concerns and, accordingly, may alert the auditor to high-risk issues that could affect assertions contained in the financial statements of commodity pools. CFTC staff suggested that CPOs share the letter with their independent auditors.

Major concerns addressed in the letter are:

- Applicability of GAAP to commodity pools' annual financial statements
- Non-U.S. GAAP reporting
- Reporting of investments in futures contracts in the condensed schedule of investments
- Fund-of-fund disclosures
- Master-feeder structures
- Audit opinion
- New pools—initial annual reports
- Final annual reports
- Recent changes to Part 4 of the Commission's regulations
- Common deficiencies noted during NFA's review of annual reports
- The Division of Clearing and Intermediary Oversight (DCIO) and NFA contact information

The letter also noted that CPOs may avoid some of the most common and easily remedied deficiencies by doing the following:

- File one copy of the report with the NFA. CPOs are no longer required to file copies of any such reports with the CFTC.
- File the report as soon as possible, but no later than the due date. For pools with a December 31, 2004, year-end, the due date is Thursday, March 31, 2005 (unless a time extension has been granted). CPOs operating a fund-of-funds pool should review the streamlined procedures described in CFTC Regulation 4.22(f)(2) for requesting

an extended due date. Reports that may require an extension of time for any other reason, or fund-of-funds pools that require a further extension of time, should contact the NFA and follow the provisions of CFTC Regulation 4.22(f)(1).

- Include a signed oath or affirmation, as required by CFTC Regulation 4.22(h), with each and every copy of the report, filed with NFA. Binding the oath as part of the report package or attaching it to the cover page is a helpful practice followed by a number of CPOs.

The current and all previously issued letters to commodity pool operators are available at the CFTC Web site at www.cftc.gov under the heading “Law & Regulation, Compliance.”

Self-Regulatory Organization Regulations

Under the Exchange Act, all broker-dealers are required to be members of SROs such as the NYSE and the NASD, or some other organization that is designated to perform routine surveillance and monitoring of its members. During the past year, a number of significant regulations were issued by SROs, including those described in the following sections.

NASD Rulemaking

- *Notice to Members 04-71—SEC Approves New Rules and Rule Amendments Concerning Supervision and Supervisory Controls.* On June 17, 2004, the SEC approved rule changes (Supervisory Control Amendments) by NASD that both create and amend certain rules and interpretive materials to address a member’s supervisory and supervisory control procedures. On September 30, 2004, the SEC granted accelerated approval to proposed rule changes to the Supervisory Control Amendments to conform certain parts of the new rule requirements to the NYSE’s recently approved internal control amendments. Effective Date: January 31, 2005.

- *Notice to Members 04-58—SEC Grants Accelerated Approval of Rule Change Relating to Transfers of Specifically Designated Customer Account Assets through the Automated Customer Account Transfer Service* (ACATS.) On July 14, 2004, the SEC granted accelerated approval of amendments to Rule 11870 making the procedures for transferring specifically designated customer account assets through the ACATS system consistent with the procedures for transferring securities account assets in their entirety through the ACATS system unless the customer authorizes a partial transfer of assets to be facilitated outside of ACATS. The amendments also permit customers to authorize an account transfer, in whole or in part, via electronic signature in a format recognized as valid under federal law to conduct interstate commerce. These changes conform to recent amendments to New York Stock Exchange Rule 412 and the Interpretation of Rule 412.
- *Notice to Members 04-38—NASD Reminds Member Firms of Their Obligations to Adhere to Credit Extension Requirements and Day Trading Margin Rules.* On March 11, 2004, NASD announced a disciplinary action that resulted in a $10 million fine against three firms for improperly extending credit in violation of Federal Reserve Board Regulation T and, in numerous instances, allowing trades that avoided NASD Rule 2520's day trading margin requirements (NASD actions). The NASD indicated that firms should familiarize themselves with the facts surrounding the NASD actions and review their own procedures to ensure that strong safeguards are in place relative to compliance with Regulation T and Rule 2520. In this regard, firms should also review the full text of Regulation T and Rule 2520, as well as related materials, to ensure full compliance with all credit extension provisions and day trading margin rules.
- *Notice to Members 04-37—SEC Approves Rules Requiring Members to Create Business Continuity Plans and Provide Emergency Contact Information.* On April 7, 2004, the SEC approved the new NASD Rule 3500 Series, which requires

members to establish emergency preparedness plans and procedures. Rule 3510 requires each member to create and maintain a business continuity plan and enumerates certain requirements that each plan must address. The rule further requires members to update their business continuity plans upon any material change and, at a minimum, to conduct an annual review of their plans. Each member also must disclose to its customers how its business continuity plan addresses the possibility of a future significant business disruption and how the member plans to respond to events of varying scope. Rule 3520 requires members to designate two emergency contact persons and provide this information to NASD via electronic process.

- *Notice to Members 04-33—Limited Net Capital Relief from the Reclassification of Certain Equity as Liabilities in Accordance with Statement of Financial Accounting Standards No. 150.* See the "Mandatorily Redeemable Instruments" section of this Alert for a brief discussion of this topic.
- *NASD Notice to Members 04-30—NASD Reminds Firms of Sales Practice Obligations In Sale of Bonds and Bond Funds.* See the "Developments in Fixed Income Markets" section of this Alert for a brief discussion of this Notice to Members.
- *Notice to Members 04-13—SEC Approves Amendments to Rule 2710*, Corporate Financing Rule, *and Rule 2720*, Distribution of Securities of Members and Affiliates—Conflicts of Interest. The approved amendments modernize and simplify the rules to better reflect the various financial activities of multiservice firms. The Corporate Financing Rule regulates underwriting compensation and prohibits unfair arrangements in connection with public offerings of securities. The rule requires members to file with NASD information about initial public offerings (IPOs) and certain secondary offerings. The Corporate Financing Department reviews this information prior to commencement of the offering to determine

whether the underwriting compensation and other terms and arrangements meet the requirements of applicable NASD rules.

- *Notice to Members 03-63—SEC Issues Guidance on the Recording of Expenses and Liabilities by Broker/Dealers.* See the "Broker-Dealer Expense-Sharing Agreements" section of this Alert for a discussion of this topic.

The rules are available at the NASD Web site at www.nasd.com.

Please be aware that to assist broker-dealers in complying with the SEC rules regarding financial and operational matters, NASD is now publishing certain interpretations provided by the staff of the Division of Market Regulation of the SEC on its Web site. Interpretations are being added monthly. You can view the interpretations at the following address http://www.nasd.com/stellent/idcplg?IdcService=SS_GET_PAGE&nodeId=289.

NYSE Rulemaking

- *Information Memo 04-38, Amendments to Rules 342, 401, 408 and 410 Relating to Supervisions and Internal Controls.* On June 17, 2004, the SEC approved amendments to NYSE rules to strengthen the supervisory procedures and internal controls of members and member organizations. To allow sufficient time for the adoption and establishment of necessary systems changes, an effective date of December 17, 2004, was set for compliance with the amendments. However, good business practice suggests compliance with many of the provisions as soon as possible. The amendments prescribe general standards with respect to internal controls via the addition of paragraph .23 to NYSE Rule 342, "Offices—Approval, Supervision and Control". Other amendments to Rule 342 and its Interpretation, as well as amendments to Rule 401, "Business Conduct;" Rule 408, "Discretionary Power in Customers' Accounts;" and Rule 410, "Records of Orders" are more specific in their focus and were developed in response to problems identified at member organizations in high-risk regulatory areas.

- *Information Memo 04-24, Rule 446—Business Continuity and Contingency Plans.* On April 7, 2004, the SEC approved NYSE Rule 446, "Business Continuity and Contingency Plans," which requires members and member organizations to establish and maintain business continuity and contingency plans.

- *Information Memo 04-23, Financial Accounting Standards Board Statement No. 150 — Temporary Relief On Calculation of Net Capital.* See the "Mandatorily Redeemable Instruments" section of this Alert for a brief discussion of this topic.

- *Information Memo 04-20, Amendments to Rule 412,* Customer Account Transfer Contracts, *and its Interpretation.* On March 12, 2004, the SEC approved amendments to Rule 412 and its Interpretation. The amendments mandate use of the ACATS system for *partial* transfers, unless otherwise specifically requested and authorized by a customer. *Partial or non-standard* transfers are instances in which *specifically designated assets* are transferred from an account held at one broker-dealer to an account held at another broker-dealer. In contrast, *standard* transfers are instances where account assets, *in their entirety*, are transferred from one broker-dealer to another broker-dealer. The amendments also require the utilization of all automated functionalities available through the ACATS system in connection with both standard and partial transfers. These include Partial Transfer Receive (PTR), Partial Transfer Delivery (PTD), Fail Reversal, Mutual Fund Fail Cleanup, and Reclaim Processing. In addition, the amendments clarify that electronic signatures are a potential means of customer authorization; clarify certain designated exceptions to transfer instructions; and eliminate the requirement that prescribed forms be used with respect to transfer instructions or reports.

- *Information Memo 03-49, Recording Certain Broker-Dealer Expenses and Liabilities.* See the "Broker-Dealer Expense-Sharing Agreements" section of this Alert for a discussion of this topic.
- *Information Memo 78-32, Section 11(a) of the Securities Exchange Act of 1934.* This Information Memo was issued in May of 1978. This brief discussion is included to emphasize its continuing importance. This memo discusses the business mix test requirements for members and member organizations wishing to effect transactions for proprietary accounts under Section 11(a)(1)(G) and Rule 11a-1-1(T). The Exchange will only rely upon statements of gross revenues, evidencing compliance with the business mix test, if they are covered by a report of outside auditors, evidencing that the statement was prepared in accordance with GAAP. If the Annual Audited Financial Statements are *not sufficiently detailed* to indicate business mix compliance, *a supplementary report must be filed*.

The NYSE is working on an Information Memo which will provide guidelines for introducing broker-dealers who act as principals to transactions in reverse repurchase or repurchase transactions and guidelines for their agent broker-dealers. The NASD is also expected to issue a similar Notice to Members to establish certain required risk management practices for introducing broker-dealers that engage in secured lending activities as principals.

The rules are available at the NYSE Web site at www.nyse.com.

NFA Rulemaking

NFA Pilot Program for Electronic Filing of Pool Financial Statements. The National Futures Association has developed EasyFile, a web-based system for CPOs to file their pool financial statements (PFS) electronically. The system will be available by early January, 2005 for the December 31, 2004 PFS filings. EasyFile for CPOs will involve a three-step process:

- Upload a PDF of the identical PFS provided to the pool's limited partners, including the CPO's oath or affirmation, footnotes, and the Independent Auditor's Opinion, if applicable.
- Enter key financial balances into a standardized form or schedule.
- Validate the submission to process some basic edit checks by the system and prompt the submitter to read and agree to an electronic oath or affirmation.

This electronic oath or affirmation can serve as the CPO's oath if the firm fails to include such oath in its PDF file. Participation in the program will be voluntary for the year ending December 31, 2004, and is expected to become mandatory for the year ending December 31, 2005.

Audit and Accounting Issues and Developments

Value of Exchange Memberships

During the past year, the value of U.S. exchange memberships has continued to fluctuate with NYSE's membership seats hit the hardest. Over the past year and a half, the NYSE went through one of the most difficult periods in its 212-year history. Its chairman was forced to resign as a result of public outcry following disclosures about the size of his compensation package; its governance structure was reformed to address issues that arose in the wake of the pay scandal; and its five largest specialists were accused of improper trading, raising questions about the integrity of the Exchange's trading system. Then, in August 2004, the NYSE proposed to overhaul its automated trading system, causing a further decline in exchange membership prices driven by the increase in electronic trading that is likely to undermine the role of specialists. In September 2004, following the announcement of this proposal, the NYSE reported the sale of a seat for $1.21 million, which is 35 percent lower than a year ago. The prices reached their record high in August 1999, with a seat being sold for $2.65 million.

Although declines in the value of exchange memberships do not affect regulatory net capital, because exchange memberships are excluded from the net capital calculation, such declines continue to raise concerns about the value of such assets reported in financial statements prepared in accordance with GAAP. Paragraph 7.34 of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* (the Guide) currently states that exchange memberships owned by a broker-dealer and held for operating purposes should be valued at cost or at a lesser amount if there is an other-than-temporary impairment in value. In light of the issuance of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, the AICPA and FASB staff have been considering the accounting guidance for exchange memberships provided in that paragraph. The issue is whether an exchange membership is an intangible asset with indefinite life that should be measured under FASB Statement No. 142, or whether it is a long-lived asset that should be measured under FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.* Readers should be alert to a final decision that may impact the accounting for exchange memberships.

In July 2004, the FASB staff issued a proposed FASB Staff Position (FSP) FAS 142-c, *Application of FASB Statement No. 142,* Goodwill and Other Intangible Assets, *to Exchange Memberships*. According to the proposed FSP, an exchange membership may have attributes of an intangible asset, a financial asset, or both. The proposed FSP would have required broker-dealers to determine whether an exchange membership is an intangible or financial asset and account for it as a single asset. On September 8, 2004, the FASB did not approve the proposed FSP and asked the FASB staff to work with the AICPA staff to modify the wording in the Guide. The FASB's intent was to make a change without issuing an FSP.

Based on the discussions between AICPA staff and FASB staff, it is expected that the next edition of the Guide (in 2005) will be revised to indicate that exchange memberships representing only the right to conduct business on an exchange should be accounted for as intangible assets in accordance with FASB

Statement No. 142, *Goodwill and Other Intangible Assets.* Such memberships may have finite or indefinite lives based on the terms of the arrangement and the estimated life of the exchange. However, many practitioners believe that it will be rare for an exchange membership to have a finite life. If an exchange membership is assigned an indefinite life, it would be tested for impairment in accordance with paragraph 17 of FASB Statement No.142, which requires an impairment loss to be recognized if the carrying amount of an intangible asset exceeds its fair value. If an exchange membership is considered a finite-lived asset, then it would be tested for impairment under guidance provided in paragraphs 7 through 24 of FASB Statement No. 144 under which an impairment loss is recognized only if the carrying amount of an asset is not recoverable and exceeds its fair value. The carrying amount is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset. Restoration of previously recognized impairment loss is prohibited by both FASB Statements No. 142 and No. 144. Exchange memberships classified as intangible assets would be subject to the disclosure requirements of paragraphs 44 through 46 of FASB Statement No. 142.

As an auditor of a broker-dealer, you need to be satisfied concerning the propriety of the carrying value of a membership and whether the carrying value has been impaired, as required by paragraph 5.143 of the Guide.

Mandatorily Redeemable Instruments

FASB Statement No. 150

FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). A financial instrument issued in the form of shares is mandatorily redeemable and, therefore, within the scope of FASB Statement No. 150, if it "embodies an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event certain to occur." (According to FASB Statement No. 150, the term "shares includes various forms of ownership that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form.")

Effective Date. FASB Statement No. 150 generally became effective for the mandatorily redeemable financial instruments of publicly traded companies, including publicly traded broker-dealers, for the first interim period beginning after June 15, 2003. FSP FAS 150-3 defers the effective date of the mandatorily redeemable provisions of FASB Statement No. 150 and all related FSPs for nonpublic entities. However, any broker-dealer that files financial statements with the SEC is considered to be an SEC registrant and is not eligible for the additional deferral under FSP FAS 150-3. As a result, for nonpublic broker-dealers, mandatorily redeemable financial instruments became subject to the provisions of FASB Statement No. 150 for the first fiscal period beginning after December 15, 2003.

Potential Impact. FASB Statement No. 150 may have a significant impact on the financial statements of certain broker-dealers. For example, under FASB Statement No. 150, broker-dealers that have issued shares that must be sold back to the company upon the holder's death or termination of employment must record those shares as liabilities, rather than equity, as they previously were treated under GAAP, because the shares are mandatorily redeemable upon an event certain to occur. As a result, some broker-dealers may not report any equity in their GAAP financial statements and may have insufficient net capital under the SEC Rule 15c3-1, "Net Capital Requirements for Brokers or Dealers."

Temporary Relief From Certain Provisions of Rule 15c3-1

On February 19, 2004, the SEC granted temporary relief from certain provisions of Rule 15c3-1 with respect to the anticipated impact of FASB Statement No. 150 on broker-dealers that are nonpublic entities. According to an SEC No-Action Letter, the

Division of Market Regulation will not recommend enforcement action to the SEC if a broker-dealer that is a nonpublic entity, in calculating net capital under Rule 15c3-1, adds to its regulatory net worth the carrying value of mandatorily redeemable financial instruments that FASB Statement No. 150 excludes from the firm's GAAP equity. The limitations on withdrawal of equity capital contained in paragraph (e) of Rule 15c3-1 still would apply. The amount added back to net worth also could be treated as equity in determining a broker-dealer' s compliance with the debt to debt-equity total in paragraph (d) of Rule 15c3-1, provided it otherwise meets requirements of that paragraph. This relief would not affect the treatment of properly subordinated debt under Appendix D to Rule 15c3-1. This temporary relief applies only to the calculation of net capital and does not extend to the treatment of mandatorily redeemable financial instruments in broker-dealer financial statements prepared in accordance with GAAP. A broker-dealer that wishes to take advantage of this relief must advise its designated examining authority of its intent. The SEC Division of Market Regulation letter can be found on the Web at http://www.sec.gov/divisions/marketreg/mr-noaction/sia021904-out.pdf.

Effective Date. On September 7, 2004, the SEC issued a follow-up letter to clarify the effective date of the relief. The relief granted in the February 19, 2004, letter became retroactively effective as of December 16, 2003 and remains effective through December 15, 2004. Consequently, non-public broker-dealers no longer may add back the value of mandatorily redeemable financial instruments to net worth in calculating net capital after December 15, 2004.

Additional Information. Readers should also refer to NASD NTM 04-33, *Limited Net Capital Relief from the Reclassification of Certain Equity as Liabilities in Accordance with Statement of Financial Accounting Standards No. 150*, and NYSE Information Memo 04-23, *Financial Accounting Standards Board Statement No. 150—Temporary Relief on Calculation of Net Capital,* which provide regulatory guidance for the implementation of the deferral. Those documents can be viewed at www.nasd.com and www.nyse.com, respectively.

CFTC No-Action Letter

In August 2004, the CFTC's Division of Clearing and Intermediary Oversight issued a No-Action Letter at the request of the futures industry's Joint Audit Committee with relief available for all applicable FCMs. The letter stated that for purposes of regulatory compliance with minimum capital and debt-equity ratios, the Division would not recommend enforcement against any FCM which did not implement the FASB Statement No. 150 reclassification of mandatorily redeemable interests as debt, with such relief effective for the year beginning December 15, 2003, and no longer effective after December 15, 2004. This No-Action Letter mirrors the relief the SEC's Division of Market Regulation has applied to nonpublic securities broker-dealers for the same time period, and was granted in order to provide such entities that may also be registered FCMs sufficient time to restructure equity with mandatorily redeemable features if they so desired and remain in capital compliance with the CFTC.

Corrective Actions

As the SEC temporary relief will no longer be effective after December 15, 2004, broker-dealers should consider amending their partnership, limited liability company, shareholder, or other agreements to avoid the potentially adverse impacts of FASB Statement No. 150 on net capital. A number of broker-dealers have eliminated from their agreements the requirement that the company buy back equity upon an owner's death or termination of employment, and instead, put in place *cross buy-sell agreements*. A cross buy-sell agreement is an agreement among owners which says that under stated conditions, i.e., the death or termination of employment, the person withdrawing from the company or his or her heirs are legally obligated to sell their interest to the remaining owners (not the company), and the remaining owners are legally obligated to buy at a price fixed in the agreement.

Other broker-dealers have revised their ownership agreements to provide the company with *the right of first refusal* under which all the owners agree that they will not sell their equity to anyone without first offering it to the company. The company is under no obligation to buy, but it has an option to do so. Both cross buy-sell agreements and the right of first refusal help achieve the same objective as the provisions obligating the company to purchase back an owner's equity upon occurrence of a certain event—ensuring that active owners retain control over the company. However, cross buy-sell agreements and the right of first refusal allow broker-dealers to continue to classify their ownership interests as equity rather than liability.

Issuing *different classes of equity* is another way of avoiding reporting no equity in broker-dealers' GAAP financial statements and solving the net capital requirement issue. Under this approach, certain classes of equity will have features of mandatorily redeemable financial instruments and will be classified as liabilities while other classes will not have those features and will be classified as equity.

It should be noted that if broker-dealers amended their agreements during the year to eliminate mandatorily redeemable features from equity instruments, payments and changes in value related to those instruments while they were classified as liability should be recorded as interest expense up to the date the corrective action is implemented.

FASB Interpretation No. 45—Differences Between Accounting and Regulatory Rules

FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,* requires disclosures in interim and annual financial statements about obligations under certain guarantees issued by the company. Furthermore, it requires recognition at the beginning of a guarantee of a liability for the fair value of the obligation undertaken in issuing the guarantee, with limited exceptions. However, certain guarantees are not subject to the initial recognition and initial measurement provisions but are only subject to the disclosure requirements.

The AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* has been updated in 2004 to provide sample disclosures satisfying the requirements of FASB Interpretation No. 45. Please refer to Note 14, "Guarantees," in Exhibit 4-8.

According to provisions in paragraph 7 (f)-(h) of Interpretation No. 45, guarantees between or among affiliated or related entities are not required to be measured and reflected in the financial statements, only disclosed. However, according to Appendix C to Rule 15c3-1, *Consolidated Computations of Net Capital and Aggregate Indebtedness for Certain Subsidiaries and Affiliates,* every broker or dealer in computing its net capital and aggregate indebtedness pursuant to 17 CFR Rule 15c3-1, subject to certain exceptions, is required to consolidate in a single computation assets and liabilities of any subsidiary or affiliate for which it guarantees, endorses, or assumes directly or indirectly the obligations or liabilities.

For net capital purposes, FCMs are also obligated to recognize affiliate guarantees at face value and consolidate all affiliate liabilities in accordance with CFTC Rule 1.17. The CFTC's Division of Clearing and Intermediary Oversight has also emphasized that with respect to the consolidation of subsidiaries and affiliates by FCMs, any resulting net capital flow-through benefit of consolidation may only be used to increase excess net capital, and cannot be applied to satisfy the minimum net capital requirement of the entity.

Auditing Considerations Related to Proprietary Trading

What Is Proprietary Trading?

A firm's trading account is usually a material item in a broker-dealer's statement of financial condition. Pricing of firm inventory may also have a material impact on the profit and loss. Given the increased popularity of proprietary trading this year and the potential risks involved, an auditor of a securities firm involved in proprietary trading needs to ensure that he or she properly plans and performs the audit in that area.

Firm trading activity can be broadly divided into dealer and positioning strategies. 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 will be vulnerable to market volatility during the period between the execution of the purchase and the execution of the sale.

Positioning strategies involve the broker-dealer's buying and selling securities in anticipation of certain market movements and holding such positions for longer periods than with dealer strategies. Should a trader anticipate 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 and significant losses can be incurred if a trader incorrectly forecasts the market. Also, short sale transactions may affect a broker-dealer's net capital. A broker-dealer with a proprietary short position in an equity security may be required to deduct a percentage of the market value of the position when computing net capital under Securities Exchange Act Rule 15c3-1.[11]

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 Internal Revenue Service (IRS), since they are purchased with the expectation of future capital gains. The broker-dealer's records must clearly indicate by the close of the day on which an investment security is acquired that it is held for investment.

Security positions resulting from proprietary trading are reported at current market or fair values, and unrealized gains or losses resulting from marking these to the market or fair value are included in profit or loss. 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."

[11] See Rule 15c3-1(c)(2)(vi)(J) under the Exchange Act.

Auditing Considerations

Auditors should refer to the guidance in SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 322), and the companion AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012520kk), when auditing transactions and accounts related to proprietary trading.

Valuation of Firm Inventory. Inventory positions should be measured at fair value. To ensure that reported inventory balances are fairly stated, the auditor needs to understand the pricing approaches and methods used by the firm for valuing various types of securities and determine whether such approaches and methods allow the firm to arrive at a reasonably accurate measure of fair value.

Using the applicable approaches or methods, the auditor should verify the reported prices of those security positions whose value is a significant component of the inventory balance, derived from internal valuation techniques or based largely on adjustments to the quoted prices of similar securities. To the extent possible, the auditor should review recent or subsequent trading activity in these securities as reported by independent pricing sources in order to assess the reasonableness of management's valuations.

In addition, in reviewing the firm's trading activity during the audit period, the auditor needs to consider whether the firm concentrates trading activity in particular securities with the same group of counterparties. The concern is whether the trades are bona-fide and represent genuine demand. In situations in which the total market value of a financial instrument is not readily realizable (for example, if a broker-dealer makes a market in a financial instrument or owns a substantial block of a financial instrument traded in an active market), it is industry practice to apply block discounts to such positions. In June 2004, the FASB issued an exposure draft of a proposed Statement entitled *Fair Value Measurements*, which allows broker-dealers to continue to use block discounts. See the discussion of this exposure draft in the "On the Horizon" section of this Alert.

Principal Transaction Revenue. To ensure that revenue from proprietary trades is fairly stated and recorded in the proper period, the auditor should consider performing the following procedures:

- Perform detail tests of realized revenue recognized on selected principal transactions:
  - Agree selected transactions to general ledger and stock record activity.
  - Determine the opening market value (cost basis) and the transaction price to recalculate the gain or loss on the selected transactions.
  - Agree the unrealized gain or loss to the daily summary.
- Perform detail tests of unrealized gains and losses by verifying closing prices to independent price sources and recalculating daily profit and loss (P&L) for selected principal transactions.
- Perform analytical procedures and analyze unusual variances:
  - Quarter-to-quarter
  - Year-to-year
- Beginning with source documentation, recalculate the principal transactions revenue on a sample basis and agree the amounts to the general ledger.

Firms that transact in less liquid instruments are challenged by the requirements of Emerging Issues Task Force (EITF) Issue No. 02-3,[12] *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities*, which precludes them from recognizing dealer profit, or unrealized gain or loss at the inception of the contract, absent observable market prices or inputs.

[12] Please refer to the discussion of FASB Exposure Draft on *Fair Value Measurements* in the "On the Horizon" section of this Alert for a discussion about interaction of that proposed Statement with EITF Issue No. 02-3.

When testing firm trading, the auditor also needs to make sure that the broker-dealer accrues for inventory positions relating to unsettled trades.

Consideration of Internal Control. When determining the nature, timing, and extent of the substantive tests to be performed with respect to a firm's proprietary trading activities, the auditor needs to understand how the firm controls market risk exposure.[13] In a dynamic trading environment, one of the most important elements of risk management is the presence of constant communication between the trading department and senior management. The second most important element is that the accounting records faithfully represent the economics of the firm's trading activities. The auditor should consider evaluating the following: (1) the quality and breadth of management's and the trading department's apparent understanding of the market risk inherent in the firm's trading activities, and separately in its portfolio; and (2) the trading department's ability to identify, measure, monitor, and modify the firm's exposures.

When testing client's controls over the firm's proprietary trading activities, the auditor should try obtaining answers to the following questions:

Validity, Completeness and Valuation:

- How and when does the trading department document its activities?
  - How does the trading department (*a*) verify the identity of the counterparty, and the time and date and initial cost or obligation related to each position, and (*b*) determine the fair value of each position on a continuous basis?
- To what extent does this documentation facilitate a timely and continuous review and tracking of the unrealized losses and profits in the trading department's positions?
  - When and how is such information provided to the accounting department?

[13] It is assumed for this discussion that the firm has effective internal controls relative to its overall operations.

Risk Management:

- How does the trading department identify, measure and monitor the price risk inherent in its individual positions and use these measurements in managing its portfolio?
- How often does management review proprietary trading activity and positions? From what source does it receive such information?
  - To what extent do the system applications or documents used by management capture the risks inherent in the individual positions and diminished or magnified in the portfolio?
  - To what extent does management relate identified and measured market risks to the firm's overall operations and how does it document its findings?
- How and when does management communicate its priorities and concerns regarding proprietary trading activities to trading department personnel?
- What actions can the trading department pursue to modify existing or perceived adverse risks or to take advantage of perceived opportunities?
  - How is senior management involved in these decisions and actions?
- How does senior management verify that the trading department follows management guidelines?

Specific control activities related to proprietary trading are listed in paragraph 6.58 of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities.*

Litigation, Claims, and Assessments

In April 2003, regulators finalized the global settlement with 10 of the nation's top investment firms involving conflicts of interest between research and investment banking, under which the firms were required to pay roughly $1.4 billion. The penalties imposed under this settlement rank among the highest ever paid in a civil securities enforcement action. In addition to the monetary payments, the firms were required to comply with significant requirements that dramatically reformed their practices, including separating their research and investment banking departments, how research was reviewed and supervised, and making independent research available to investors.

Some consider the global settlement to be the biggest regulatory change to affect the securities industry since the deregulation of brokerage commissions in 1975. The names of the firms involved in this scandal have been tarnished and their reputation has been damaged. However, the research scandal is far from over. Wall Street firms should brace themselves for an onslaught of investor lawsuits and arbitration actions citing recommendations of their analysts. Although the securities firms involved neither denied nor admitted their guilt, regulators made available to the public emails and other documents uncovered during their investigation, thereby providing aggrieved investors and their lawyers with new evidence at almost no cost.

As an auditor of a securities firm involved in legal proceedings, you may need to evaluate management's consideration of the financial accounting and reporting implications of those proceedings pursuant to FASB Statement No. 5, *Accounting for Contingencies*. FASB Statement No. 5 addresses accounting and reporting for loss contingencies, including those arising from litigation, claims, and assessments.

In addition, auditors need to be aware of their responsibilities under SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 337). SAS No. 12 provides guidance on the procedures an independent auditor should consider for identifying litigation, claims, and assessments and for the financial accounting and reporting of such matters when performing an audit in accordance with GAAS. It provides, in part, that auditors should obtain evidential matter relevant to the following factors:

- The existence of a condition, situation, or set of circumstances indicating uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments
- The period in which the underlying cause for legal action occurred
- The degree of probability of an unfavorable outcome
- The amount or range of potential loss

Because the events or conditions that should be considered in the financial accounting for and reporting of litigation, claims, and assessments are matters within the direct knowledge and, often, control of the management of an entity, management is the primary source of information about such matters. Accordingly, the independent auditor's procedures with respect to litigation, claims, and assessments should include the following:

- Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.
- Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.
- Obtain from management a description and evaluation of litigation, claims, and assessments that existed at the date of the balance sheet being reported on, and during the period from the balance-sheet date to the date the information is furnished, including an identification of those matters referred to legal counsel; and obtain assurances from management, ordinarily in writing, that it has disclosed all such matters required to be disclosed by FASB Statement No. 5.
- Obtain assurance from management, ordinarily in writing, that it has disclosed all unasserted claims that the lawyer has advised them are probable of assertion and must be disclosed in accordance with FASB Statement No. 5. In addition, the auditor, with the client's permission, should

inform the lawyer that the client has given the auditor this assurance. This client representation may be communicated by the client in the inquiry letter or by the auditor in a separate letter. The auditor also needs to consider unusual and/or infrequent cash receipts and disbursements.

An auditor ordinarily does not possess legal skills, and, therefore, cannot make legal judgments concerning information coming to his or her attention. Accordingly, the auditor should request that the client's management send a letter of inquiry to those lawyers with whom management consulted concerning litigation, claims, and assessments.

Auditors also need to be aware that contingent liabilities could result in an increase in a broker-dealer's aggregate indebtedness and, accordingly, its net capital requirement. According to a comment from the SEC to NASD, a broker-dealer that is the subject of a lawsuit that could have a material impact on its net capital must obtain an opinion of counsel regarding the potential effect of such a suit on the firm's financial condition. Absent such opinion, the item must be considered, at a minimum, a contingent liability and included in the calculation of aggregate indebtedness.

The audit normally includes certain other procedures undertaken for different purposes that might also disclose litigation, claims, and assessments. Such procedures might include reading minutes of meetings of stockholders, directors, and appropriate committees; reading contracts, loan agreements, leases, correspondence from taxing or other governmental agencies, and similar documents; obtaining information concerning guarantees from bank confirmation forms; and inspecting other documents for possible guarantees by the client.

Consideration of Fraud

As always, considering fraud remains a crucial responsibility for auditors of financial statements. Auditors should follow the requirements of SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). The 2004 edition of the AICPA Audit and Accounting

Guide *Brokers and Dealers in Securities* (product no. 012704kk) includes a detailed discussion of SAS No. 99 that is tailored specifically for the securities industry.

In addition, the AICPA has issued guidance on the implementation of SAS No. 99, including *Fraud Detection in a GAAS Audit—Revised Edition* (product no. 006615kk) and CPE courses entitled *Fraud and the Financial Statement Audit: Auditor Responsibilities Under New SAS* (product no. 731811kk), *Auditing for Internal Fraud* (product no. 730273kk), and *Identifying Fraudulent Financial Transactions* (product no. 730245kk).

AICPA 2004 Audit and Accounting Guide *Brokers and Dealers in Securities*

AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* (the Guide), with conforming changes as of May 1, 2004, has been updated to reflect the issuance of recently issued authoritative pronouncements. The Guide is available through the AICPA's reSOURCE Online and reSOURCE CD-ROM products, as well as through a loose-leaf subscription service. Paperback editions of Audit and Accounting Guides can be purchased as well.

> **Help Desk**—Subscriptions to AICPA reSOURCE, subscriptions to the loose-leaf service, and paperback copies of the Guide may be obtained by calling the AICPA Order Department (Member Satisfaction) at (888) 777-7077, by faxing a request to (800) 362-5066, or by going online at www.cpa2biz.com.

New Auditing and Attestation Pronouncements and Other Guidance

Presented below is a list of auditing, attestation and quality control pronouncements, and other guidance issued since the publication of last year's Alert. For information on auditing and attestation standards, quality control standards and other guidance that may have been issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/

members/div/auditstd/technic.htm and the PCAOB Web site at www.pcaobus.org (public company audits only). You may also look for announcements of newly issued standards in The *CPA Letter, Journal of Accountancy,* and the quarterly electronic newsletter, "In Our Opinion," issued by the AICPA's Auditing Standards team and available at www.aicpa.org/members/div/auditstd/opinion/index.htm.

SOP 04-1 (*November 2004*) (Not applicable to audits conducted in accordance with PCAOB standards)	*Auditing the Statement of Social Insurance* This SOP assists CPAs in auditing the statement of social insurance—a financial statement required by Federal Accounting Standards Advisory Board (FASAB) Statement of Federal Financial Accounting Standards (SFFAS) No. 17, *Accounting for Social Insurance,* and SFFAS No. 25, *Reclassification of Stewardship Responsibilities and Eliminating the Current Services Assessment.*
ASB Audit Interpretation No. 17 of SAS No. 58 (*June 2004*) (Not applicable to audits conducted in accordance with PCAOB standards)	"*Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards"* This Interpretation provides illustrative language in the auditor's report to clarify that an audit performed in accordance with GAAS does not require the same level of testing and reporting on internal control over financial reporting as an audit of an issuer for whom Section 404(b) of the Sarbanes-Oxley Act of 2002 is applicable.
ASB Audit Interpretation No. 18 of SAS No. 58 (*June 2004*) (Not applicable to audits conducted in accordance with PCAOB standards)	*"Reference to PCAOB Standards in an Audit Report of a Nonissuer"* This Interpretation clarifies the applicability of GAAS and provides illustrative language for a dual reference reporting situation when the audit was conducted in accordance with both GAAS and the auditing standards of the PCAOB.
PCAOB Auditing Standard No. 1 (*May 2004*) (Applicable to audits conducted in accordance with PCAOB standards only)	*References in Auditor's Reports to the Standards of the Public Company Accounting Oversight Board* This standard requires that auditors' reports on engagements conducted in accordance with PCAOB standards include a reference that the engagement was conducted in accordance with those standards. The rule replaces previously required

	references to GAAS. It also adopted technical amendments to its rules on interim standards that referred to existing professional standards of auditing, attestation, quality control, ethics and independence. This standard is effective beginning May 24, 2004.
PCAOB Auditing Standard No. 2 (*June 2004*) (Applicable to audits conducted in accordance with PCAOB standards only)	*An Audit of Internal Control Over Financial Reporting Performed in Conjunction With An Audit of Financial Statements* This standard addresses both the work that is required to audit internal control over financial reporting and the relationship of that audit to the audit of the financial statements. This standard is effective for audits of companies with fiscal years ending on or after November 15, 2004, for accelerated filers, or July 15, 2005, for other companies.
PCAOB Auditing Standard No. 3 (*August 2004*) (Applicable to audits conducted in accordance with PCAOB standards only)	*Audit Documentation and Amendment to Interim Auditing Standards* This standard establishes general requirements for documentation an auditor should prepare and retain in connection with engagements conducted pursuant to the standards of the PCAOB. This standard is effective for audits of financial statements of companies with fiscal years ending on or after November 15, 2004.
PCAOB Conforming Amendments (*November 2004*) (Applicable to audits conducted in accordance with PCAOB standards only)	*Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2*, An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit of Financial Statements. The conforming amendments immediately supersede the predecessor attestation standard, AT Section 501, *Reporting on an Entity's Internal Control Over Financial Reporting.* In addition, portions of Auditing Standard No. 2 replace SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), as amended, as it applies to financial statement only audits. The Conforming Amendments affecting integrated audits for accelerated filers will take effect for fiscal years ending on or after November 15, 2004. Amendments affecting only audits of financial statements and those affecting integrated audits of

(*continued*)

	nonaccelerated filers subject to the SEC's rules implementing Section 404 of the Act will take effect for fiscal years ending on or after July 15, 2005.
PCAOB Rules (*Various dates*) (Applicable to audits conducted in accordance with PCAOB standards only)	In addition to the standards discussed above, the PCAOB has also received SEC approval for numerous rules. The newly issued rules pertain to a number of topics such as, various amendments to the interim standards, terminology, oversight of non-U.S. registered public accounting firms, registration deadline for non-U.S. firms, inspections of public accounting firms, investigations and adjudications, registration withdrawals, and other matters.
PCAOB Staff Questions and Answers (Applicable to audits conducted in accordance with PCAOB standards only)	*(1) Auditing Internal Control Over Financial Reporting.* These questions and answers consist of three separate sets–questions 1-26, questions 27-29, and questions 30-36. *(2) Audits of Financial Statements of Non-Issuers Performed Pursuant to the Standards of the PCAOB*
Suggested Framework for Internal Controls Related to PCAOB Auditing Standard No. 2	*A Framework for Evaluating Process/Transaction-Level and Information Technology General Control Exceptions and Deficiencies* Developed by representatives of nine firms and a professor, this framework reflects their views on a methodology consistent with their understanding of PCAOB Auditing Standard No. 2. The framework can be obtained at www.aicpa.org/cpcaf/download/framework_v2.pdf.
AICPA Toolkit (*December 2003*) (nonauthoritative)	*The AICPA Audit Committee Toolkit* This toolkit provides comprehensive advice on audit committee duties such as agenda setting, conducting executive sessions and evaluating the effectiveness of auditors and the audit committee, itself. It also offers basic information on important topics such as internal controls, anti-fraud accountability and off-balance-sheet transactions.
AICPA Practice Alert 2003-3 (*January 2004*) (nonauthoritative)	*Acceptance and Continuance of Clients and Engagements* This Practice Alert provides practitioners and their firms with guidance regarding the establishment of

	policies and procedures for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for that client.
AICPA Practice Alert 2004-1 (*October 2004*) (nonauthoritative)	*Illegal Acts* This Practice Alert is intended to guide the auditors of non-issuers with respect to illegal acts.
AICPA Technical Practice Aid 9110.15 (*September 2004*) (nonauthoritative)	*Reporting on Medicaid/Medicare Cost Reports* This Technical Practice Aid discusses the form of report an auditor should issue to comply with the "certification" requirement from payors in regard to health care organization financial statement audit engagements.
AICPA Audit and Accounting Practice Aid (*November 2004*) (nonauthoritative)	*Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* This Practice Aid can help practitioners better understand and apply the Statements on Quality Control Standards issued by the AICPA. It contains new policies and procedures that a firm should consider including in its system of quality control to be responsive to the changing environment.
AICPA Audit and Accounting Practice Aid (*June 2004*) (nonauthoritative)	*Auditing Governmental Financial Statements: Programs and Other Practice Aids* This Practice Aid provides audit programs and other tools to help practitioners conduct their governmental audits in light of the extensive provisions of GASB Statement No. 34 and the new financial reporting model it introduces.
New COSO Framework	*Enterprise Risk Management—Integrated Framework* This document describes the essential components, principles, and concepts of enterprise risk management for all organizations, regardless of size. With heightened concern and focus on risk management, the framework provides boards of directors and managements with a clear roadmap for identifying risks, avoiding pitfalls, and seizing opportunities to grow stakeholder value. This new framework is expected to be widely accepted as the benchmark for dealing with business risk. The framework can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com/store.

The summaries provided above are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standards and other guidance. You should visit the applicable Web site for complete information.

The standards and interpretations promulgated by the AICPA Auditing Standards Board (ASB) are now available free of charge by visiting the AICPA's Audit & Attest Standards Team's page at www.aicpa.org/members/div/auditstd/Auth_Lit_for_Non Issuers.htm. Members and nonmembers alike can download the auditing, attestation, and quality control standards by either choosing a section of the codification or an individual statement number. You can also obtain copies of AICPA standards and other guidance by contacting the Member Satisfaction Center at (888) 777-7077 or online at www.cpa2biz.com.

Recent AICPA Independence and Ethics Pronouncements

The AICPA *Independence and Ethics Alert—2004/05* (product no. 022475kk) contains a complete update on new independence and ethics pronouncements. This Alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain that Alert to be aware of independence and ethics matters that will affect their practice. In addition to the other matters discussed in *Independence and Ethics Alert—2004/05*, auditors should be aware of these recent issuances by the AICPA Professional Ethics Executive Committee:

- ***Revised AICPA Ethics Interpretation No. 101-3, Performance of Nonattest Services.*** This revised Interpretation modifies the practitioner's responsibilities for maintaining independence when providing nonattest services (for example, tax or consulting services) to attest clients.
- **AICPA Members Who Outsource**—Ethics Ruling No. 112, "Use of a Third-Party Service Provider to Assist a Member in Providing Professional Services," under Rule 102 (AICPA, *Professional Standards*, vol. 2, ET sec. 191.224-.225), and Ethics Ruling No. 12, "Applicability

of General and Technical Standards When Using a Third-Party Service Provider," under Rule 201 and Rule 202 (AICPA, *Professional Standards*, vol. 2, ET sec. 291.023-.024). These rulings provide new requirements related to members who outsource certain professional services.

New Accounting Pronouncements and Other Guidance

Presented below is a list of recently issued accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the publication of this Alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and the *Journal of Accountancy*.

FASB Statement No. 151 (*November 2004*)	*Inventory Costs, an amendment of ARB No. 43, Chapter 4* This Statement clarifies that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and by requiring the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities.
FASB Statement No. 132 (revised 2003) (*December 2003*)	*Employers' Disclosures about Pensions and Other Postretirement Benefits—an Amendment of FASB Statements No. 87, 88, and 106* This Statement revises employers' disclosures about pension plans and other postretirement benefit plans by requiring additional disclosures to those in the original Statement 132 about the assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension plans and other defined benefit postretirement plans.
FASB Interpretation No. 46(R) (*December 2003*)	*Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of Accounting Research Bulletin No. 51* This Interpretation was issued to clarify some of the provisions of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities,* and to exempt certain entities from its requirements.

(*continued*)

FASB EITF Issues (*Various dates*)	Go to www.fasb.org for a complete list of EITF issues.
FASB Staff Positions (*Various dates*)	Go to www.fasb.org for a complete list of FASB Staff Positions related to FASB Statements, FASB Interpretations and EITFs.
AICPA Audit and Accounting Guide (*January 2004*)	*Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies* This new AICPA Audit and Accounting Guide applies to all banks, savings institutions, credit unions, and finance companies. It also applies to entities that do not consider themselves to be finance companies that engage in transactions that involve lending to or financing the activities of others, and entities that do not consider themselves to be mortgage companies that engage in transactions that involve mortgage activities or transactions. This Guide supersedes the AICPA Audit and Accounting Guides *Banks and Savings Institutions, Credit Unions, and Finance Companies.*
SOP 03-4 (*December 2003*)	*Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide*, Audits of Investment Companies, *and AICPA Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships (See summary below.)
SOP 03-5 (*December 2003*)	*Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide,* Audits of Investment Companies This SOP provides guidance on reporting financial highlights by separate accounts of insurance enterprises.
SOP 04-2 (*December 2004*)	*Accounting for Real Estate Time-SharingTransactions*
AICPA Audit and Accounting Practice Aid (*May 2004*) (nonauthoritative)	*Valuation of Privately-Held Company Equity Securities Issued as Compensation* This Practice Aid provides useful information on measuring the cost of such transactions and properly reflecting them in company financial statements.

AICPA Technical Practice Aid 6930.05 (*July 2004*) (nonauthoritative)	*Sale of Real Estate Investments Held by Employee Benefit Plans and Discontinued Operations*
AICPA Technical Practice Aid *6400.45* (*August 2004*) (nonauthoritative)	*Applicability of FASB Interpretation No. 45—Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—Physician Loans* This Technical Practice Aid addresses whether physician loans are subject to FASB Interpretation No. 45.
AICPA Technical Practice Aid 6400.46 (*August 2004*) (nonauthoritative)	*Applicability of FASB Interpretation No. 45—Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others —Mortgage Guarantees* This Technical Practice Aid addresses whether mortgage guarantees are subject to FASB Interpretation No. 45.
AICPA Technical Practice Aids 6300.05–.08 (*October 2004*) (nonauthoritative)	Related to SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts*

The summaries provided above are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standards and other guidance. You should visit the applicable Web site for complete information. You can obtain copies of AICPA standards and other guidance by contacting the Member Satisfaction Center at (888) 777-7077 or online at www.cpa2biz.com.

Below is a discussion of a pronouncement listed above that has particular significance to the securities industry. This summary is for informational purposes only and should not be relied on as a substitute for a complete reading of the applicable standard.

SOP 03-4

SOP 03-4, *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide Audits of Investment Companies and AICPA Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships, provides guidance on the application of certain provisions of the AICPA Audit and Accounting Guide *Audits of Investment Companies* and AICPA SOP 95-2 that are directed to the reporting by nonregistered investment partnerships of financial highlights and the schedule of investments. It amends certain provisions of the *Audits of Investment Companies Guide* and SOP 95-2 by adapting those provisions to nonregistered investment partnerships based on their differences in organizational and operational structures from registered investment partnerships.

In particular, this SOP amends footnote 13 to Chapter 7 of the *Audits of Investment Companies Guide* to clarify that only investment partnerships regulated as brokers and dealers in securities under the Exchange Act that manage funds for those who are officers, directors, or employees of the general partner are excluded from the requirement to provide a portfolio of investments under paragraph 7.12. As a result, brokers who are organized as partnerships which trade for their own account and have a large number of limited partners are no longer safe harbored to issue financial statements as brokers and dealers in securities. Instead, they will have to follow the *Audits of Investment Companies Guide*, which requires a schedule of investments and financial performance information.

SEC Staff Accounting Bulletins

Auditors of public companies and of those companies that file with the SEC need to consider the accounting and financial reporting requirements contained in the SEC regulations as well as requirements imposed upon auditors. The summaries below are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable rules. See the SEC Web site at www.sec.gov for complete information.

SAB No. 104 (*December 2003*)	*Revenue Recognition* This SAB updates portions of the interpretative guidance included in Topic 13 of the SEC's codification of staff accounting bulletins to make it consistent with current authoritative accounting guidance. The SAB's principal revisions relate to the rescission of material no longer necessary because of private-sector developments in U.S. GAAP.
SAB No. 105 (*March 2004*)	*Application of Accounting Principles to Loan Commitments* This SAB adds section DD, "Loan Commitments Accounted for as Derivative Instruments," to Topic 5, "Miscellaneous Accounting," of the Commission's codification of SABs. The new section provides interpretative guidance SEC-registered companies should consider when recognizing such commitments, and it emphasizes certain disclosure requirements that may be relevant to mortgage banking activities.
SAB No. 106 (*September 2004*)	Section 4, "Interaction of Statement 143 and the Full Cost Rules," under Topic 12-D, *Oil and Gas Producing Activities—Application of Full Cost Method of Accounting* The interpretations in this SAB express the staff's views regarding the application of FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, by oil and gas producing companies following the full cost accounting method. The SAB, which adds Section 4 to Topic 12-D of the SAB series, deals with the impact of FASB Statement No. 143 on the full cost ceiling test and on the calculation of depreciation, depletion, and amortization.

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. You should check the appropriate standard-setting Web sites (listed below) for a complete picture of all accounting and auditing projects in progress. Presented below is brief information about certain projects that are expected to result in final standards in the near future. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

The following table lists the Web sites of various standard-setting bodies, at which information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline.

Standard-Setting Body	*Web Site*
AICPA Auditing Standards Board (ASB) (Note that for audits of public companies, the Public Company Accounting Oversight Board sets auditing standards.)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	http:/www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.fasb.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm
Public Company Accounting Oversight Board (PCAOB)	www.pcaobus.org

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by email about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your email address to memsat@aicpa.org. Indicate "exposure draft email list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

Below are discussions of some of the projects that have particular significance to the securities industry. These summaries are for informational purposes only.

Exposure Draft on Fair Value Measurements

In June 2004, the FASB published an exposure draft of a proposed Statement, *Fair Value Measurements*, which would establish a framework for measuring fair value that would apply broadly to financial and nonfinancial assets and liabilities, improving the consistency, comparability, and reliability of the measurements. The fair value framework would clarify the fair value measurement objective and its application under other authoritative pronouncements that require fair value measurements. Thus, the exposure draft would replace any current guidance for measuring fair value in those pronouncements.

The exposure draft also would expand current disclosures about the use of fair value to measure assets and liabilities. The disclosures focus on the methods used for the measurements and would apply whether the assets and liabilities are measured at fair value in all periods such as trading securities or in only some periods such as impaired assets. The comment period for the exposure draft ended on September 7, 2004. This proposed Statement would be effective for financial statements issued for fiscal years beginning after June 15, 2005, and interim periods within those fiscal years. The final standard is expected to be issued in the first quarter of 2005. The exposure draft can be accessed at http://www.fasb.org/draft/ed_fair_value_measurements.pdf.

Below is a brief discussion of some of the provisions of the exposure draft that should be of interest to broker-dealers and their auditors.

Fair Value Hierarchy

The proposed Statement would establish the fair value hierarchy which groups into three broad categories (levels) the inputs that should be used to estimate fair value. The hierarchy gives the highest priority to market inputs that reflect quoted prices in active markets for identical assets and liabilities (whether such prices are quoted in terms of completed transaction prices, bid and asked prices, or rates) and the lowest priority to entity inputs developed based on an entity's own internal estimates and assumptions.

Level 1 Estimates. Fair value shall be estimated using quoted prices for identical assets or liabilities in active reference markets whenever that information is available. The Level 1 reference market is the active market to which an entity has immediate access or, if the entity has immediate access to multiple active markets, the most advantageous market. The most advantageous market is the one with the price that maximizes (or minimizes) the net amount that would be received (or incurred) in a current transaction for an asset (or liability). For purposes of determining the most advantageous market, costs to transact in the respective markets shall be considered. However, the price used to estimate fair value, that is, the price in the most advantageous market, shall not be adjusted for those costs. Transaction costs shall be accounted for in accordance with the provisions of other applicable pronouncements, generally in the period incurred.

Level 2 Estimates. If quoted prices for identical assets or liabilities in active markets are not available, fair value shall be estimated using quoted prices for similar assets or liabilities in active markets, adjusted as appropriate for differences, whenever that information is available.

Level 3 Estimates. If quoted prices for identical or similar assets or liabilities in active markets are not available, or if differences between similar assets or liabilities are not objectively determinable, fair value shall be estimated using multiple valuation techniques.

Pricing in Active Dealer Markets

This proposed Statement would require that the fair value of financial instruments traded in active dealer markets where bid and asked prices are more readily and regularly available than closing prices be estimated using bid prices for long positions (assets) and asked prices for short positions (liabilities). For offsetting positions, mid-market prices shall be used for the matched portion. Bid and asked prices shall be used for the net open position, as appropriate.

The Effect of Entity's Credit Standing on Fair Value of Liabilities

The estimate of fair value for a liability should consider the effect of the entity's credit standing so that the estimate reflects the amount that would be observed in an exchange between willing parties of the same credit quality.

Measurement of Blocks

While working on this project, the FASB considered the appropriateness of a fair value measurement using a block discount. For unrestricted securities with quoted prices in active markets, many FASB pronouncements (including FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*) require that fair value be estimated as the product of a quoted price for an individual trading unit times the quantity held. In all cases, the unit of account is the individual trading unit. For large positions of such securities (blocks) held by broker-dealers and certain investment companies, the AICPA Audit and Accounting Guides for those industries (the Guides) permit fair value to be estimated using blockage factors (adjustments to quoted prices) in limited circumstances. In those cases, the unit of account is a block.

The FASB initially decided to address that inconsistency in this proposed Statement as it relates to broker-dealers and investment companies. The FASB agreed that the threshold issue is one of determining the appropriate unit of account. However, the FASB disagreed on whether the appropriate unit of account is the individual trading unit (requiring the use of quoted prices) or a block (permitting the use of blockage factors).

The majority of the FASB believes that the appropriate unit of account is a block. However, the FASB was unable to define that unit or otherwise establish a threshold criterion for determining when a block exists as a basis for using a blockage factor. The FASB subsequently decided that for measurement of blocks held by broker-dealers and certain investment companies, current practice as permitted under the Guides should remain unchanged until such time as the FASB fully considers those issues.

Interaction of the Exposure Draft and EITF No. 02-3

The FASB decided that valuation techniques that rely on significant entity inputs, requiring more subjective estimation methods and extrapolation, may be used for Level 3 estimates, but only as a practical expedient and to the extent that such estimates are not precluded under other applicable pronouncements (for example, as in EITF Issue No. 02-3). The FASB decided not to address issues relating to EITF Issue No. 02-3, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities.* EITF Issue No. 02-3 precludes recognition of an unrealized gain or loss at inception of a derivative instrument if the fair value estimate is, in effect, a Level 3 estimate using significant entity inputs. EITF Issue No. 02-3 does not address similar issues in periods subsequent to inception. The FASB is addressing related issues in its revenue recognition project.

Disclosures

The proposed Statement would require the following disclosures for assets and liabilities that are remeasured at fair value on a recurring (or ongoing) basis during the period (for example, trading securities):

1. The fair value amounts at the end of the period, in total and as a percentage of total assets and liabilities
2. How those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used)
3. The effect of the remeasurements on earnings for the period (unrealized gains or losses) relating to those assets and liabilities still held at the reporting date

Industry Comment Letter

The Bond Market Association, the International Swaps and Derivatives Association (ISDA), and the Securities Industry Association through a joint industry working group provided the FASB with comments on the exposure draft. To view the comment letter, please visit the ISDA Web site at the following link: http://www.isda.org/speeches/pdf/FV-Comment-Letter-09-02-2004.pdf.

Status

In November, the FASB plans to begin redeliberations of the exposure draft, considering significant issues raised by respondents. The final standard is expected to be issued in the first quarter of 2005 and would be effective for financial statements issued for fiscal years beginning after June 15, 2005, and interim periods within those fiscal years.

Exposure Draft on Share-Based Payment

On March 31, 2004, the FASB issued a proposed Statement, *Share-Based Payment—an amendment of FASB Statements No. 123 and 95*, which would eliminate the ability to account for share-based compensation transactions using APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and generally would require instead that such transactions be accounted for using a fair-value-based method. In October 2004, the FASB approved a six-month delay in the options expensing rule, to June 15, 2005. This accounting proposal is engulfed in highly charged political debate and as such the ultimate resolution of share-based compensation accounting remains uncertain. See the FASB Web site at www.fasb.org for complete information.

Proposed FSP FAS 140-b

In August 2004, FASB issued proposed FSP FAS 140-b, *Application of EITF Issue No. 85-24*, 'Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge,' *When Future Distribution Fees Are Sold to Unrelated Third Parties.* Mutual fund shares sold without a sales load payable at the time of purchase (front-end sales load) are commonly referred to as “B shares.” Instead of a front-end load, B shares often have an asset-based fee (12b-1 fee) that is charged over a period of years. B shares typically also charge a contingent deferred sales charge (CDSC). The CDSC, sometimes referred to as a back-end load or sales charge, is an asset-based fee charged to investors redeeming B shares during a stated period.

The proposed FSP addresses situations in which the distributors of B shares enter into transactions in which the right to receive future 12b-1 fees and the CDSC is exchanged for a lump-sum payment from a third party. These exchanges may include some level of recourse and various indemnities that protect the third party in the event that the 12b-1 plan is rescinded by the fund’s board. Some distributors entering into such exchanges have accounted for the exchange as a sale of an unrecognized financial asset or as the receipt of fees resulting in full revenue recognition of the future 12b-1 fees and the corresponding recognition of previously deferred expenses.

In the proposed FSP, the FASB staff stated that it does not believe revenue or gain recognition is appropriate at the time the cash is received from the third party for a right to future fees. The FASB staff believes that cash received from a third party should not be considered “fees” as discussed in EITF Issue No. 85-24, *Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge.* The staff believes that transfers of the rights to future fees that are not recognized as a receivable by the distributor are not within the scope of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* The FASB staff believes the classification of the cash received from a third party should be based on the provisions of EITF Issue No. 88-18, *Sales of Future Revenues*, that is, as debt or deferred income.

The FASB discussed the proposed FSP at its meeting on October 27, 2004, and made the following decisions:

1. The scope of that proposed FSP should be expanded to address situations in which the application of EITF Issue

No. 85-24 could result in revenue recognition upon sale of the right to future 12b-1 fees.

2. Continuing involvement should be evaluated as it relates to the control group to which the distributor belongs and as it relates to retention of risks and rewards in the 12b-1 fees.

3. Recourse obligations should be recognized consistent with existing guidance.

The FASB directed the staff to redraft proposed FSP FAS 140-b and to present it to the FASB for consideration by the end of November 2004.

EITF Issue No. 04-5

EITF Issue No. 04-5, I*nvestor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Rights* may also be of interest to auditors and practitioners. For many years, financial statement preparers and auditors have debated how to evaluate whether a partnership should be consolidated by one of its partners. Recent guidance provided in FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (revised December 2003), regarding kick-out rights in the context of evaluating variable interests and consolidation of variable interest entities, has renewed the debate over what considerations are relevant in making that evaluation, particularly with regard to whether the general partner should consolidate a limited partnership. In practice today, the question of whether a partnership should be consolidated by one of its partners is typically addressed by analogizing to the guidance in AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures,* which specifically provides guidance on the accounting for investments in real estate ventures including investments in corporate joint ventures, general partnerships, limited partnerships, and undivided interests. The Issue is what rights held by the limited partner(s) preclude consolidation in circumstances in which the sole general partner would consolidate the limited partnership in accordance with GAAP absent the existence of the rights held by the limited partner(s).

Auditing Pipeline—Nonpublic Companies

The proposed standards discussed in this section would not apply to the audits of public companies. Readers should keep abreast of the status of the following projects and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Seven SASs Related to Audit Risk Proposed

In December 2002, the AICPA's ASB issued an exposure draft proposing seven new SASs relating to the auditor's risk assessment process. The ASB believes that the requirements and guidance provided in the proposed SASs, if adopted, would result in a substantial change in audit practice and in more effective audits. The primary objective of the proposed SASs is to enhance auditors' application of the audit risk model in practice by requiring:

- More in-depth understanding of the entity and its environment, including its internal control, to identify the risks of material misstatement in the financial statements and what the entity is doing to mitigate them.
- More rigorous assessment of the risks of material misstatement of the financial statements based on that understanding.
- Improved linkage between the assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks.

The exposure draft consists of the following proposed SASs:

- *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards
- *Audit Evidence*
- *Audit Risk and Materiality in Conducting an Audit*

- *Planning and Supervision*
- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling

The proposed SASs establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the proposed SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit. Readers should be alert for the issuance of final Standards in the first half of 2005.

Proposed SAS, *Communication of Internal Control Related Matters Noted in an Audit*

This proposed SAS will supersede SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, and significantly strengthen the quality of auditor communications of such matters in audits of nonpublic companies. Readers should be alert for the issuance of a final standard.

Proposed SSAE, *Reporting on an Entity's Internal Control Over Financial Reporting*

This Statement establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting as of a point in time (or on an assertion thereon). Specifically, guidance is provided regarding the following:

- Conditions that must be met for a practitioner to accept an engagement to examine the effectiveness of an entity's internal control and the prohibition of acceptance of an engagement to review such subject matter

- Engagements to examine the design and operating effectiveness of an entity's internal control
- Engagements to examine the design and operating effectiveness of a portion of an entity's internal control (for example, internal control over financial reporting of an entity's operating division or its accounts receivable)
- Engagements to examine only the suitability of design of an entity's internal control (no assertion is made about the operating effectiveness of internal control)
- Engagements to examine the design and operating effectiveness of an entity's internal control based on criteria established by a regulatory agency

Readers should be alert for the issuance of a final standard.

Resource Central

On the Bookshelf

The following AICPA publications deliver valuable guidance and practical assistance as potent tools to be used in your engagements:

- Audit and Accounting Guide *Brokers and Dealers in Securities* (product no. 012704kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012520kk)
- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012514kk)
- Audit Guide *Audit Sampling* (product no. 012530kk)
- Audit Guide *Analytical Procedures* (product no. 012554kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, As Amended* (product no. 012774kk)

- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk)
- *Accounting Trends & Techniques—2004* (product no. 009896kk)
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk)
- Practice Aid *Fraud Detection in a GAAS Audit* (product no. 006615kk)

AICPA Practice Aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools*

This Practice Aid (product no. 006600kk) provides practitioners with nonauthoritative practical guidance on auditing financial statements of futures commission merchants, introducing brokers, and commodity pools. Organized to complement the Audit and Accounting Guide *Brokers and Dealers in Securities*, this Practice Aid includes an overview of the commodity industry; discussions of regulatory considerations, auditing considerations, and accounting standards; and illustrative financial statements of FCMs, IBs, and commodity pools.

Audit and Accounting Manual

The *Audit and Accounting Manual* (product no. 005134kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs, auditor's reports, checklists, engagement letters, management representation letters, and confirmation letters.

AICPA reSOURCE Online: Accounting and Auditing Literature

Get access—anytime, anywhere—to the AICPA's latest *Professional Standards, Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, and *Accounting Trends & Techniques*. To subscribe to this essential online service, go to cpa2biz.com.

Educational Courses

The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry. Those courses include:

- *AICPA's Annual Accounting and Auditing Update Workshop* (2004 edition) (product no. 736180kk, text; for product numbers for other formats please refer to the cpa2biz Web site). Whether you are in industry or public practice, this course keeps you current and informed, and shows you how to apply the most recent standards.
- *Fraud and the Financial Statement Audit: Auditor Responsibilities Under New SAS* (product no. 731811kk, text; for product numbers for other formats please refer to the cpa2biz Web site). The new fraud standard may not change your responsibilities for detecting fraud in a financial statement audit, but it will change how you meet that responsibility. Practitioners will benefit from a risk assessment approach to detecting fraud in a financial statement audit. You will learn the conceptual framework necessary to understand the characteristics of fraud.
- *Auditing for Internal Fraud* (product no. 730273kk). This course provides the auditor with the tools to identify fraud schemes. It trains CPAs to focus their analytical and substantive tests on the fraud triangle when evaluating internal controls. It also illustrates the latest in fraud prevention and detection programs implemented by industry leaders.
- *Identifying Fraudulent Financial Transactions* (product no. 730245kk). Learn to identify the red flags of fraud in financial information and to analyze a variety of fraud schemes. You will develop a framework for detecting financial statement fraud and learn about fraud schemes in revenue, inventory, liabilities, and assets.
- *Independence* (product no. 739165kk). This interactive CD-ROM course reviews the AICPA authoritative literature covering independence standards (including the

AICPA SEC practice section independence requirements), SEC regulations on independence, and Independence Standards Board (ISB) standards.

- *SEC Reporting* (product no. 736771kk, text; for product numbers for other formats please refer to the cpa2biz Web site). This course helps the practicing CPA and corporate financial officer learn to apply SEC reporting requirements. It clarifies the more important and difficult disclosure requirements.
- *Internal Control and IT: Reliable Reporting and Fraud Prevention* (available January 14, 2005) (product no. 732550kk). This course will provide an overview of the key auditing standards, conceptual frameworks, IT infrastructures and auditing issues you are likely to face on medium to small company engagements.

Online CPE

AICPA InfoBytes, offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. Selected as one of *Accounting Today's* top 100 products for 2004, AICPA InfoBytes now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 ($369 nonmembers) for a new subscription and $119 ($319 nonmembers) for the annual renewal. Divided into one- and two-credit courses that are available 24/7, AICPA InfoBytes offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com/infobytes.

CPE CD-ROM

AICPA's Standards Update and Implementation Guide (product no. 738465kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

National Securities Industry Conference

Each year, the AICPA cosponsors with the Financial Management Division of the Securities Industry Association the National Conference on the Securities Industry, which is specifically designed to update auditors and securities industry financial executives on significant accounting, legal, financial, and tax developments affecting the securities industry. Information on the conference may be obtained by calling the AICPA CPE Conference Hotline at (888) 777-7077 or visiting the AICPA Web site at www.aicpa.org.

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To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

Web Sites

AICPA Online and CPA2Biz

AICPA Online, at www.aicpa.org, offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, www.cpa2biz.com offers all the latest AICPA products, including the Audit Risk Alerts, Audit and Accounting Guides, the professional standards, and CPE courses.

Other Helpful Web Sites

Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the "Information Sources" table at the end of this Alert.

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This Audit Risk Alert replaces *Securities Industry Developments—2003/04*. The *Securities Industry Developments* Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be appreciated. You may email these comments to ymishkevich@aicpa.org, or write to:

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INFORMATION SOURCES

Organization	*Web Site, Address, Telephone*
American Institute of Certified Public Accountants	www.aicpa.org Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 Telephone: (888) 777-7077
Financial Accounting Standards Board	www.fasb.org Order Department: 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 Telephone: (203) 847-0700
Financial Crimes Enforcement Network (FinCEN)	www.treas.gov/fincen
U.S. Securities and Exchange Commission	www.sec.gov Publications Unit: 450 Fifth Street, NW Washington, DC 20549-0001 Telephone: (202) 942-4040 Public Reference Room: Telephone: (202) 942-8090 (202) 942-8092 (tty)
Securities Industry Association	www.sia.com 120 Broadway, 35th floor New York, NY 10271-0080 Telephone: (212) 608-1500
New York Stock Exchange, Inc.	www.nyse.com 11 Wall Street New York, NY 10005 Telephone: (212) 656-3000
National Association of Securities Dealers, Inc.	www.nasd.com 1735 K Street, NW Washington, DC 20006-1500 Telephone: (202) 728-8000
The Bond Market Association	www.bondmarkets.com 360 Madison Avenue New York, NY 10017-7111 Telephone: (646) 637-9200

Organization	*Web Site, Address, Telephone*
Commodity Futures Trading Commission	www.cftc.gov Three Lafayette Center 1155 21st Street, NW Washington, DC 20581 Telephone: (202) 418-5000
Futures Industry Association	www.futuresindustry.org 2001 Pennsylvania Avenue, NW Suite 600 Washington, DC 20006 Telephone: (202) 466-5460
National Futures Association	www.nfa.futures.org 200 West Madison Street Chicago, IL 60606 Telephone: (800) 621-3570

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